Pension Reform, Social Security and NHI

Recommendations of the Inter-Departmental Task Team
on Social Security and Retirement Reform

Presentation to the South African Payroll Association National Conference

5 September 2012

Andrew Donaldson, DDG: Public Finance, National Treasury

Social Security Reform Background

- Following the 2002 Taylor Committee Report and subsequent work of the Dept of Social Development and National Treasury on social security and retirement provision, Cabinet appointed an Inter-Ministerial Committee in 2007 to study and recommend reform to the social security system
- The IMC appointed an Inter-Departmental Task Team on Social Security and Retirement Reform (IDTT) to provide technical advice and recommendations for consideration by Cabinet
- The IDTT has analysed the current system, identified gaps in coverage and efficiency, and prepared recommendations for reform
- The IDTT's longer term recommendations on social security reform are currently under discussion by Cabinet
- Medium term reform of pension industry governance, tax treatment and prudential regulation is under way

Gaps in the Current Social Security System

- Lack of a mandatory pension and insurance fund
- Results in 2.7 million workers (primarily low-income earners) having no coverage other than through social assistance grants
- Means testing and cash payment systems for social assistance grants are costly and administratively burdensome
- Poor coordination between social insurance funds (UIF, RAF, Workers Compensation) results in double-dipping, inconsistent benefits and costly administration
- Private retirement and insurance schemes are not cost-effective for low-income contributors and savings are often not preserved to retirement

The coverage problem

- The Taylor Committee identified **uneven coverage** as a major weakness of social security provision in South Africa.
- The **agricultural sector** is perhaps the sector worst served by occupational pension arrangements. **Construction** is also characterised by low levels of coverage.
- In part this is due to the **low proportion of permanent workers** at low-income levels.
- However, pension coverage is also poor at higher income levels, even though the proportion of permanent workers is much higher.
- Other determinants of coverage include firm size and union membership.

Pension coverage

	Tier One		Tier Two		Tier Two/Three	
Income level	**<R12,000**		**R12-R75,000**		**R75-R150,000**	
	Pension in permanent*	Permanent in total**	Pension in permanent	Permanent in total	Pension in permanent	Permanent in total
Agriculture, hunting, forestry	**23%**	**56%**	**39%**	**79%**	**75%**	**98%**
Mining, quarrying	59%	63%	90%	88%	95%	95%
Manufacturing	39%	44%	76%	70%	83%	96%
Electricity, gas, water supply	0%	31%	81%	58%	100%	98%
Construction	23%	17%	49%	43%	37%	96%
Wholesale and retail trade	25%	38%	61%	71%	82%	99%
Transport, storage, comms	4%	30%	65%	67%	82%	99%
Financial, real estate business	41%	41%	65%	73%	85%	96%
Community, social, personal	43%	49%	87%	85%	96%	97%

* Pension coverage among those with permanent jobs; ** Percentage of workforce with permanent jobs

Data from QLFS, 2007

Objectives of the Proposed Reform

- Recognize the Constitutional right of all South Africans to social security
- Eliminate gaps in the system by ensuring broad coverage, through income smoothing, risk coverage, and social assistance grants
- Objective of a minimum 40% income replacement rate at retirement through combined benefits from three program tiers
- Improve consistency of benefits, reduce benefits overlap and increase administrative efficiency through coordination of risk insurance programs
- Contribute to ensuring fair labour standards for all employees, including those in temporary and atypical employment
- Integration of social security reform with National Health Insurance

Key long term reform recommendations

- Introduce a mandatory defined benefit pension plan that includes coverage for death, disability and unemployment
- Government subsidy for participation of low-income earners in the DB plan
- Eliminate the means test for social assistance grants
- Administrative consolidation for social insurance funds and extended benefits under UIF
- Regulatory reform of the pension and life insurance industry
- Policy consolidation and institutional reform led by a single department responsible for Social Security

A four-tier framework

- The proposed reforms envisage a four-tier framework. The tiers are income-related.
  - ***Tier One*: Social grants** – The means test thresholds are likely to be raised in order to expand coverage and ensure the old age grant forms part of income replacement for low-income workers.
  - ***Tier Two*: The National Social Security Fund** – a mandatory contributory arrangement paying pensions and risk benefits (disability, survivor, funeral).
  - ***Tier Three*:** Tax-incentivised contributions to **accredited occupational or private funds** over and above NSSF contributions. Possibility of automatic enrolment for people earning above a certain income level.
  - ***Tier Four*:** Voluntary, contributory, non-tax-advantaged programmes.

NSSF objectives

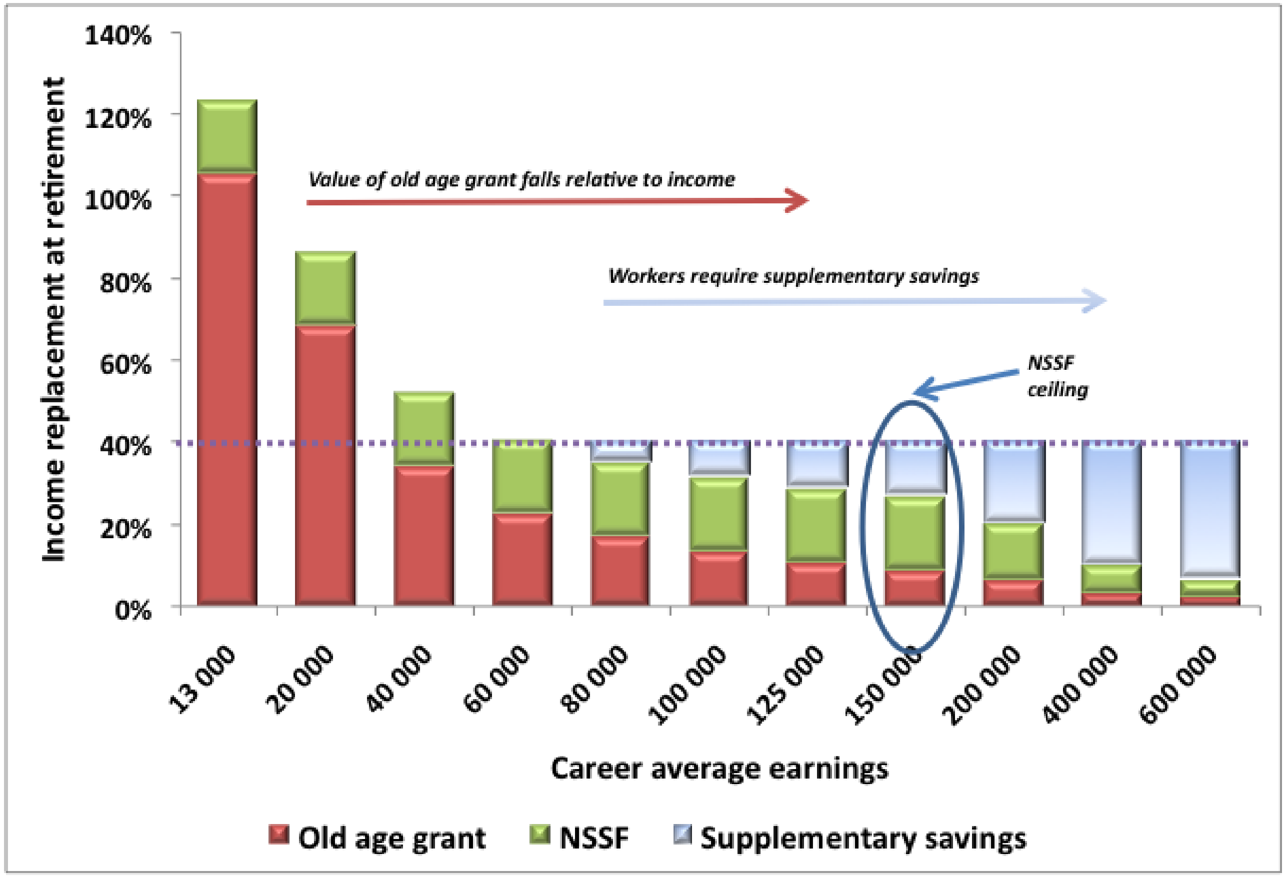
- The NSSF has been designed to achieve the following objectives:
  - **Broaden social security coverage** – extend participation to workers in atypical employment, less formal work and more vulnerable sectors
  - **Lifetime income smoothing** – helping the working population save some of today's income to support consumption in retirement years.
  - **Insurance against income-related risks** – participants are insured against risks such as longevity (we do not know how long we will live), disability and death of an income-earner (survivorship).
  - **Complement labour-market initiatives** and **reduce the burden on employment** as principal source of household income security.
  - **Sharing of risk** across the entire workforce – social solidarity.

The NSSF – possible design features

- Contributions will be **10 % of income** above a floor of R13 000 per year and up to a ceiling – likely to be split between employer and employee – or 12 % including UIF.
- Contributions of **low-income workers will be subsidised** by Government.
- The proposed NSSF will be run on a **defined-benefit** basis.
- This means that the benefits will be based on a worker's salary and thus provide a certain level of income replacement.
- Pensions will be determined by years of contribution and career-average wages.
- Revenues will go into a **single pool** out of which benefits will be paid.

Retirement income composition

Composition of retirement income at different income levels against a 40% target



Bargaining Council funds – fund level

- 40 Bargaining Councils in South Africa - 29 have retirement funds
- Some have more than one fund - currently there are 43 BC funds
- Regional councils more likely to have a retirement fund than national councils
- All are DC funds; 75% are provident funds
- Where a fund is offered, participation is usually high
- Membership: > 800,000 in total

Bargaining Council funds – member level

- Fund size varies: 500 – 350,000 members
- Small employers comprise bulk of members: Mostly < 40 staff
- Generally aimed at low-income workers:
  - Average covered wage: R43,000
  - Highest wage covered: R100,000
- Contribution rate varies – weighted average of 14.4 per cent
- Contributions usually split equally between employer and employee

BC fund benefits

- Provident funds pay out a **cash lump sum at retirement** rather than an income stream. Risk benefits also lump sum.
- Lump sum preferred by people in rural areas, where **annuities might not be practical**. However, retirees soon exhaust their savings.
- BC funds offer survivor, disability and funeral benefits, though **not all funds offer all three** – survivor benefits most common.
- Changes to tax treatment of provident funds under consideration – will look more like pension funds but lump sums will still be available for small accumulations.

Bargaining council funds: pros and cons

‘Good’ BC funds

- Benefit designed to deliver reasonable replacement rates
- Governance good
- Admin good and very cheap
- Self-insured risk benefits good value
- Investment strategy appropriate
- Generally large, national funds: Metal, Motor.

‘Bad’ BC funds

- Insufficient contributions
- High, non-transparent internal administration cost
- Cross-subsidies to Council
- Administration errors / lack of capacity
- Examples of poor governance and lack of controls
- Inappropriate investment strategies
- Usually smaller, regional funds

Impact of NSSF on BC funds & low-income workers

- NSSF contributions will partially **crowd out** contributions to BC funds.
- Even if accredited, few BC funds will have a **high enough contribution rate** and sufficient **high-income workers** to stay in business.
- Low-income workers cannot pay **two sets of fees** to different funds.
- A low-cost **default option for supplementary contributions**, run on a DC basis, may emerge.
- Low-income workers will be compensated for loss of their BC fund by **subsidised contributions to the NSSF** and by **access to old age grant**.
- NSSF benefits may be perceived as **lower than benefits offered by most BC funds** (and will not be automatically available as cash on termination of employment).
- Impact of employer contributions on employment at low-income levels.

DB for NSSF vs DC provident funds

- The NSSF is proposed as a defined benefit system, while most provident funds are **defined contribution (DC)** funds.
- In DC schemes, members have **individual accounts** where contributions gain interest based on investment returns.
- Appropriate for environment where workers desire **rapid access to their savings**.
- Also appropriate for **irregular contributions**, both in terms of frequency and size.
- However, poor investment management can lead to very low returns – **individuals bear risk**.
- Returns can also be **eroded by administrative costs**, asset management fees etc.

Social security reform: transition issues

- Opt-out from the NSSF is currently not proposed, though early implementation will focus on sectors with poor coverage at present
- Public service employees already have a well-funded defined benefit arrangement – transition to a standard social security arrangement may mean a separation of DB and DC elements within the public service retirement arrangement.
- In the event that a mandatory NSSF is introduced, transition from existing arrangements will be phased in over long period.
- Possibility for consolidation of retirement funds in umbrella funds.
- Vested rights will be respected.

National Health Insurance

- NHI aims to provide **universal access** to decent healthcare.
- Long-term vision is a unified health financing system with both public and private sector provision. This means establishment of NHI **“purchasing” capacity** – national, provincial, district.
- NHI will involve alignment and consolidation of statutory medical insurance arrangements of the occupational compensation funds and road accident fund.
- Will be **rolled out over 14 years**. First phase includes **hospital revitalisation** programme, strengthening of **primary health care** and introduction of regional **pilot projects**.
- Financing needs associated with NHI proposed to be met by **increases to income tax, value added tax and corporation tax**. A specific **payroll contribution is currently not proposed**.
- Arrangements for **prescribed minimum benefits** and employer contributions to medical schemes and post-retirement medical scheme contributions are likely to be revised.

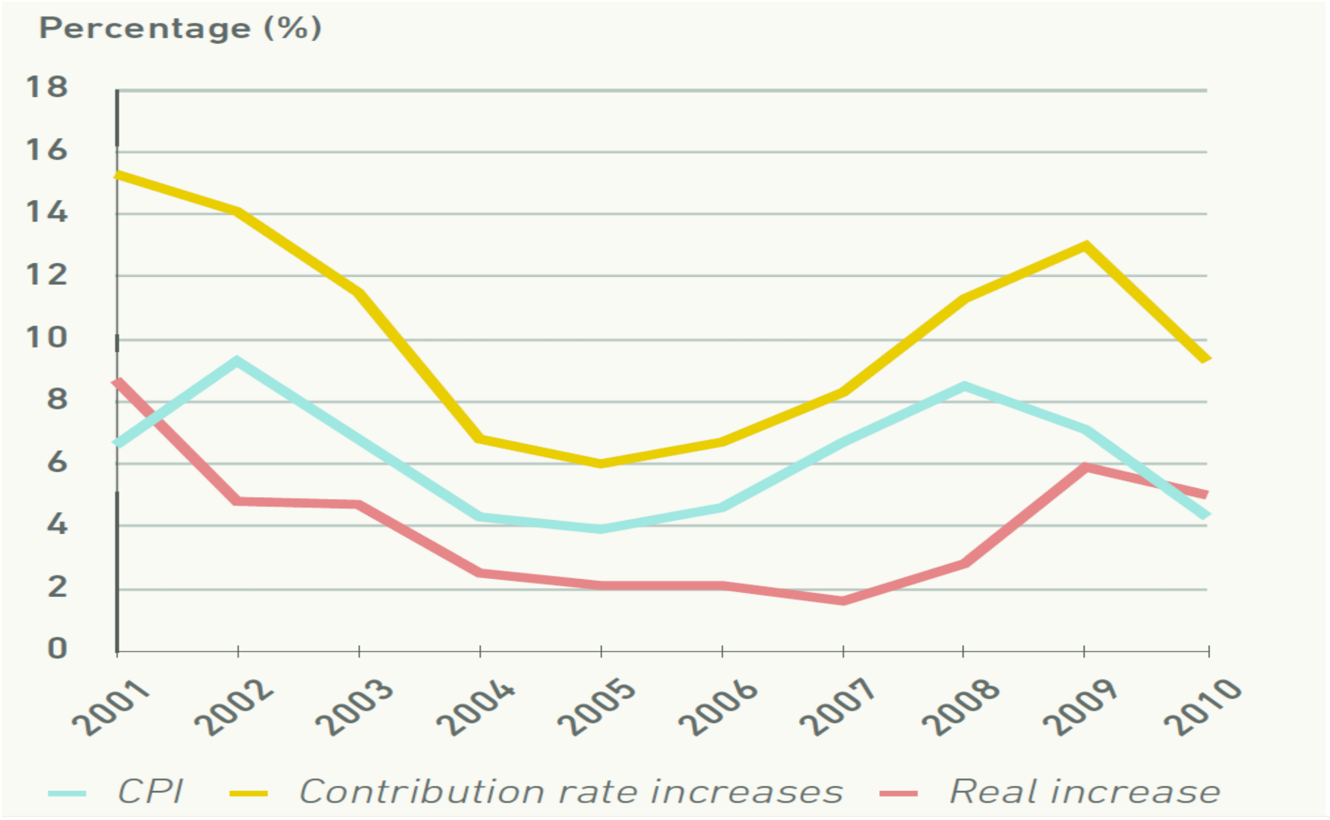
Towards NHI – options for improving medical benefits of vulnerable workers

- Medical scheme membership is generally unaffordable for low-income workers and their employers
- Occupational injury, emergency care and road accident injury compensation arrangements could be improved and aligned – benefits to workers and employers
- Clinic services and mobile health facilities are critical for family care – options for standard benefits and cost-sharing could be explored
- Tax credits for medical scheme membership could become refundable and targeted at basic primary care – substantial cost implications
- Primary and preventative health services often poorly coordinated: district "purchasing" may provide opportunities for bringing GP providers into public service

Medical schemes and Health insurance Demarcation – what is the issue?

- Insurance underwriting interferes with the principle of social solidarity underpinning medical schemes
  - ✓ **Risk pools are undermined when healthier members join cheaper options**, which typically pay lower rates to specialists, and insure themselves against the costs of using a higher-charging specialist through a Gap Cover policy.
  - ✓ Long- and short-term health insurance products, which provide similar benefits to medical schemes, could **harm medical schemes by attracting younger and generally healthier members away from schemes**
  - ✓ **Younger, healthier members opting out of schemes** if left unchecked, “could result in increasing costs for the older and less healthy who remain dependent on medical schemes for their cover”.
- Policy holders think they are buying a medical scheme
- Insurers **discriminate against policy holders by risk rating** based on the policy holder’s health.

Medical scheme contribution increases 2001 -2010



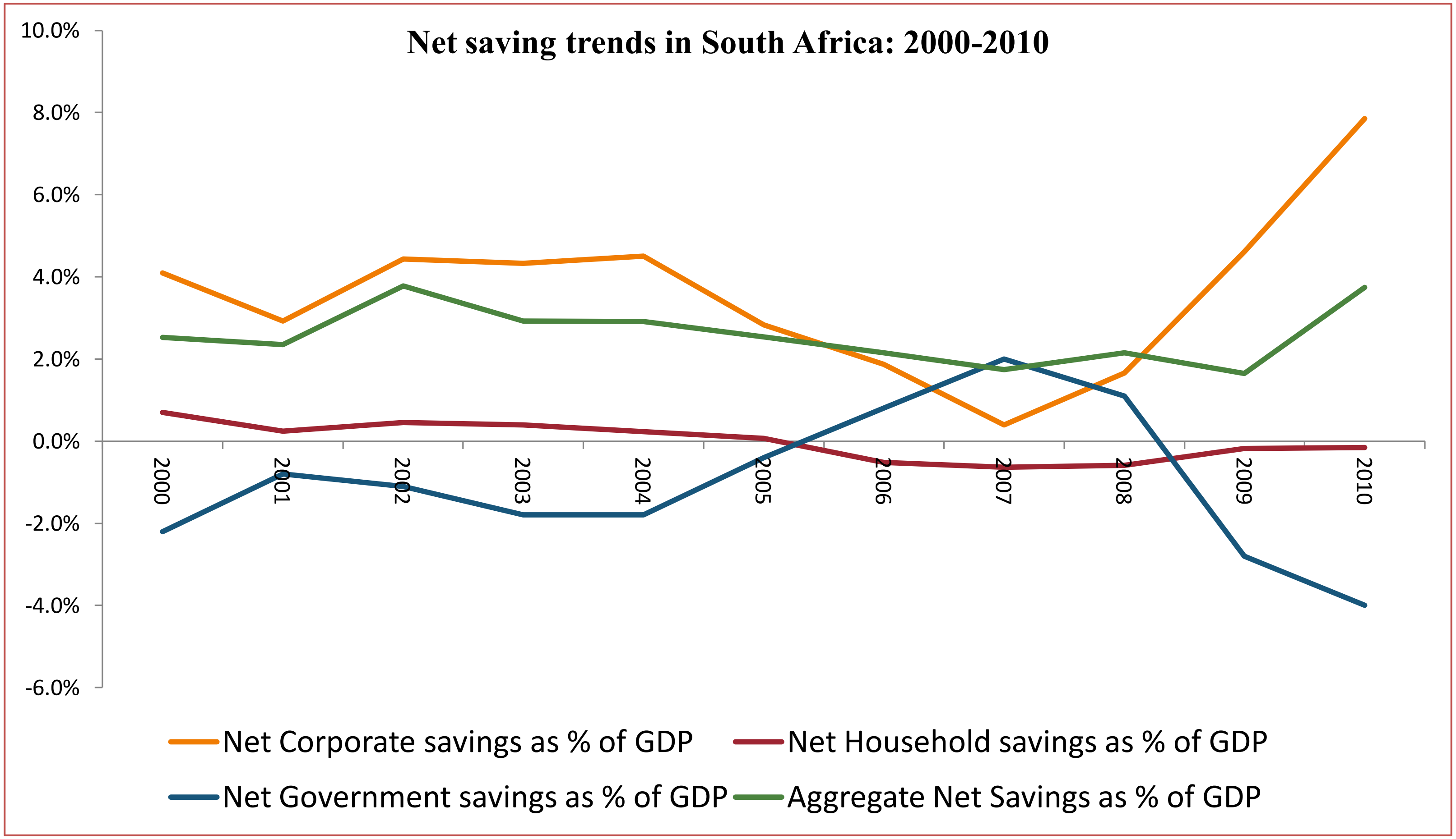
Way forward on demarcation

- Structural weakness to be addressed in medical schemes environment
  - No risk equalisation
  - No mandatory contributions
  - No reference price lists
  - Poor enforcement
  - Poor disclosure
  - No low income medical schemes
- Regulation of gap cover and cash hospital plan products intended to demarcate insurance as complement rather than replacement of medical scheme membership

10 proposals to make the financial sector safer and serve SA better (2011 Budget)

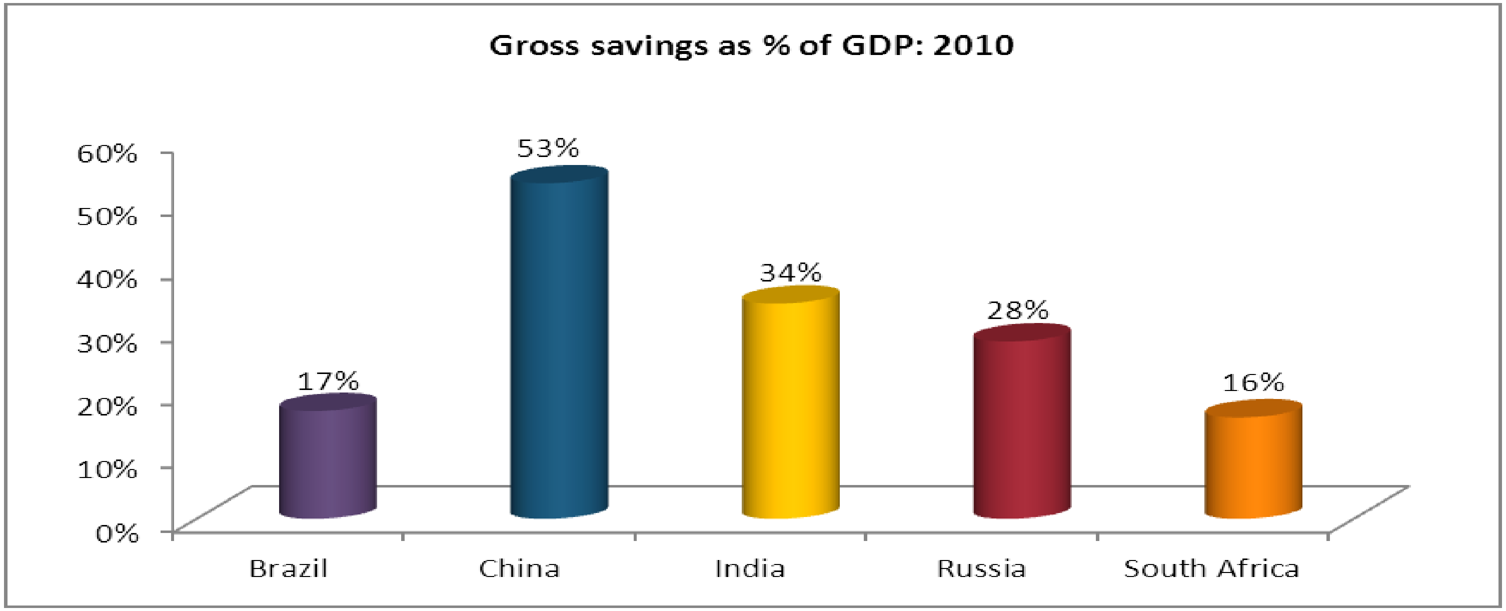
1. "Twin-peak" model of financial regulation
2. Strengthen the operational independence, integrity and accountability of regulators
3. Expand the regulatory system to include macro-prudential supervision, and establish an interagency Financial Stability Oversight Committee
4. Strengthen market conduct supervision and the ombuds system. Expand scope of FSB to cover market conduct in retail banking
5. Clarify roles and responsibilities i.e. uniformity of policy, legislation, regulation and supervision across legislation governing financial regulators
6. Council of Financial Regulators to improve coordination
7. Increase the scope of regulation to cover unregulated activities
8. Public entities and funds operating in the financial system should not be exempted from general legislation and regulatory standards
9. Improve enforcement capacity of regulators, strengthen accountability and enable agencies to act without fear or favour
10. Rationalise advisory and technical committees and enhance consultation processes with the industry and key stakeholders

Savings trends in South Africa…



International comparison

- South Africa's current gross national saving rate of 16% does not compare well with some of our BRICS counterparts
- With a gross savings rate of 53% and 34%, China and India, respectively recorded 10.3% and 7.3% annual growth in GDP (World Bank)



Strengthening retirement savings in SA

- **"Strengthening Retirement Savings: Overview of the 2012 Budget proposals"**
  - paper released on 14 May 2012
- The proposals for improving retirement savings arise from the 2012 Budget announcements and seek to address the following concerns:
  - Inadequate retirement savings
  - Low levels of preservation and portability
  - High fees and charges
  - Low levels of annuitisation
- Currently, retirement funds (which manage around R2.4 trillion) are the destination of more than half of household savings

Strengthening retirement savings in SA

- Proposed urgent short- to medium-term reforms include:
  - Requiring preservation and portability
  - Improving fund governance and the role of trustees
  - Extending existing pension laws to all public pension funds
  - Reforming the annuities market
  - Creating a uniform approach to the taxation of retirement funds
  - Measures to reduce the costs of retirement products
  - Introducing tax incentives to promote retirement and other investment products
- A series of technical discussion papers will be released over 2012 in the above areas
- Longer-term reforms will be dealt with through Social Security Reforms

Preservation and portability

- Preservation seeks to address pre-retirement leakage caused by payments to:
  - members leaving pension and provident funds upon job changes and retrenchment
  - non-members in cases of divorce order settlements
- Preservation is the requirement that:
  - money saved for retirement through a pension fund or provident fund, should remain in such a fund until the person retires, or
  - should be rolled over into another similar retirement savings vehicle when a person changes jobs or receives a divorce order settlement (without incurring taxes or penalties)
- While the stated intention is to protect retirement funding through preservation and portability, there might be a need to allow access to the retirement benefits in some limited instances
  - Withdrawals to be allowed for individuals who are temporarily unemployed or need to undergo life-saving operations, up to a 1/3rd of accumulated benefits
- Proposal to be phased in given consideration to **protecting vested rights**

Improving fund governance

- Pension fund governance problems emerge from weaknesses in governing boards of trustees
  - No relevant experience and skills
  - Conflicts of interest
  - But this is a tough job!
- Proposal
  - Application of **"fit and proper"** standards
  - Put in place mechanisms and legal requirement to achieve proper training (e.g. trustee toolkit training a requirement)
  - Strengthen governance by elevating PF Circular 130 to a Directive
  - Empower and legally protect trustees ("whistle-blowers") to act independently without fear or favour
  - Professionalise the **role of principal officer**

Extending pension laws to public funds

- GEPF, local government and other official pension funds characterised by rules and regulations different from private sector funds
- PFA rules and developments not incorporated into public sector pension funds
  - Clean break policy (currently being implemented for GEPF)
  - Members access to Pension Funds Adjudicator
  - Minimum benefits
- Proposals
  - All public sector pension funds to register under PFA and be supervised by the FSB
  - Design a uniform public sector pension funds act consolidating all funds not supervised under the PFA

Reform of annuities market & reduction of costs

Annuities market

- Annuitisation crucial in dealing with post-retirement **leakage**; i**nvestment** & **longevity** risk
- **Living annuities** in particular are a complex product, requiring financial advice and regular reviews, people may not be managing them effectively
- **Conventional life annuities** seem expensive and opaque because they are a form of insurance, but protect against longevity and investment risk
- Review of annuities pricing currently underway
  - Proposed RSA Retail Bond backed living annuity may spark competition and reduction of costs
- Looking into a life-living annuity combination

Retirement products costs

- Reducing costs to **reasonable/fair levels** is important
- Standardising **disclosure** and **transparency**
- Further **consolidation** of pension funds would aid effective supervision and provide for economies of scale
- Consideration for **standardising products**
  - Encourage competition on prices and not product type
- Final review to be released by **October 2012**

Introduce a tax-free savings vehicle

- Nature of tax incentivised product
  - Similar to many accounts in OECD countries (e.g. Canadian RESP, UK ISA)
  - Can be invested in savings accounts, Treasury Retail Bonds, money market instruments, Collective Investment Schemes (CIS)
- Nature of tax incentive
  - Tax free capital growth, income and exit (T-E-E)
- Administration
  - Limits are legislated and promoters of products are required to run them within the legislated parameters
  - SARS makes an assessment on documented accounts of conduct
- Ideal take-up (target) market
  - Middle to high income households
- Contribution caps
  - Yearly contribution limit (e.g. R30 000)
  - Lifetime contribution limit (e.g. R500 000)

Harmonising retirement fund taxation

- Uniform retirement contribution model:
  - Proposes harmonising the tax treatment of contributions to and benefits from pension and provident funds (and retirement annuity funds)
  - Will substantially reduce the complexity of our current retirement system
  - Achieve greater equity in the tax system by rationing tax exemptions
- Treatment of contributions:
  - Employer contributions treated as a fringe benefit and therefore taxable in the hands of employee, if above the caps
  - Exemption for employer & employee contributions, up to a percentage ceiling (22.5% of income, 27.5% for over-45's), and up to a rand amount (R250 000 and R300 000, latter for over-45's)
- Treatment of benefits:
  - Proposal to phase in annuitisation of 2/3rds of provident fund benefits, similar to pension and retirement annuity fund
  - **NB** : alignment will lead to tax benefit for provident funds employee contributions
  - Proposal to be phased in given consideration to <u>**protecting vested rights**</u>
  - Consider raising *de minimus* annuitisation requirement from R75 000

Process of Consultations for Retirement Savings proposals

- Broad consultations and public comment on Overview Paper
- Specific and more detailed consultations over coming technical discussion papers
  - Some papers require less consultations (e.g. over lowering costs) than others (e.g. preservation)
  - Appropriate consultation processes for different papers
  - Meetings will be convened with key stakeholders, including trade unions, employers, businesses and industry
- Additional consultations when any proposals put in the form of legislation
  - Two periods of public comment with bills
  - First period is after bill is approved by government, but before it is tabled in Parliament
  - Second period is after bill is tabled in Parliament
- Further consultations at request