

# South Africa



## Pension System Design

The South African pension system is composed of a non-contributory, means-tested public benefit program, various pension and provident fund arrangements and voluntary savings.

The old-age grant provided by the government under pillar 1 is the main source of income for 75% of the elderly population in retirement. This inversely implies that about three quarters of the population reach retirement age without a funded pension benefit.

Employer-based retirement plans have a long history in South Africa. The retirement funding system has been in place since 1956 when the Pension Funds Act was passed. But occupational retirement plans are limited to those employed in the formal sector. Among those, the coverage rate is quite high by international comparison and is estimated to be between 66% and 84%.

For some professions, employers are free to define mandatory membership as an obligatory condition of employment. According to the National Treasury, the ratio of total pension fund assets to GDP in South Africa was about 63%, which compares favourably internationally. According to the 2007 annual report of the Financial Services Board, total pension fund assets amounted to ZAR 1284bn (EUR 172bn) in 2005, up from ZAR 1098bn (EUR 143bn) in 2004.

However, many people lack effective access to an affordable retirement funding plan due to the economic structure of the country. South Africa has a high rate of unemployment and a substantial part of the working-age population is informally employed, that is, they are involved in non-standard forms of work.

In order to address income poverty among the elderly, the government has proposed a

social security and retirement reform. It is based on reports from various commissions that reviewed the current status and the need for reform of the South African pension system. The key objective is to set up an appropriate social security concept that prioritizes the needs of people without any incomes, with insufficient incomes or who are engaged in informal activities leading towards the creation of a comprehensive social security system. In February 2007, the government announced the broad principles of the new social security framework in the [National Budget Review 2007/2008](#) – risk pooling and redistribution are to be the underlying features.

In line with international practice, the government is considering the introduction of a mandatory earnings-related contributory system administered on a payroll-tax basis. In the context of a comprehensive social security framework, a basic social security arrangement is proposed to complement the redistributive social assistance.

The proposed mandatory contributory earnings-related savings and benefits system will be a funded system with contributions accumulating in individual accounts rather than financed on a pay-as-you-go basis. The following principles form the framework for the proposed system:

- **Equity** – uniform rates of contribution and benefits for all participants
- **Risk pooling** – collective funding arrangements
- **Mandatory participation** for employees in the formal sector; the self- and irregular-employed should be encouraged to

- participate voluntarily in system
- **Administrative efficiency** – part of the social security reform will be the consolidated administration of basic social benefits
- **Solidarity** – minimum benefits assured through redistribution and cross-subsidisation

According to the **National Budget Review 2007** published by the National Treasury, the government will seek agreement on the legislative and institutional framework for the social security reform during 2007/2008. Details on the design of the new pension system in regards to aspects such as contribution rates, wage subsidies for low-income earners, tax treatment of contributions and benefits and the management of investment funds will be subject to additional discussion papers to be released by the National Treasury. The government will undertake a comprehensive process of consultation with all social partners before finalising the new dispensation. Implementation is expected in 2010, although experts consider this date ambitious. Improved economic performance and the strength of South Africa's finances have created room for social security reform to be implemented.

## Public Pensions

The state pension system provides a means-tested monthly minimum income of ZAR 940 (EUR 94) (effective from April 2008) to men over the age of 65 and women over 60. An initial step of the social security reform will be to decrease the retirement age for men. Phased in by 2010/11, the qualifying age for men and women will then be standardized at 60 years. However, because of the demographic challenges ahead, it is planned that the retirement age will be revisited beyond 2011.

The social old-age grant is financed from general revenues and aims to reducing poverty among the elderly. This creates disincentives, especially for low-income earners, to save for retirement and contributes to a widespread preference for

2nd pillar provident funds that pay a lump sum rather than annuity benefits.

For 75% of the elderly population the old-age grant is the main source of income in retirement. In the course of the general overhaul of the state pension system, it is being discussed if the means test should be abolished or if the threshold should be changed so incentives for private retirement savings, especially for low-income earners, are created.

## Occupational Pensions

Employer-based retirement plans have a long history in South Africa. The retirement funding system has been in place since the Pension Funds Act of 1956. But occupational retirement plans are limited to the workforce employed in the formal sector.

Today, the majority of employees in the private sector are covered by defined contribution schemes while those in the public sector largely enjoy coverage under defined benefit arrangements. The shift from DB to DC dramatically took place during the 1980s and 1990s when the so-called provident funds were newly established. Despite the risk transfer from the employer to the employee, the shift was mainly viewed as advantageous for fund members. In case employees with defined benefit coverage changed jobs, their contributions were refunded with a low rate of interest and employer contributions were only included after a long period of service. In contrast to defined benefit arrangements, defined contribution schemes capture the investment rewards of a bull market, although they also expose the accumulated capital to market volatility.

Defined contribution pension arrangements either appear in the form of a provident fund or a pension fund established in terms of the Pension Funds Act. Both need approval by the Registrar of Pension Funds and the Commissioner of Inland Revenue. Both plans are similar, but differ with regard to tax-exempt contribution limits and retirement benefit options. Provident funds may provide retirement benefits in one

lump sum payment while pension funds are only allowed to provide one third of the total value as a lump sum.

According to figures from the Financial Services Board, retirement funds in South Africa had 1,283 billion (EUR 172bn) assets under management in 2005. Assets increased by 17.6% from 2004.

Self-administered funds, which are funds that either perform all the functions themselves or that outsource one or more of these functions, saw the strongest increase with a growth of 24.7%. Underwritten funds operate exclusively by means of policies of insurance issued by registered insurers.

In contrast to underwritten and self-administered retirement funds, the Pension Funds Act does not supervise official funds, funds that have been established by special laws for employees of the State and certain parastatal institutions, and special sector funds. These funds were established and governed by acts other than the Pension Funds Act. Supervision is performed by governmental agencies other than the Financial Services Board.

In 2005 there were a total of 13,390 retirement funds operating in the market with a total membership of 9.2 million.

### Pension fund governance and regulation

To this day, the legislative landscape is quite diverse and is composed of different acts and regulators. In the course of the retirement fund reform, the regulation and supervision of all retirement funds will be placed under one Retirement Act. The core principles of the new regulatory design will target adequate governance structures and mechanisms, put funding rules in place and assure appropriate liability calculation methods, set up quantitative regulations and prudent person principles and, last but not least, establish effective supervision.

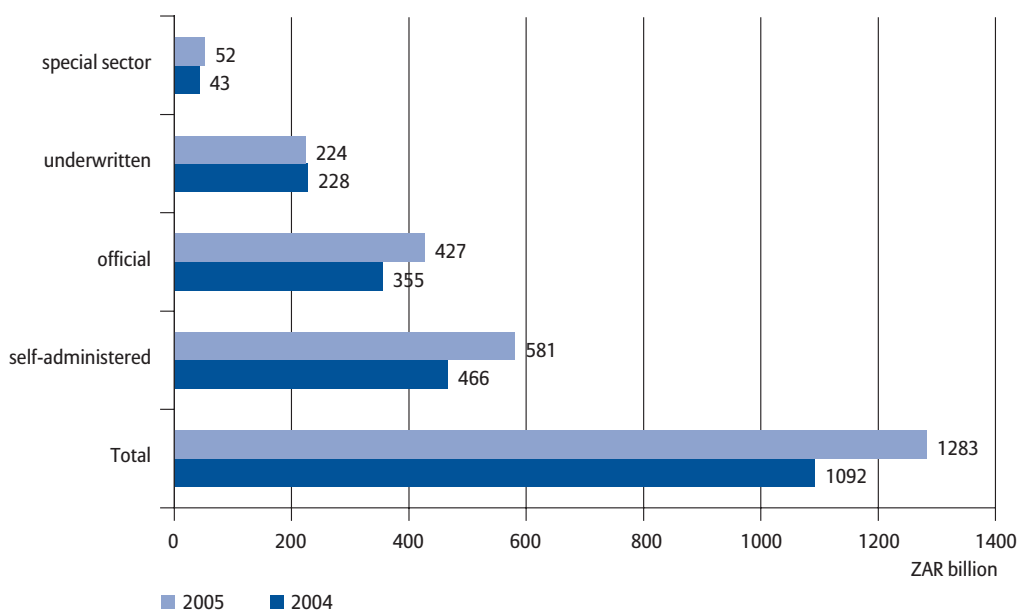
### Investment regulation

The registrar of Pension Funds has defined investment requirements and guidelines:

- 75% in ordinary and preference shares
- 25% in property, property shares and property trusts
  - 90% in shares and property combined
- 25% in claims secured by mortgage bonds on immovable property
- 10% in Krugerrands
- at least than 20% of the fund may be invested in any one institution: Cash, fixed deposits, gilts and semi-gilts
- 15% in assets outside South Africa

In the course of the proposed comprehensive pension reform, focus has

Retirement funds by fund type



Source: Financial Services Board South Africa, Annual Report 2007

been placed upon reforming the private pension system with regards to governance, regulation and protection of member rights.

Social assistance and benefits from the proposed contributory social security are not considered adequate income replacement, especially for higher income employees. Therefore, participation in any form of occupational pension fund or individual retirement fund will likely be mandatory up to certain earnings limits. In addition, voluntary contributions will be encouraged through tax incentives.

While the coverage rate among those employed in the formal sector is high, the figures conceal that the vast majority of pension plan members start contributing too late in their careers to accumulate sufficient assets. Moreover, they cash in their savings when they change jobs. Another point of concern is that rising costs and risk premiums are increasingly eroding the accumulated assets. The costs of retirement fund arrangements, especially for annuity products, are high by international comparison.

The main challenges in the private pension system in South Africa include

- Increasing competition through improved transparency and disclosure and through the removal of regulatory barriers for potential product providers.
- Support of market consolidation.
- In order to achieve economies of scale, small pension funds shall merge for the benefit of multi-employer or industry arrangements.
- Today, there are 13,500 funds in existence with 80% having less than 100 members.
- Compulsory preservation and portability.
- In order to provide an adequate income in retirement, accumulated assets must be preserved upon the change of employment and early withdrawals must be limited. Pension fund members will be obliged to transfer their balance to a new occupational fund or to an individual retirement account.
- Consistent approach with regard to the benefits payment mode and the tax treatment.
- Improvement of governance and regulation.

## Distribution method

Currently, pension funds may pay out a third of the retirement interest in the form of a lump sum, two thirds must be converted to an annuity unless the full retirement interest is ZAR 25,200 (EUR 2700) or less due to high administration cost with regard to small annuities. No restrictions currently apply to benefits received from provident funds. The new bill that amends the current taxation law proposes to increase the amount that can be withdrawn as a lump sum to ZAR 75,000 p.a.

## Tax treatment of contributions and benefits

Employer contributions to approved pension and provident funds are tax-deductible up to 10% of the employee's remuneration. In practice, the Commissioner of the Inland Revenue allows up to 20%; higher limits can be allowed if justifiable. Compared to provident funds, employee contributions to pension funds are tax-exempt up to the greater of 7.5% of remuneration or ZAR 1750 (EUR 190). Provident funds are normally non-contributory.

Income received from annuities is taxable. The taxation of lump sum payments from provident and pension funds is complex. Lump sum payments are partially tax-free and partially taxable. The taxable amount actually depends on the years of service or years of employment respectively, and the retiree's highest annual average salary during any five consecutive years in the service of the employer. The draft version of the Taxation Laws Amendment Bill sets out a simpler taxation structure for lump sum payments. Once in a lifetime, ZAR 300,000 (EUR 32,300) could be withdrawn tax-free. The amount between ZAR 300,000 and ZAR 600,000 will be subject to a flat-rate tax of 18% and the amount exceeding 600,000 will be taxed at a rate of 36%.

Benefits from a retirement fund to which contributions did not qualify for tax-exemption may be paid out tax-free.

## Outlook

South Africa's pension system is at an early stage of development. The proposed social security and retirement reforms are intended to ensure that all South Africans receive at least a basic level of retirement benefits through a combination of social assistance and a contributory social security arrangement. Furthermore, high-income earners will be obliged to contribute to a supplementary pension arrangement, such as a work-place related pension fund or an individual retirement fund, to assure adequate income replacement. Additional voluntary savings will be encouraged through tax incentives.

Creating a comprehensive social security system will involve large fiscal and institutional adjustments. So far, the principles and aims were presented to the public for further discussion. The government will undertake a comprehensive process of consultation with all social partners before finalising the new dispensation. Implementation is planned for 2010. The reforms will be implemented in several phases.

The opportunities for financial services providers in the market will develop in the context of funding of occupational and private individual pension funds – but the size of the opportunity cannot yet be assessed. Details of the whole reform package are in an early stage of discussion and need to be further clarified.

# Outlook

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Closing Date:  
April 2008