ASISA

The Speaker
New Assembly Building
Parliament Street
Cape Town

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16 October 2020

Dear Madam,

Comments on Notice 504 of 18 September 2020 (Government Gazette 43726) - Notice to introduce a private member's Bill namely the Pension Funds Amendment Bill, 2020 ("the draft Bill")

Introduction

The Association of Savings and Investment South Africa (ASISA) was formed in 2008 and is empowered by a mandate from an industry that manages some R6.6 trillion of the nation's savings and investments. The majority of ASISA's members are South Africa's asset managers, collective investment scheme management companies, life insurance companies and linked investment service providers. ASISA members manage the long-term savings and investments of customers in the following regulated product ranges:

- Pension and Provident Funds
- Retirement Annuity and Preservation funds
- Endowment Policies
- Collective Investment Schemes (unit trusts, exchange traded funds, hedge funds)
- Risk protection policies such as life, disability and dread disease cover.

ASISA proactively engages with the National Treasury (NT), Financial Sector Conduct Authority (FSCA) and the Prudential Authority (PA) on matters of policy, regulatory reform and other issues.

General comment on the draft Bill

One of the stated objects of the draft Bill is "to alleviate financial pressure during an emergency such as the COVID-19 emergency or any other emergency similar to COVID-19". ASISA members are sympathetic to the hardship which many employees and/or their household members have experienced as a result of COVID-19. These may have been retrenchments, salary cuts, or deaths in their families, resulting in lower household incomes. While it is appreciated that the draft Bill seeks to facilitate relief from this financial hardship, ASISA members do not support the draft Bill for the reasons set out below.

The purpose of a retirement fund is to provide pension benefits for retiring members and death benefits for dependents of deceased members. Retirement funds are long term savings vehicles. The longer-term financial needs of members are a priority for retirement funds.

The objects of the draft Bill state that "a member will be able to leverage their pension fund investment prior to their retirement date, *without eroding their provision for eventual retirement*" (own emphasis). This statement is made without any rationale as to how this conclusion is reached. Most ASISA members strongly disagree.

Interventions considered must balance immediate COVID-19 cashflow problems experienced by members of funds against the known longer-term retirement savings problem. The International Organisation of Pension Supervisors (IOPS) in its Statement on pension supervisory actions to mitigate the consequences of the Covid-19 crisis (dated 26 May 2020), warned "against actions that may lead to material worsening of the retirement outcomes of beneficiaries."

Housing loans and guarantees to secure housing loans by pension funds have been permitted in law because providing a guarantee to secure a housing loan enhances long-term wealth accumulation. By using their retirement fund to guarantee housing loans granted by banks (or other lenders), fund members leverage their retirement savings to secure an asset which should in most instances strengthen their financial positions and retirement security over time. The rationale for allowing this is that by leveraging their retirement savings as security for the funding of a home loan, they are able to access said funding at more favourable interest rates than they would otherwise (for example where the debt is unsecured). ASISA members are of the view that the collateralized loan model is inappropriate for retirement funds if the loan is not being used for the same long term financial security goals as a retirement fund. A loan for short term consumption does not accord with the same policy which allows for housing loans. Loan defaults will result in the guarantees being called up, which will effectively give fund members premature access to retirement savings. There is great risk that the longer-term financial consequences of the proposed loan guarantees (negative impact on retirement outcomes) will far outweigh any short-term benefits.

COVID-19 relief should be temporary relief. The proposed legislation does not stipulate it being for a temporary period. Therefore, it creates an expectation that retirement funds will be permanently available to secure loans for short term consumption and personal crises. This is detrimental to members' long term outcomes. It goes beyond the objectives and purpose of a retirement fund, and is not aligned to National Treasury's long-term retirement savings policy. In fact the likely outcome will be the opposite, where retirement funds would become de facto providers of revolving short-term loans rather than vehicles of long term retirement funding. In other words, there is a risk that members will simply switch their short-term unsecured loan borrowings to the retirement fund.

The servicing of these loans will continue for years longer than the relatively short term hardship caused by COVID-19, causing loan debt for members who can ill afford the loan

payments. It potentially encourages poor financial behaviour of accessing loans for short term needs instead of attempting to cut household expenditure to live within a reduced income for a comparatively short period. Although in some cases a lender will amortise the interest due on the loan and only require payment of capital and interest at a later date, in other cases repayments for loans granted by financial institutions must commence immediately after the loan is granted. If a member requires a loan because of COVID-19 hardship, repaying capital and interest will cause additional hardship and the risk of defaulting will be high. The guarantee will then be called up and the member's retirement savings will be significantly depleted. In fact, the risk is material that the default behaviour may become one of "borrowing and subsequent defaulting", especially where the credit providers have such easy access to liquid and accessible security backing the loan.

Savings in retirement funds at a member level on average is very low. Statistics within the industry show that at least 50% of members have less than R50 000 in capital in their funds. Sanlam Benchmark Survey, 2020: 61% of pensioners can't make ends meet. Alexander Forbes Member Watch analysis, 2019: 50% of members are expected to retire with less than a 20% replacement ratio; the average benefit at retirement is approximately R350 000. Statistically around 60% of fund members in employer funds have accumulated 6 months' salary or less, particularly at lower salary levels. Failure to preserve retirement capital has depleted savings levels in South Africa. Additional premature access to retirement savings for employed fund members as proposed in the draft Bill will result in considerable further decimation of workers' retirement savings.

This goes against government policy and other legislative initiatives to stop leakage from retirement funds. National Treasury has been attempting to solve the non-preservation issues for many years. Compulsory preservation is favoured, although it has been difficult to obtain buy-in for implementation. Nevertheless, in-fund preservation has been introduced and provident fund annuitisation on retirement will soon be implemented. The draft Bill potentially erodes all these preservation measures.

In any event, while it is acknowledged that the intention of the draft Bill is honourable, the proposal is likely to have limited success as the affordability criteria of the National Credit Act ("NCA") would remain applicable – unless it is contemplated that the NCA affordability provisions would simultaneously be relaxed. If the NCA requirements are to remain unchanged, security for a loan might give an advantage to a member who meets the bank and NCA lending criteria but not assist a person in need who does not meet the lending criteria of the NCA. Providing additional security will not be that helpful if the member does not have the ability (i.e. income/cashflow) to service the loan. Simply providing a guarantee or security will not change the member's ability to repay the loan.

Experience of more than one large ASISA member on pension-backed housing loans has indicated a decline ratio in excess of 80% on most funds. In fact, most providers of pension-backed housing loans historically have terminated or significantly scaled back their operations. Under COVID-19 these decline ratios are likely to be higher still - and the very members who arguably have the greatest true need for short term financial

assistance are the least likely to meet the NCA lending criteria. It is difficult to see a business case for loan providers to access this market again.

Worse still, this will be open to abuse by members who do not have need of financial assistance simply as a means to access their retirement assets for a variety of reasons (and with no intention to repay the loan).

Current legislation

1. Section 19(5)(a) of the Pension Funds Act, 24 of 1956 ("PFA"), provides that a fund may, if its rules permit, grant a loan or furnish a guarantee to enable a member to redeem a loan, for housing purposes, granted to the member against security of either:

1.1 the pledge by the member of his / her benefit; or

1.2 immovable property which belongs to the member or his / her spouse and on which a residence will be erected which is / will be occupied by the member or a dependent of the member.

2. Section 19(5) limits the purposes for which loans can be granted by funds to members or loans guaranteed for housing. The object of the provision is to allow members to access their retirement capital or use such capital as a guarantee for the purposes of acquiring adequate housing for themselves and their families. At the same time, section 19(5)(b) ensures that such retirement capital is adequately secured by a mortgage or a pledge to protect the interests of all the active members and pensioners of the fund.

3. Section 37A of the PFA prohibits a person from using their pension entitlement as security for general debts.

4. Section 37D of the PFA allows for a deduction to be made from the member's share of the fund / benefit entitlement should the housing loan guarantee be called upon if the member defaults on the loan.

Impact of the proposed new S19 (5BB) on current legislation

The proposed legislation is completely inadequate to deal with the complexity of the issue.

The newly contemplated section 19(5BB), which does not prescribe the purpose for which the loan must be used, is contrary to the protection provided by the PFA, in particular section 37A, which prohibits a person from using their pension entitlement as security for *general debts*. The draft Bill effectively proposes diminishing this protection by allowing guarantees to be provided for loans to cover any debts.

The proposed section 19(5BB) does not contemplate the pledging of the member's benefit to the fund as security for the loan, nor does it contemplate any other security for

the loan. Without the member pledging his / her benefit entitlement as security for the loan, the fund would have guaranteed the loan without itself having any security, placing the fund in a precarious and risky financial position. Arguably, funds' boards would not be able to guarantee such loans to the funds' membership without breaching their fiduciary duty to ensure that the funds are financially sound and responsibly managed.

The proposed section 19(5BB) directly contradicts section 19(5B) which provides that a fund may not grant any loan or furnish any guarantee for any purpose other than that provided for in section 19(5) (i.e. housing loans).

The proposed amendment is further technically flawed as it does not contemplate a corresponding amendment being made to section 37D of the PFA that would allow for a deduction to be made from the member's share of the fund/ benefit entitlement should the guarantee be called upon should the member default on the loan. Without this corresponding amendment, the fund would have guaranteed the loan without being allowed to make a lawful deduction from the member's benefit entitlement should the financial institution / third party loan provider call on the guarantee provided by the fund.

The proposed section 19(5BB) therefore contemplates the untenable situation where unsecured loans are granted without limiting the reason for the loan (unlike in the case of section 19(5)(a)) and the fund guaranteeing such loans, without having the corresponding right to make deductions from the member's benefit / benefit entitlement where the member defaults on the loan.

The proposed section 19(5BB) contemplates the guarantee of a loan not exceeding 75% of the member's share of the fund. Where a fund's rules already allow for it to either grant a loan or furnish a guarantee in respect of a loan granted to a member for the purposes set out in section 19(5)(a) of the PFA, it is unclear how the provision of such a housing loan/guarantee (including the prescribed limitations on the value of the loan granted) would correlate with a loan granted in terms of the proposed section 19(5BB). Simply put, section 19(5BB) does not recognize that a member's share of the fund may already be encumbered as contemplated in section 19(5)(a).

Section 37D(3) deals with the hierarchy of deductions – this would have to be expanded to clarify where in the hierarchy a loan as envisaged by the draft Bill falls.

Additional points of concern

- <u>Proposed 75% limit</u>

Housing loans and guarantees backing housing loans by pension funds are limited to 90% of fund value. This proposal of guarantees for 75% of fund value for seemingly general debt, is too high. The
rationale for the proposed percentage of 75% is not given, but presumably the 75% limit is to allow for a fall in the value of the member's share due to adverse investment returns. Banks and credit providers would all apply their own limits for maximum loans based on their own credit risk assessments. However, no allowance is made for taxation on the

benefit. The current tax dispensation is cumulative and ASISA members' experience of housing loan guarantees is that they are generally limited to the post-tax benefit (generally 65%) or 40% of the gross benefit. This means that the potential to leverage a member's share in a fund for general debt is limited. In ASISA members' view, the proposed 75% limit is much too high. In a defined contribution fund this will put the other members' fund credits at risk.

Problems could arise as interest accumulation on the loan could potentially be greater than fund growth, moving the member outside of the maximum.

- Income tax

The 75% proposed maximum does not take into account that if the guarantee is called up, the amount paid from the fund will be a taxable benefit in the hands of the member. After tax, the benefit might be insufficient to cover the loan.

Tax on withdrawals during membership will cause a layered tax effect. Tax must be paid on the security withdrawn. But the tax is an additional withdrawal and so additional tax is payable.

Amendments to the Income Tax Act will be required to deal with taxation in circumstances where the loan is called up.

- Administrative complexity

Even if the take-up of the proposed pension-backed guarantees is limited, the functionality still needs to be put in place. The draft Bill introduces a large (and disproportionate) level of complexity and potential operational costs for administrators - and such costs will ultimately be transferred to members through higher administration fees (and also high costs linked to the loans themselves such as initiation fees, etc).

Amendments to fund rules would be required, as well as systems and other administrative changes. Noting loans on the system, payment of creditors on loan defaults after verifying the correctness of the amounts claimed, applying for tax directives and calculating what balance remains, staff training and applications for tax directives will be required. This will also place additional pressure on SARS and the FSCA.

There would be a significant impact on the operational and administration burden that would fall on the board of Trustees as well as the administrator. Trustees might have to have dedicated regular trustee meetings to assess requests for granting loan guarantees. As it is, the governance requirements for housing loans and guarantees are onerous and expose fund trustees to risk. Extending these requirements to non-housing loan guarantees exacerbates this problem. These burdens inevitably add to fund costs.

Managing the technical compliance aspect of the draft Bill related to the maximum guarantee value (75% of fund value) will be both technically demanding and theoretically challenging, as interest accumulation on the loan could potentially be greater than fund growth, moving the member outside of the maximums.

There is no question that additional costs will be incurred which will result in additional charges to funds that will ultimately impact on members' savings. Whilst pension-backed housing loans have
been granted at lower interest rates compared to personal loans, and therefore the loans contemplated by the draft Bill may well also be granted at lower interest rates, the additional administration fees charged by the fund will increase the total cost of the loan.

- Qualification criteria

There is no indication in the draft Bill as to what the criteria should or may be applied in implementing section 19 (5BB). Would lending institutions be expected to assess that the loans are for financial distress brought about, not by poor financial management, but by COVID-19 or an emergency similar to COVID-19? Or is the expectation that fund trustees would have this responsibility before agreeing to the loan guarantee?

It should be noted that it will be extremely difficult if not impossible to assess whether individuals are taking loans for consumption funding rather than for emergency relief. This raises questions regarding:

- How to prove financial distress as a result of Covid 19?
- How to assess this?
- Who assesses whether the reason is credible?
- On what basis can the loan or guarantee be refused?

The above would require lending institutions or funds to do a full investigation of a member's financial position in order to satisfy themselves that the member is indeed under financial pressure. If there is any expectation that this burden should fall on fund trustees, it needs to understood that this would create an untenable burden and risk for fund trustees. The assessment of whether or not a member is under financial pressure would be extremely time consuming and is not an established process for funds. The ultimate decision would in any event to a large degree be subjective, which would further increase the trustees' risk.

- Further impacts on trustees

The proposed draft places the obligation on trustees to decide whether to make this facility available to the members of their fund. The political and labour ramifications of deciding whether or not to amend rules to accommodate the proposed amendment should not be underestimated. Trustees will be placed in a situation of conflict. Their duties are to meet the objectives of the fund i.e. to provide retirement benefits for its members and benefits for dependents and to act in the best interests of members in relation to their long term savings and financial sufficiency in retirement. However, they might experience union, employer and other political pressure to make available short term loan guarantees. The business of retirement funds may experience conflict between becoming more involved with short term consumption funding instead of the true purpose of a retirement fund - long term savings.

- Asset liquidity

Depending on the take-up of loan guarantees, and the predominance of defaults before retirement or withdrawal, retirement funds may need to hold more liquid assets than they currently do. This is in direct conflict with the broader discourse in South Africa about the need to leverage retirement funding to support longer term illiquid projects such as infrastructure. Further, given that members' assets will be held as security for loans made, the issuers of the loan may require members' assets to be held in less volatile/risky assets (to protect the security behind the loan), which is likely to result in value destruction for members over time.

- Retirement annuity and Preservation funds

The draft Bill does not cover retirement annuity and/or preservation funds specifically, although, being pension funds, they are included in the ambit of the draft Bill by implication.

Under the provisions of the Income Tax Act, retirement annuity funds may not provide for access to cash prior to retirement (and then only to one-third of the proceeds at retirement). These funds
would not be suitable as guarantors of the proposed loans because pre-retirement access to monies is not allowed.

Preservation funds typically do not allow pension-backed loan arrangements (due to there not being an employer facilitating monthly repayments). Also, once the legally permitted once-off withdrawal from the fund has taken place, these funds would also not be suitable as guarantors of the proposed loans because further pre-retirement access to monies is not allowed. It is therefore difficult to see the draft Bill benefiting members of these funds either.

- Other deductions

Complications will arise in the event of default on the loan and the order of access to the member's share of the fund (bearing in mind housing loans already taken, tax deductions to be made, divorce orders, maintenance orders, etc).

- Death benefits

There will be an impact on death benefits as the loans will have to be settled first. In the case of housing loans, this is a benefit to surviving spouses and children because their house is paid off. In the case of consumption-based loans, there will be little, if any benefit to them.

In addition, providing pension-backed loans can be problematic in respect of members closer to retirement as the guarantee can only be enforced on the lump sum taken in cash (maximum one-third).

- Moral hazard

As stated above, it is not clear to what extent lending institutions e.g. banks will investigate the reason for the loan application. This could lead to the abuse of retirement funds and

cause unnecessary strain on the fiscus, where people make tax deductible contributions to retirement funds knowing that they plan to take out a loan and never repay the loan.

The draft Bill will introduce a very real and serious moral hazard into the system. Fund members may well use this as an opportunity to access and then squander their retirement savings, or may even go so far as to use this as a manner of avoiding maintenance obligations (by reducing the unencumbered amount available for the maintenance court to attach in respect of arrear maintenance), or reducing the unencumbered amount available to be paid to his/her ex-spouse in terms of section 7(8) of the Divorce Act. The member would simply default on the loan which would then be settled by the lending institution calling up the guarantee.

- Prudential standards

The proposed s19(5BB) allows a fund to furnish the guarantee "subject to prudential standards". Clarity is required as to what prudential standards are being contemplated.

Conclusion

ASISA members re-iterate that they believe that the draft Bill is well-intended. However, it unfortunately does not reflect an understanding of the retirement system or the behaviours of retirement fund members. While intending to assist only those fund members who need access to loans for COVID-19 and other emergency relief, the proposed solution will be in fact be open to all members of retirement funds, whether they are receiving reduced salaries/business income or not. The damage to workers' retirement savings will be considerable. The outcome of the proposals will be at odds with the national imperative that retirement savings be preserved, not accessed prematurely. The draft Bill, if enacted, will decrease the long-term likelihood of adequate Retirement provision for many members who take advantage of the loan guarantee arrangement, resulting in a larger proportion of the population becoming reliant on the state old age pension.

Yours faithfully,

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