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THE RETIREMENT INDUSTRY NEWSLETTER

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LOCAL NEWS

The use of pension fund money as security for loans opens a can of worms

A legislative proposal to make this possible has the wellbeing of the poor in mind, but is misguided Pensions are sacrosanct in providing security for one's retirement years and should not be tampered with lightly. So careful consideration needs to be given to a legislative proposal by DA MP Dion George to allow members of pension funds to use their pensions as security for loans. It touches on a sensitive topic that is sure to arouse considerable debate. The proposal in the form of a private member's bill is well-intentioned and comes at a time when many are suffering financial distress as a result of the Covid-19 pandemic that has thrown many people out of work.

They may well question the rationale for having an asset they cannot access and may even go to the desperate length of resigning from their jobs to get their hands on it. Many probably have done so already. In terms of George's proposal there will be no restriction on the purpose of the loan which will, however, be limited to 75% of the value of the pension fund. Pension fund trustees will decide if they want to offer loans and the loan limits, and it will be up to financial institutions to decide if they want to offer a loan. The Pension Funds Act already allows pension funds to offer pension-backed home loans, though not all of them do, which leaves many people as permanent tenants when they could buy their own homes.

But this is for the purpose of investment in a fixed asset that can be attached in the event of a loan default, rather than for consumption expenditure, which George's bill would allow. Banks are likely to be more lax about providing loans for just about anything if they had the security of a pension asset to fall back on in the event of default on repayment. The banking sector already suffers from bad debts, a situation that has worsened dramatically in 2020 during the pandemic. SA is a heavily indebted nation and it would seem reckless to open the window to more indebtedness.

This is one of the Treasury's reservations about the proposal. Instead of loosening the reins, it would rather tighten them to prevent people cashing in their pensions when they leave their job preretirement. According to the National Credit Regulator's credit market report, the total outstanding gross consumer credit for the quarter ended June 2020 was R1.96-trillion, of which unsecured credit amounted to R221bn. Linked to the over indebtedness is SA's low savings rate, which is among the lowest in the world, amounting to about 15% of GDP in 2018

compared to a world average of 25.1%. So the level of personal savings for retirement is probably very low. One could argue that the trade-off is between destitution now and destitution in retirement, but what draining off pensions means in the case of a loan default is that the pension less in retirement will become dependent on state old-age pensions. The state bears the cost of allowing people access to their pensions, and the financial burden of supporting them is passed on to future generations. This would go against the government's stated commitment to fiscal consolidation. The Treasury is already budgeting to spend R274bn on state old-age pensions over the next three years.

Admittedly George is not proposing to make mandatory the use of pensions as security for loans. It would be up to pension fund trustees to decide whether to grant them or not, though whether they would want to play the role of loan adjudicators and bear the additional administrative burden is questionable. And as George himself concedes, expectations would be created that they do so. George's proposal is well-intentioned with the wellbeing of the poor top of mind, but it is misguided in the broader scheme of things. More will be said about it during public hearings on the bill held by parliament's finance committee when the voice of the pension fund industry will be heard. In any event, his proposal would be better considered within an overall reform of the pension regime, which is under discussion among the Treasury, industry and labour.

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Why a conservative retirement plan isn't watertight

Playing it safe with your retirement plan could be an unsustainable approach in the long term. Here's why experts suggest taking advantage of a combined approach to secure your financial future.

What is a conservative approach?

Often, 'conservative' and 'safe' are used interchangeably to describe a scenario where most risks are mitigated, giving you peace of mind. When investing in, for example, interest-bearing funds, this 'safety' is largely owed to a low risk of capital loss and low market volatility. But when it comes to your retirement planning, being too cautious can have the opposite effect: you could end up with an uncomfortable retirement after years of hard work. As Denis Viljoen, Business Development Manager at Glacier by Sanlam, explains: "Everyone deserves to retire with dignity. Unfortunately, if your money is invested too conservatively, you might wake up one day to the reality that your savings are just not going to afford you that dignity," he says.

Why a totally conservative approach to retirement isn't reliable

When you're in an 'up' market, you want to enjoy a piece of the pie (i.e. investment returns). A conservative approach to investing doesn't offer this. "If minimal risks are taken when investing because your focus is on generating constant cash flow, the underlying portfolio will tend to underperform during rising markets," says Denis. Besides returns, inflation is also a vital consideration when selecting the right retirement income solution. Again, a conservative approach doesn't necessarily account for this, which means your investment won't meet or beat inflation. "Equity exposure is vital for income to keep up with inflation," Denis continues.

True safety in diversity

Diversifying your asset allocation is vital for mitigating market risks and securing your capital in the long term. With this approach, you can rest assured that a single event won't wipe out your entire portfolio. "In a diverse portfolio, assets are less correlated; when one rises, the other one's value may fall, and vice versa," explains Denis. "It's your best defence in a financial crisis." To achieve this, look at including more growth assets that are uncorrelated in your portfolio to decrease volatility. Lower volatility leads to additional returns when income is taken because it helps manage what we refer to as sequence risk – the risk of your portfolio losing value during a market downturn just before or after retiring. "Look at diversifying between offshore equities, local bonds and local equities," Denis suggests.

Diversification through a combined approach

On average, retirees draw down more from their retirement capital than guideline recommendations, shares Denis. The impact of this is a greater risk of running out of capital, and in instances where leaving a legacy to beneficiaries is a retirement goal, the opposite happens – with beneficiaries often having to take care of their retired loved ones instead. "Combining different retirement income solutions balances capital preservation and growth," says Denis. "This allows you the freedom to live your life fully and enjoy peace of mind."

Combining a life annuity and a living annuity harnesses the benefits of both solutions for an optimal income that takes care of fixed costs and ad hoc expenses. "The advantages of buying both these solutions are that you're guaranteed an income for life, you can benefit from possible income growth in the future since your investments have market exposure, and when you pass away, the remaining capital in your living annuity can be passed on to your dependants," explains Denis. You also have the flexibility to adjust your income percentage if markets take a dip.

The benefits of an asymmetric approach

Unlike a conservative approach, an asymmetric approach reduces volatility and allows for a more growth-orientated approach in a portfolio. How does it do this? By combining a portfolio of traditional asset classes and uncorrelated sources of returns, the risks of capital loss and volatility are managed so that you share in only one third of market dips and two thirds of market ups. Because risks are managed, you enjoy a smoother return profile. “Besides reducing volatility in returns, asymmetric returns are designed to preserve capital and offer downside protection,” says Luke McMahon, Portfolio Manager at Glacier Invest. “This approach is crucial when managing retirement assets, as it focuses on compounding sustainable positive returns and increasing the probability of achieving financial survival.”

The right solution for you

A financial adviser is key to helping you realise your retirement income goals. By reviewing your assets and liabilities to determine your total wealth, they can partner with you to answer questions you have about your retirement and suggest the right income solutions depending on your financial standing, risk appetite, longevity risk and sequence risk. “There is no place for a single product anymore. A financial adviser has to consider all offerings in combination to meet a client’s very personal, specific needs,” says Denis. Partnering with a financial adviser allows you to have confidence, knowing that you are moving in the right direction to realise your retirement goals, but are also in trusted hands to receive ongoing advice as and when your retirement goals change.

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If you’re planning to minimise tax for the year ahead, start now

Maximising your contributions to a retirement fund – a pension fund, provident fund or retirement annuity (RA) – is the single most effective way of reducing your tax bill for the 2021/22 tax year, and experts agree it’s better to spread your contributions over the year than invest a large lump sum at the end of it. Mica Townsend, business development manager and employee benefits consultant at 10X Investments, says: “If you’re not using the maximum tax allowance (by contributing 27.5% of the greater of your taxable income or remuneration, to a maximum of R350 000 a year, to a retirement fund), you are basically rejecting the government’s offer to return some of your taxes to you. Along with tax-free savings accounts, retirement contributions are the most tax-efficient way to save.”

There are further benefits. Gareth Collier, who has the Certified Financial Planner accreditation and is a director at Crue Invest, says: “You do not pay tax on interest, dividends or capital gains while you’re invested in a retirement fund, which offsets the negative effects of tax on your interim and future income.” For salaried employees whose benefits include an employer-sponsored pension or provident fund, there is generally a set range of contribution rates. “You should try to increase your contributions to a level that you are comfortable with,” Collier says. “Contributions to your company’s retirement fund are made pre-tax, which allows you to gear up your savings to provide you with a pensionable income once retired, instead of paying taxes that will most likely not benefit you at all.”

Your employer might limit the opportunity to change your contribution rate to a certain time of year. “Changes are admin-intensive, so it is easier for big corporates to do everything in one month instead of every time an employee wants to change their contribution rate,” says Collier. “Talk to your HR department about your company’s policy.” Alternatively, you could supplement your contributions to your employer’s fund by setting up an RA. And if you are self-employed, this is the appropriate vehicle for gaining the tax benefit. As to the timing of these investments – monthly, or as a lump sum at the end of the tax year – Collier says it is not an either-or situation.

“It depends how much you are able to invest throughout the year. You can do both. If your income is R15 000 a month and you receive a year-end bonus of R15 000, it is a good idea to do a monthly debit order against your income and a lump-sum investment from the R15 000 bonus to maximise your retirement contributions.” Townsend says: “There’s always a bit of a scramble in February, and some people miss the cut-off date for the tax year-end.” She recommends regular monthly contributions, rather than ad hoc annual contributions, for several reasons. “If you make a big investment in late February, unit prices could be high. It is better to spread your exposure across the year, which evens out any volatility in the market.”

Behavioural economists have observed our present bias, and one way this manifests is in the tendency to favour money in our pockets today over security in retirement. Monthly payments counter this effectively, because the amounts involved are much smaller than a large sum just before tax year-end. “Once a monthly payment is set up, you might soon not even notice that amount going off your account. It will become part of your normal expenses, like rent or your bond,” says Townsend. “Also, you will see how relatively small sums start to add up.” Contributing monthly harnesses the power of time. “Money invested at the beginning of the tax year has almost 12 months longer to compound than money you invest at the end of the year,” says Townsend. “Over time, this can put you at a significant advantage.”

OTHER THINGS YOU CAN DO

Besides retirement contributions, there are other ways to reduce your tax. Here are some of them:

- Medical scheme fees tax credits. If you contribute to a medical scheme, the monthly tax credit (for the 2022 tax year) is R332 for the main member, R664 for a member with one dependant and another R224 for each additional dependent. The total is multiplied by 12. There are potential additional medical expenses tax credits related to contributions and for out-of-pocket expenses not covered by your medical scheme. To claim the latter, keep all receipts. Submitting them all to your medical scheme (even if you know they will be rejected as they aren't covered) will ensure they are on record.
- Travel and subsistence expense claims. Proof of business travel (a logbook recording the date of each business trip, distance and destination) and expenses such as fuel, service, licence and insurance, and slips for out-of-town expenses, such as accommodation, meals and incidentals are needed.
- Expenses incurred as a selfemployed person. These could include advertising costs, rental of equipment and property, or costs of keeping a home office space (such as a portion of rental or interest on your bond, rates and electricity), entertainment, phone and stationery.

"If you are self-employed, you have more options available to you to improve your tax efficiency, compared with those who work for an employer," says Collier.

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INTERNATIONAL NEWS

Covid-19 Relief Law Gives Companies More Time to Fund Pensions

Single-employer plan sponsors will have 15 years—up from seven now—to cover pension deficits, and flexibility in how money earmarked for 2019 and 2020 pension contributions can be used.

Finance chiefs will get more time to cover their companies' pension deficits and more flexibility with the cash they have put into retirement plans as part of the new Covid-19 aid package. Market disruptions caused by the pandemic and near-zero interest rates have made it harder for companies to manage their pension obligations, especially plans sponsored by a single employer. Low interest rates contribute to higher liabilities, increasing the amount of funding that companies need to set aside for pension obligations. Single-employer plans often promise to pay out fixed sums to retirees, sometimes over several decades, similar to other defined-benefit plans. More than 20,000 U.S. companies offer these single-employer plans, according to consulting firm Mercer LLC.

Many of these plans, which are largely underfunded, have fared well with the rise in the stock market over the past few months. The funding level of single-employer plans sponsored by S&P 500 companies rose roughly 4.7 percentage points to 91.5% at the end of 2020, compared with the previous year, professional-services firm Aon PLC said. The funded status has since climbed to 95.3% as of Feb. 28. The estimated aggregate deficit of single-employer pensions sponsored by S&P 500 companies was $102.1 billion as of Feb. 28, tumbling 72.8% from the prior year, Aon said But as interest rates are expected to remain low for a while, companies need long-term support to continue making contributions to their plans and to cover any potential future market volatility or cash crunch, advisers say.

The $1.9 trillion aid package that President Biden signed into law earlier this month helps sponsors of single-employer plans hold on to cash and delay paying off any deficit in their plan over a 15-year period vs. the current seven-year period. It also set aside about $86 billion for struggling multiemployer pensions, which are jointly run by unions and companies. The law creates a more predictable and favorable basis for measuring the liabilities that ultimately determine the funding obligation, said Jonathan Price, a senior vice president at the Segal Group Inc., an employee-benefits consulting firm. Companies can use as a minimum, a corporate bond yield of roughly 5%, to determine the value of their pension liabilities.

Before the law, there was no such minimum. The floor rate, which is higher than the current market rate, is expected to reduce short-term contributions that companies need to make for their plan. “If you’re a CFO, the ability to, in any given year, not have an ironclad requirement to put cash into a pension plan is always a good thing,” said Matt McDaniel, a partner at Mercer. The law also extends an existing option allowing companies to revise their funding obligations to help them free up cash. The U.S. government has provided this flexibility throughout the past decade, most recently in 2015. That option started to phase out earlier this year. Under the Covid-19 package, companies can redeploy funds designated for 2019 and 2020 pension contributions, as long as they make those payments at a later date.

The reduction in future pension costs creates an opportunity to use the cash to offset labor costs and stabilize the business amid the pandemic. The relief doesn’t pose an advantage to employees, except that companies could spend the funds on hiring or to avoid layoffs. Companies also can adopt these changes as far ahead as next year. The new law will largely start phasing out in 2026. The option is intended to help chief financial officers and treasurers struggling to pay into single-employer plans as they invest in their businesses, Mr. Price said. Airlines and hotel operators are among the companies that look to benefit most from the pension-relief measures, as businesses that have been hit the hardest look to better manage their cash. **Full Report:** ***https://www.wsj.com/articles/covid-19-relief-law-gives-companies-more-time-to-fund-pensions-11616491801***

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