

# Managing defined-benefit members' expectations when accessing their savings pot

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**With the two-pot retirement system changes to the retirement industry legislation imminent (implementation date is 1 September 2024), there is little doubt that this is the next biggest transformation to sweep over the retirement industry since the introduction of umbrella funds or the conversion of retirement funds from defined-benefit (DB) to defined-contribution (DC) funds.**

For those who are not familiar with the new two-pot retirement system legislation, once implemented, the following changes will occur (ignoring certain exceptions defined in the legislation):

- Any retirement savings a member has saved up until 1 September 2024, along with the rights applicable to those savings, will be preserved in a vested pot.
- After 1 September 2024, members' future contributions to retirement savings will all be split 1/3 to a savings pot and 2/3 to a retirement pot.
- Even though the savings pot is intended to be available as a lump sum at retirement, members will be allowed to access up to 100% of their savings pot once per year before retirement (subject to a minimum withdrawal amount, which is currently R2 000).
- Members will be forced to preserve their retirement pot until retirement. It will then need to be used to purchase a pension either from an insurer or from the fund to which they belong (if allowed).
- Should a member decide to access his/her savings pot before retirement, the withdrawal transaction will be treated as additional income for the year and taxed at the member's marginal income tax rate.
- All administration costs of the withdrawal transaction will be deducted from the savings withdrawal benefit.

At its core, the two-pot retirement system has two benefits for those individuals saving for retirement – the one is the fact that a member will be able to access some of his/ her retirement savings before retirement, without having to leave employment (a current pitfall in the retirement funds industry), and the other is the fact that a large part of the member's future retirement savings will be preserved until retirement (something that has been lacking in the industry for many years).



## Administration changes required for accessing a savings pot

Although there are significant changes required by administrators to implement the new legislation, administering a withdrawal from a member's savings pot will be relatively easy in a DC fund, as the withdrawal amount will simply be deducted from the available capital in the member's savings pot. After the administration costs for the withdrawal transaction and tax have been deducted from the withdrawal amount, the net benefit will be paid to the member.

For a DB fund, however, the administration of the accumulation of and a withdrawal from the savings pot will be more complex given that a member's withdrawal benefit will first have to be calculated by an actuary. Furthermore, a member's withdrawal benefit is related to the number of years of service as opposed to the amount of contributions made.

The savings pot and retirement pot will have different pensionable service dates on the two-pot retirement system

implementation date, and additional service the member accrues will be allocated 1/3 and 2/3, similar to how the DC member's contributions will be split.

Therefore, unlike a DC fund where the administrator merely needs to track the size of each pot, the DB fund administrator will need to keep a record of the different pensionable service dates of each pot, which will change based on the number of months since the implementation and the number of withdrawals the member makes.

## Calculating the size of a member's savings pot

As implied above, the size of a member's savings pot in a DC fund will be the sum of all the 1/3 contributions made per month, plus the investment return on these contributions, less any historical withdrawals already made. This balance in this account can therefore easily be made available to the member, who can withdraw the full amount at any point, provided that he/she has not made a withdrawal in the current tax year.

To calculate the size of a DB member's savings pot, the actuarial reserve value (ARV) will be calculated as usual, based on the fund's rules, using the member's total pensionable service. This ARV will then be split in proportion to the member's pensionable service date of each pot at the time of the withdrawal.

A member will then be able to decide how much of the savings pot he/she wants to withdraw, and either the actuary of the fund or the administrator will need to calculate by how much the service date of the savings pot and the total service will need to be adjusted after the withdrawal is processed, so that the adjusted ARV value can be calculated in the future.

## Cost of making a withdrawal from a savings pot

The legislation states that all tax and administration fees may need to be deducted from the withdrawal benefit, which is why a minimum withdrawal amount of R2 000 is stipulated. In a DC environment, if we assume the following:

- Member withdrawal amount: R10 000
  - Marginal tax rate: 31%
  - Transaction fee: R200
  - Costs are deducted before tax is applied for
- the net benefit to this member would be R6 762  $(R10\ 000 - R200) \times (1 - 0.31)$ .

Note that costs are usually deducted first from any benefits before tax is applied for, and for the purpose of the illustrations in this article, we are assuming that the same principle will continue to apply.

In the DB environment, the same tax and cost would apply as above; however, there would be an additional cost for the calculation of the member's ARV and revised pensionable service date, which would need to be considered. These withdrawal calculations would take up approximately 1 hour of an actuary's time, which could result in costs of up to R5 000 per withdrawal request.

Hence, in the above example, a DB member withdrawing R10 000 would only be paid a net benefit of R3 312  $(R10\ 000 - R200 - R5\ 000) \times (1 - 0.31)$ .

In addition to the monetary costs, one can also consider the time it takes for a withdrawal benefit to be processed. Barring the initial inception period, in the DC environment this process is expected to be not much longer than the time the administrator currently takes to process a normal fund withdrawal.

The time it takes to process the DB withdrawal would be significantly longer given the involvement of an actuary to determine the value of the withdrawal benefit.



## Managing member expectations

One of the key principles of the Treating Customers Fairly framework is managing members' expectations. Given that members will gain access to part of their retirement savings when the two-pot retirement system is implemented, it stands to reason that expectations will be created as to how much a member can withdraw from his/her savings pot and how long it would take to access his/her savings.

Clear communication is key, especially when it comes to explaining the difference between what the member requests as a withdrawal amount and the actual benefit that he/she will receive. This is even more prevalent with defined-benefit members, given the extra costs and time involved in determining their withdrawal benefit amounts.

If the current methodology of determining a DB member's withdrawal benefit is maintained, it will be very difficult to explain to a member of a DB fund, why his/her net savings withdrawal benefit is so much smaller and takes so much longer to process, than that of a member of a DC fund, when both withdrawal requests amounts are the same.

## A possible solution to managing costs of withdrawals in a DB fund

In the withdrawal example shown above, it is evident that the main difference between a DB and a DC net withdrawal amount, from a member's perspective, is the additional cost of the actuary's time to perform each calculation. If one could remove this cost, a DB and DC withdrawal transaction could be processed on a very similar basis, thereby treating both members more fairly.

Our suggestion for removing the actuarial cost per withdrawal would be a one-off cost to a DB fund per triennial valuation, where the fund's actuary would produce a table (or several tables) of withdrawal factors for each member group (example per gender and age) to determine the cost of one day's service in the fund for each member group, based on the latest statutory valuation's assumptions.

The administrator could use these tables to look up the factor based on which member is requesting the withdrawal, and then determine the size of the savings pot the member has access to by multiplying the number of service days in the savings pot by the looked-up factor. The administrator could then also tell the member by how much the pensionable service date of the savings pot and total service would need to be adjusted, given the size of the withdrawal that is requested, by dividing the amount of the withdrawal by the cost of one day's service.

In doing this, an actuary does not need to be involved in each withdrawal request, thereby removing the additional cost per quote for each withdrawal and improving the turnaround time of the withdrawal payments. The fund would only need to cover the one-off cost of the actuary determining the factor tables at each valuation.

## Conclusion

Although the majority of the defined-benefit funds in South Africa have already converted to defined-contribution funds, there are still several actively operated defined-benefit funds in South Africa, and the future legislative changes are going to make administering these funds significantly more complex and costly. Boards of management of these funds will need to consider the changes and costs carefully, to properly and fairly manage the expectations of their members.

