Government's retirement reform strategy is contradictory - Liberty

The government's strategy towards retirement reform poses some interesting contradictions. On the one hand the cost of advice is being targeted by government as being the main contributor to the high costs of savings for individuals through intermediary commission structures.

However, on the other hand government policy is to encourage small business start-ups - and who other than the intermediary is going to offer the two- or three-employee firm advice on how to save and plan towards retirement?

Rowan Burger, head of Investment Strategy at Liberty, explains that government's proposals miss the key point that retirement savings are poor not primarily by the high cost of saving, but by the absence of compulsory preservation of retirement savings. "People cash in their retirement savings simply because they are able to do so, and the penalties imposed on early termination kick in only for this reason. Were compulsory preservation implemented, reasonable retirement benefits would be achieved by the industry on the current fee and investment return basis."

Government has proposed a range of retirement reforms aimed at increasing the savings rate of the population. Burger says the life assurance industry is going to have to rethink its investment products to ensure that they meet the demands of government proposals, and should begin immediately to prepare for these changes.

Impact of longevity

Once finalised, these reform proposals will impact everyone, yet few people understand the issues around retirement, particularly how longevity is radically altering retirement planning. Industry is taking the opportunity to focus on the expensive structural inefficiencies in the savings system to ensure that policyholders are able to enhance the return on their investments.

"If you look at where these government proposals are headed, it is safe to assume that for high net worth individuals the tax regime will not be more favourable than it is right now, as government is looking at subsidies for low income earners and caps for high income individuals. Therefore, I recommend they maximise their contribution deductions while they can. Government is committed to honouring existing rights attached to savings which means current benefits will remain. I do not recommend cashing in because of fear of future legislation - they could at least gain greater flexibility over their capital now than they would under proposed new rules," says Burger.

He explains that the retirement reform discussions are wide-ranging proposals to reform social security and retirement fund arrangements. The National Treasury is also likely to concentrate on short to medium term retirement fund reforms that will complement the broader and longer-term social security reforms that are planned.

Objectives of reform

He lists three broad objectives of retirement reform - firstly, to improve our rate of savings; secondly, to ensure savers retire with a reasonable income; and thirdly, it has to be fair and low cost. The first issue requires both increasing the number of people in the country who save, and secondly introducing compulsory preservation so that those who have saved towards retirement cannot access their savings to spend it.

"Members currently have three options when they leave an employer: they can take it in cash; transfer it to a new employer; or transfer it into a preservation fund or retirement annuity. However, 90% of people take the first option simply as this is the easiest. The impact of this is that while retiring members ought to get a pension at retirement equal to 70-90% of their final salary, in fact they get about 30%."

The National Treasury has proposed that some level of preservation of retirement become a default option when employees change jobs. But at the same time introduce a tax free savings scheme to help encourage savings for emergencies such as job loss.

Access for the unemployed

"Treasury is also proposing that the unemployed be given some access to their preserved retirement savings and that access will also be allowed in cases of demonstrated medical need. Further, the new preservation arrangements would not affect current retirement savings, which would still be available when an employee changes jobs," says Burger.

On retirement, most people use their pension savings to purchase an annuity on which to live. The latest reform proposal is therefore to reform this annuity market, having identified the level of costs of some retirement savings products as an issue. By far the largest component of costs is the charge for financial advice, with the other two components being asset management fees and administration.