Impact of the two-pot system on retirement benefits

The two-pot system is on everyone's minds in the retirement fund industry. With the proposed implementation date of 1 March 2024 looming large, service providers, trustees and members are scrambling to be ready. In this article, I seek to illustrate the impact that the two-pot system may have on retirement benefits using some illustrative fund credit projections in defined contribution funds.

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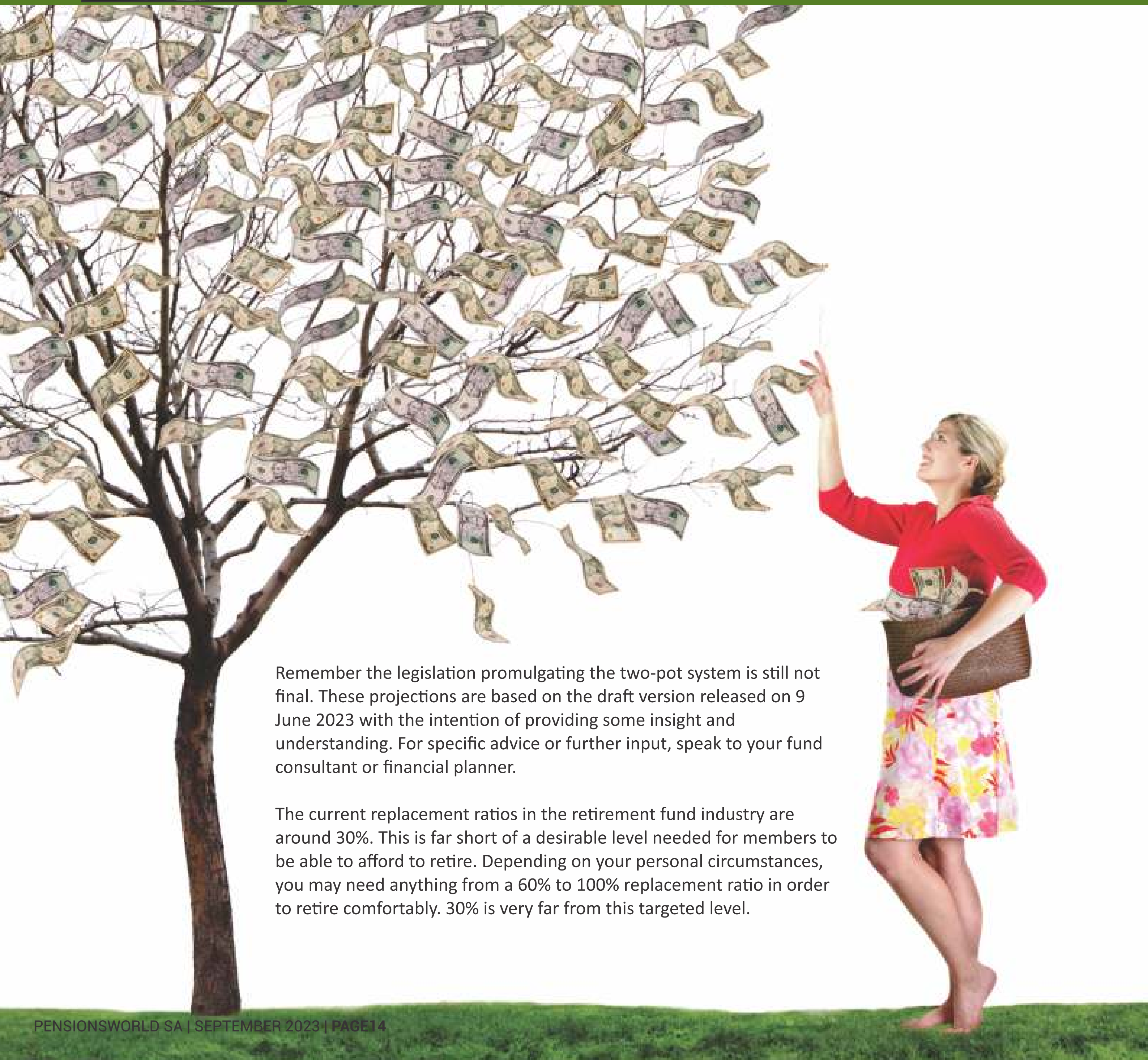

Remember the legislation promulgating the two-pot system is still not final. These projections are based on the draft version released on 9 June 2023 with the intention of providing some insight and understanding. For specific advice or further input, speak to your fund consultant or financial planner.

The current replacement ratios in the retirement fund industry are around 30%. This is far short of a desirable level needed for members to be able to afford to retire. Depending on your personal circumstances, you may need anything from a 60% to 100% replacement ratio in order to retire comfortably. 30% is very far from this targeted level.

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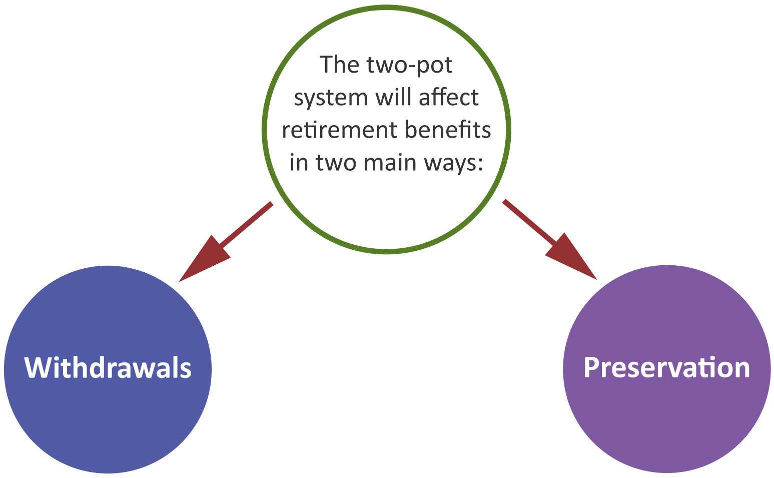
If you are a member of a defined contribution fund, the main factors that will affect your final benefit are:



Withdrawals
The two-pot system allows withdrawals of up to a third of your annual contributions. Meaning, if you contribute R6 000 a year, you are able to withdraw R2 000 (plus interest) in that year. Any withdrawals will obviously lower your retirement benefit.

Retirement funds represent the greatest savings/investments that the majority of South Africans will ever have. In fact, most South Africans have no other savings. So most South Africans will have to borrow if there is a specific need, for example, housing, medical expenses, education and life emergencies.

As a result, even employed South Africans are heavily in debt. The idea behind the two-pot system is that you now can have access to a small portion of your retirement fund benefit to help pay for these important and sometimes unexpected events. However, there is nothing stopping you from taking money out of your retirement fund without a legitimate reason. You can access your savings pot for a heart attack or you can access it for a trip to the casino. It's up to you. Unfortunately, nothing is for mahala. If you are ill disciplined and take out too much, your final retirement benefit will suffer. Withdrawals will lower your benefit.

Preservation
Right now if you leave employment before retirement age (55) you can withdraw all (100%/everything/alles/zonke) your money in cash, leaving nothing saved for your retirement. You do have the choice of preserving your money, which will keep your retirement savings invested. But you don't have to preserve – it is your choice. In reality, very few people preserve their benefits. Not preserving is a major factor resulting in low benefits and replacement ratios at retirement. The two-pot system seeks to bring in compulsory preservation**.** This means that if you leave employment before retirement age you will have to preserve your benefit. You can still have access to whatever is in your savings pot. But whatever is in your retirement pot cannot be accessed. The idea behind this is that this will improve retirement benefits and hopefully offset the impact of allowing withdrawals from the savings pot.

You can see that the two-pot system brings in two elements that work in opposite directions when it comes to your retirement benefit. Withdrawals reduces your benefit, preservation increases it.

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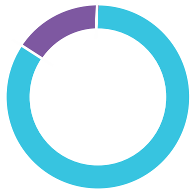
Fund credit projections

Let's look at the impact of the two-pot system on your retirement benefit with some examples. We will look at this from the point of view of a new member (because it is easier for me). If you are an existing member and want to know how your benefit will be affected, it is best to speak to your fund financial planner. Meet our example member:

Name: Sipho Gumede
Age: 20
Starting fund credit: 0
Retirement age: 60
Starting salary: R20 000 a month
Contribution rate: 12% (Net to retirement)

Mr Gumedes projected replacement ratio at retirement age and pension at retirement age (in today's money terms) are:



Replacement ratio: 85%

Pension: R 17 000 p.m

This is the baseline projection. It is what could have happened without the impact of the two-pot system. This is his maximum benefit if he takes nothing in cash and converts everything to a pension when he reaches retirement. The pension has been discounted so that it makes sense in today's money terms. We will now look at the impact of the two-pot system. Keep the above numbers in mind. The impact will be shown by how much the replacement ratio and pension changes.

Impact of allowing access to the savings pot

Mr Gumede has a choice of withdrawing between 0 and a third of his annual contributions. He contributes R2 400 a month or R28 800 a year. He can withdraw up to R 9 600 (plus interest) in that year.

If he withdraws the full allowance every year then his benefit changes as follows:

Scenario: 100% withdrawal every year

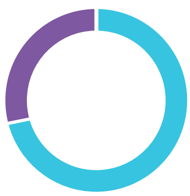
Replacement ratio: 57%

Pension: R 11 300 p.m

You can see that his benefit in retirement has dropped from R17000 a month to R11 300 a month.

What if instead of taking out the full allowance he only takes out half of what he can from the savings pot? So now he withdraws R 4 800 (plus interest) in that year:

Scenario: 50% withdrawal every year

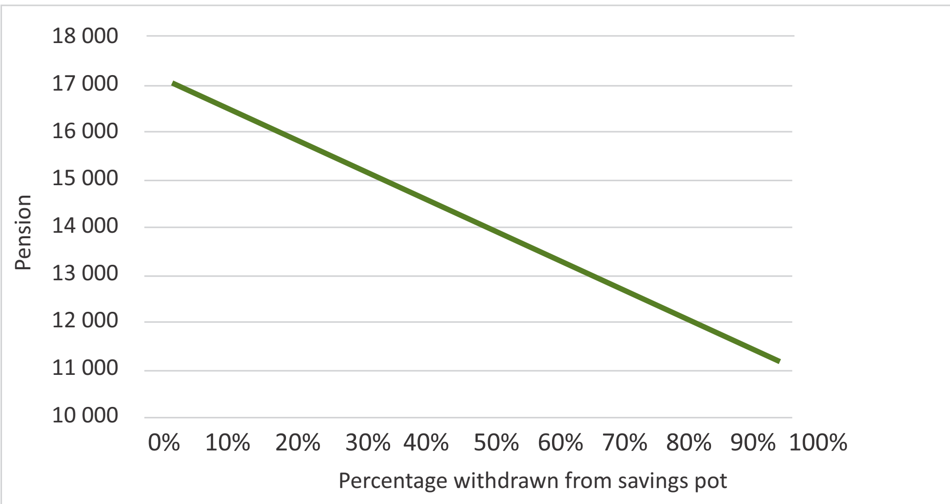


Replacement ratio: 71%

Pension: R 14 200 p.m

Now his retirement has dropped from R17000 a month to R14 200 a month.

The graph alongside shows the impact of different withdrawal levels on his final benefit.



Impact of preservation

Now in the baseline example, Mr Gumede worked for 40 years. In the South African context, this level of long service is rare. In reality, workers are retrenched and unemployed for long periods. The official rate of unemployment in South Africa is currently 33%. The unofficial rate is 43%. These are extremely high.

To provide projections that are more realistic, we will look at scenarios where Mr Gumede is unemployed for various amounts of time. Employed South Africans work for about 20 years and are unemployed for about 10 years.

We will look at scenarios where Mr Gumede is unemployed for:

- 4 years
- 10 years
- 16 years
- 22 years

Firstly, we will assume that he preserves nothing and takes his full benefit in cash every time he loses/changes employment.

Years unemployed	Replacement ratio	Monthly pension
0	85%	R17 000
4	12%	R2 400
10	9%	R1 900
16	7%	R1 400
22	5%	R1 000

This shows how not preserving your benefit drastically reduces your final retirement benefit.

We will now show how this changes if you preserve your benefit every time you change/lose employment as under the two-pot system.

Years unemployed	Replacement ratio	Monthly pension
0	85%	R17 000
4	77%	R15 500
10	65%	R13 000
16	53%	R10 600
22	41%	R8 100

This shows that there is a significant benefit to preserving your benefit. If you are unemployed for 10 years then your final pension increases from R1 900 to R13 000 by preserving. Thus the compulsory preservation in the two-pot system can go a long way to improving benefit outcomes. This scenario however, ignores the allowance to withdraw from the savings pot.

Impact of accessing the savings pot and preservation combined

The table below combines the impact of savings pot access and compulsory preservation on Mr Gumede's replacement ratios:

Years unemployed	0% withdrawal	50% withdrawal	100% withdrawal
0	85%	71%	57%
4	77%	64%	51%
10	65%	54%	44%
16	53%	44%	35%
22	41%	34%	27%

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Below is how Mr Gumede's pensions are impacted:

Years unemployed	0% withdrawal	50% withdrawal	100% withdrawal
0	R17 000	R14 200	R11 300
4	R15 500	R12 900	R10 300
10	R13 000	R10 900	R8 700
16	R10 600	R8 900	R7 100
22	R8 100	R6 800	R5 400

You can see that the outcomes under the proposed two-pot system vary greatly and it is clear that compulsory preservation improves benefit outcomes significantly. However, for benefits to be better than under the current system it is important that this be combined with low levels of withdrawal from the savings pot. If the full allowance is withdrawn from the savings pot then outcomes are not clearly improved.

Because of the above, it is vitally important that communication to members be clear. They must know the consequences of withdrawing from the savings pot and the impact it can have on their final benefit. This will help to ensure that the access is used as intended for legitimate emergencies. This will then help to result in improved benefits for members.