Legal Report

November 2023

1. Two-Pot system on early access to retirement savings

The final Revenue Laws Amendment Bill ("the Bill"), dealing with the introduction of the Two-Pot system on early access to retirement savings, has been tabled in Parliament.

It is proposed in the Bill that the implementation date of the Two-Pot system be postponed from 1 March 2024 to 1 March 2025. According to National Treasury, this is due to the magnitude of the reform and the desire to ensure that when implemented the system operates as seamlessly as possible. This will also provide sufficient time for funds and trustees to consult fund members about rule changes and to communicate clearly to members what the impact on their future contributions will be. Parliament's Standing Committee on Finance however on 21 November 2023 objected to the postponement of the implementation date. Unless Parliament eventually votes otherwise, the implementation date of the Two-Pot system will accordingly remain 1 March 2024. This will leave the retirement fund industry, as well as the South African Revenue Service (SARS) and the Financial Sector Conduct Authority (FSCA), with very limited time to get everything ready, and will make the timely implementation of the system extremely challenging.

Although it in view of the above seems unlikely that the implementation date will be postponed to 1 March 2025, references to the 1 March 2025 implementation date have been retained in this report as that is how the Bill reads currently.

In terms of the Two-Pot system retirement fund members will have access to a portion of their retirement savings before termination of their fund membership. Three new components will be created within a retirement fund, namely a vested component, a retirement component and a savings component.

The vested component will consist of the member's fund value as at 28 February 2025, and the current retirement fund regime will remain applicable to this component. One third of contributions post 1 March 2025 will go to the savings component, and two thirds to the retirement component. All other credits and allocations to the member's account, including group life and disability benefits, must be allocated in the same manner as contributions, in other words one third to the savings component and two thirds to the retirement component.

In the case of defined benefit funds, the one third and two thirds must be calculated with reference to the member's pensionable service. Defined benefit funds that are unable to apply the pensionable service basis, may allocate contributions utilising a reasonable method of allocation as approved by the FSCA.

Arrear contributions that became payable before 1 March 2025, will be allocated to the vested component, despite the fact that they are only paid after 1 March 2025.

10 percent of the value of the vested component as at 28 February 2025, to a maximum of R30 000, will be allocated to the savings component as so-called seed capital. This is to enable members to have immediate access to a portion of their retirement savings when the Two-Pot system comes into effect. The determination of the seeding amount can occur on or after 1 March 2025, but the allocation must be backdated to 1 March 2025. The seed capital must further be taken proportionately from the T-day vested and non-vested portions of the vested component.

No further contributions can be made to the vested component, except that members of provident funds who were 55 years or older on 1 March 2021, and who are still members of the same fund, will continue contributing to the vested component unless they elect to participate in the Two-Pot system. Should they continue contributing to their vested component, their full contributions will be allocated to the vested component, and they will not be able to contribute to the savings component and retirement component.

As currently, contributions and growth will be exempt from tax, while withdrawals and benefits will be taxed.

Withdrawals from the savings component (referred to in the Bill as "savings withdrawal benefits") can be made without any conditions, but only one withdrawal can be made during a tax year. The minimum withdrawal amount is R2 000, before taking into account any charges or transaction costs, and a member must accordingly have an amount of at least R2 000 in the savings component before being allowed to make a withdrawal. If a member resigns from employment, and he/she has already made a withdrawal from the savings component during the tax year, an additional withdrawal will only be allowed if the member's interest in the savings component is less than R2 000.

Savings withdrawal benefits will be included in the member's taxable income for that year, and will be taxed at his/her marginal rate. The withdrawal tax table will accordingly not apply to withdrawals from the savings component. The withdrawal tax table will however still apply to withdrawals from the vested component.

Although it is not yet clear how the fund will know the tax amount to be deducted from a savings withdrawal benefit, it would seem that the intention is not that the fund will have to apply for a tax directive in the normal manner. It is in this regard stipulated in a new paragraph 2(2C), to be inserted in the Fourth Schedule to the Income Tax Act, that when deducting tax in respect of a savings withdrawal benefit, the fund must apply the fixed tax rate that SARS directs must be used. This would seem to be a similar process to that which currently applies to pensioners with more than one source of income.

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Amounts contributed to the retirement component cannot be accessed before retirement. At retirement date, the total value in the retirement component must be paid in the form of an annuity, except if the member's interest in the retirement component, calculated together with two thirds of the T-day non-vested portion in the vested component, does not exceed R165 000. (In the case of a provident fund member younger than 55 on 1 March 2021, the T-day non-vested portion is his/her contributions, plus fund return on such contributions, from 1 March 2021 onwards.)

Full withdrawals from the retirement component can take place when a member emigrates from South Africa or ceases to be a tax resident. This is however subject to the three year rule that under the current regime applies to members of a retirement annuity fund and preservation fund. The three year rule will not apply to the vested component of a member of an occupational fund or to the vested component of a member of a preservation fund who has not yet made his/her once-off withdrawal.

It was stipulated in the Draft Revenue Laws Amendment Bill that the amount in the savings component may on retirement or death be allocated to the retirement component and paid as an annuity. This provision was not included in the final Bill, which creates the impression that the amount in the savings component may on retirement or death only be received in cash, and no longer as an annuity. This would seem to be a mistake, and the legislation will hopefully be amended to clarify that the amount in the savings component may on retirement or death also be received as an annuity.

If the amount in the savings component is paid as a lump sum on retirement or death, it will be taxable as a retirement lump sum benefit subject to the retirement lump sum table.

Members cannot transfer amounts out of the retirement component, but can only transfer to the retirement component in another fund.

No transfers can be made into the savings component, unless they are from the savings component in another fund.

If a member transfers to another fund, all components must be transferred to the transferee fund. It is in other words not possible to transfer only one component while leaving the other components behind. Put differently, it will not be possible to split components between funds.

Both transfers of components between funds, and transfers to another component in the same fund, will be subject to the fund obtaining a tax directive.

Deductions from a member's benefit in terms of section 37D of the Pension Funds Act must be made proportionately across all three components, in other words proportionately from the vested component, savings component and retirement component.

Beneficiary funds, unclaimed benefit funds and pensioners will be excluded from the Two-Pot system. In the draft response document, in which National Treasury responded to comments received on the Draft Revenue Laws

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Amendment Bill, it was stated that funds in liquidation, closed funds and dormant funds will also be excluded from the Two-Pot system. The Bill does however not include an exemption for such funds. The legislation will hopefully be amended at some point to include an exemption in respect of funds in liquidation, closed funds and dormant funds.

Subject to certain conditions, legacy retirement annuity policies will also be excluded from the Two-Pot system. The reason for this is that the inclusion of these policies would require a re-design of the policies.

A bill dealing with the amendments that have to be made to the Pension Funds Act to make provision for the Two-Pot system, will be published at a later stage. It is not yet known when this bill will be published, and the unavailability of the Pension Funds Act amendments is a further obstacle in the way of the timely and successful implementation of the Two-Pot system.

2. Joint Standard on IT Governance and Risk Management

The Financial Sector Conduct Authority (FSCA) and the Prudential Authority (PA) have published a Joint Standard on Information Technology (IT) Governance and Risk Management.

The Joint Standard applies to financial institutions as defined in the Standard. This definition includes insurers, but does not include retirement funds.

The Joint Standard sets out very detailed requirements relating to the principles for IT governance and risk management that financial institutions must comply with, in line with sound practices and processes, in managing IT risk.

The Joint Standard seeks to address the following:

- ensuring that financial institutions have established a sound and robust IT risk management framework;
- assisting financial institutions in integrating technology risk management into their overall management systems; and
- ensuring that oversight of IT risk management is incorporated into the governance and risk management structures, processes and procedures of a financial institution.

The Joint Standard will commence on 15 November 2024.

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3. Draft Prudential Standard on regulation 28 quarterly reporting requirements

The Financial Sector Conduct Authority (FSCA) has, for public comment, published a draft Prudential Standard on the quarterly reporting requirements in terms of regulation 28 of the Pension Funds Act.

In terms of the Standard all retirement funds will be required to submit a report, in a prescribed format, to the FSCA on a quarterly basis in respect of:

- assets held in terms of regulation 28; and
- any non-compliance with, or breaches in terms of, regulation 28.

A fund must complete all fields of the quarterly report and must submit the report to the FSCA within 90 days after the last day of the respective quarters.

The background to the publication of the draft Standard is as follows:

Funds are currently only required, on a quarterly basis, to report instances of non-compliance with regulation 28 (exception reporting). Quarterly reporting of assets held in accordance with regulation 28 (holistic reporting) is not currently required.

After regulation 28 was amended with effect from 3 January 2023, the FSCA published Draft Prudential Standard 1 of 2023. In this Standard the current exception reporting approach was changed to an approach where retirement funds are not only required to report on non-compliance, but on all assets held in compliance with regulation 28 (in other words holistic reporting).

On the basis of concerns raised during the public commentary process, amongst others with regard to timing pressures, the FSCA decided to remove the holistic reporting requirement from Prudential Standard 1 of 2023 and to proceed with submitting this draft Prudential Standard to Parliament. The Prudential Standard to be submitted to Parliament (hereinafter referred to as “the exception reporting Prudential Standard”) therefore merely perpetuates the current approach of quarterly reporting on non-compliance with regulation 28.

The FSCA however remains of the view that there is a need to provide for holistic quarterly reporting in conjunction with the current exception reporting approach. As such, the FSCA has now published a further draft Prudential Standard (“the holistic reporting Prudential Standard”) for public comment, which incorporates both non-compliance reporting and reporting on assets held in compliance with regulation 28.

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In summary, the envisaged approach is as follows:

- The exception reporting Prudential Standard will be submitted to Parliament and the FSCA will attempt to finalise this Prudential Standard as soon as possible after the requisite parliamentary period has elapsed.
- Concurrently, the FSCA has started consulting on the draft holistic reporting Prudential Standard. Consultation and refinement of the draft holistic reporting Prudential Standard, as well as submission thereof to Parliament, is envisaged to occur throughout 2024 and this Prudential Standard will likely only be made final early in 2025.
- Once the holistic reporting Prudential Standard is made final, it will repeal the exception reporting Prudential Standard.

Comments on the draft holistic reporting Prudential Standard, and reporting format, can be provided to the FSCA until 31 January 2024.

4. National Financial Ombud Scheme South Africa

In 2021, National Treasury and the Financial Sector Conduct Authority mandated the World Bank Group to carry out a diagnostic review of the South African financial ombud system. One of the World Bank's key recommendations was to consolidate the ombud system into a new single Ombud scheme, to cover the whole of the financial sector (excluding retirement funds until a later stage).

In anticipation of the broader consolidation of the ombud system proposed in the World Bank review, the Credit Ombud Association, the Ombudsman for Banking Services, the Ombudsman for Long-term Insurance and the Ombudsman for Short-term Insurance have voluntarily embarked on an amalgamation exercise. This has culminated in the formation of the National Financial Ombud Scheme South Africa. If granted recognition by the Ombud Council, this new Ombud scheme intends to start operations in January 2024.

The new scheme's rules have been published for public comment. Comments in this regard may be submitted to the Ombud Council in writing on or before 14 December 2023.

One of the aspects of note in the rules of the new Ombud scheme is that the new scheme, like the current Ombudsman for Long-term Insurance, will have an equity jurisdiction, meaning that it will not be bound by legal principles, but will also be able to take considerations of fairness and equity into account. It is in this regard stipulated in the rules of the scheme that the scheme "*must determine what in its opinion is equitable, fair and reasonable in all the circumstances*".

It is further stipulated in the rules that any complaint which falls under the jurisdiction of the Pension Funds Adjudicator or the FAIS Ombud is excluded from the jurisdiction of the new Ombud scheme, unless the Pension Funds Adjudicator or the FAIS Ombud has declined to deal with the complaint and agreed that the new scheme should deal with the complaint.

Retirement funds or other clients requiring more information should not hesitate to contact their consultant.

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