South Africa’s new Two (three) Pot system

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February 2024

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For Financial Advisors and their Clients

In 2024, South Africa will finally see another major change to our retirement system. Although known as the “Two Pot system”, in reality, and for most, it will be a new three pot system. All retirement savings invested before 1 September 2024 will vest in a vested pot (pot 1), while all new contributions after 1 September 2024 will be allocated between a savings pot (pot 2) and a retirement pot (pot 3). Investors aged 55 and older as of 1 September 2024 will only have one pot - if you so choose.

Sounds complicated, doesn’t it? In the article below, we’ll attempt to clarify some of the more pertinent aspects of this new system as well as consider the potential portfolio construction implications.

Background

The new system was primarily created to bridge the divide between two, seemingly irreconcilable needs. The first was to allow South Africans to utilise their retirement savings during difficult times, permitting them to access short-term emergency funds when necessary. The second was the need to preserve savings for one’s eventual retirement and create a more sustainable pot of savings for retirees and less dependence on the government.

South Africa’s dismal savings rates are well publicized. According to the latest Sanlam Benchmark Survey[1] findings, less than 10% of retirees can maintain the same standard of living they enjoyed before retiring – a scary statistic. In addition, the latest Baseline Survey[2] found that 46% of adults tend to prioritise current spending above saving for their future, while a third have no retirement plan in place whatsoever. Preserving the majority of one’s contributions towards retirement should therefore be seen as a welcome development, however, this will only benefit those actively contributing towards their retirement. This change doesn’t address poor savings rates in general, but it is a step in the right direction.

In South Africa, one can imagine a situation where an individual or a family’s situation becomes so dire that the current utility of each rand in their savings pot far outweighs its future utility. Having access to a third of your savings should in theory at least create some resilience and support when most needed.

It is indeed a very clever way for the government to mitigate demands on the fiscus during stressful periods – especially given its current high debt levels and limited reserves. The new regulation essentially proposes to create an additional source of liquidity or funding during

[1] Source: Sanlam Benchmark Survey 2023: [Benchmark 2023_Insights.pdf (sanlam.co.za)]
[2] Source: SANews (2023): [SA urged to make smart financial decisions | SAnews]

difficult times, which could assist individuals while simultaneously reducing demand on the government fiscus.

In our view, a good balance has therefore been struck between reaching these two goals, i.e., preserving savings for the future, while allowing for some flexibility and resilience.

The Two (three) Pots

As things currently stand, the new proposed implementation date of the Two Pot system will be 1 September 2024[3]. This would immediately create:

- **Pot 1**: a vested pot that contains all your retirement savings prior to 1 September 2024,
- **Pot 2**: a savings pot that you may access once every year; and
- **Pot 3**: a retirement pot that will not be accessible (even when resigning) and has to be preserved until retirement.

Savings Pot

The savings pot may be funded by an initial lump sum from your vested pot, which may be up to 10% of your pot, but limited to R30 000[4]. By way of an example, if your current total retirement savings before implementation day is R100 000, you would be able to transfer up to R10 000 (10%) to your new savings pot. If, however, you have R1 000 000 saved you would only be allowed to transfer R30 000, i.e., 3%. The cap of R30 000 is not expected to create a massive liquidity challenge for current funds when financing the savings pot from the vested pot.

From the implementation date, **one-third** of your total annual contribution will go to your savings pot. The savings pot can be withdrawn, once every year, subject to a minimum amount of R2000. There aren't any maximums, and the full value of the savings pot may be withdrawn. In addition, you would also be able to transfer funds from your savings pot to your retirement pot tax-free[5]. However, this is a one-way transfer as you would not be able to transfer funds again from your retirement pot to your savings pot.

It is important to note that if you withdraw money from your savings pot, a means test won't be conducted. However, this withdrawal amount will be added back to your annual income, and you will be taxed at your marginal tax rate. That said, when you retire, you have the option to either receive the funds in your savings account as a lump sum or transfer them to your retirement account, which will allow you to withdraw these funds at preferential tax rates.

[3] Source: Chong & Van Vuuren (2023): Two-pot system effective date - 1 September 2024? (fanews.co.za)
[4] Source: BusinessLive "Retrenchment relief may be in pension reform 2.0" (6 February 2024)
[5] Source: Howell (2023): More tweaks for the 'two-pot' retirement system - BDO ; Chong (2022): Ten things you ought to know about SA's planned two-pot system for retirement savings | Webber Wentzel

Retirement Pot

From the implementation date, **two-thirds** of your total annual contribution will be allocated to your retirement pot, with compulsory preservation. You will not be able to access money in this pot due to financial difficulties or when changing jobs, which is a major change and one that will most definitely lead to better long-term outcomes. At retirement, the funds in this pot must be annuitised, except for the amount(s) transferred from your savings pot, i.e., all funds in excess of your two-thirds that must be annuitised.

Vested Pot

All funds saved in your retirement plans prior to the implementation date will form part of your vested pot. The benefits as accrued up to that point will continue to apply to this vested pot along with all old rules and legislation[6]. Funds in your vested pot may also be transferred to your retirement pot on a tax-free basis.

The positives

Under the new retirement savings system, up to two-thirds of your savings will now be preserved. This is a positive development for South Africans, as many gain access to a portion of their retirement savings and withdraw this portion when they change jobs or resign from their current employment. The new system aims to encourage the preservation of savings over the long term, which would effectively end this practice. It's important to note that this mostly applies to employer pension and provident funds, as retirement annuities do not allow withdrawals when a person resigns or changes employers.

One can also argue that it might encourage more people to start saving more formally towards retirement as the additional optionality may reduce concerns or fears of locking away your savings without any access or liquidity. This might be especially true for entrepreneurs and those using retirement annuities.

Areas of concern

To benefit from compounding, you must save and invest for as long as possible. Accessing any part of your savings before retiring will result in the loss of compounding and negatively affect your overall future wealth. Therefore, accessing any funds in your savings pot should only be done under exceptional circumstances.

The concern also exists that the availability (or rather accessibility) of the "savings pot" creates a behavioural bias for the savings pot to be used as a "savings account" and the belief that these funds can be used regularly. This should be avoided as much as possible. As always engaging

[6] Source: Howell (2023): More tweaks for the 'two-pot' retirement system - BDO ; Chong (2022): Ten things you ought to know about SA's planned two-pot system for retirement savings | Webber Wentzel

with your financial advisor regularly and reviewing your financial plan and current position will be as important as ever.

Younger savers, specifically those with retirement annuities, with savings of R300 000 or less will be put to the test. On the implementation date, they will essentially gain access to 10% of their total savings which they might not need but might withdraw regardless. This short-term gain could have material long-term wealth creation implications.

There are also industry concerns in terms of implementation; the added complexity needed to administer the different pots or systems, the administrative burden of pension fund rules that will need to be amended and approved by the regulator and the necessary laws that will need to be amended.

With this being said, pension fund rules cannot be amended before the Pensions Fund Amendment (PFA) bill is tabled in Parliament[7]. The new proposed implementation date of 1 September 2024 is a year and six months later than initially proposed, so perhaps it's not unreasonable to expect the industry to be prepared for the new system.

Investment implications

As things currently stand, we don't seem to have any clarity on how Regulation 28 will be applied and guidance in this regard is a necessity. Will it be applied on a member level or each pot individually? If it's applied on the member level (i.e., the combined look-through exposures of all three pots) it would require additional systems checks and requirements on the part of administrators, funds, and linked-investment service providers (LISPs).

If it is applied to each pot individually, the addition of the savings pot needs to be carefully considered. Since this pot could essentially be withdrawn in its entirety every year, the time horizon of this pot becomes more short term and investing in risky assets (which require a longer investment horizon) may not be appropriate anymore. However, should investors decide to invest in more liquid, less risky investments in this pot, their overall asset allocation could de-risk and they run the risk of not having enough exposure to growth assets (on average across your different pots).

Smart thinking will be necessary in how the retirement pot is then constructed within the limitations of Regulation 28. It could also lead to the need for greater personalization in this space as opposed to generic, off-the-shelf solutions.

[7] Source: Chong & Van Vuuren (2023): Two-pot system effective date - 1 September 2024? (fanews.co.za)

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