The issues that hinder the improvement of the employee benefits system

Pensionable pay: The law of unintended consequences

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One of the issues that is likely to have serious implications for many years to come is that of the level and definition of ‘pensionable pay’. This seemingly harmless term, not defined under South African law, has serious implications for retirement funding. To understand why we have this problem, it’s necessary to consider the evolution of South African employee benefits.

When the quantum of income that an employee deems as pensionable is highly variable or represents only a fraction of their true income, this means that employees will fail to save enough over time to adequate replace the income reflected in their true final

Why we have pensionable salaries: Then and now

Historically employers offered total rewards systems based on a ‘pay plus benefits’ basis. Retirement fund arrangements were typically on a defined benefit (DB) basis, which meant that if experience was adverse, the employer carried the cost. Many employers also offered a separate post-retirement medical aid benefit that funded the employees’ medical costs in old age. Again, the employer picked up the tab if things did not run according to plan.

Volatile salaries could result in the retirement fund liabilities being extremely unstable, and this would have direct implications for the employer contributions and their balance sheet. So the salary used for retirement funding was often defined to exclude bonuses, commissions and other volatile elements of the pay package.

In addition, because part of the retirement costs were going to be funded by the postretirement medical aid benefit, the salary level used for retirement funding purposes was set to be less than the full salary excluding volatile items. The Income Tax Act referred to this as retirement funding income (RFI) and the balance of earnings was referred to as non-retirement funding income (NRFI). RFI is commonly referred to as pensionable pay or pensionable salary and the percentage of total income classified as RFI is termed the pensionable salary percentage or the pensionable pay percentage.

DB retirement benefits are determined according to pensionable pay at retirement, so a low pensionable pay percentage meant lower costs for the employer, and this was kept firmly within the employer's control. However, the shift to defined contribution (DC) funds, accompanied by the transition to a total cost to company (TCTC) basis, meant a change in the control and influence of the pensionable pay percentage.

Where TCTC arrangements have been put in place, pensionable salary is typically expressed as a percentage of TCTC, typically between 60% and 80% although some employers allow this percentage to be as low as 30%. As a number of deductions, including those for insured benefits and retirement fund contributions, are based on pensionable pay, a low percentage immediately means more take-home pay for the employee.

If the pensionable percentage were reduced dramatically the year before the claim, the benefit would be paid based on this lower pensionable salary, even if a very high pensionable salary percentage had been paid for many years previously. The implications for retirement funding are also severe.

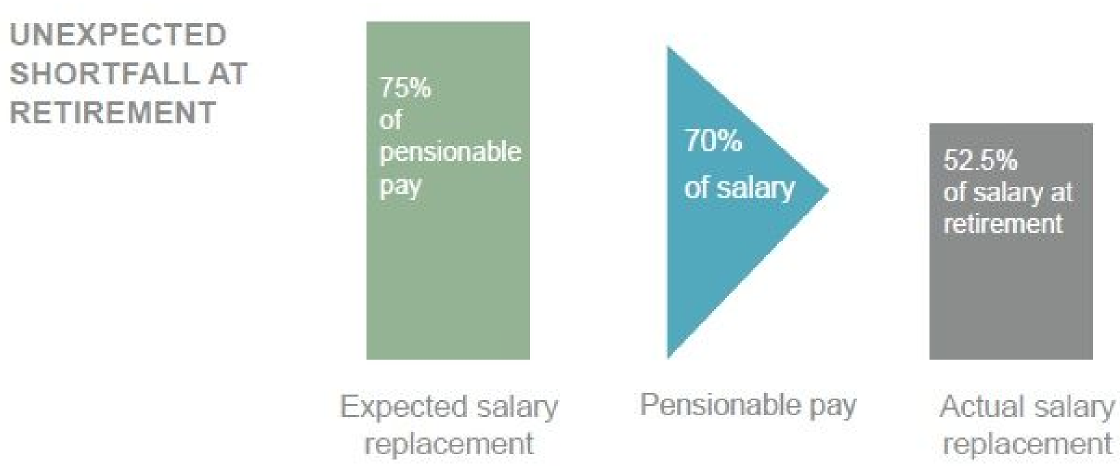
> **How many people realise that benefits are designed to replace only a portion of their total income?**

The two-tier gap

The retirement benefit in a DC fund is impossible to predict, but many employers and trustees wish the fund to be managed in a way that produces a reasonable retirement benefit. What exactly constitutes a reasonable retirement benefit is uncertain but most South African retirement funds use replacement ratios of 70%–79%. In other words, they aim to replace 70%–79% of pensionable pay as an income in retirement. But if pensionable pay is only 70% of total income, a 75% replacement ratio only delivers a retirement income of 52.5% of pre-retirement income!

The projected replacement ratios across the various economic sectors are already visibly low, leaving a gap between total income before retirement and pension after retirement. However, many employees may be unaware of the fact that the use of the pensionable pay in calculating the replacement ratio hides a second gap, that between total income and pensionable pay.

This might be in part due to the fact that very few benefit statements with projected retirement benefits actually show members what this means in terms of rands and cents.



Even if employees think their employee benefits meet their retirement, death and disability needs, it is questionable how many realise that these benefits are designed to replace only a portion of their total income. In fact, a survey of employers[1] revealed that there was considerable confusion between the contribution rate to retirement funds and pensionable salary percentages.

> **From a retirement savings perspective, large disparities between monthly contributions make the employee vulnerable to market volatility**

Introducing variable pay structures into the mix

So far, we've considered what happens when the pensionable pay and total income are relatively stable. A further complication is that in some industries, take-home pay is extremely volatile. This may be due to the basic pay structure, such as in the fishing industry where pay depends on the season, the weather and the shifts being worked. In the retail industry, workers can be paid on a sales commission basis. Volatile pay may also be due to generous incentive bonuses, prevalent in professional and business services, energy and certain manufacturing industries.

In these instances, there are some difficulties in structuring appropriate benefits for members. For example, if actual earnings are used in the fishing industry, without any adjustment, the benefits provided on death or disability could be quite variable, and might depend on factors clearly beyond the control of the employee.

From a retirement savings perspective, large disparities between monthly contributions make the employee vulnerable to market volatility. This is because investing in the markets just before a market crash can permanently dent savings while investing just before markets begin a recovery can result in higher returns. Over time these should average out but extraordinarily high bonuses or volatile earnings invested for only a short time might be exposed to this phenomenon.

> **Explaining the rands and cents impact of financial decisions can be much more beneficial than discussing traditional investment return metrics such as performance relative to benchmarks**

Defusing the time-bomb

National Treasury reform proposals[2] suggested that the concepts of RFI and NRFI may soon be scrapped. Tax incentives would be based on percentages of total income instead of RFI and NRFI, although the exact definitions are still uncertain. While sponsors using a TCTC basis would not be compelled to change their fund rules to have pensionable salary reflect total income, it is expected that many would do so. Total income in this context is technically the greater of taxable income and employment income.

If the contribution rate toward retirement savings remained fixed, then contributions to retirement funding could shoot up dramatically. For example, an employee with a 70% pensionable pay percentage would pay 43% more towards retirement funding, and have a reduced level of take-home pay.

Employers, unions and retirement funds need to take corrective action before these changes are implemented as well as prepare for their implementation. While it would be premature to focus on the specifics of adjusting to the proposed tax regime, there are some general principles that should be borne in mind.

Show employees the money
As mentioned before, very few retirement fund members are shown what their projected benefits are in rands and cents. In response to this, some funds have started introducing benefit statements to put things into perspective and allow members to make more informed decisions about whether they are on track for retirement and whether they have enough death and disability cover in place.

Where employees can choose their pensionable pay percentages or their contribution rates towards retirement funding, they should be shown the consequences on their disability, death and projected retirement benefits at the same time.

Rethink goals
Research suggests that the 75% replacement ratio may be too low for many South African households[3]. Trustees need to apply their minds to what a suitable retirement goal might be and use this goal as part of their asset-liability matching. Explaining the rands and cents impact of

financial decisions can be much more beneficial than discussing traditional investment return metrics such as performance relative to benchmarks[4].

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Start talking about the other volatility

Although investment volatility receives a significant amount of attention, volatile salaries get much less consideration. One option may be to relate benefits to total income averaged over a number of months or years. However, this is unhelpful where the volatility is significant, when salary inflation is high, or where new staff members are concerned. An alternative may be to allow for additional voluntary contributions (AVCs) to be made to retirement funding on a regular basis to keep contributions relatively stable. Similarly, risk salaries can be determined, which roughly reflect the average level of take-home pay without volatility.

Have minimum thresholds

Employees can make bad financial decisions regardless of how financially educated they are. Allowing for very low pensionable pay percentages not only allows members to make choices that may well be bad for them, it gives employees the impression that the company unofficially endorses these poor choices.

> **Pensionable pay, particularly if it is volatile, may be extremely detrimental to employee benefit outcomes and we believe many members are unaware of its consequences**

Implications

Pensionable pay, particularly if it is volatile, may be extremely detrimental to employee benefits outcomes and we believe many members are unaware of its consequences. Employers will need to start communicating around this issue as well as take other remedial action when designing their total rewards systems.

References

1 Future of Employee Benefits Employer Online Survey 2012
2 National Treasury (2012d)
3 Butler & Van Zyl (2012b)
4 Fowler & Campisi (2010)

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