Mass exits: Coping with the downturn

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Authors and contributers

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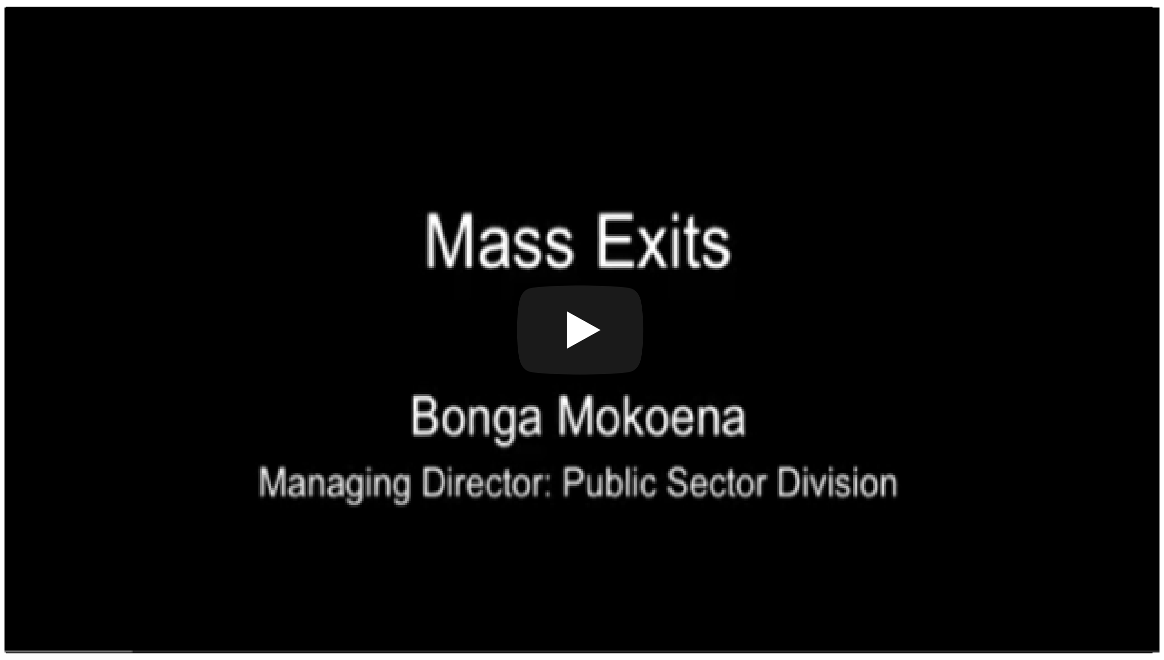
When a significant proportion of the workforce leaves an employer at the same time the impact on the individuals, their industry and society as a whole can be devastating. This situation can arise because of:

- Retrenchment
- Transfer from one company to another due to merger and acquisition activity
- Dismissal, for example, due to strike action.

Whatever the cause of mass exits, some form of anticipation and contingency planning can help reduce their impact. This chapter covers retrenchment and transfers, where the lead times are usually considerably longer than dismissal due to strike action.



Retrenchments

The consequences
Large scale retrenchments arise when employers liquidate or restructure. This is a sad reality of industries in decline, for example, the textile industry. If the industry in question is relatively healthy, there may be prospects of re-employment for the members. This would not be the case in a declining industry, particularly if the skills are not transferable. The effects begin long before the employee actually leaves the organisation. In the build-up to the actual exit, employees may work reduced hours or 'short time'. This results in lower pensionable pay, which affects retirement fund contributions and the level of insured benefits under a retirement fund arrangement.

A consequence of reduced hours may well be reduced death and disability cover. Where funds offer housing loans using the member's benefits as collateral, the affordability of the housing loan repayments may reduce dramatically, potentially resulting in default. This can lead to the members accessing their benefits to settle the loan. Tax is also payable on such loan settlements and members also have to accept a reduced tax-free amount at retirement. As administration fees have a significant fixed cost element to them, a fund may find that the administration costs start to make up a greater proportion of the contributions made into the fund when reduced hours are in place. This erodes the amount of the contributions ultimately allocated towards the members' retirement savings.

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In terms of the actual retrenchments, the greater the prospect for longer-term unemployment, the greater the desire to access retirement savings will be, particularly in the absence of other savings. About 90% of withdrawal benefits are accessed as cash[1]. This leakage erodes the individual's prospects for financial independence at retirement and places a significant burden on government-funded benefits and the communities in which these workers live.

A second negative consequence of accessing retirement savings is that these amounts are also potentially double taxed. Certain retrenchment benefits are taxed more favourably at the date of retrenchment. However, this tax-free retrenchment benefit will reduce the tax-free amount at retirement, which increases the marginal tax rate on retirement cash lump sums. See the 'Tax on withdrawal' section. Retrenched employees therefore bear the double burden of the cash portions of their already depleted retirement savings being taxed at a higher tax rate.

A third consequence is that the cash lump sums are often used to fund lifestyle expenditure. This may make the decline in living standards even more painful when the money runs out. Members who exit funds will also be affected by lapses in their risk-benefit cover, leaving them and their dependants vulnerable to any possible adverse life events. Even where members are employed again after a short period, there may still be certain gaps in insured benefit cover where pre-existing conditions or waiting periods may apply to any new insurance or medical cover provided by their new employer arrangement.

Managing the consequences

In circumstances where the industry is in decline and the government cannot afford to bail it out, longer-term unemployment is a real prospect for workers unless re-skilling programmes are undertaken. Introducing these retraining programmes should be an objective of the government, the unions and the industries concerned.

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To manage housing loans when 'short time' is in place, members, employers and funds should engage with the housing loan credit provider and try to reach a more affordable repayment agreement. The provisions of Section 19(5) of the Pension Funds Act[2] might however constrain the credit provider and fund's ability to help all members.

hen retrenchments become unavoidable, it is critical that employers give members enough lead time to find alternative employment and make financial arrangements. Longer lead times also allow members an opportunity to access financial advice. Employers going through this process should seriously consider arranging specific financial advice to be made available for affected members, possibly at the workplace. Members should be made aware of these issues as part of the communication around the retrenchments.

For example, the individual can make use of any severance package received and any unemployment insurance income, while seeking employment, and decide to preserve the growing retirement fund benefit in a preservation fund. Having access to a once-off withdrawal from the preservation fund would give the individual some security that they would have access to additional funding for survival purposes if they are not re-employed by the time their severance package and unemployment insurance benefits are finished. In certain circumstances, it is almost inevitable that the amounts will need to be accessed.

These circumstances include situations where there is a general decline in a particular industry and skills are not readily transferrable to other industries. In this case, it may be more cost-effective for these individuals to access their full benefits at withdrawal rather than incurring the administration expenses and commissions involved in transferring to a preservation fund. Access to cost-effective and seamless preservation fund options would also help members – and warrants further investigation by employers and trustees. Employers may also wish to consider paying for a period of extended risk cover as part of the retrenchment package.

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Transfers

The consequences
The lengthy negotiations around the purchase and sale of a business often involve a great degree of due diligence. When retirement funds were predominantly defined benefit (DB), valuing the fund was an integral part of the sales process due to the significant financial implications for the company. With the risks relating to retirement funding having shifted to members in defined contribution (DC) funds, the perception of companies is often that little or no attention to retirement fund arrangements is required. As a result, depending on the rules, retirement fund members may have an opportunity to withdraw their retirement fund benefit even though their employment is being transferred to the new business owners without any substantial changes. This would not in itself be a bad thing, provided that members act responsibly and choose to defer tax and preserve their benefits in preservation funds, retirement annuity funds or in their new employer's retirement funds. However, all the evidence points towards low preservation rates.

Managing the consequences
A little planning and attention to detail during the merger and acquisition process would result in the sale agreement providing details of how members' benefits will be dealt with. Ideally these provisions would confirm that members' benefits are to be preserved through transfers to the new employer's retirement funds or within the existing arrangement, which would then be allowed to continue. Arrangements would be made for the relevant fund rules to be amended to facilitate either of these approaches.

Tax on withdrawal

The default tax treatment on lump sum withdrawal benefits is as follows:

VALUE OF LUMP SUM	TAX RATE
R0 - R22 500	0%
R22 501 – R600 000	18%
R600 001 – R900 000	27%
R900 000 or more	36%

This table applies to the combined withdrawal benefits that become available to members on or after 1 March 2009. This means that if a member received a withdrawal benefit of R100 000 from a retirement fund on 1 April 2009, they will pay R13 950 in tax (first R22 500 tax-free, the rest taxed at 18%).

If the member then received a further withdrawal benefit of R20 000 on 1 May 2010 from another retirement fund, the member will pay R3 600 in tax (18%) on that benefit. Each withdrawal benefit pushes the member higher up on the tax scale and the member will pay more tax each time a benefit is taken in cash.

However, withdrawal benefits on qualifying retrenchments receive beneficial tax treatment. Paragraph 2(1)(a) of the Second Schedule to the Income Tax Act provides (with effect from March 2009) that in the event of a member receiving a lump sum benefit as a result of employment being terminated due to:

- The employer having ceased to carry on business or intending to cease carrying on the trade for which the employee was employed
- That person having become redundant in consequence of having being affected by the general reduction in personnel or class of personnel then the benefit having accrued to the member will be taxed on the same basis as a retirement benefit.

This exemption does not apply to members who at any time were directors of the company or who at any time held more than 5% of the share capital of the company. However, the member will then be penalised at retirement date when the tax on any lump sum taken on retirement is calculated, as the amounts accessed will be set off against the tax-free amounts they qualify for at retirement, notwithstanding the fact that these amounts will already have been taxed. This has the effect of increasing the marginal rate of tax on the retirement lump sum benefit taken.

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Other consequences to consider

Mass exits also create a challenge for trustees considering the appropriate investment strategy to adopt. Mass exits usually arise in poor economic conditions, which are often also reflected in poor financial markets. This, in turn, may result in a reduction in members' accumulated savings at the point when they may need to access these benefits to survive a period of unemployment. This locks in market losses to the detriment of the members.

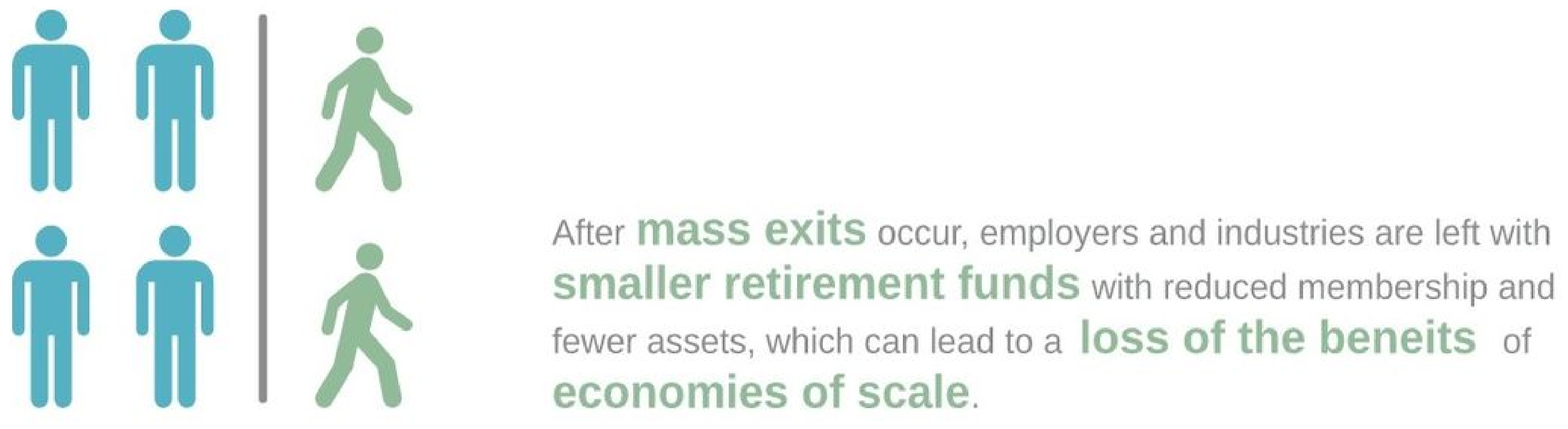
The difficult question for trustees in these circumstances is whether to change the fund's investment strategy to provide capital protection, at the expense of the fund's longer-term strategy. Although theoretically appealing, in reality, the trustees are unlikely to know which members will be affected by the downsizing and which will not. Any change in investment strategy will then also have an inherent risk to the members who remain in the fund, as they will either enjoy profits or sustain losses as a result of the temporary change in the investment strategy.

Implications

The impact on the individuals affected has been explored in some detail above. With planning, the consequences can be managed to some extent. There are also longer-term implications for the government because of increased dependence on state benefits. Mass exits also have an impact on those who survive the process and retain employment, although not as dramatic. After mass exits occur, employers and industries are left with smaller retirement funds with reduced membership and fewer assets, which can lead to a loss of the benefits of economies of scale. This then drives up per-member administration, investment and risk-benefit costs and, at the extreme, can potentially threaten the financial viability of the retirement arrangement.

Under these circumstances, it is critically important for the employer and trustees to conduct a full review of the benefit arrangements to decide which services and benefits are truly value-adding and necessary, to make sure the arrangement remains as cost-effective as possible. A conversion from a stand-alone retirement fund arrangement to an umbrella fund might relieve the loss of economies of scale. Offering members fewer choices may help keep costs to a minimum.

If compulsory preservation were to be implemented as part of the retirement fund reform process, the framework will be significantly tested where mass exits occur due to a decline in industry or even a downsizing of a particular employer. With limited access to accumulated savings to provide for urgent financial needs, the unemployment insurance support system would need to be bolstered. Otherwise, there is likely to be great unhappiness among affected members who are not able to meet their urgent financial needs while having savings preserved for their retirement.



References

1 Member WatchTM 2012 data set
2 Act No 24 of 1956, as amended

EMPLOYEE BENEFITS | ECONOMIC DOWNTURN | RETRENCHMENTS