Financial Sector
Conduct Authority

FSCA COMMUNICATION 27 OF 2024 (RF)

Two-Component System considerations for defined benefit funds

1. PURPOSE

The purpose of this communication is for the Financial Sector Conduct Authority (FSCA) to communicate to the retirement funds industry –

(a) the preferred approach which will be considered best practice when applying the two-component system to defined benefit members, or members with a defined benefit underpin, to ensure consistency between funds; and

(b) the need for approval of alternate methods of allocation of contributions.

2. BACKGROUND

2.1 On 4 June 2024, the Revenue Laws Amendment Act, 2024 (Act No.12 of 2024) came into effect, which amended the Income Tax Act, 1962 (Act no. 58 of 1962) to give effect to the so-called Two -Component system (also known as the Two Pot system.) The Income Tax Act now details the components in the case of funds with a defined benefit funding structure as follows -

(a) under the definition of "retirement component", the total value attributed to this component on or after 1 September 2024 is to be determined with reference to two thirds of the member's pensionable service as contemplated in the rules of that fund on or after 1 September 2024[1]; and

(b) under the definition of the "savings component", the total value attributed to this component on or after 1 September 2024 is to be determined with reference to one-third of the member's pensionable service as contemplated in the rules of that fund on or after 1 September 2024.[2] There is also allowance for a once off amount of 10% of the vested component calculated as at 31 August 2024, limited to R 30 000 and transferred to the savings withdrawal component on 1 September 2024[3].

2.2 The definition of "retirement component" further provides that where a fund with a defined benefit structure is unable to allocate contributions as contemplated in sub-paragraph (a) above, the fund may allocate contributions utilising a reasonable method of allocation, which method must be approved by the FSCA.

2.3 Similarly the definition of the "savings component" provides for a fund that is unable to allocate contributions in accordance with sub-paragraph (b) above, would require the FSCA's approval of the use of an alternative method of allocation.

[1] See paragraph (a)(ii) and (iii) of the definition of "retirement component" in the Income Tax Act, 1962.
[2] See paragraph (b) (ii) and (iii) of the definition of "savings component" in the Income Tax Act, 1962.
[3] See paragraph (a) of the definition of "savings component" in the Income Tax Act, 1962.

3. APPLICATION OF THE TWO-COMPONENT SYSTEM TO DEFINED BENEFIT MEMBERS

For a defined benefit member, therefore, the application of the two-component system requires consideration of the pensionable service (as contemplated in the rules of that fund on or after 1 September 2024) that falls within each component and requires the conversion of service to an amount that the service is worth.

4. PRINCIPLES

4.1 The calculation of the capital equivalent of the service being sacrificed should a member opt to receive a part of their savings component must make this financially neutral to both the fund and the member at the effective date of the savings component withdrawal request.

4.2 Once the member has decided on the amount to be paid, the valuator will be required to calculate the service given up by the member representing the value of the cash payment made and the reduced pensionable service that will be available at retirement in calculating the pension.

4.3 In order to perform this calculation, the fund needs to consider the actuarial reserve value that the fund would be holding at the effective date of the request, based on the assumptions as determined in the note[4] below. The greater of the actuarial reserve value and the minimum individual reserve in terms of Section 14B(2) of the Pension Funds Act, 1956 (Act No. 24 of 1956) at this same date should be applied in converting the lump sum to pensionable service.

4.4 The reduced service must be clearly communicated to the member.

5. DIFFERENT SCENARIOS

5.1 The treatment of pensionable service in the case of funds with split accrual rates follows the same principles. The actuarial reserve value, subject to a minimum of the prescribed minimum individual reserve value, must be the same immediately before the effective date of the savings withdrawal benefit to immediately after this. (This could entail removing fewer years at the higher accrual rate or more years at the lower accrual rate. The Rule Amendment should clearly specify the manner in which the service reduction will be applied.)

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[4] **Note:**

A.1 The assumptions to be applied are assumptions consistent with those used by the valuator in the accepted statutory valuation with an effective date coincident with or the closest preceding the effective date of the calculation, provided that :

A1.1 the assumptions may be revised at any point in time to be relevant to the circumstances when a calculation is made and the board must implement any revised assumption within a reasonable period of time following the acceptance of the statutory actuarial valuation report; and

A1.2 if the period between the effective date of the last statutory valuation and the calculation date exceeds three years, the assumptions must be revised to at least reflect those that the valuator would use should a statutory actuarial valuation be performed at the financial year end coincident with or closest preceding the calculation date.

A.2 In periods of high market volatility, rather than waiting for a statutory actuarial valuation report to be accepted, funds may consider adapting the assumptions to be in line with markets, provided the board follows the same methodology in setting the assumptions as was applied in the last accepted statutory actuarial valuation report but basing this methodology on the up to date bond yields at the calculation date.

5.2 For defined contribution funds where individuals have a defined benefit underpin at retirement, both the defined contribution savings component as well as the defined benefit service must be reduced should a savings withdrawal be made. The calculation of the reduction in service relates to the conversion of the lump sum payment to pensionable service as detailed under the principles section above, regardless of the comparison between the defined contribution benefit and the value of the defined benefit underpin at this date. The reduction in service for the underpin must be clearly communicated to the member.

5.3 Where a defined benefit fund includes an additional benefit related to a defined contribution payment for example when the rules treat additional voluntary contributions ("AVC's") as a defined contribution additional benefit, any savings component withdrawal should be proportionally deducted from the defined benefit value and the AVC value, with the defined benefit reductions being implemented as a change in pensionable service.

5.4 This methodology will effectively reduce both the main member's pension at retirement due to the reduced pensionable service and the contingent spouse's pension on death after retirement, since this is a percentage of the main member's pension.

6. APPLICATION FOR APPROVAL OF USE OF ALTERNATIVE METHODOLOGY

6.1 As explained in paragraph 2 above, any fund that is unable to allocate contributions accordingly may allocate contributions utilising a reasonable method of allocation, which method must be approved by the FSCA.

6.2 An application in terms of paragraph 6.1 must be submitted in writing to the FSCA via email for the attention of Giulia Tognon at giulia.tognon@fsca.co.za with a motivation as to why they are unable to allocate contributions as set out in this Communication.

7. ENQUIRIES

For further information regarding this Communication, please contact Giulia Tognon at giulia.tognon@fsca.co.za in the Actuarial Services department of the FSCA.

ASTRID LUDIN
DEPUTY COMMISSIONER

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