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South Africa's Two-Pot Retirement System

Striking the Balance Between Flexibility and Security

The Two-Pot Retirement System in South Africa, introduced last month, makes a significant reform on how retirement benefits are managed. This system is part of the ongoing pension government reforms aimed at balancing preserving retirement benefits and providing access to cash in times of financial emergencies. According to the Association of Savings and Investments South Africa (ASISA), a startling 94% of South Africans are not on track to retire comfortably. One of the main reasons behind this alarming statistic is that people cash out all their pension savings when changing jobs. The new legislation aims to counter this by preventing access to retirement funds during job transitions, thereby promoting long-term savings. However, it offers some flexibility by allowing limited access to a portion of savings during unexpected financial strains.

Key Features of the Two-Pot System

Contribution Split:

Contributions to retirement savings are now split into two pots, a Savings Pot and a Preservation Pot, designed to balance liquidity and long-term savings preservation. A third (1/3) of the savings goes into the Savings Pot with the remaining two-thirds (2/3) allocated to the Preservation Pot.

Annual Withdrawals from the Savings Pot:

The Savings Pot can be accessed during a person's working years. It is designed to provide liquidity for emergencies and other pressing financial needs without depleting the retirement savings. One can withdraw a minimum of R2 000 once per tax year. There is no maximum limit on the withdrawal amount. Withdrawals from your Savings Pot are taxed per the individual's marginal tax rate. The remaining funds in the Savings Pot will be taxed as a lump sum benefit using the retirement lump sum tax table upon retirement. The tax rate is generally lower than an individual's marginal tax rate.

No Access to Preservation Pot Before Retirement:

The savings in the Preservation pot will remain untouched until one reaches retirement age. This pot aims to ensure that a substantial portion of the savings is preserved for retirement income, which is the intended purpose of retirement savings.

Introduction of the Vested Pot:

All accumulated savings before the system start date, 1 September 2024, were transferred to a third pot known as the Vested Pot. For individuals with such accumulated savings, a one-off compulsory transfer of 10% (capped at a maximum of R30 000) of the savings in the Vested Pot was transferred to the Savings Pot. The rest of the retirement savings will stay in the Vested Pot and will be subject to the current withdrawal rules of the specific pension fund.

Benefits of the Two-Pot System: Securing Long-Term Retirement Benefits

In South Africa, where debt levels are high, many individuals choose to withdraw their entire retirement savings when they change jobs. According to the Sanlam Benchmark Survey, 37% of individuals in 2023 and 50% in 2024 opted to cash out all their savings when switching jobs. The individuals are therefore less likely to save sufficiently for their retirement exposing them to longevity risk – the risk of outliving their savings on retirement! The Preservation Pot safeguards the long-term retirement benefits from being eroded by pre-retirement withdrawals. Nevertheless, individuals have the flexibility to access part of their funds in emergencies, reducing financial stress or the need for some costly debt. By locking a significant portion of the savings away, there is a reduced likelihood of retirees facing hardship later in life.

The system offers a flexible yet structured approach to managing retirement funds, but there are potential risks if not used responsibly.

Risks to Fund Members

Although the system aims to prevent premature depletion of retirement funds, the ability to withdraw from the Savings Pot could result in underfunded retirements over the long term. Since the system's introduction, financial service providers have seen a surge in withdrawals. According to BusinessTech, Alexander Forbes reported withdrawals of R1 billion in the first week, while Momentum received requests totalling R2.5 billion within the first 25 days. Some financial advisors have reported some fund members to be making these withdrawals for their daily expenses rather than as a last resort.

Although the total withdrawals under the new system are projected to be lower than the amount typically lost through early access under the previous system, the economic environment and individual financial behaviour could change this trend. Some fund members may decide to stop saving for their daily expenses and solely rely on the Savings Pot putting undue pressure on it. Regardless of whether these withdrawals are justifiable, they diminish the compound growth aspect inherently possessed by retirement savings leading to poor retirement outcomes.

Fund members also need to understand the tax implications of the new system. Any withdrawals from the Savings Pot will be taxed at the individual's marginal tax rate. The amount will be added to the individual annual tax income and can push someone to a higher tax bracket. South African Revenue Service (SARS) will deduct any outstanding tax debt on the amount withdrawn, potentially adding to the financial burden of those already in distress.

Risks to Fund Managers

The liquidity needs of pension funds are likely to change under the Two-Pot System. The Savings Pot will need to be invested in more conservative liquid assets to allow for withdrawals, while the Preservation Pot can be invested in riskier long-term assets aimed at maximising returns. Fund managers will need to balance these different objectives, restructuring their portfolios to meet liquidity needs without exposing members to unnecessary investment risks.

Education and guidance from financial advisors and pension funds will be essential to mitigate the new risks faced by the fund members. Fund managers should provide the fund members with a clear education on responsible saving and the long-term consequences of premature withdrawals.

Moreover, pension funds should advise members on how to structure withdrawals in a tax-efficient manner.

For Example

Advisors can help members understand that spreading withdrawals over multiple years, rather than withdrawing large sums at once, can minimize the tax impact.

If actions of the member lead to poor retirement outcomes, the fund managers are likely to be blamed for having not guided their member or gave misleading information.

The changes in systems to accommodate the new design of the retirement savings are likely to increase administration costs in the short term.

Risks to the Government

The government will work with all stakeholders to ensure the the new system is able to achieve its objective of preserving retirement savings. If too many individuals run out of retirement savings prematurely, there could be an increased dependency on government social security programs. This could strain public resources and increase the financial burden on the government to support aging populations who outlive their savings.

The government must also closely monitor the short-term economic impacts of the Two-Pot System. A rapid influx of cash into the economy from increased withdrawals could drive up household spending, leading to inflationary pressures. This, in turn, may weaken the Rand, negatively affecting individuals who withdraw funds to cover immediate financial needs. The potential weakening of the currency could erode the purchasing power of those withdrawals, compounding financial difficulties for individuals relying on the Savings Pot.

A Path Forward:
Ensuring Responsible Use of the Two-Pot System

The Two-Pot System offers crucial support for those in financial hardship while enforcing mandatory savings preservation. However, its success depends on individuals using this flexibility wisely, ideally seeking professional advice before making withdrawals. Promoting financial literacy, encouraging disciplined saving, and focusing on long-term goals are key to ensuring the system strengthens South Africa's financial resilience and secures retirement security for all.