

Your Life

Learning **Planning** Living



Pension Scheme and Provident Fund

HOW PENSIONABLE SALARY AFFECTS RETIREMENT SAVINGS

The Primary Aim of a Retirement Fund

The primary aim of a retirement fund is to accumulate savings to provide for an income in retirement. For most people, their expenses in retirement are lower because, for example, they have paid off their bond, they no longer incur expenses such as saving for retirement, travelling to work, their taxes are lower, etc.

The ratio of income in retirement to income immediately prior to retirement is known as the **Replacement Ratio**. As a rough rule of thumb, retirees should require an income of around three-quarters of their income prior to retirement, i.e. a Replacement Ratio of 75%.

The ISASA Pension Scheme and Provident Fund target a replacement of approximately 75% of **Pensionable Salary**. This means that if a member contributes to the fund over the whole of their working lifetime, then this goal should be achieved. However, many factors affect this goal's achievement, such as length of service, investment returns and, salary increases.

Every year members receive a Member Benefit Statement, which includes projections of their Replacement Ratio at retirement based on Pensionable Salary.

Pensionable Salary vs Total Earnings

An aspect often overlooked in the Replacement Ratio is the composition of a member's earnings and how much of them is included in Pensionable Salary. If the non-pensionable component of a member's earnings is high, then the actual Replacement Ratio expressed as a percentage of total earnings will be much lower than the ratio expressed as a percentage of Pensionable Salary.

Teacher/Member Remuneration Packages

Teacher packages in ISASA schools typically comprise a number of elements that are not included as part of Pensionable Salary. These could include:

- 13th cheques/bonuses
- Allowances for taking on greater responsibility, e.g. department head, housemaster, additional duty allowances
- Allowances to compensate for expenses incurred in fulfilling one's responsibilities, e.g. cell phone and travel allowances
- Subsidised housing
- Reduced school fees

The total of all the components is often referred to as the employee's **Total Cost to Company** (TCTC). The non-pensionable elements of a teacher's TCTC can make up a significant portion of a teacher's TCTC. As a result their retirement income as a percentage of their total earnings is much lower than the projected Replacement Ratio stipulated in their Member Benefit Statement.

Example

June is a teacher earning a cash salary of R 30 000 per month. She is also a Department Head for which she receives a non-pensionable allowance of R 5 000 per month. In December each year, she receives a 13th cheque. June's annual earnings are made up as follows:

Cash salary	R 360 000
Dept. Head allowance	R 60 000
13 th cheque	<u>R 35 000</u>
Annual earnings	R 455 000

June's Pensionable Salary would typically be only the cash salary component of her earnings. Her Pensionable Salary as a percentage of her total earnings would then be $360\,000 \div 455\,000 = 79\%$.

Note that this does not take into account any other benefits that June might enjoy. If it did, the percentage would be lower.

What does this mean?

Let's assume that June was on track to achieve a Replacement Ratio of 75% of Pensionable Salary when she retired. She may well have expected a net income in retirement of 75% of what she had before she retired. However, her actual Replacement Ratio based on her total earnings is only:

$$79\% \times 75\% = 59\%$$

So whilst June thought she was on track for a comfortable retirement, the reality is that she will have a more significant drop in earnings than she anticipated. If June had other non-pensionable components to her earnings, her actual Replacement Ratio would be even lower.

Apart from the impact on retirement income, the death and disability benefits whilst still in active employment are also usually based on Pensionable Salary or Risk Salary and are therefore lower than if some of the other earnings components were included.

What can be done to improve the retirement outcomes for members?

A few suggestions to improve the outcomes for members are as follows:

1. Definition of Pensionable Salary

Individual schools have the flexibility to decide on the definition of Pensionable Salary for their employees. Considering this, they can extend the definition of Pensionable Salary to include additional components of earnings. The two key components to consider include (if they are not already included) are:

- Allowances for additional responsibilities, and
- 13th cheques

Concerning the allowances for additional responsibility, it isn't easy to justify why the remuneration related to the additional responsibility is non-pensionable. One could have a situation where two teachers with exactly the same career paths and have identical, earnings, except that Teacher A is promoted to Department Head for the last 15 years of her career. In contrast, Teacher B remains a teacher without the added responsibility. If Pensionable Salary is defined as only the cash salary, the two teachers will accumulate the same amount of retirement savings even though Teacher A had added responsibilities for 15 years.

2. Communication and Employee Contribution Rates

Suppose an employer maintains the narrow definition of Pensionable Salary of being only the cash component, the impacts of this will need to be communicated to staff early. This is especially important when a teacher is promoted to a post where the additional earnings are in the form of a non-pensionable allowance. Under these circumstances, employers should recommend that teachers increase their retirement fund contribution rates (subject to the overall tax-deductible maximum of 27.5%) to allow for the fact that a much larger portion of their earnings will be non-pensionable.

Similarly, employers could encourage and facilitate employees making voluntary contributions with respect to their 13th cheques and any other non-pensionable earnings they receive.

3. Retirement Age

Although not directly related to Pensionable Salary, retirement outcomes for members can be improved significantly by increasing the retirement age for members.

Call to Action

If you would like to improve the retirement outcomes for your employees, please contact the ISASA Consulting Team, who are more than willing to talk you through the various options.

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