

To: THE BOARD OF TRUSTEES

From: THE BENEFITS AND ADMINISTRATION COMMITTEE

Date: 26 JUNE 2014

Re: REVISION OF THE APPROACH TO IMPLEMENTATION OF THE CLEAN BREAK PRINCIPLE

1. PURPOSE

The purpose of this memorandum is to recommend that the Board of Trustees (“the Board”) of the Government Employees Pension Fund (GEPF or “the Fund”) approves the implementation of the clean break principle using a “service adjustment” approach rather than the current “debt” approach.

2. BACKGROUND

- 2.1 The clean break principle allows for the non-member spouse to claim a portion of the member’s interest in the Fund, in terms of a valid divorce order, at or around the date of divorce and not at the date of exit as was the previous GEPF practice. This principle was introduced for private pension funds through the amendment of Section 37D of the Pension Funds Act and the Second Schedule to the Income Tax Act (Act 58 of 1952) with effect from 13 September 2007. Although the GEPF does not fall under the Pension Funds Act, it is required to comply with the Income Tax Act.
- 2.2 The Fund’s previous actuarial consultants have submitted various documents laying out various options of how the GEPF could change the previous practice. These documents were discussed at length at previous BA-C meetings and workshops. The key area of debate was around the adjustment of the member’s benefit after payment of the divorce settlement to the non-member spouse. More specifically, it was around whether to adjust the member’s service or to create a “debt” owing by the member to the Fund which would be deducted against the member’s exit benefit. This debt would also increase with interest in order to cater for the opportunity cost of not having the divorce settlement invested in the Fund.

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- 2.3 At its meeting in November 2009, the BA-C requested a look at the feasibility of a member being given a choice as to whether he/she would like to have his/her benefit adjusted on exit by creating a debt account at date of divorce or by having his/her pensionable service reduced as a result of the divorce settlement. Due to the complexity of allowing this choice from a systems perspective and the difficulty of explaining the implications of this choice to members, it was decided at the Clean Break Workshop held by the BA-C on 19 February 2010 that the debt approach would be adopted rather than giving a choice. The Board of Trustees approved the adoption of the clean break principle using the debt approach at its meeting on 14 April 2010. Following the enactment of the laws to allow for the clean break principle into the GEPF, the GEPF Rules were amended to allow more specifically for the debt approach with effect from 1 April 2012.
- 2.4 The main reasons that the debt approach was viewed as preferable at the time to the service adjustment approach were centered around simplicity from a systems perspective. The service adjustment approach was viewed as more complex especially since:
- The member had a choice on resignation as to whether to take cash or to transfer the benefit to another approved retirement fund. The cash resignation benefit was in some cases much lower than the transfer benefit. This was probably set intentionally to encourage preservation of retirement provision. The Divorce Act prescribes the cash resignation benefit as the basis for determining the divorce settlement at the date of divorce. The problem was that the Fund had no way of knowing at the date of divorce what option the member would take on resignation. Basing the divorce settlement on the cash resignation benefit via an adjustment to the member's service and then the member chooses to transfer upon actual resignation might have not been cost neutral.
 - Certain categories of members are entitled to benefit enhancements which are dependent on service. Adjusting service could have created distortions in relation to enhancements.
 - Further complications could have resulted in cases where members chose to purchase service.
 - The GEPF benefit structure is such that the format of the benefit received by a member on exit (that is, gratuity or gratuity and annuity) is also dependent on service.

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- 2.5 Based on the above complications and others not mentioned, the Board decided that the debt approach would be much simpler to adopt. However, following implementation the Fund has received numerous queries and concerns from members. These relate to the concept of debt, which is not acceptable to members. The interest accruing on the debt worsens the situation from the members' perception. Members struggle to understand why they would owe money to the Fund. Also, they are concerned that the interest on the debt could be such that the accumulated debt is higher than the gratuity lump sum paid on retirement or even the entire retirement proceeds.
- 2.6 It is mainly the volume of queries and complaints by members and structures representing members that has led the BA-C to request another look at the feasibility of an alternative approach for implementing the clean break principle. In some cases, members have explicitly requested that the Fund adjusts service rather than creating a debt. The service adjustment approach is also now simpler to implement since the resignation benefit has been amended so that receiving cash and transferring would yield the same benefit (that is, actuarial interest) in most cases.
- 2.7 The Fund's actuaries have investigated and tested the service adjustment approach for the GEPF. In essence, the approach is such that "foregone" or "divorce" service (that is, the service equivalent of the divorce settlement) is stored in the system and deducted upon the member's exit. This is done so that the actual service remains unchanged until exit so as to attract any enhancements that the member may be entitled to. The attached letter to the Acting Principal Executive Officer titled *"Service-adjustment approach for divorce: scenario testing and administration implications"* sets out various scenarios under which the service approach was tested and touches on possible ways to transition from the debt approach for those divorce cases which have already been implemented under the debt approach. A letter is also attached in response to some of National Treasury's concerns around the debt approach – in an informal meeting National Treasury representatives expressed a preference for the service adjustment approach.
- 2.8 Should the Trustees agree to transition to the service adjustment approach, the following areas would need to be considered:
- Can the current administration system handle the proposed service adjustment methodology?
 - What changes would need to be made to the GEP Law and the GEPF Rules in order to accommodate the service approach?
 - Last but by no means least, how will the communication to members be handled?

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- 2.9 Attached is a note from the GPAA Legal Department setting out legal implications of the service adjustment approach. In particular, that changes are likely to be required to the GEP Law in order to accommodate the service adjustment approach.
- 2.10 Communication to members is extremely important and needs to be clear and understandable. It may be worthwhile having a separate discussion on the communication strategy. The proposed communication may be sent to the BA-C or the Board for approval, if required.

5. RECOMMENDATION

- 5.1 It is recommended that the Board of Trustees approves:
- Moving from the debt approach to the service adjustment approach for all future and unprocessed divorce orders.
 - Moving members who are currently on the divorce debt approach to the service adjustment approach.
 - That a separate discussion is held between the Fund and GPAA around the communication strategy for approval by the Board.
 - The effective date of the change to the service adjustment approach be set as the first of the month following the latest of enactment of the GEP Law amendments, gazetting of the rule amendments and the consultation process with employee organisations admitted to the Public Service Co-ordinating Bargaining Council (PSCBC).

MAJOR GENERAL AL DE WIT
CHAIRPERSON: BENEFITS AND ADMINISTRATION COMMITTEE
DATE: _____

Approved / Not approved / Comments

DR R MOKATE
CHAIRPERSON: BOARD OF TRUSTEES
DATE _____