

February 2010

## Bond Reduction or Preservation?

*“As a rule, one should preserve withdrawal benefits and resist the temptation to use retirement savings to fund consumption every time one changes jobs”*

**Table 1: The amount by which the estimated after-tax return on the preserved benefit exceeds the interest paid on the bond (with no reinvestments)**

Return on lump sum	Bond Interest Rates		
	8%	13%	18%
CPI + 3%	R 187 250	R 120 827	R 47 903
CPI + 5%	R 354 882	R 288 459	R 215 534
CPI + 7%	R 567 478	R 501 056	R 428 131

**Table 2: The effect of withdrawals on the required contribution rate**

Contribution Rates Required to Obtain a Pension of 75% of Salary			
Real Rate of Return	3%	5%	7%
No Withdrawal	20.60%	13.30%	8.30%
First 5 years withdrawn	26.30%	18.20%	12.30%
First 10 years withdrawn	34.30%	25.50%	18.50%
First 15 years withdrawn	46.30%	36.90%	28.80%

A member who resigns after 10 years (of 30 years of contributory membership) and withdraws all benefits in cash, will have to increase his contributions from 13.3% to 25.5% for the next 20 years to retire on a 75% pension.

A common question asked by members who terminate employment is whether they should preserve their withdrawal benefit or use it to reduce their bond. We explore this question in more detail.

### Debt and Retirement

Members are well-advised to enter retirement with no debt. With that in mind, we consider the state of the average South African member with a comparatively high mortgage and consumer debt burden and the resultant need among many members to reduce their mortgage debt as soon as possible.

As a rule, one should preserve withdrawal benefits and resist the temptation to use retirement savings to fund consumption every time one changes jobs. However, many members see the partial settlement of their mortgage bond as a sensible and appropriate use of withdrawal benefits.

### The Analysis

In our investigation, we compare the probable returns of a R100 000 withdrawal benefit, preserved and transferred to another fund, versus taking the amount in cash, and using the after-tax amount of R82 000 (using current tax tables and assuming that the member has already utilised the tax-free component) to pay off part of their bond. We want to consider the difference in value between the amount of interest saved by settling R82 000 of the mortgage, and the amount accumulated by preserving the lump sum in a retirement or preservation fund.

At an interest rate of 13%, the interest reduction from early settlement of part of the bond is R233 460. At a rate of 12.25% (typical long-term returns for an aggressive equity portfolio), the net returns on the preserved benefit will be R734 516 (assuming a provident fund withdrawal of the full lump sum at the prevailing retirement fund tax rates). The difference is R501 056. The result remains negative even if one considers a wide range of interest and investment growth rate scenarios as indicated in the adjacent table. For example, if the bond interest rate is 13% and the investment return is CPI + 5%, then the expected after-tax retirement benefit will be

R288 459 more than the total interest payable on the bond. Using an example where no reinvestment is made, is arguably a worst-case scenario. Unfortunately, it is one consistent with our experience of countless members who utilise their withdrawal benefit for direct consumption on things like education, home improvements and other living costs. In these examples, it would be much better for a member to preserve retirement savings than to reduce his or her bond.

### Extending the Analysis

The obvious extension to this investigation is to consider the case where the monthly interest saving is reinvested by the member. Based on the first example, we assume that the monthly bond reduction resulting from the lump sum payment is invested in a collective investment with similar returns to those of the member's retirement investment. In this case, the benefit of early settlement increases to R797 000 – a net benefit to the member of R63 000. We have assumed Capital Gains Tax for a member with a marginal tax rate of 25%.

Such calculations are dependent on economic factors such as bond interest rates and investment returns which cannot realistically be predicted over a 20-year period. The benefit or detriment to a member also depends on the number of outstanding years on the mortgage when the lump sum payment is made. Of course, future tax and legislative changes could affect this result materially. However, any case must always be considered in light of lost historical contributions. In Table 2, we outline the important effect on future required contributions when various periods of historical contributions are withdrawn before retirement.

### Conclusion

From this investigation, it is clear that no single solution exists and that expert advice that takes a member's specific needs into account should be sought.

**Gawie du Toit**  
Managing Director