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Insights

WHAT EVERY GHANAIAN EMPLOYEE SHOULD KNOW ABOUT THE NEW 3-TIER PENSION

The Pensions Act of 2008 has introduced two new pension tiers, to operate in conjunction with the SSNIT pension scheme. These two new tiers provide significant benefit for the Ghanaian worker. However, they introduce some additional risks.

Tier 2 and tier 3 schemes may be utilized at ANY time as the down-payment for a mortgage on your primary home without you paying any taxes, making them the best way to save for home ownership

To fully enjoy these benefits and minimize the associated risks, we believe that every Ghanaian worker should know and understand the nature of the new Tier 2 and Tier 3 schemes. Importantly, the Ghanaian worker should know that:

- Tier 2 and 3 schemes offer the opportunity for higher investment returns because they represent investments in assets such as stocks, real estate and bonds
- The payout under both tier 2 and tier 3 is the sum of your contributions plus the investment gains associated with them, minus any regulatory and service fees and charges. As such, the benefit depends on how well your service providers manage your investments.
- Because contributions to tier 3 schemes are made before income tax is assessed, employees can get additional tax savings by increasing their contribution to tier 3.
- Tier 2 and tier 3 benefits are available as a lump sum and can be used for any purpose when accessed. In general, tier 2 benefits cannot be accessed before retirement. To keep the tax savings on tier 3 contributions, the funds need to remain in the scheme for at least 10 years for formal sector contributions, or 5 years for informal sector contributions; however, tier 2 and tier 3 schemes may be utilized at ANY time as the down-payment for a mortgage on your primary home without you paying any taxes, making them the best way to save for home ownership
- Competition among service providers to manage your tier 2 and tier 3 schemes will lead to better investment returns and service levels
- The use of banks as custodians of the scheme assets provide additional safety for the scheme investments and cash

Overview of the 3-Tier Pension

The Pension Act of 2008 has introduced two new pension tiers, namely tier 2 and tier 3, to supplement the SSNIT pension scheme. Tier 2 is a mandatory defined contribution scheme[1] to which every employee contributes 5% of their gross salary. Tier 3 is also a defined contribution scheme; however, it is voluntary, and it is up to the employee and/or the employer to determine how much of the employee's salary will be contributed to this tier. Importantly, tier 2 and tier 3 schemes are managed by private sector trustees, licensed by the National Pensions Regulatory Authority (NPRA). These two tiers are not managed by SSNIT.

Tier 2 and Tier 3 Advantages
— Opportunity for Higher Returns

Unlike the SSNIT tier 1 scheme[2], in which the retirement benefit grows with the rate of growth of your salary, your retirement benefits under tier 2 and tier 3 pension schemes grow with the value of the investments the scheme trustee makes. On average, investments in stocks, bonds and property grow much quicker than salaries do, leading to a higher benefit to employees under tier 2 and tier 3, than would have been available with a similar investment in the old one tier pension scheme.

— Benefits are a function of contributions and investment returns

Unlike the SSNIT tier 1 pension benefit, which represents a fixed percentage of your salary, tier 2 and tier 3 benefits are entirely dependent on how much you contribute and what the investment gains or losses on those contributions are. These investment gains are a function of how well your funds are managed, which in turn is dependent on the investment ability of your tier 2 and tier 3 trustee.

— Tax Savings

The law allows contributions into tier 2 and tier 3 to be made without the government taking any income taxes on the amount of the contribution. For formal sector workers, the tax benefit from tier 2 contributions is not new, as this benefit existed under the old 1-tier system. However, the tax benefit for tier 3 schemes is completely new. For most employees, this tax savings on tier 3 contributions can be as large as the income from two years of investing without the tax saving available under tier 3.

Importantly, these tax benefits extend to workers in the informal sector as well, who can contribute up to a maximum of 35% of their gross salaries into tier 3 schemes without paying taxes. As an informal sector worker you can now participate in the formal investing sector without worrying about how the government will tax your hard-earned income.

— Lump Sum and Accessibility

The benefit from tier 2 and tier 3 schemes are available to employees as a lump sum once certain eligibility criteria are satisfied. In tier 2, the employee may access all of their benefit on reaching the retirement age of 60. In tier 3, formal sector employees may access their benefit after 10 years to avoid paying taxes, while informal sector employees may access their benefit after 5 years. In all cases, the benefit may be withdrawn early without having to pay taxes, for the purpose of securing a mortgage for the purchase of a primary home.

— Competition and Choice

Tier 2 and tier 3 pension schemes are run by privately managed companies, working in a competitive environment, and governed by industry standards and regulations. This gives every employee a say in the choice of who their service provider is, and the power to ensure that selected service providers, particularly the trustees, perform or get replaced. This healthy competition among trustees and other service providers puts employees in a position to enjoy better investment returns, and to expect superior service levels.

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— Private Custody

Under the new law, tier 2 and tier 3 schemes are managed by trustees, but the cash and the investments of the scheme are not held by the trustees. Instead, they are held by custodians, which are banks specially licensed for the purpose of taking custody of scheme cash and investments. This structure ensures that the trustee has limited ability to misuse the funds, if they so intended.

Furthermore, having the scheme cash and investments in the custody of the custodian ensures that they are removed from the control of both the government and the employer. With this structure, you can have the confidence that your benefit from tier 2 and tier 3 will be there when you need it.

— Monitoring Investment Performance

By law, employees are given quarterly statements on the performance of their investments in tier 2 and tier 3 schemes, and this helps them monitor their contributions. In an event where an employer does not contribute to the pension scheme, the trustee is mandated to find out why a contribution was not made and accordingly send a statement to that employee. Also, where an employee's contribution is decreased or increased, reports are sent to both the employer and employee – this further buttresses the point that communication is key as the employee is kept abreast with all changes that occur in either his monthly contribution or returns.

Conclusion

The 3-tier pension structure makes it possible for every Ghanaian to enjoy a comfortable retirement provided the pension funds invested in the tiers 2 and 3 schemes are managed properly. As such, every Ghanaian worker should have a keen interest in which trustee manages their pensions and whether the trustee offers them the best returns possible. Ghanaians should actively monitor their pension management so they can enjoy the full benefits of the 3-Tier structure

[1]The SSNIT tier 1 defined benefit scheme promises to pay you 50% or more of the average of your best 3 years' salary if you have contributed to the scheme for at least 15 years.

[2]In a defined contribution scheme the employee contributes a fixed amount which is invested in financial assets. The employee's benefit on retirement is not a predetermined amount but depends solely on how well the investments of the scheme have performed.

PETRA TRUST
the pensions expert

Street Address: F304/5 | Dade Close | North Labone
Mailing Address: P. O. Box CT 3194 | Cantonments

Phone: +233 (302) 740 963/4
+233 (302) 763 908
E-mail: info@petratrust.com
Website: www.petratrust.com