[Retirement - Why we need to radically change our thinking](#)

Financial solutions for retirement - The underappreciated annuity

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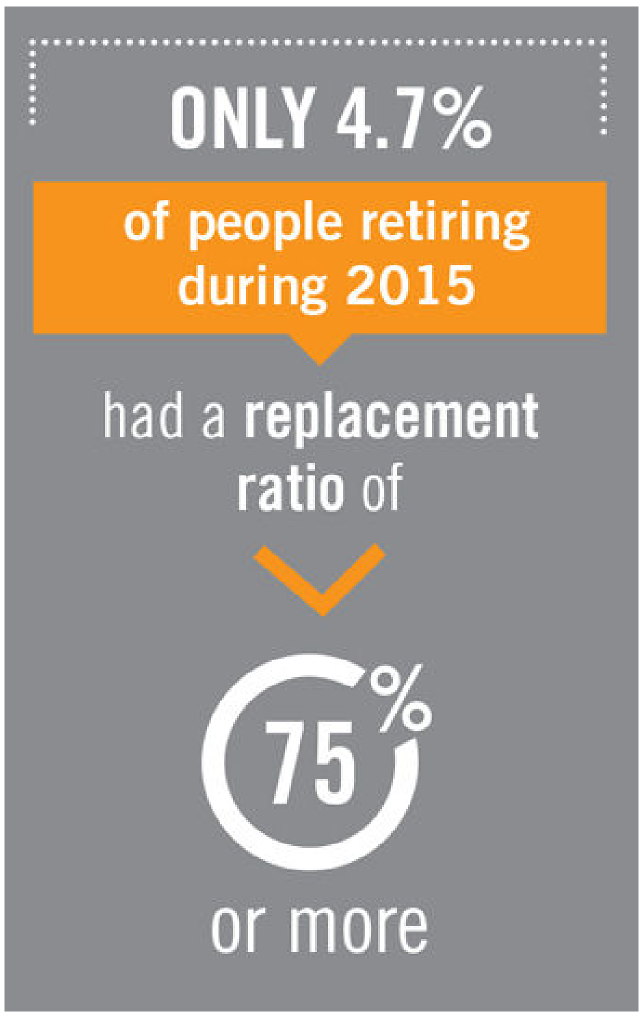
PRIORITISING RETIREMENT SAVINGS

We started our discussion in this edition of Benefits Barometer with the February 2016 pause – that moment when National Treasury announced that they were postponing the Taxation Laws Amendment Act of 2015. We then discussed how we could perhaps move beyond that impasse by allowing individuals to use these long-term savings to address more priorities than income protections. We are in no way suggesting that individuals should abandon retirement savings altogether. Even the Singapore model stressed that no matter how individuals prioritised their goals for long-term savings, the first port of call was to solve for that minimum income that would ensure that they didn't become dependent. So how do we get people to see the value in these products?

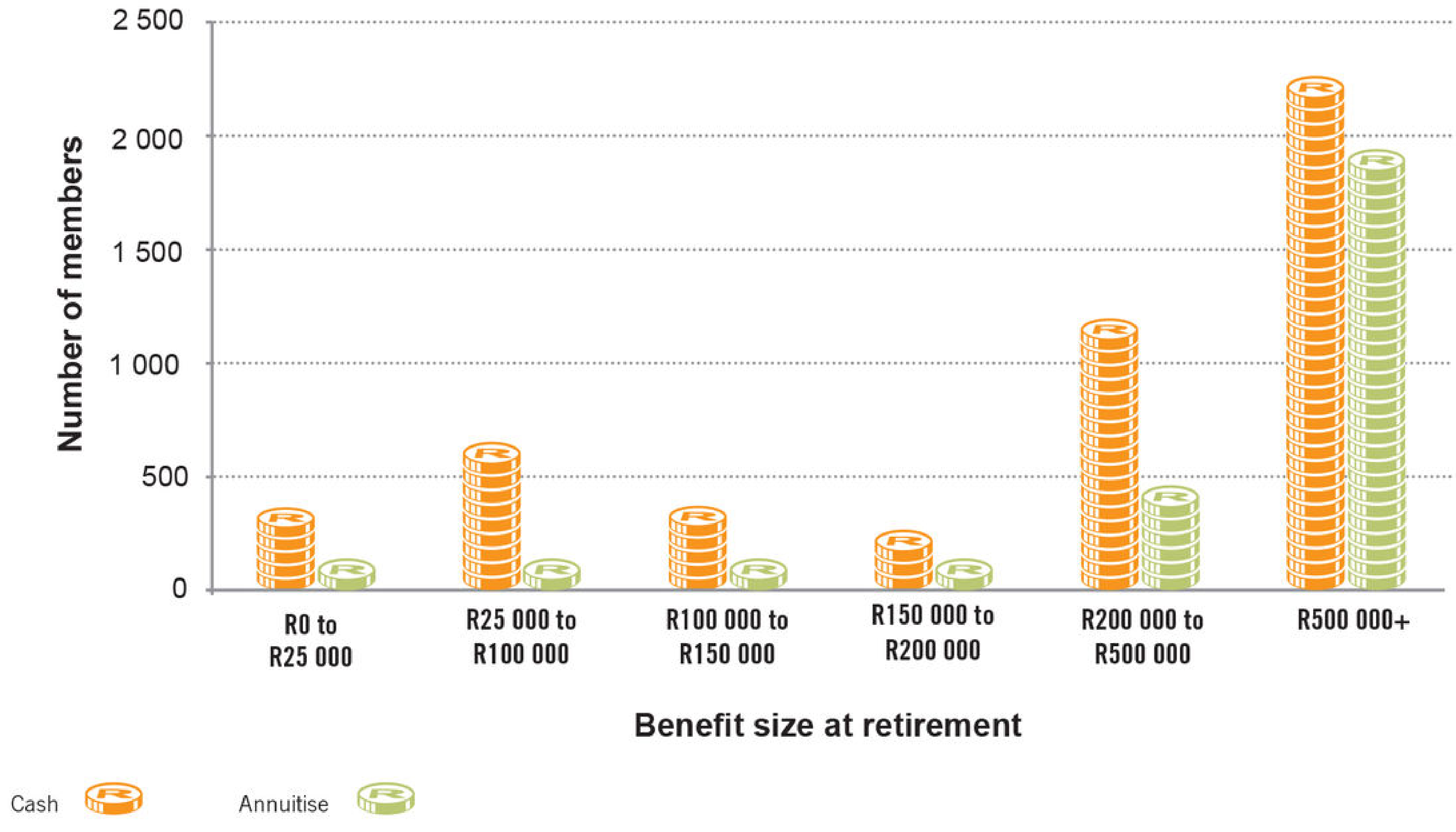
Where we are with annuities

Everyone can agree that South Africans do not have the best retirement outcomes. At the end of 2015 we found that individuals were retiring from our funds with an average replacement ratio of 31.8%. Only 4.7% of the people retiring during 2015 had a replacement ratio of 75% or more[1]. Moreover, the 2015 Sanlam Benchmark Survey found that around 30% of the retirees surveyed had spent their retirement lump sum within two years[2]



At the moment, the only disincentive that provident fund members have against taking their full benefit in cash is tax. The way that benefits are taxed on retirement should indicate to an individual what proportion of their benefits they should be annuitising (use to buy a pension). However, evidence from our Member Watch™ database shows that people are more likely to take cash at retirement

Number of retirees choosing to take cash rather than annuitise by benefit size



Source: Alexander Forbes Member Watch™ database, 2015

Poor retirement outcomes led the National Treasury to table draft default regulations on 22 July 2015, setting out the requirement for all funds to provide an annuity strategy that was appropriate for their membership. Once the law is enacted, we know that funds will have to comply and offer annuities. But unless we address the aversion issue that individuals face, the exercise is unlikely to get the desired results.

WHY DON'T PEOPLE ANNUITISE?

Making the decision to buy an annuity at retirement involves handing over funds which have taken years to build up to someone else: an insurer. Buying a guaranteed annuity carries the risk for the member that they die soon and so lose these funds to that insurer. They may actually view the purchase of an annuity as taking a gamble on their own life expectancy. The more risk-averse member may actually view buying an annuity as taking a certain, known amount of cash and swapping that for an uncertain and infl exible stream of much smaller payments[3]

In a joint study between Alexander Forbes and Just Retirement, we found that almost two-thirds of retirees are likely to decide for themselves what to do with their pension money, without advice[4]. But there are a multitude of reasons why someone may choose not to annuitise and to take cash instead:

- They don't know what an annuity is.
- They don't understand the value of buying an annuity.
- They don't trust advisers or understand financial jargon.
- They have a low level of financial literacy and aren't confident in making financial decisions.
- They simply aren't interested in the retirement income problem.

What's in a word?
Compulsory annuitisation is scary on two fronts:

1. **COMPULSORY** effectively means that people lose their freedom to decide – something that South Africans have started to enjoy only recently, given our 20 years of democracy.
2. **ANNUITISATION** can be an even more daunting word than 'compulsory'. Investopedia defi nes an annuity as a "contractual fi nancial product sold by fi nancial institutions that is designed to accept and grow funds from an individual and then, upon annuitisation, pay out a stream of payments to the individual [at that] point in time"[5]. Ask the average person for a defi nition and they would struggle to get even the basic concept right

So what does this mean? Well, we believe that to demonstrate the value of annuitisation to an employee, you need to get them to understand the principles of annuities, starting with what they actually are.

UNDERSTANDING THE VARIOUS TYPES OF ANNUITIES AND THE BENEFITS THEY OFFER

There are five main types of annuities with variations of each available from insurers:

1. **Level annuities:** The pension income does not increase.
2. **Fixed-increasing annuities**: The pension income increases by a specified percentage each year.
3. **Inflation-linked annuities**: Annual pension income increases are linked to inflation, for example 75% of inflation.
4. **With-profit annuity**: Pension income increases are based on the performance of an underlying pool of assets.

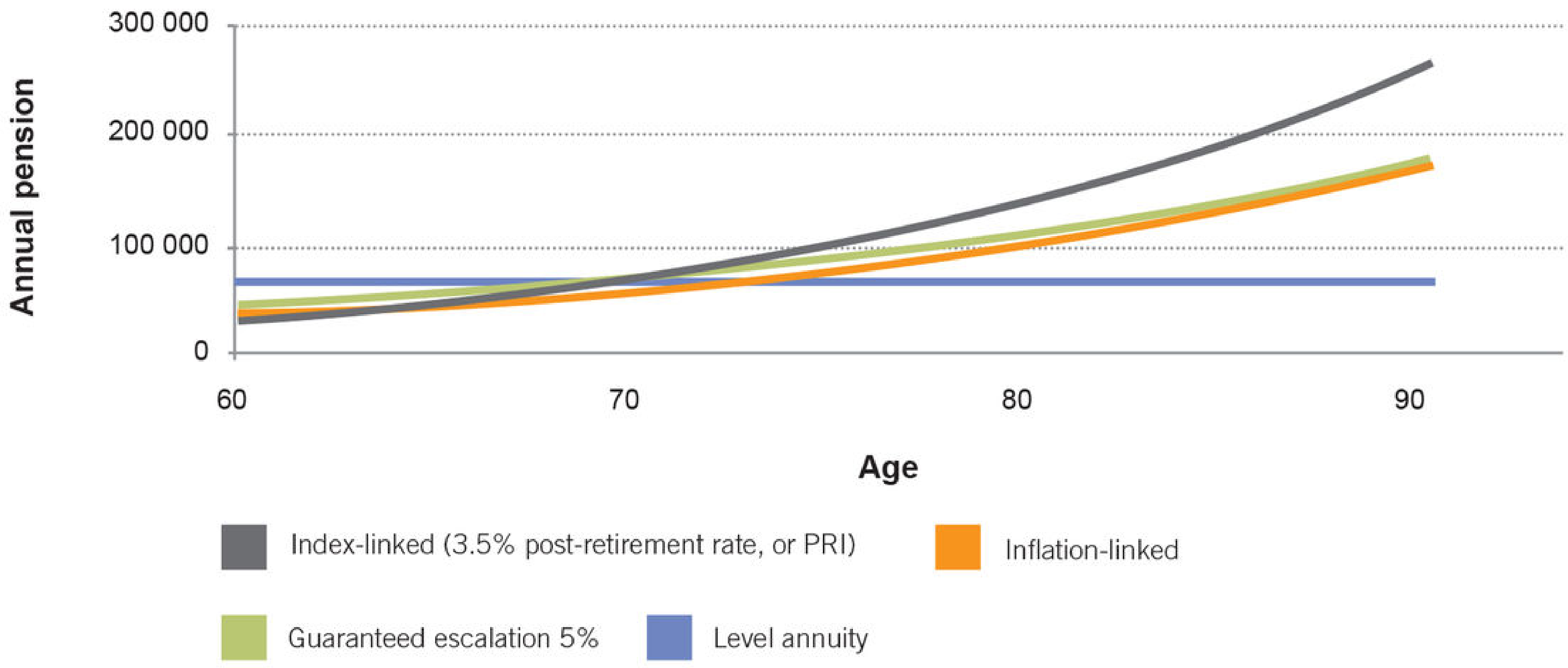
5 **Living annuity**: An individual invests their capital value at retirement and draws on that and its investment income at a rate that's allowed by the South African Revenue Service (SARS).

Besides the living annuity, most annuity types are guaranteed in that the insurer promises to pay an income stream for as long as you live. Of course there's the risk that the insurer goes out of business, but capital adequacy requirements make this highly unlikely.

Individuals may never understand all the complexities around annuities, but the information they are shown when making their product choice often leads to most retirees selecting level annuities or living annuities because they provide the highest starting income.

The following figure demonstrates how the income under the first four types of annuity can change over time. Notice that although a level annuity provides the highest initial income, it takes roughly eight years for the other annuity types to outstrip this level of income. Importantly, the other annuity types provide income that's intended to maintain an individual's living standards over time and so the increase that they provide end up being very important

Annual pension at age 60 (male) for R500 000 investment



Source: Finweek, 2016

The graph also highlights an interesting issue for with-profit annuities. Over time these annuities may provide the highest level of income, but they are arguably the most complicated because of how bonuses (or interest payments) are added over time. **Retirees need to understand both the benefits and the risks of the products they are taking up.**

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> **One of the other reasons people are inclined to opt for living annuities at retirement is to ensure that they leave something behind for their families.**

One of the most commonly missold types of annuities is the living annuity. People don't recognise how having a high drawdown rate can eat into their capital and put them at risk of running out of money long before they pass away. As a way to mitigate this risk, some providers set a minimum capital amount an individual needs to have to take up the product. One of the other means of mitigating this risk is to automatically switch people out of the living annuity and into a guaranteed annuity (or one that provides an income for the rest of their life) when the individual's fund account falls to a certain level. In fact, one of the recommendations in the draft regulations is to give the employer or trustees the right to automatically switch retirees out of living annuities when their fund values fall to a low level.

The draft regulations also set out a series of age-related drawdown rates for living annuities, for example members younger than 60 may not draw more than 7% per year, members between the age of 60 and 65 may not draw more than 8% per year, and so on[6].

One of the other reasons people are inclined to opt for living annuities at retirement is to ensure that they leave something behind for their families. But what does a guaranteed annuity bring to the table that a living annuity does not?

Understanding the value of annuitising

Employer-sponsored pensions are not uncommon. A total of 44% of the funds administered by Alexander Forbes, whether standalone or part of the umbrella fund, are pension funds[7]. Many of these funds outsource their pension liabilities to an insurer and have them pay benefits to members, thereby extinguishing any liability the fund and employer may have otherwise had. In keeping with the theme of our earlier chapter on the economic value of benefits, let's unpack the value of employer-sponsored pensions:

1. **A hedge against longevity risk**
   Retirees often don't understand the risks they're taking on, how to quantify them and how to hedge against these risks. Interest rate and demographic risks (particularly longevity risk) are the most important risks that individuals face in making their annuity decisions. From our joint study with Just Retirement, we found that three out of four working people surveyed rate their health as above average, and most think about their own life expectancy quite a bit when deciding how to use their pension amount. Overall, they anticipate they will live until approximately 85 years[8]. Annuities, whether provided by the employer or indirectly by an insurer, provide payments for as long as the person stays alive, hedging any uncertainty around life expectancy.
2. **A point for reputation**
   Employers have an interest in making sure that their workers are adequately protected during their working years and after they retire, since this will help them attract and retain the highest quality candidates. In fact, research has found that workers with a pension tend to remain in a job for a longer period[9]. As such, employers ensure that funds deliver the best outcome to members.
3. **Lower costs**
   Besides the benefits of lower investment fees on pooled assets in the pre-retirement fund accumulation phase, when buying annuities in bulk, the employer may receive discounts from the insurer that individuals might not be able to access in their personal capacity.
4. **Annuity rates are guaranteed**
   One of the major benefits of occupational pensions is that the annuity rate given at retirement may be guaranteed in advance. For example, the individual's employment contract may stipulate that they will receive a pension of R4 500 per month for every R1 million in retirement fund assets. This gives them the ability to plan better for retirement, and it also shifts the interest rate risk to the employer. If bond yields fall sharply over the period to retirement, resulting in an increase in the cost of annuities, the member is protected against a lower retirement income.

CONCLUDING THOUGHTS

Half the battle for acceptance involves getting people to understand the value of an idea. In this case, those values can apply to the individual, the employer and the country. Annuities make sense. It's just not always that easy to get to the heart of that sense.

While we've argued that employees should be given some freedom as to how to allocate their savings over their financial journey, we've still maintained that there should be a minimum income available for retirement. To that end, being able to purchase the right annuity is an important decision.

Perhaps the lesson in relation to annuities is that the best ideas can be easily ignored if our communication with our members isn't effective. In fact, getting our members' attention and keeping it is the ultimate challenge if any of these recommendations are going to provide the results that are needed. Our next chapter tries to tackle this issue. Most specifically, it addresses the question of how we are going to provide what is effectively financial planning advice to a population that most likely will never use a financial planner or even have access to one.

References

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ANNUITISATION | ANNUITIES | COMPULSORY ANNUITISATION | LEVEL ANNUITIES | FIXED-INCREASING ANNUITIES | INFLATION-LINKED ANNUITIES | WITH-PROFIT ANNUITIES | LIVING ANNUITIES | GAURANTEED ANNUITIES | LONGEVITY RISK