ANALYSIS OF PREVIOUS RETIREES' DECISIONS

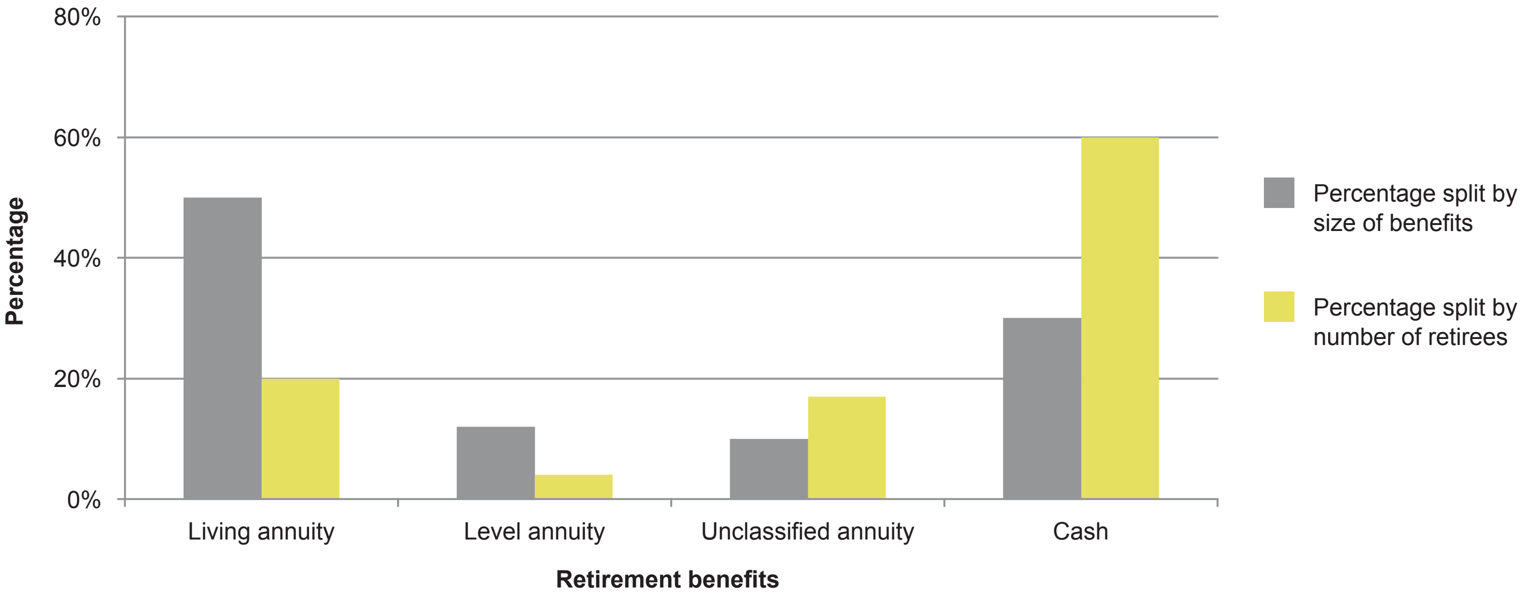
We have already discussed in **Part 2, Chapter 1** how to do a broad analysis of needs and wants within the fund. In addition, trustees can also analyse recent decisions by retirees as well as the profile of upcoming retirees. This analysis should help trustees to make sure they have the appropriate menu of options available and an advice framework, if needed.

Let's look at an example of such an analysis. The analysis is based on a large fund in the retail and wholesale industry.

The graph below shows the annuitisation decisions of recent retirees by size of their benefit and the proportion of retirees selecting each annuitisation option.

In our example here, the evidence suggests that members with significant fund credits are purchasing living annuities. By contrast, members with low fund credits (or potentially low incomes) are simply withdrawing cash. This gives trustees some sense of what type of default annuity will be the most attractive to members. It also allows trustees to check if decisions appear to be prudent. If many retirees appear to be making particular kinds of poor decisions, then they can incorporate this into the advice framework.

PERCENTAGE OF RETIREMENT BENEFITS



Source: Alexander Forbes Research & Product Development

ANALYSIS OF UPCOMING RETIREES

We can also carry out an analysis of upcoming retirees. This involves looking at those employees who are within seven years of their normal retirement age.

A look at the projected fund credits of upcoming retirees can help to shed some light on the likely decisions that they will make when they reach retirement. The graph below serves as an example of how projected fund credits may look.

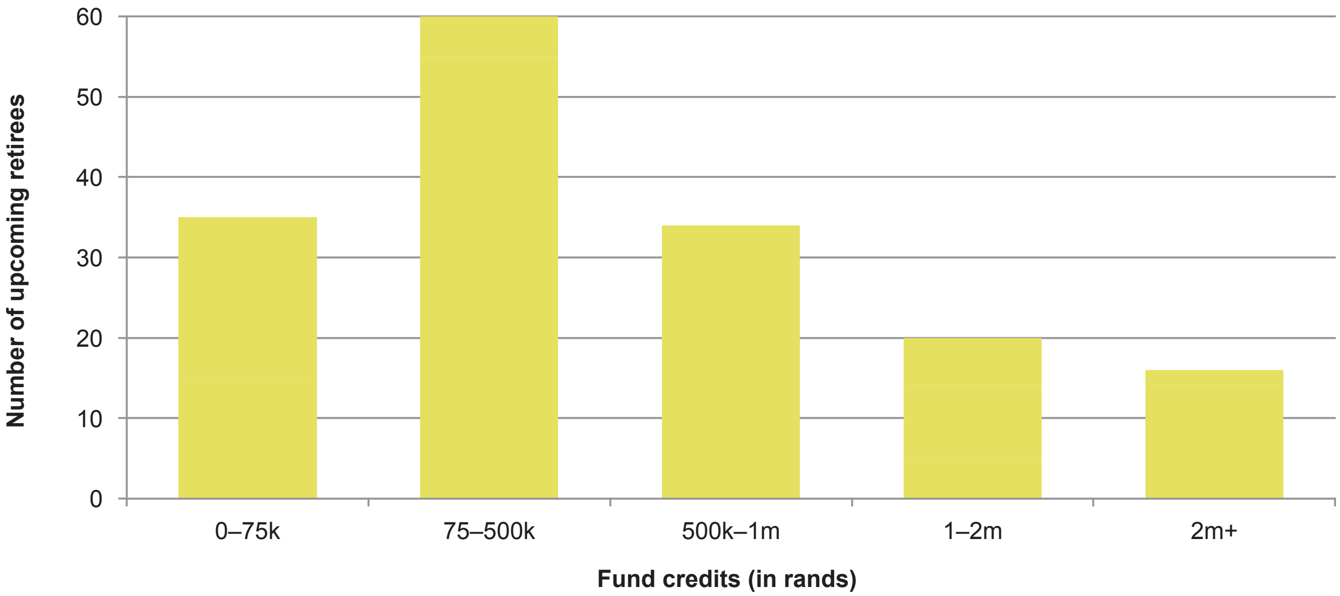
Given the spread of projected fund credits for upcoming retirees, we can note the following:

- Retirees usually take benefits of less than R75 000 in cash, as the cost of an annuity exceeds the advantages.
- Benefits up to R1 million usually imply a low replacement ratio and the retiree cannot afford to take a significant amount of risk. A guaranteed annuity is usually most appropriate.
- Members with benefits over R1 million can often afford to invest in living annuities, but it is recommended that a portion be invested in a guaranteed annuity to reduce the risk of longevity.

A final, but perhaps more crude, assessment is to look at the spread of salaries of upcoming members. In some instances, annual salaries have been used as a proxy for the financial literacy levels of members. Although this may be a less precise approximation, it could supply a basic guideline.

Living annuities for example require a significant level of financial understanding (and financial advice) to set an appropriate investment strategy and drawdown rate, and to understand that the pension is not guaranteed for life. A higher level

PROJECTED FUND CREDITS OF UPCOMING RETIREES



of financial sophistication is required to understand the risks and lack of predictability of the pension and appreciate the benefits of a living annuity.

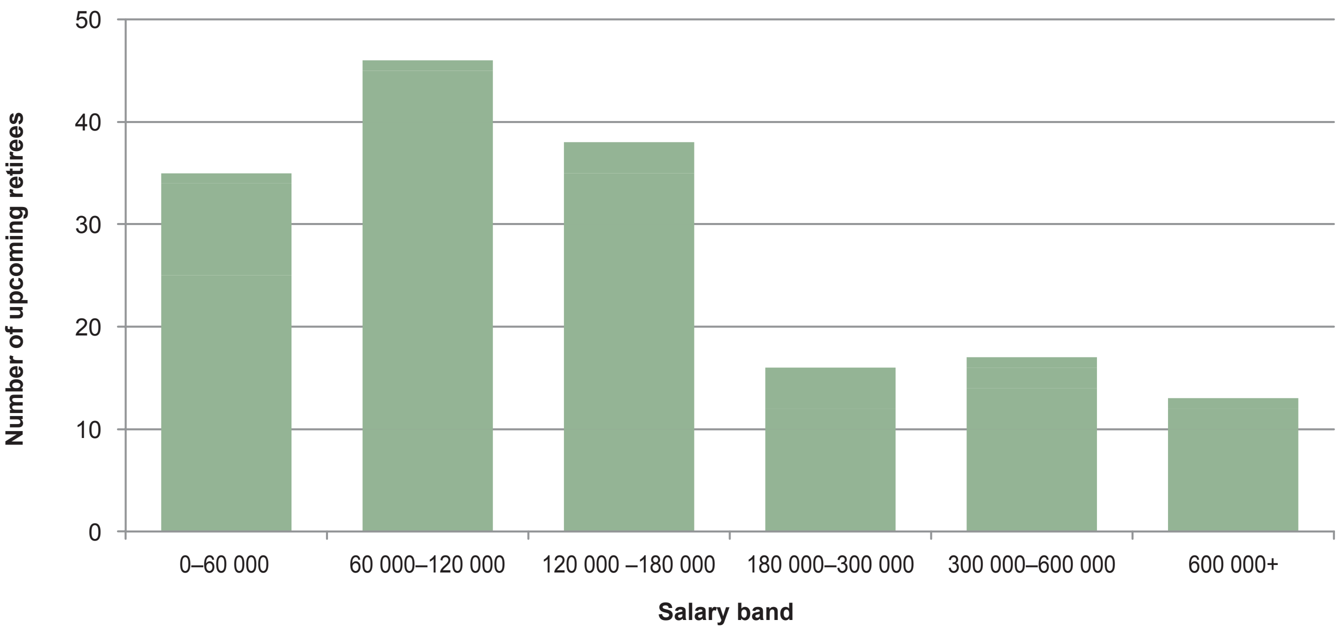
Inflation-linked annuities are easy to understand as they provide pension increases equal to inflation for the rest of the retiree's life. These annuities are therefore predictable (in real terms) and offer the ultimate form of financial security. With-profit annuities fall somewhere between living annuities and inflation-linked annuities. Pension increases are linked to an underlying investment return but are guaranteed never to be negative (in other words, the pension will never reduce) and are guaranteed for life.

For our example fund, the graph below shows that we have a skewed salary picture. This can complicate things, and may indicate that a single default annuity option may not be suitable for all members. The implied variability in financial literacy is self-evident.

These type of analyses will help trustees and their advisers to identify what kinds of annuities to offer, whether there are enough retirees and whether trustees and employers have a big enough governance budget appetite to make an in-fund solution feasible and what level of advice they'll need. They may also provide sufficient information for a smart default to be structured where members' defaults are contingent on this kind of information.

By limiting the questions to which annuities are likely to be best for the population, trustees can design tailored communication and education with this in mind. And as time goes on, the trustees can monitor the take-up and establish whether their approach is working.

ANNUAL SALARIES OF UPCOMING RETIREES



Source: Alexander Forbes Research & Product Development