Living annuity pensioners in danger of running out of money

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Illustration: Colin Daniel

The vast majority of pensioners who depend on investment-linked living annuities (illas) are drawing down incomes that could leave them unable to maintain their lifestyles if they live for a long time.

A financial services industry survey released this week shows that almost 70 percent of illa pensioners are, in the initial years of their retirement, drawing down more than five percent of their retirement savings – a drawdown rate of five percent will enable an illa to be sustainable, numerous researchers have found.

The figures were revealed in the first annual Association for Savings & Investment SA (Asisa) illa survey.

The Asisa research shows that 21 percent of illa pensioners may run out of money within 7.5 years, because they are drawing down pensions equivalent to 15 percent or more of their retirement savings.

Most pensioners who are drawing down higher-than-acceptable pensions have smaller rand amounts saved for retirement. And, by number of pension contracts sold, 12 percent of illa pensioners are drawing the maximum allowed pensions of 17.5 percent (on illas sold from 2007) and 20 percent (on illas sold before 2007).

The research also shows that the 6 693 illa pensioners who are drawing a monthly income at rates of 17.5 percent to 20 percent are receiving an average of only R1 640, which is a mere R440 more than the state old-age grant to the indigent who are 60 years and older. This indicates that these pensioners are suffering the consequences of having:

* Made bad investments;

* Drawn down an income at rates that were too high in the early years of their retirement; and/or

* Saved too little for retirement.

Although Asisa says the situation is, on average, better than it expected, other research released this week by retirement fund ser-vices provider Alexander Forbes shows a worsening trend, with illa pensioners drawing down more and more each year (see graph, link at the end of the article).

Alexander Forbes has found that illa pensioners are reasonably active in their drawdown choices every year and have generally increased their percentage drawdown rates over the past few years.

John Anderson, Alexander Forbes's managing director: research and product development, says there is also a trend of more illa pensioners choosing the highest drawdown category.

In 2007, 22 percent of annuitants were on the maximum drawdown rate of 17.5 percent, but last year 35 percent of pensioners were on the maximum drawdown rate.

Anderson says it is of concern that the percentage of annuitants who are drawing down more than 15 percent has risen from 27 percent in 2007 to 43 percent in 2011.

"With muted returns expected in future, this leaves very little option for these pensioners other than adjusting their lifestyles downwards or running out of money," he says.

Last year, R23.9 billion flowed into living annuities provided by 21 Asisa companies, bringing the total amount invested to R155.2 billion by December 31, 2011. In total, there were 278 415 illa contracts.

Based on the number of policies held, the average pension drawdown rate last year was 9.31 percent, but when calculated by the rand value of each illa, the average drawdown rate was only 6.99 percent.

Consulting actuaries Geoff London & Associates, which collated the figures for the Asisa research, say this "significant discrepancy" implies that illa pensioners with smaller amounts of money are drawing down, as a percentage, larger amounts than are wealthier illa pensioners.

Peter Dempsey, Asisa deputy chief executive, says overall the figures show that, at an average drawdown rate of about seven percent, Asisa considers the risk of an illa pensioner's capital "being completely eroded is much lower than previously thought".

However, the industry would prefer to see an average drawdown rate that is closer to five percent.

An unknown percentage of drawdowns at higher rates are made by people who had a shorter life expectancy due to ill-health or advancing age, as well as withdrawals by beneficiaries who receive an illa after the death of the pensioner. Shorter life expectancy explains the high drawdown rates of people under the age of 55 and over the age of 70, Dempsey says.

"Asset managers and economists agree that investors can expect returns of between five and 10 percent in the foreseeable future, which will help to protect capital, provided drawdown rates remain in the same range and policyholders maintain an appropriate asset composition in their portfolios," he says.

Unfortunately, there are people who have not saved enough for retirement who turn to illas for the wrong reason, Dempsey says.

Pensioners who have chosen illas because they can draw down higher initial pensions than those offered by guaranteed annuities will face hardship if they have sufficient retirement capital to maintain a certain lifestyle only in the early years of their retirement, he says.

ILLAs PUT THE BALL IN YOUR COURT

The investment-linked living annuity (illa) structure, which was created 22 years ago, has left a large but unknown number of pensioners facing destitution, because they were not provided with proper advice by either the product providers or financial planners.

The illa (pension) products are bought at retirement using savings in a tax-incentivised retirement fund, including pension funds and retirement annuity funds.

An illa pensioner is required to:

* Withdraw an annual income of between 2.5 percent and 17.5 percent of his or her residual capital. The decision on the rate must be made annually on the anniversary of the product.

* Take responsibility for the underlying investments. The pensioner takes the risk that the investments will provide, after costs, an after-inflation return that will sustain the income flow until death. By industry agreement (not law), the underlying asset allocation should meet the prudential investment requirements of regulation 28 of the Pension Funds Act, which limits how much may be invested in a particular asset class and sub-asset class.

On death, the annuitant may bequeath the illa to his or her heirs, who can decide to withdraw the capital in cash or receive an income taxed in their hands. As a consequence, a bequeathed illa is not subject to estate duty.

STANDARDS AIM TO ENSURE YOUR PENSION LASTS

In an attempt to ensure the proper use of investment-linked living annuities (illas), the Association for Savings & Investment SA (Asisa) has provided a set of standards to govern the sale and maintenance of the products.

The action was taken following tales of financial hardship from illa pensioners, with complaints to various adjudicators and ombuds, and subsequent government intervention, as well as research that established it is very unwise, in most cases, to withdraw more than five percent of the annual value of the residual capital if an illa is to be sustainable.

Members of Asisa must ensure that all the illas they market, administer or underwrite comply with the “Standards on living annuities”, and they must ensure that independent intermediaries who sell their products also comply with the standards.

The four illa product standards are:

Standard 1. Appropriate drawdown

An illa allows you to set your income level subject to the official drawdown limits (between 2.5 and 17.5 percent).

Neither the percentage nor the rand income level you select is guaranteed for the rest of your life. The income level you select may be too high and may not be sustainable if:

* You live longer than you expected; or

* The return on the capital is lower than that required to provide a sustainable income for life.

As part of the standard, Asisa has published an indicative table (see “Years before your income will start to reduce”, link at the end of the article) to assist you to decide on an appropriate drawdown rate. The table assumes that, over time, you will adjust the percentage drawdown to maintain the same amount of real income (that is, allowing for inflation of six percent a year). Once the number of years in the table has been reached, your income will diminish rapidly in the subsequent years. When using the table to set a drawdown rate, you should take into account your financial situation and all your sources of income.

The table is a guideline only, to assist you in making informed decisions about your annuity.

The table may also be structured so that it shows the effects of inflation, with the column headings as real (after-inflation) returns, such as “CPI – 3.5%; CPI – 1%; CPI + 6.5%”.

In terms of the standard, you may:

* Transfer your illa from one product provider to another, in terms of either the Long Term Insurance Act or the Pension Funds Act; and

* Convert an illa (in part or in full), when it is governed by the Long Term Insurance Act, to a conventional guaranteed life annuity administered by the current life assurer or by another assurer. This is a once-off option that cannot be reversed.

Standard 2. Appropriate investments

An illa allows you to select a wide range of investments in respect of the capital that will generate the annuity. The risk to the investments that underlie your annuity should be assessed annually.

You should use prudential investment regulation 28 under the Pension Funds Act as a general guide to assess the overall asset composition of the investments that underlie your annuity. Among other things, regulation 28 sets a maximum exposure of 75 percent to equities and 25 percent to property.

Standard 3. Asset composition information

You must be told the actual asset composition of your illa at retirement and at least once a year thereafter, to allow you and your financial adviser to assess the risk in line with standard 2.

Standard 4. Industry-based analysis and monitoring

Asisa members that provide illas are required at the end of each year to provide illa status reports to Asisa.

PRESERVATION FUNDS MAY NOT SURVIVE

National Treasury is considering changing the drawdown rates for investment-linked living annuities (illas) from between 2.5 percent and 17.5 percent to between zero and 17.5 percent.

If the rate can be as low as zero, preservation funds are likely to be under threat, because you may be able to transfer directly to an illa the savings you have accumulated in an occupational retirement fund that you want to preserve for retirement. This would save you the future cost of transferring from a preservation fund to an illa, bypass the costs of a preservation fund and potentially provide you with a better pension.

And in a financial emergency, you may have greater access to your money on an ongoing basis (as a pension withdrawal) than you would with a preservation fund, which allows you to make one withdrawal.

TREASURY WARNS IT MAY REGULATE ALL RETIREMENT PRODUCTS

National Treasury has warned that it may have to consider regulating the costs of all retirement products if the financial services industry and government cannot resolve the problem of the excessively high cost of retirement and pension products.

This warning was issued by Olano Makhubela, National Treasury’s chief director of financial investments and savings, at a series of roadshows on retirement fund regulation organised by the Financial Services Board.

National Treasury would prefer not to have to regulate costs, and it is currently in discussion with the industry on how it can reduce the costs of its products to acceptable levels, Makhubela says.

Research by government and others has shown that retirement products offered by the financial services industry in South Africa are high by international standards.

Makhubela also repeated concerns about the potential for investment-linked living annuities (illas) to provide a sustainable income in retirement.

Makhubela says that illas have three risks, namely, that pensioners will draw down too much, live for a long time and make poor investment decisions – and any of these risks could “quite easily result in a depletion of retirement savings”.

Pension products are costly and often confusing, and this is why government is pressing for the introduction of default pension products that retirement fund trustees can offer to their members and that will be low cost and simple, requiring no financial advice, he says.

In a recent discussion document on saving, National Treasury said that costs are reducing potential illa pensions by 20 percent.

To make illas more competitive on costs, National Treasury plans to introduce its own low-cost illa linked to RSA Retail Bonds, which offer, among other things, inflation-linked returns.