TRUSTEE TUTOR

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Trustee Tutor 21: Annuities explained

The two-pot retirement system has brought the worlds of institutional benefits (retirement funds) and retail benefits (individual investments) closer together in a lot of ways. And, although all retirement fund trustees have had to understand annuities since the default regulations came into effect on 1 March 2018 (1 March 2019 for existing funds), a fund's annuity strategy is preferred, rather than compulsory for retiring members. And not all members had to purchase an annuity.

Two-pot's requirement of a compulsory retirement component now makes the understanding of annuities far more important for both trustees and fund members.

This issue of Trustee Tutor has been put together help you understand annuities better.

What is an annuity?

Around the world annuities are used as an effective financial planning tool in retirement. If you think about it, very few people will actually need, or responsibly use, a large lump sum of money at retirement. Most will need to invest the lump sum of money they've saved over their working lifetimes to provide them with a monthly income (like a salary) during their retirement.

That's where annuities come in.

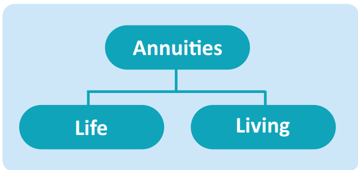
> An **annuity** is a financial term to describe a regular income stream that you get from an initial once-off payment, lump sum or investment.
> Source: JustSA

In other words, an annuity is a financial product that gives you the opportunity to convert your retirement lump sum into a monthly income. This is how retiring members convert their fund lump sums into the income they will earn during their retirement. Because of this, an annuity can also sometimes be called a pension.

Different types of annuities

Experience shows that many retiring fund members don't understand the different types of annuities that they can choose from when they retire.

Very simply, annuities can be classified as either life or living annuities:



A **life annuity** is an insurance product that guarantees to pay an income for the rest of the annuitant's life.

> An **annuitant** is a person who receives an income from an annuity.

The income that is paid during the annuitant's life will never reduce, regardless of what happens to the underlying investments or how long the annuitant lives. This monthly income may increase, depending on the type of life annuity chosen.

There are thus two guarantees with a life annuity:

1. The income will pay for the rest of the annuitant's life
2. The income will never reduce

Because of these guarantees, life annuities are also sometimes referred to as **guaranteed** annuities. These guarantees, however, come with a downside, in that the annuity stops as soon as the annuitant passes away (unless it is a joint-life annuity, discussed later).

A life annuity is becoming a more popular solution among South African retirees who may have saved just enough (or not enough) for their retirement.

A **living annuity** on the other hand, is an investment product. An annuitant's savings are invested in a range of investment portfolios of their choice, and their investment value fluctuates in line with the performance of the chosen investments. The annuitant can choose how much of an income they'd like to receive for as long as there is savings left in the investment. The minimum level they can choose to receive is 2,5% and the maximum is 17,5% of the investment value per year. This value can then be paid out monthly, quarterly, semi-annually or annually, depending on the frequency the annuitant chooses.

The "4% pension drawdown rule" refers to a common guideline in retirement planning where a retiree withdraws 4% of their total retirement savings in the first year, then adjusts that amount annually for inflation. The mathematical principle is that this withdrawal rate should allow their annuity to last for roughly 30 years (based on historical market data).

The 4% rule came about in the 1990's and remains a general guideline still in place today. However, it comes with a huge health warning that it is not appropriate to all retirees. Things like tax, market conditions, inflation, etc all need to be taken into account when choosing a drawdown rate each year.

Finally, one of the attractive advantages of a living annuity is that, should the annuitant pass away and there is still an investment value in the annuity, this value can be bequeathed to heirs.

Main differences between life and living annuities

	Life annuities	Living annuities
Level of income	Remains level, increasing with the increase policy selected on joining.	Flexible between the 2,5% and 17,5% drawdown limits.
***Investments**	No choice of the underlying investment strategy and portfolio.	Annuitant can choose the underlying investment strategy and portfolios.
Longevity risk (the risk of the annuitant outliving their income)	No longevity risk. A life annuity pays until the annuitant dies.	The annuitant may draw their annuity down to zero and thus, may have no income in their later retirement years.
Market volatility risk	No volatility risk for the annuitant.	The annuitant is subject to the market fluctuations of their chosen investment portfolios.
Death/inheritance benefits	No benefit payable to the late annuitant's beneficiaries (unless it is a joint-life annuity).	The balance of the investment value is paid to the late annuitant's stipulated beneficiaries.

***Interesting note on investments:**

Regulation 28 does not apply to the investments underlying annuities. But because these annuities are often bought with retirement fund savings, many advisors recommend that the Regulation 28 limits be considered when setting the investment strategy of an annuitant's living annuity.

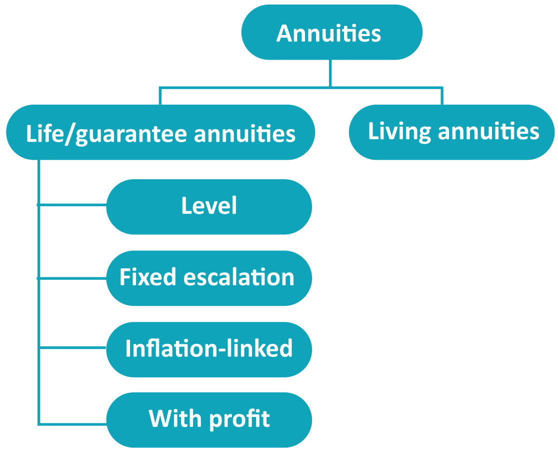
Sidebar: Living and life annuities should not be confused with retirement annuities.

Living and life annuities are financial products that pay an income after an individual has retired.

Retirement annuities, on the other hand, are investment vehicles that individuals can use to save for their retirement in a tax effective way, while they are still working, ie before retirement.

Different types of life annuities

We've looked at the broad differences between life and living annuities. As the market has evolved, different types of life annuities have come about.



Let's unpack these in a bit more detail ...

Level annuity: A level annuity provides the annuitant with a fixed level of income for the rest of their lives, in other words, it pays no future increases. Because no increases are priced into the annuity, this type of life annuity pays the highest income at the start of the annuity payments. The advantage of this is that the income is guaranteed until the annuitant passes away, in other words, they will never run out of money. The obvious disadvantage is that the annuitant's monthly income will not keep up with inflation, and they can't afford the same goods and services, or standard of living, as the years go by. Research that shows that after about the first 10 years, the benefit of the higher initial income is eroded by inflation.

Fixed escalation annuity: A fixed escalation annuity provides the annuitant with annual increases at a rate chosen by the person when they retire. The higher the annual increase chosen by the retiree, the lower the initial monthly income they receive. In other words, if the retiree chooses an annual escalation (or increase) of 5%, their annuity will be “cheaper” and thus their monthly income will start off higher compared to a retiree who chooses an escalation of 10% (whose annuity will then be more expensive, and the monthly income will start lower). A fixed escalation annuity will not protect an annuitant in times when the inflation rate is higher than their chosen escalation rate. Again, high inflation will result in the annuitant not being able to afford the standard of living they could previously enjoy.

Inflation-linked annuity: as the name suggests, the annual increases paid on the monthly pension are linked to the published inflation rates. This protects the annuitant from inflation and makes sure that they are able to continue to afford their lifestyle over their retirement years. Of all the annuities, the inflation-linked life annuity is the most expensive.

T**With profit annuity**: These annuities are linked to the investment markets. The increases paid to the annuitant depend on the performance of the underlying investments, and, importantly, can never be negative – the lowest the return can be is 0%. And once the new monthly pension amount is set with the increase rate, it can never reduce. If the investments perform poorly, however, the annuitant's monthly income may not keep pace with inflation. Typically, with profit life annuities have a starting pension around 20% higher than inflation linked life annuities.

As you can see, there is a balancing act between the starting income and the investment increases the pensioner receives into the future when choosing which life annuity is appropriate.

Inheritance benefits and estate planning

Both living annuities and life annuities offer ways to leave an inheritance for the annuitant's loved ones when they die, but they work differently:

Living annuity (can leave to any beneficiaries/heirs)

- The annuitant chooses beneficiaries who will inherit any money left in the account when they pass away.
- This money goes directly to these beneficiaries, without being subject to estate duty. (This makes living annuities an effective estate planning tool.)
- Beneficiaries can choose to receive the money as a lump sum (which will be taxed as a lump sum) or keep it in a living annuity to receive regular payments (which will then be taxed as part of their income).

Life annuity (can only be left to a spouse)

- Typically, life annuity payments stop when the annuitant dies, and there's no money left for beneficiaries.
- However, annuitants can set up a joint-life annuity that will carry on payments to their spouse until the spouse passes away. This is known as a joint-life annuity.
- Unlike living annuities, there is no lump sum benefit available with life annuities.

Tax on annuities

Members of retirement funds don't pay tax on the retirement fund benefit that they use to buy their annuity. In terms of our tax system, because the money is not taxed on its way into the annuity, it's taxed on the way out. In other words, the monthly income the annuitant receives is taxed the same as PAYE on income (according to SARS's income tax tables).

Furthermore, there is no capital gains tax on the investment growth in the living annuity. The ability to grow savings on a tax-free basis, is a major benefit that makes living annuities more attractive as a way to boost an annuitant's capital in their retirement years. (Capital gains tax is not applicable to life annuities given that they are insurance, not investment, products.)

There is also no estate duty payable on the proceeds of a living annuity on the annuitant's death, as the remaining capital does not form part of the deceased estate. (Estate duty is not applicable to life annuities as there is no balance payable to beneficiaries.)

Do retirees need to choose one or the other?

Most people who retire choose either a living annuity or a life annuity. But, retirees can have more than one living annuity, or a mix of both living and life annuities. They are even able to take extra income from a living annuity and put it into a retirement annuity, and then later use that retirement annuity to boost their living annuity income. There are some good reasons why members consider doing this:

Multiple living annuities

Investing in a number of living annuities can be an effective way to diversify investments in retirement, giving annuitants greater flexibility. They are able to set different withdrawal rates and invest in different underlying portfolios with each annuity. By splitting their annuities this way, annuitants can customise each to match their unique needs and preferences. Some retirees find this gives them more security and control, because they can adjust things depending on how each annuity performs.

Combining living and life annuities

Combining living and life annuities gives retirees the best of both worlds. A living annuity provides the flexibility and control over their investments and drawdowns (monthly income). And the life annuity provides a steady and guaranteed income for the rest of their lives. For some retirees, this mix is ideal as it combines the opportunity for their investments to grow as their needs change, with the security of a reliable base income, no matter how long they live.

Reinvesting excess living annuity income into a retirement annuity

Taking extra income from a living annuity and putting it into a retirement annuity is an effective strategy to save tax because the annuitant doesn't pay tax on that money right away. When the retirement annuity is eventually 'retired' back into a living annuity, it can provide additional tax-efficient retirement income. This investment strategy can help annuitants grow their retirement savings as well as create a sustainable and tax-optimised income stream during their retirement years.

Let's talk about annuities, retirement funds and the default regs

In terms of Regulation 39 of default regulations which became effective on 1 March 2019 (for existing funds), a retirement fund must have a default annuity strategy in place. This is a “soft default” – in other words, it's not an automatic decision of which annuity a retiring member has to invest his or her retirement lump sum in. Rather, a fund's annuity strategy is the trustees' recommended (or suggested) annuity approach for retiring members, who can then choose to “opt-in” should they wish to follow it, or “opt-out” and choose their own annuity/ies.

In terms of Regulation 39, the trustees' default annuity strategy:

- Must be appropriate and suitable for the fund members.
- Can be in-fund or out of fund.
- Can be either a living annuity or a life annuity (or a combination of both).
- Where the annuity is a living annuity, members must be regularly informed of the objectives, asset class composition and performance of the annuity.
- Members must be informed of all the fees and charges, and the impact of these, on their benefits.
- Must be reviewed annually.

From this discussion on annuities, you can see that the choice of an annuity (or multiple annuities) is a very unique decision for each retiring member. This makes it very difficult for trustees to set a default annuity strategy that will suit every member of their retirement fund.

Choosing an annuity strategy on retirement

The retirement income needs of each person is different, taking into account a myriad of factors that are specific to them. This makes their annuity choice at retirement a very personal decision – what is good for one retiree, won't be appropriate for another. Retirement benefit counselling (also a requirement of Regulation 39) is a good start for those members approaching retirement but is often very general in its approach. To make sure that each member receives appropriate advice taking their unique needs into account, it is recommended that they consult with an accredited financial advisor.

Their advisor will help them navigate and understand:

- The advantages and disadvantages of each annuity option available.
- Quotes received from different annuity providers, and help them choose which provider is reputable and sustainable.
- The best combination of annuities that will provide sufficient security and flexibility.
- The total administration (and other) costs of their annuity options.
- The underlying investment options and investment fees of any living annuities they may be considering.
- The optimal drawdown rate from their living annuity.
- The tax and estate planning implications of their annuity options.
- The changing environment both at retirement and then in their retirement years.

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How to?

Answer all the questions by inserting the correct answer(s) into the block provided next to each question, scan the pages and email to Toni Cantin at ICTS, using cpd@icts.co.za

1. Around the world annuities are used as an effective tool to:

a. Save tax efficiently for retirement. ☐
b. Provide an income in retirement. ☐
c. Provide death and disability benefits in retirement. ☐
d. Provide for medical expenses not covered by medical insurance. ☐

2. An annuity can sometimes be called a:

a. Pension ☐
b. Lump sum benefit ☐
c. Tax free savings account ☐
d. Retirement annuity ☐

3. There are two types of annuities: life and living annuities

a. True ☐
b. False ☐

4. Choose the <u>incorrect</u> answer. A life annuity:

a. Is an insurance product ☐
b. Provides an income until the annuitant dies ☐
c. Provides the annuitant with the opportunity to leave any balance left in their annuity to their heirs when they die ☐
d. Will never reduce the monthly payments to the annuitant ☐

5. A living annuity:

a. Is an investment product ☐
b. Gives the annuitant the choice of the underlying investment portfolios ☐
c. Gives the annuitant the choice of income level they wish to receive between certain limits ☐
d. All of the above ☐

6. Choose the correct statement:

a. A level annuity will pay a level monthly payment until the annuitant passes away. ☐
b. A level annuity provides a level monthly payment in times when markets are down. ☐
c. A level annuity may reduce payments when markets are down. ☐
d. A level annuity will pay at a level the annuitant chooses each year. ☐

7. Choose the <u>incorrect</u> statement: A with profit annuity:

a. Is linked to investment markets. ☐
b. Will never reduce payments to the annuitant, but may have a 0% increase when markets are down. ☐
c. Has the risk that the monthly pension may not keep up with inflation. ☐
d. Is the most expensive type of life annuity. ☐

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8. Living annuities can be left to heirs per the following:

a. The annuitant chooses beneficiaries who will inherit any money left in the account when they pass away. ☐
b. This money goes directly to the beneficiaries, without being subject to estate duty. (This makes living annuities an effective estate planning tool.) ☐
c. Beneficiaries can choose to receive the money as a lump sum (which will be taxed as a lump sum) or keep it in a living annuity to receive regular payments (which will then be taxed as part of their income). ☐
d. All of the above ☐

9. When it comes to tax on annuities:

a. The capital gain plus the returns earned are taxed as part of income. ☐
b. Estate duty is payable on living annuity proceeds received by beneficiaries. ☐
c. There is no tax or estate duty payable on annuities. ☐
d. There is no tax paid on annuities. ☐

10. In terms of Regulation 39, the trustees of a retirement fund must set out a default annuity strategy. This strategy is the default to be followed by retiring members, but they can choose to opt out.

a. True ☐
b. False ☐