EN AVANT

‘IN-FUND’ ANNUITIES – THE NEW(ISH) KID ON THE BLOCK.

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Navigating one’s way through the options available at retirement can be daunting. More often than not retirees make ill-informed choices - usually stemming from poor advice - that can prove costly over time.

The purpose of this article is to provide insight into the new (ish) addition of mainstream retirement funding vehicles, the ‘In-Fund’ annuity, but also to stress the importance of acquiring credible, independent advice from a qualified source. Perhaps I should rephrase, the ‘In-Fund’ annuity is not exactly new, it just hasn’t been available to every member of a retirement fund. However, on the 1st of March 2019 pension, pension preservation and retirement annuity funds had to implement an annuity strategy, whether it be in the form of an ‘In-Fund’ or “Out-of-Fund” annuity.

In the past, the choice offered to retirees leaving pension or provident funds was mostly to purchase a life or living annuity from an external insurer or a combination of both. Very few retirement funds offered a default ‘In-Fund’ annuity option.

The ‘Out-of-Fund’ living annuity is widely regarded as the optimal choice of retiring South Africans, especially the affluent, as it allows the member to retain control of assets housed within the structure. These living annuities are also not governed by Regulation 28 of the Pension Funds Act which means investors can invest their capital as aggressively as they desire. For these reasons these structures suit more informed investors and those who can get by withdrawing at low rates. However, history has shown that most people are uninformed and have failed to adequately save for retirement which means many need to withdraw at higher rates. This brings us to the biggest threat facing living annuitants: the possibility of withdrawing all capital before death.

To mitigate these risks treasury has stipulated that all retirement funds offer their retirees a default annuity option at retirement. An ‘In-Fund’ annuity is an annuity payable by the fund in terms of the rules of the fund. This would allow members to stay within their retirement fund and benefit from:

- economies of scale;
- avoidance of market timing (i.e. exit and re-entry process when transferring benefit to an ‘out-fund’ option);
- lack of confusing underlying portfolio options;
- lower or no advisory costs.

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A French ballet term describing a dance step requiring dancers to move **forward** and **onwards.**

In essence, an ‘In-Fund’ solution would benefit those investors who are fee sensitive, less informed, less prepared and those not willing to take on the risk of making their own underlying investment choices.

QUOTED FROM TREASURY:

“Currently workers benefit from a strong support structure provided by the retirement system while they are employed, which is effectively withdrawn for the vast majority of these workers after they retire. At retirement the workers are then left to the retail market, where they must bear the risks of retirement on their own, including the risks of poor financial advice, poor decisions, and high charges.”

“In order to increase the competitiveness of the market for retirement income products, to provide a greater degree of assistance to members of retirement funds who retire, and to require funds to use their considerable purchasing power and skill to provide their members with cost-effective annuitisation options.”

The message from Treasury is clear - that ‘monopoly’ status enjoyed by retail ‘Out-of-Fund’ service providers is coming to an end.

The differences between an ‘In-Fund and ‘Out-of-Fund’ living annuity are:

In-Fund Living Annuity	Out-of-Fund Living Annuity (via insurer)
Subject to Pension Funds Act.	Subject to Long Term Insurance Act.
Governance overseen by the Board of Trustees.	Individual insurance contract.
37C of Pension Funds Act applies at death.	Beneficiary nomination prevails at death.
Regulation 28 asset allocation restrictions apply.	Regulation 28 asset allocation restrictions do not apply (yet).
Regulation 39 applies – Trustees to monitor sustainability.	No explicit sustainability monitoring by Trustees.
Can be converted to Out-of-Fund living annuity (if fund rules allow).	Cannot be converted to In-Fund living annuity.
ASISA standards are good practice (EAC & disclosure).	ASISA standards are mandatory (EAC & disclosure).
FAIS Categorization debatable.	FAIS Retail Pension Benefits applies.
FICA requirement less burdensome upon implementation.	FICA applies upon implementation.
Section 37A & 37B – significant protection from creditors.	Less certain protection from creditors.

Source: Actuarial Society of South Africa

“To invest with success, you must be a long-term investor.”
- Johan Clifton Bogle

CHOICE! TOO MUCH OF IT CAN BE TROUBLE

If opting for the ‘Out-of-Fund’ living annuity one would certainly need the guidance of a reputed advisor as the investment choices within the structure are near limitless. For some this is attractive, for within the plethora of portfolios there are some incredible fund managers and truly excellent funds with proven track records. It must be stressed that there also many poor choices to be made, and without solid advice and guidance one is near certain to get lost in the vast sea of choice. A savvy investor partnered with an experienced advisor can navigate this sea and master it, the responsibility is therefore on the shoulders of the investor and advisor to ensure needs are met and targets achieved. If this sounds like too much stress then the possibility of an ‘In-Fund’ solution may be a viable alternative.

By selecting an ‘In-Fund’ annuity option one is guided by the Trustees of the fund, they will offer just four risk profiled portfolios, a combination of which should cover the risk profiles of most investors, except the exceptionally aggressive one; remember that ‘In-Fund’ annuities are governed by Regulation 28 of the Pension Fund Act which restricts exposures to high risk asset classes. These portfolios are referred to as default portfolios and exist to take the stress of choice from the hands of the retiree.

INCOME, HOW MUCH IS TOO MUCH?

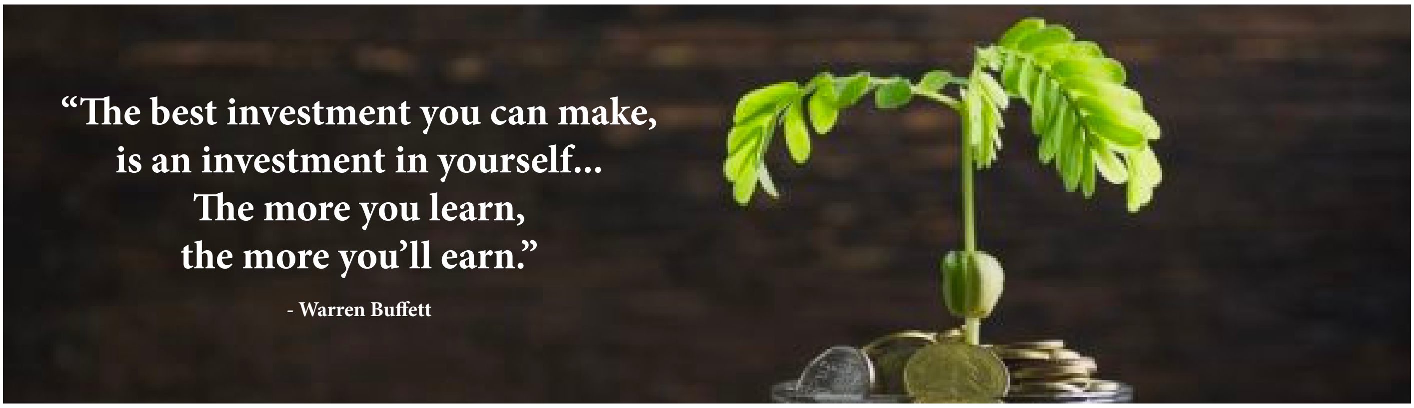
A member of an ‘Out-of-Fund living annuity’ has sole discretion in terms of income selection. The law says that a member can withdraw between 2.5% and 17.5% per annum. In order to have inflation linked growth of capital and income it is recommended that a retiree draw between 4% and 5% per annum. However, as most advisors know, most retiree’s needs are in excess of what a 4% - 5% withdrawal can provide. The result is that the investor needs to take on more risk which is ultimately unsustainable. This is a major concern to Treasury and one of the big reasons for the new legislation backing ‘In-Fund’ options.

The drawdown rates for ‘In-Fund’ annuities must comply with a prescribed standard. The Trustees must monitor the sustainability of your income and alert you if your drawdown rates are deemed unsustainable. Currently the FSCA has published recommended drawdown rates to be reviewed by the retirement industry. These maximum drawdown rates are determined by age band and gender as these impact the sustainability of income withdrawals, depending on longevity and life expectancy. The recommended drawdown rates range between 4%-4.5% for members aged 55 years and 7%-8% for members aged 85 years. These drawdown rates are not yet mandatory but it is important to note that it offers much less flexibility than an ‘Out-of-Fund’ annuity.

FEES NIBBLING AT THE PIE

Various studies have shown the cumulative effect of costs on one’s retirement nest eggs, and how even the smallest reduction in cost can amount to a significant saving over time. While costs are unavoidable, investors should obtain a few quotes for “Out-of-Funds” living annuities from a few service providers. The main stream roll out of ‘In-Fund’ annuity options will probably lead to increased competition and it will align the costing structures of ‘In’ (which are normally cheaper) and ‘Out-of-Fund” solutions, which can only be good for the investor.

“An investment in knowledge pays the best interest.”
- Benjamin Franklin



BENEFITS COUNSELLING AND ADVICE

How are members assisted in making these important retirement decisions? The new regulations also require retirement funds to provide members with access to a retirement benefit counsellor at least three months before they reach normal retirement age. The role of the benefit counsellor is to provide members with sufficient, accurate information regarding the fund’s Trustee approved annuities, the annuity strategy, the risks and costs involved of the fund’s investment portfolios and any other options available to members.

However, the regulations make it clear that retirement benefits counselling does not constitute financial advice but merely providing factual information to members. For many members, counselling may not be sufficient to meet their retirement planning needs and as a result they will also require the services of a qualified advisor. Some retirement funds are already a step ahead, allowing members to appoint a financial adviser on their ‘In-Fund’ annuity to ensure that they are able to evaluate all of the options available.

BENEFICIARY NOMINATIONS

When you pass away with a capital balance in your ‘In-Fund’ annuity, the distribution of capital will be subject to Section 37C of the Pension Funds Act. This means that the fund’s Trustees have the final say with regard to how your capital is distributed. This should, under normal circumstances, be in accordance to the deceased’s nominations.

With an ‘Out-of-Fund’ living annuity, the capital is distributed according to your wishes as set out in the beneficiary nomination form with no input from the fund’s Trustees.

CAN I JUMP SHIP?

‘In’ and ‘Out-Of’ Fund annuities have different portability options. An ‘Out-of-Fund’ living annuity is governed by the Long Term Insurance Act and NOT the Pension Funds Act. This means that once a benefit is transferred it cannot be re-transferred to another annuity option. The fund needs to be reduced to R75, 000 (if no cash benefit was withdrawn at retirement) or R50, 000 (if a cash benefit was taken at retirement) before the remaining capital can be withdrawn.

An ‘In-Fund’ annuity is governed by the Pension Funds Act, as such it can still be transferred to an ‘Out-of-Fund’ living annuity or a life annuity, should the member so wish.

“Planning is bringing the future into the present
so that you can do something about it now. ”
- Alan Lakein

CONCLUSION

There is no ‘right’ or ‘wrong’ direction when it comes to which way one should go at retirement, the choice is highly subjective. Both ‘In-Fund’ and ‘Out-of-Fund’ solutions have pros and cons that need to be fully understood before making a decision. What may well be good for the goose could be poison for the gander. Understanding one’s options is critical when deciding where to take one’s retirement benefit. Increased competition in the market will benefit consumers, which is a good development, however there still remain fundamental differences between the structures. For this reason it is of great importance that all retirees seek financial advice from a reputable advisor when considering options at retirement.

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