FINANCIAL PLANNING INSTITUTE OF SOUTH AFRICA, 
COMMENTARY ON NATIONAL TREASURY PAPER: 
ENABLING A BETTER INCOME IN RETIREMENT

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Vision

Professional financial planning for all.

Our Mission

The FPI’s mission is to advance and promote the pre-eminence and status of financial planning professionals, while at all times acting in the interests of the society (community, constituency) whom the profession serves, by:

1. Improving the quality and accessibility of professional financial planning for all in Southern Africa.
2. Acting as advocate for professional financial planning, building a recognition of the importance and need for such planning by the general public.
3. Providing a framework within which members can achieve qualifications and maintain competence to create greater value for their clients, practices and employers.
4. Ensuring that members maintain the highest ethical standards in the pursuance of their profession.
5. Providing a leadership role within financial services by providing balanced, credible input and commentary to government and the public.
6. Facilitating transformation within the profession.

Submitted by the Technical & Advocacy Services Department, with assistance from the FPI Social Security Working Group

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The Financial Planning Institute (FPI) is pleased to be given the opportunity to present its thoughts and comments for consideration in respect of the National Treasury consultation paper dealing with annuitisation and entitled ‘Enabling a Better Income in Retirement’.

At the outset, the FPI would like to stress that it believes that the fundamental keys to a meaningful better income in retirement for the majority of formally employed South Africans are dependent upon:

- the introduction of some form of compulsory preservation when fund members of funds leave an employer to take up a position with another employer;
- compulsory conversion of all or a significant portion of retirement benefit cash lump sums into a life-long income stream; and
- compulsory membership of a retirement fund for all formally employed persons.

Without these measures in place, the proposals made in this paper can, at best, be described as an interesting investigation into the potential ways and means of:

- reducing the costs associated with annuitisation; and
- modifying the behaviour of prospective annuitants toward living annuities and conventional annuities.

It is therefore submitted that the proposals made in the paper will have little immediate overall significant impact unless the fundamental keys described earlier are implemented at the same time. Even then, given that existing accrued vested rights to lump sums on retirement (particularly from provident funds) are to be preserved, it might be many years before a significant change become apparent.

Ignoring the cost issue for the moment, each annuitant has a finite sum accumulated by the time of retirement. The proposals in this paper seek to eke out the income stream for as long as possible by encouraging conservative investment and behavioural practices. In turn this implies lessening risk and most importantly receiving a lower immediate income at retirement – a fact that will not sit easily in the minds of prospective pensioners.

SPECIFIC COMMENT:

**Intermediaries:**

As an independent, solely voluntary member financed, professional certification body, it is exceptionally disappointing for the FPI to read a report peppered with references to poor and expensive advice from intermediaries. The disconcerting impression given is that whilst many prospective retirees are forced to avoid advice costs and adopt a ‘do it yourself approach’ to choosing a retirement fund product - and fail - those that consult intermediaries always find that they are recommended a product that will benefit the intermediary rather than the client.

This is hard to reconcile with one of the requirements of the FAIS Act is that there must be a written record of advice which both the client and the intermediary must sign. This document also contains a section stating the reasons why the intermediary’s advice was not followed. Anecdotal evidence suggests that in the case of living annuities, the client’s need for immediate income appears to override all other concerns.

The FPI would like to see, and would strongly support, more intense activity by the Financial Services Board in dealing with errant advisors.

The FPI has been at pains over the past quarter of a century to educate and professionally certify intermediaries so they always strive to recommend a product that suits the client’s financial needs.

Increasingly our professionally qualified members do this by charging a fee for their time and do not receive commission from a product provider. Much of the alleged “bad behaviour” could be laid at the door of product providers who incentivise the sale of a particular product through high levels of commission.
commission, and when such commission is capped as it usually is, other incentives, some being very
creative.

Many of the proposals made in the report are complex and there is no denying that there will
continue to be a need (in fact, an enhanced need) to explain the options and alternatives to
prospective retirees who are not well versed in financial matters. The need for advice will continue -
a fact that the report itself reinforces and acknowledges.

Commission:

In many instances in the report, there is mention of high levels of commission. This is strange as
commission in respect of life insurance based annuities is legislated at a maximum of 1.5% of the
purchase price of the annuity. There is also full disclosure required of all fees and charges in terms of
the FAIS legislation.

The un-level commission playing fields between basically unregulated products offered by LISPs and
the highly regulated products offered by life insurers for many years has been a source of concern to
many intermediaries. The report itself questions whether the commission structure may dispose
brokers (and agents) to sell living annuities rather than conventional life annuities.

The practice of paying trailer commission on living annuities does need some attention, especially
where the annuitant does not receive or is unaware that a service is being paid for. Trailer
commission should only be paid if advice is actually given. The FPI would prefer that the fee should
be paid by the client directly to the intermediary and by this is meant that a client can expressly
agree to the fee being paid over to the intermediary by the product provider and that this may need
to be re-confirmed on a yearly basis.

The report also comments that for people on low incomes, the need for financial advice alone makes
living annuities inappropriate. Whilst this is a rather sweeping statement, it would be a pity that this
group were to be consigned to income streams based on ultra conservative investment philosophies.
Indeed, the product design suggestions in the report imply that exposure to controlled investment
risk would be beneficial. It is important to be balanced in dealing with market volatility and placing
overemphasis on the downside potential when markets do provide long term rewards for risk taking.

Other costs:

The cost of governance and regulation are also an important factor in the equation. The report
mentions audit fees, trustee fees, brokerage, VAT, securities transfer taxes, etc. One should also add
administrative costs to this list.

It is encouraging to see that mention is made in the product design of a simpler controlling regime
designed to reduce monitoring costs. These tenets could usefully be applied across the entire
retirement funding industry.

Living annuities:

Limits:

The report correctly states that a pensioner must decide upon an income that lies between 2.5% and
17.5% per cent of the living annuity account value each year. When living annuities first came to the
market, in a time of relatively high interest rates, there were no such limits and any level of income
drawdown was permitted. The SA Revenue Service saw a nil or low drawdown as an opportunity for
the deferral of income and consequently imposed a minimum drawdown of 5% and a maximum of
20%. These limits were subsequently modified to the present levels and it has been proposed
elsewhere that the minimum limit should again be dispensed with. One would be interested in the SA
Revenue Service’s thoughts on this aspect.
The present upper limit of 17.5% is surely very high and possibly a simple measure to deal with prospective annuitants electing a high and unsustainable drawdown would be to lower that limit to 10% or 12%?

**Complexity:**

The report suggests that, from the point of view of purchasers, living annuities are complex products. That statement surely cannot refer to the way in which they are designed to work, which, with respect is quite straightforward. The complexity can only be attributed to the investment choices available.

It could be argued that retiring members are faced with exactly the same choices they had in pre-retirement defined contribution funds, so that they should be quite used to the complexities of the concept.

In contrast, whilst the report gives the impression that conventional annuities offer better long term security, it cannot be denied that they are far more complex to explain, especially:

- why there is a loss of capital on death;
- how the underlying investments are managed;
- why the initial income is so low, especially when an inflation linked annuity is discussed.

**Guarantees:**

It is true that living annuities do not carry guarantees but the statement in the report that there is a legal prohibition on guarantees is surprising. It would be interesting to uncover the reference for this statement.

**Transition - existing living annuity holders:**

For reasons that are not clear, it is proposed to reform existing living annuity policies, so that the following measures are applied to existing living annuities:

- introducing age-dependent drawdown limits which include all recurring charges;
- applying prudential asset limits;
- limiting investment choice; and
- limiting commission and advice fees that can be paid from the fund.

The FPI would caution strongly against interference with existing living annuity arrangements that could be seen as tantamount to retrospective legislation (which always brings about unintended consequences) and almost certainly lead to a Constitutional Court challenge. There would be no objection to these measures being introduced on a voluntary basis for existing annuitants, but forced application should be avoided.

**Life insurers:**

Why it is considered necessary to remove the ability of life insurance companies to receive tax-protected money other than to pay conventional or with-profits life annuities is a puzzling proposal. What is needed is a competitive market operated on a level playing field, not the stifling out of one player. On these terms, should life insurers find that they are unable to operate profitably, they will soon withdraw their products.

**Voluntary purchase annuities:**

Nowhere in the report does it mention the use of voluntary purchase annuities, possibly due to the fact that there is little encouragement for prospective pensioners to use them. Nevertheless, they could prove to be valuable especially to the lower paid.

As the situation stands at present, retiring members of a provident fund are primarily entitled to a cash lump sum and, after paying whatever tax is due, they then have the option of effecting a voluntary purchase annuity with the proceeds.
Each voluntary purchase annuity payment is deemed to consist of a capital repayment element and an interest element and since the capital invested has already been through the tax process, it is deemed to be unfair to tax it yet again. Only the interest element is taxed.

Exemption of the capital element is not life long as it is based on a set of mortality tables in the Income Tax Act. Once an annuitant has aged beyond his/her expectation of life, then the annuity becomes fully taxable.

It is therefore strange why many lower paid workers would opt for a fully taxable compulsory purchase annuity when it might well lessen their tax burden even more by using a voluntary purchase annuity.

The reason may lie in current SA Revenue practice that will only allow a lump sum to be passed free of tax into a compulsory purchase annuity if the rules of the provident fund specify that the benefit is not a cash lump sum but a pension that can be fully encashed at the option of the fund’s trustees.

It is submitted that this rule has now become blurred in practice and perhaps it would be beneficial for National Treasury to review the position of voluntary purchase annuities as possibly another avenue to be investigated in increasing the income available at retirement.

It should be noted that voluntary purchase annuities are not popular with the wealthy as the amounts of tax that have to be paid up front from a cash lump sum make the option unpalatable for many.

**GENERAL COMMENTS:**

**Lower paid workers:**

There is a statement in the report that, historically, provident funds were intended for lower paid workers. This is not the entire story. People in all sectors of society have historically been attracted to provident funds, perhaps demonstrating both:

- a lack of trust in successive governments not to interfere with pension income (witness recent proposals to use pension fund money for government projects, retirement fund taxation, etc); and
- the basic attraction that a large cash lump sum has in the psychology of every individual.

Provision funds only gained momentum in the mid-1980s when the (entirely false) conception spread that only through provident funds could the lower paid become entitled to the employer’s contributions on resignation from employment.

The FPI does, however, give its full support to proposals to align provident funds and pension funds.

**Life insurance component:**

There is a reference in Table 3 of the report to a retirement annuity having life insurance cover under the heading of ‘Longevity Insurance Component’. Yet the reference follows from a comment concerning the lack of inclusion of a longevity component in a living annuity.

It should be made clear that the product being referred to is the retirement annuity and not the living annuity. Few people actually incorporate life cover into a retirement annuity, preferring to cover this risk in a separate life insurance policy. This can be attributed to the tax levied upon death and the complications of Section 37c of the Pension Funds Act.

**Defined benefit funds:**

Importantly, the report makes no mention of how defined benefit funds that take on the role of providing and paying pensioners are to be integrated into these proposals.
If one is to assume that funds must parallel the principles expounded in this report in their valuation funding assumptions then one might expect funding rates to increase, although it is fairly likely that valuators have recognised the longevity risk already and made appropriate provision.

A clear statement of intent in respect of defined benefit funds - and indeed funds that pay pensions directly - would be welcomed.

The appearance of the R currency sign in 3 rows of the multi-employer column in table 2 could be deleted.

**COMMENTS ON RECOMMENDATIONS:**

**Retirement Income Trust (RIT):**

As the design of the proposed RIT is very similar to a living annuity apart from the lack of investment choice, it is difficult to understand the need for a new legal vehicle. The objective could easily be achieved by amending existing legislation to require all living annuity purveyors to offer such a product.

Furthermore, introducing yet another vehicle into the annuity market will add to the confusion and complexity that the report describes and surely lead to unintended opportunities for arbitrage of some description.

Analysing the features of the RIT:

- **Receive the same tax treatment provided to current living annuity policies.**

  This cannot be a reason for a separate product.

- **Not permit investment choice, in order to reduce charges.**

  Such a product could be easily implemented by living annuity vendors.

- **Individuals may choose to split their funds between RITs with different underlying investment strategies.**

  There can only be minor variations between RIT providers as to their investment strategy having to observe more conservative prudential asset limits, so it is difficult to see the advantage of splitting.

  The ability to split must surely be more expensive than using one provider. It also encourages churn which is also an expense.

  One would be interested in SA Revenue’s views on splitting of an annuity from an income tax collection perspective, where several small annuities can pass beneath the tax radar where one bulk annuity would not.

  Splitting implies the need to take advice on the relative merits of the investment strategies of the various RIT providers. This is surely not in conformance with the requirements of a low to nil advice product.

- **Be subject to age-dependent drawdown limits, which will include all recurring charges**
It is difficult to comment on age dependent limits as the report does not describe in detail what is envisaged apart from saying at one point that 5% might be a sustainable drawdown rate for a 65 year old *in good health*.

Whilst different drawdown rates at different ages may be a good idea in principle, one cannot but wonder about the complexity of a system based on age and seemingly envisages medical evidence to be required for a drawdown rate to be decided, let alone subsequent health monitoring.

Simplicity and fairness are uneasy bedfellows. Generally the one extinguishes the other.

- **Pay death benefits to the member’s nominated beneficiary that equal the value of the member’s account at death**

  This is the current position, which is subject to tax and presumably the intention to tax remains?

- **Be subject to prudential asset limits similar to, but possibly more conservative than, the current Regulation 28**

  A more conservative approach of course means a lower income although it is recognised that such income might last longer.

- **Strictly limit commission fees payable to intermediaries**

  As mentioned at the start of this response, commission is already strictly controlled for life insurer provided annuities. If the product is made simple, then the need for advice (and commission) decreases.

- **Not pay advice fees or consulting fees from the fund.**

  This suggestion is fully in line with the philosophy of the FPI expounded earlier. We fully agree that such costs should be met by negotiation between the adviser and the client.

- **Permit members to transfer their assets to other RITs or to conventional life annuities free of charge, with strict limits on sales commission on transferred monies.**

  It is inherently unfair to expect transfers to take place between providers at no cost. There is administration to be done, records to be created, tax affairs to be reconciled and these all have a cost. There could be a standard fee.

  As has been said earlier, it is difficult to understand why anyone would wish to transfer from RIT to RIT. The suggestion that commission be paid from the assets transferred is inconsistent with the suggestion in the previous point that no advice or consulting fees should be paid from the fund.

- **Transition**

  Automatic enrolment into a default RIT, living annuity or conventional annuity may appear to be a sensible approach but an examination of the consequences indicates that there will be problems:

  - Powers will need to be taken by the retirement fund to bring auto enrolment about. The Pension Funds Act will need amendment for this to happen.
  - Trustees will not be happy with having to approve the choice of an external provider as it increases their fiduciary burdens.
- Allowance for opting out implies that advice will have to be given.
- In practice, it can be expected that there will be significant numbers of members who will change their mind after auto enrolment. Certainly members retiring from provident funds will still opt for the full cash. It is recommended that auto enrolment takes place only after the member has agreed that cash is not required. It must also be made abundantly clear that once auto enrolment has taken place, the option to take cash falls away.

- **Increased longevity protection**

  Although the report couches the need for longevity protection as a major need for the individual annuitant (which it undoubtedly is), it is unfair to play down the benefit to the fiscus of reducing the number of persons dependent on the state. It is therefore only fair that the state make some financial contribution towards achieving this protection.

  The report intends that longevity protection be achieved mainly through product design and most of these measures have been dealt with before.

- **Operate largely automatically, with individuals being required to make few, if any, choices**

  This is inconsistent with the proposal to allow individuals to split their accumulated assets amongst various RITs.

- **Bar investment choice, but may invest in risky assets to some degree, obeying prudential requirements on asset holdings**

  It is essential that there is a balanced approach to investing assets and the use of equity investments.

- **Not permit assets to be withdrawn too rapidly**

  Presumably this will be achieved through the age and health related limits on the drawdown rates.

- **Maintain transparent charges, and a simple design, with total and actual expense ratios lower than a certain threshold.**

  It would be informative if the level of the expense threshold could be quantified.

- **Offer members the ability to transfer their funds to another qualifying default product, or to a conventional life annuity**

  Comments on the inadvisability of transfers to other RITs are provided above. There is no objection to transferring to a conventional annuity but it is expected that there will be few takers unless conventional annuities are made more financially attractive. Older people who are close to exhausting their retirement savings will certainly not be attracted by a low income from a conventional inflation proofed annuity.

- **Not pay death benefits to members’ dependants that are greater than a certain threshold, to support risk pooling**

  This design feature is the first suggestion that RITs will operate as a pooled annuity arrangement and that there will be a degree of cross subsidisation between annuitants. This is the major difference between a RIT and a living annuity where each annuitant is exposed to his own longevity risk.

  Is the intention to finance the longevity risk merely by taking money from deceased members or is some other charge to be made by the pool - for example a proportion of the investment return?
This aspect needs considerable amplification and may well represent a major impediment to general acceptance of the RIT concept.

- **Avoid imposing a large regulatory burden on providers, including solvency, administration and product design constraints**

  It is not at all clear what is envisaged here and the detail is required. If costs are to be reduced by simplifying regulation, then why can the same approach be taken for all retirement funding business?

- **Pay only initial commission. Commission can be paid on switches between products, on a sliding scale, for the first two switches, after which no commission will be paid**

  This feature is difficult to understand as payment only on the initial investment should be levied once as initial commission. Payment of commission on switches, which, as argued earlier, is not warranted, is not initial commission.

  In any event, the FPI believes that advice subsequent to the initial investment should not be paid from the fund as indeed the report itself recommends elsewhere.

**Default retirement income trust account (variant):**

As the FPI understands the concept the suggestion is to start off with a living annuity type approach and gradually shift the annuitant’s investment into a conventional annuity as they age; similar in fact to the concept of pre-retirement life stage management in the pre-retirement accumulation phase.

The idea may certainly have considerable merit but much more detail is required before further comment can be given.

**Conventional life annuities:**

There is no dispute that the conventional life annuity is the safest and most conservative option for a prospective annuitant. The fact that the numbers affecting these contracts is rapidly declining reflects the perception that they are perceived to be poor value for money. Whether the proposals made will be successful in changing that perception is a moot point.

It should also be apparent that over time an inequality will develop between successive cohorts of conventional annuity pensioners. Those who enter into such contracts at times of low interest rate will receive a much lower income than those who retire when interest rates are high.

It is also unclear why the trustees of retirement funds should be compelled to obtain quotations for conventional annuities from several providers and then arrange for the retiree to choose one. In essence the suggestion places another onus on trustees to take on the role of the financial advisor. It is naive to suppose that the retiring member will not then launch into a discussion about his personal long term retirement planning. Many trustees are not equipped to take on this task.

More disturbing is the responsibility placed upon the fund to automatically elect a quote on a best-execution basis. Again trustees cannot be expected to act as a financial advisor.

Turning to the standards:

- **Capital preservation on death (a guaranteed term of about five years might be appropriate)**

  It is unclear what this standard is - presumably incorporation of a 5 year payment guarantee? Presumably if prospective annuitants wish to have a longer guarantee period and agree to a
commensurate reduction in income, it should be available? If so, this should be another discussion for the financial advisor and not the trustees.

- **Fixed-level increases in payment set below the inflation rate - such as 3 per cent a year, or 50 per cent of CPI.**

  Of course, fixing an inflation rate as a numeral takes no account of changing economic circumstances in the future where inflation may be at any level. Investigation should be made into aligning this standard with the pension increase policy required of retirement funds.

- **Variable annuities, such as with-profit annuities targeting a particular rate of increase, could also be considered**

  See below for comments.

- **Spouse’s protection, which could be mandatory at two-thirds of the benefit level for the surviving spouse**

  The FPI concurs that some protection for a surviving spouse should be mandatory, but a spouse’s pension of two thirds of the annuitant’s income is rather high, given that market norms would suggest 50%. The two thirds level would contribute to a further reduction in the initial income flow.

- **This option would not permit retired individuals to invest in risky assets (unless a variable annuity was chosen), would not be transferable once purchased and would not permit high initial incomes**

  It has always been the FPI’s understanding that conventional annuities carry no investment choice so it is difficult to understand the risky assets comment.

  There is no issue with not permitting subsequent transfers.

  However, exactly what is meant by avoidance of high initial incomes needs considerable clarification.

- **To some extent, this problem may be managed through the bulk purchase of conventional annuities by retirement funds, which already occurs**

  Bulk purchase of annuities is a valid way of disposing of an existing book of annuities. It is by no means clear whether the discounts would be applicable to future annuitants as they retired, one by one in the future.

  Also the comment about bulk purchase implies that perhaps the writer was considering only large privately administered pension funds. Umbrella funds and certainly provident funds for that matter do not have the wherewithal to actually pay pensions. They are generally outsourced.

**Variable annuities:**

Variable annuities have been available for some time with mixed success. They include with profit annuities where the prospective annuitant pays a premium to invest in a pool of assets designed to provide backing to bonus increase pensions.

Again, they are perceived as unattractive as the initial income is low and the future increases unpredictable.

One would need considerably more detail before being able to measure the full potential of the suggestion.
IN CONCLUSION:

National Treasury proposes a three-tier structure for annuitizing retirement balances:

- **One-third of retirement balances may be taken in cash, as at present.**
  
  This maintains the status quo.

- **The remaining two-thirds of the retirement balance, up to a ceiling, must be used to purchase a default product that contains some protection against unanticipated longevity risk.**
  
  This proposal may be suitable for lower income annuitants but may be irrelevant for higher income pensioners who do not need this protection.

- **Any other retirement funds may be used to purchase drawdown products such as RITs or living annuities**
  
  This is effectively the status quo and needs no further comment apart from the comment on the proposed ingredients of the RIT, living annuities and conventional annuities outlined above.

We thank you for the opportunity to comment on these issues.

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