FRIDAY, 17 NOVEMBER 2023

irfa dispatch

THE RETIREMENT INDUSTRY NEWSLETTER

TABLE OF CONTENT

LOCAL NEWS

- The two-pot system and your savings withdrawal benefit
- Plugging retirement funding GAPs with hybrid solutions

INTERNATIONAL NEWS

- Labour vows pensions review in effort to boost funding for UK growth
- UK pension funds step in to build affordable homes

LOCAL NEWS

The two-pot system and your savings withdrawal benefit

Big changes to the South African retirement system are coming, which may change how you interact with your retirement savings – including the ability to access a portion of your investment in an emergency. Below Jaya Leibowitz reminds us not to lose sight of the importance of preserving retirement savings, and cautions investors against dipping into these funds unnecessarily.

Commonly referred to as the “two-pot system”, the new rules applicable to retirement funds, proposed to launch on 1 March 2025, will require all future contributions made to retirement funds, including retirement annuity funds and umbrella funds, to be split into two portions: two-thirds of your contribution will be allocated to a retirement component, which must be preserved until you retire, while the remaining one-third will be allocated to a savings component, from which you will be able to withdraw once per tax year prior to your retirement (referred to as a “savings withdrawal benefit”). The withdrawal amount will be limited to the value in the savings component at the date of withdrawal. (For more detail on the basics of the two-pot system, please refer to The two-pot system – what we know for now). The main idea behind this new system is to promote the preservation of retirement fund savings until retirement, while also providing retirement fund members with some access to their savings in times of need before they reach their retirement age.

The most recent draft of the amendments to legislation requires that, when the new system is implemented, a portion of the savings in a member’s existing retirement fund account, amounting to the lesser of 10% or R25 000 (National Treasury has proposed that this be increased to R30 000), must be allocated to their savings component. This means that existing members who need access to cash will be able to access a savings withdrawal benefit shortly after implementation. While access to one savings withdrawal benefit per year may come as a welcome relief to many who genuinely need it, if you are able to, you should rather use (or set up) a separate emergency fund for this purpose, and do what you can to preserve your retirement investment for its intended purpose: to provide you with an income in retirement.

Immediate impact of accessing a savings withdrawal benefit

In terms of the current draft of the new legislation, a savings withdrawal benefit will be included in the member’s gross income for the tax year in which that benefit was accessed. This means

that the amount withdrawn will be taxed at the member's marginal tax rate. If you are unemployed and have no income in the year of the withdrawal, you would be able to withdraw up to R95 750 from your savings component tax-free (this is the tax threshold for South African tax residents under the age of 65). As mentioned above, the maximum amount available for a savings withdrawal benefit will be the amount that has accumulated in the savings component (contributions plus growth, less any costs) at the date of the withdrawal. However, if you are earning, it is important to understand that because it is included in gross income, the withdrawal amount could push you into a higher tax bracket.

This tax treatment aims to discourage individuals from accessing a savings withdrawal benefit when they have other sources of income and don't really need to dip into their retirement fund savings. By way of example: Sally is a 35-year-old full-time employee with a taxable income of R370 000. Based on the 2023/2024 income tax table (**see Table 1**), her tax liability will amount to R59 997 (R42 678 + 26% of the amount above R237 100 – primary rebate of R17 235). If Sally decides to access a savings withdrawal benefit of R25 000, she will be pushed into a higher tax bracket and will be liable for tax of R67 722 (R77 362 + 31% of the amount above R370 500 - primary rebate of R17 235).

Table 1: Personal income tax rates for the 2023/2024 tax year

Taxable income	Tax rate
R0 – R237 100	18% of taxable income
R237 101 – R370 500	R42 678 + 26% of taxable income above R237 100
R370 501 – R512 800	R77 362 + 31% of taxable income above R370 500
R512 801 – R673 000	R121 475 + 36% of taxable income above R512 800
R673 001 – R857 900	R179 147 + 39% of taxable income above R673 000
R857 901 – R1 817 000	R251 258 + 41% of taxable income above R857 900
R1 817 001 and above	R644 489 + 45% of taxable income above R1 817 000

Note: Rebates are deductible from tax payable: R17 235 per year for all individuals; R9 444 for taxpayers age 65 and over; R3 145 for taxpayers age 75 and over.

Long-term impact of accessing a savings withdrawal benefit

Accessing a savings withdrawal benefit at any time prior to retirement may have a far bigger impact than you realise. If you are young, you may think that you will have plenty of time to save the amount that you have withdrawn, but not preserving that investment will cost you more than you may think as you will miss out on the power of compounding. Often referred to as the "eighth wonder of the world", compounding means you earn returns today on the returns you earned yesterday, over and above the amounts of money you contribute. If, for example, you plan to retire at age 65 and decide to take a savings withdrawal benefit of R50 000 at the age of 35 to spend on a holiday or a few months of fun, you could lose out on up to R870 000 that would have been used to provide you with an income during retirement. That's a big

difference. (Total investment growth assumed is 10% per year for 30 years – inflation at 6% plus 4% – and the investment is assumed to grow at a steady rate; no volatility is taken into account).

Emergency withdrawals

Despite the above, there may be urgent reasons why a member of a retirement fund who does not have an emergency fund may need to access their savings withdrawal benefit – such as to pay for medical expenses, pay off outstanding debt or fund basic living costs during a time of unemployment. Before going ahead with a withdrawal, consider the questions below and talk to your independent financial adviser:

1. Do you really need the withdrawal amount to pay for something important? If yes, do you need the full amount or could you reduce it?
2. What is your marginal tax rate likely to be in the year of the withdrawal and how might the withdrawal amount impact your overall tax liability?
3. How much tax are you likely to pay on the withdrawal itself?
4. How is the withdrawal likely to impact your long-term savings towards retirement?

Staying invested is key

Wherever possible, retirement fund members should avoid accessing their savings withdrawal benefit. If you have another source of capital and/or income and do not have essential expenses that you would not otherwise be able to afford, always maintain your investment in your retirement fund. Staying the course will significantly impact the amount of money you will have to provide you with an income during your retirement.

FA News | 15 November 2023

Plugging retirement funding GAPs with hybrid solutions

Hybrid solutions made up of an innovative mix of life and living annuities are rewriting how financial planners can help their clients navigate longevity and market risks. Although a bit of a product shop, the recent Momentum Investment Retirement Reimagined 2.0 webinar offered some valuable insights into the long-term benefit of including guaranteed annuities in a client's living annuity portfolio. The asset manager supported its views with extensive data from its own customer base, illustrating how to side-step the so-called living annuity risk spiral.

The risk of a negative inheritance

Martiens Barnard, Head: Technical Marketing for Momentum Investments, reminded the assembled financial and risk advisers that their clients were living far longer in retirement. The consequent longevity risk is forcing clients to take on higher market risk in their portfolios in the hope of generating enough return to maintain their income through retirement. "If markets do not perform, these annuitants face the added risk of leaving a negative inheritance, as their asset base may not have grown sufficiently to provide for them past age-85 or 90," Barnard said. He also pointed out that the combination of higher yields and market turmoil has seen a far greater uptake of life annuities over living annuities among retirees over the last year or two.

There are, however, alternative solutions that will hopefully allow your clients to capture the best of both the life and living annuity worlds. "We have relaunched our living annuity to enable clients to choose a guaranteed annuity portfolio as a component within their living annuities," explained Barnard. The asset manager has chosen the acronym GAP to refer to this guaranteed annuity portfolio, which is billed as enabling financial advisors to give holistic, personalised financial advice to enhance clients' chances of achieving retirement success. The proof, as the saying goes, is in the pudding, and Momentum was quite comfortable to back its pro-GAP claims by sampling from its book of retirement plans.

Financial advisers are familiar with the traditional financial building blocks available to build their clients' pensions. These include life annuities, with profit annuities and living annuities. "Our hybrid annuity, being the key focus of today's discussion today, is nothing but a living annuity that gives you access to a life annuity, in the same way you would get access to a range of funds or unit trusts," Barnard said. The 'shift in thinking' proposed during the webinar was for advice professionals to view a life annuity as another asset class, rather than obsessing over the pros and cons of life versus living annuities. Your focus should be on optimising your client's investment portfolios.

Squeezed by lacklustre market returns

“Living annuitants are under pressure,” said Barnard, referring to an analysis of Momentum’s book of retirement income outcomes in that product. “There are a lot of retirees drawing high single-digit incomes, and many are drawing incomes that are much higher,” he said. Remember, your clients can drawdown between 2.5% and 17.5% of their living annuity assets as income each year, with the Association for Savings and Investment South Africa (ASISA) consistently reporting an average annuity drawdown across the market of 6.5%. Sustainable drawdown rates will vary from one annuitant to the next, and should accommodate age; age-at-retirement; expected years in retirement; portfolio size; portfolio return benchmarks etc.

Barnard reminded the audience that an investor that is withdrawing 8% from a living annuity at the age of 80, is in a very different financial situation to a client withdrawing the same percentage at age 60. By slicing and dicing the data, he was able to present an accurate ‘heat map’ of how appropriately clients were funded for retirement in different age bands. “The light green bubbles [in this slide] represents clients that are at the income drawdown levels prescribed by the academic literature; they have likely started off with an income drawdown level in the region of about 4.5% to 5.5%,” Barnard said. He warned that there were many retirees in the unfortunate situation of having to chase high returns over multiple decades, or risk having insufficient income.

Unpacking the living annuity plus GAP case study

To illustrate the GAP as an asset class argument, Barnard introduced an imaginary retiree, called Greg. Greg is 65-years-old and drawing 7% per annum from his living annuity. He was, however, in the group that had to chase 11% per annum in returns just to make his retirement equation work… Put differently, he was among the thousands of retirees being ‘undone’ by the so-called living annuity risk spiral. Assuming Greg persists with traditional financial instruments, he can increase the risk and return profile of his annuity by, for example, moving into a medium- or high-equity funds. But in either medium- or high-equity, Greg faces a higher chance of not generating the required return; plus, higher equity exposures increase the risk of much lower long-term outcomes.

Further information is added to the model, namely that Greg starts with R2 million in a pure living annuity, starting with a 7% drawdown. The choice is for a medium risk fund that will hopefully deliver enough performance to accommodate a 5% annual increase in income draw. According to Barnard, at a return of just under 11% per annum, Greg would hit the 17.5% cap on drawdowns in his 83rd year, and by age 89 would receive only half of his income need. Momentum then ran 2000 market realistic simluations to show Greg’s three possible end-states: in the first, the retiree makes it to age-100 with adequate income; in the second, the retiree gets more than half the income needed; and in the third, the retiree gets less than half

the income needed. The simulations make it possible for asset managers and financial planners to study the impact of longevity, market and sequence risk in a living annuity portfolio, among other factors. PS, a number of comparisons were made, but to describe these in words without the slide pack is near impossible. Suffice to say, the entire exercise was aimed at creating a baseline into which to introduce the life annuity as an asset class within the living annuity portfolio.

Going beyond the efficient frontier

"When the conversation turns to asset allocation, everyone thinks about the efficient frontier, where investment portfolios are put together to try and get the maximum expected return for the minimum amount of risk," Barnard said. In Retirement Reimagined 1.0, Momentum sought to optimise the living annuity by minimising market and longevity risk through the use of an income map … for Retirement Reimagined 2.0 the focus turned to protecting the inheritance value in the GAP component of this solution. Barnard explained that GAP was an uncorrelated asset class because volatile markets had no impact on the income it generated.

"When markets are not performing well, you basically get a hedge against significant underperformance," he said. He then explained a trade-off from diverting say 35% of the R2 million in Greg's portfolio to a GAP, being that Greg gets a serious negative return from the GAP if he dies in year one. The situation improves on surviving more years in retirement "Our simulation shows there is a reasonable chance that introducing a GAP can actually increase the inheritance that you leave to your nominated beneficiaries at extended ages; but initially, the opposite is true because there is no inheritance from a GAP," Barnard said.

Optimising life annuities for retirement

Retirement Reimagined 2.0 thus sought to optimise for inheritance so that clients do not have the initial GAP-related shortfall in inheritance. The solution is to sweeten the GAP with a guarantee period of 10-, 15- or a maximum of 25-years, according to clients' needs. Upon death, the owner of a guarantee-term life annuity receives a pay-out of the present value of the remaining income payments in that guarantee-term, which payment is made into the living annuity. "We believe that we can reverse the living annuity risk spiral by including a GAP as a hedging strategy against market and longevity risk, and a guarantee-term GAP to reduce the risk of an initial low inheritance," Barnard concluded. And that, dear reader, is how product innovation can mitigate longevity, market and sequence risks for South Africa's retirees.

FA News | 14 November 2023

INTERNATIONAL NEWS

Labour vows pensions review in effort to boost funding for UK growth

Shadow chancellor says party plans to go further than Tories in unlocking retirement fund capital

The Labour party will conduct a sweeping review of the UK's pension system to find ways of unlocking billions of pounds worth of retirement fund capital for the country's growth if it wins the next general election, shadow chancellor Rachel Reeves has said. Speaking a week before the Autumn Statement, Reeves unveiled a series of measures that went further than proposals set out so far by chancellor Jeremy Hunt to boost British long-term pension investment in UK businesses. The UK pension market is among the largest in Europe and worth about £2.5tn, according to government analysis. However, British pension funds have largely shunned UK-listed equities and small unquoted companies in favour of offshore markets and domestic gilts. Reeves said on Monday that if Labour won power, it would review the entire pensions landscape to ensure it delivered "full potential" for savers and companies.

This would range from private sector defined contribution (DC) and defined benefit schemes to local authority pensions. "The economy is not working — growth is the missing ingredient of this economy," Reeves told reporters, setting out plans to get "better returns for pension savers and [drive] more capital into fast-growing businesses". Her comments indicate a growing political consensus around the need to find new ways of channelling savings into companies that could drive up the UK's moribund growth rate. With the election drawing nearer, both Labour and the Conservatives are leaning heavily on the private sector to boost investment as they confront badly strained public finances.

In addition to a system review, Reeves unveiled plans to go further on several current government policy initiatives aimed at steering more pension cash into the UK economy, including stronger powers for the regulator to drive out poorer-performing pension schemes. In July, Hunt unveiled the so-called Mansion House compact, committing nine of the UK's largest DC pension providers to the target of allocating at least 5 per cent of their "default" — or most popular — funds to unlisted equities by 2030. Hunt hopes it will deliver roughly £50bn in DC cash for unlisted assets, such as unquoted companies, which are potentially higher returning but higher risk, by 2030 if the wider sector follows suit. Labour wants to "build" on his reforms by establishing a state-backed scheme for DC pension funds to invest a proportion of their

assets alongside the British Business Bank, the state-owned economic development investor, into UK growth assets. Hunt's compact did not specify signatories to invest in the UK, which Reeves described as a "missed opportunity". Significantly, Reeves did not propose to force funds to invest in UK assets, saying: "I don't think mandating is the right thing to do." Labour did not announce a target for pension investment in the UK, but unions welcomed the drive to steer more pension investment into the domestic economy. The party estimates its reforms could enable an average saver to earn an extra £21,000 to £37,000 in retirement income. Recommended Explainer UK economy Can Jeremy Hunt deliver on his pension reforms? The Trades Union Congress, the umbrella body for the UK's trade union movement, said:

"The lack of measures in the Mansion House proposals to ensure that extra money allocated to 'productive finance' was invested in UK companies and projects was one of their biggest flaws." "If workers' pension contributions were channelled into investments that give them better returns and boost the UK economy, it could be a win-win," it added. Reeves also accused the government of hitting working households with tax increases and presiding over a weak economic performance, with the Bank of England forecasting zero growth next year. The Institute for Fiscal Studies think-tank has forecast that UK tax revenues will hit 37 per cent of national income next year, when the election is expected, compared with 33 per cent at the time of the last poll in 2019.

Labour is accusing the Conservatives of pushing through 25 tax increases in the current parliament, including raising the main rate of corporation tax and freezes to income tax and National Insurance thresholds. "More taxes is not the way to grow the economy — my priority is easing the burden of taxes on working people," Reeves said, adding that she would "not make any promises to cut taxes unless I can say where the money is going to come from". In response, a Tory official said Labour did not have "a leg to stand on" given the tax increases when it was last in government, and that the party's borrowing plans "will almost certainly lead to higher taxes for working people".

Financial Times | 13 November 2023

UK pension funds step in to build affordable homes

Pension Insurance Corporation is building 125 affordable homes in London as part of £500m plan for 1,000 affordable homes over next five years

The UK's pension funds are increasingly stepping in to build affordable homes as the housing crisis worsens. Pension Insurance Corporation (PIC), a specialist insurer of defined benefit pension schemes, is the latest to enter the market. It is building 125 affordable homes in Kingston upon Thames, south-west London, in partnership with the developer London Square and its affordable housing subsidiary, Square Roots. The £50m project, which is due to be completed by November 2025, is backed by a £4.9m grant from the mayor of London's affordable housing programme. It is the firm's first direct investment in affordable housing. PIC intends to invest £500m over the next five years to build about 1,000 affordable homes across England and Wales.

"For every pension scheme that we take on, we need to back each of those schemes with a portfolio of assets," said Allen Twyning, PIC's lead manager on the Kingston project. "What [affordable housing] offers is very predictable rental cashflows linked to inflation, a lot of these driven by central government policy. They are sustainable investments. They're there for the long term; it is a really good match for what we're trying to do in terms of paying pensioners and helping create homes for people who desperately need them." PIC, which insures 339,900 pension scheme members at FTSE 100 companies and in the public sector and has £44.9bn in financial investments, has also invested in build-to-rent developments, student accommodation and senior living.

Across the West Midlands, Legal & General pledged last year to construct 3,000 affordable homes over five years, starting with The Junction, a brownfield site which has been empty for two decades. Partnering with Lovells, L&G is in discussions about creating affordable 1,000 homes in the region. The total programme is backed by L&G's £138m grant from Homes England. In Kingston, the homes will be built on the site of an NHS clinic that closed two years ago, with 44 apartments to be made available at London affordable rent, and 81 apartments for shared ownership. The former will be set at rents that the mayor of London views as "genuinely affordable". About 340,000 new homes are needed in England each year, of which 145,000 should be affordable homes, according to research commissioned by the National Housing Federation and the homeless charity Crisis from Heriot-Watt University.

However, only about 50,000 affordable homes were built each year on average between 1991 to 2022, according to government figures. Last year, 59,175 affordable homes were completed in England, up by 13% on the previous year, and similar to pre-pandemic levels. Housing associations have built most of those homes in the past, but this has slowed dramatically because of high inflation hitting construction and operating costs, rising borrowing costs and rent caps introduced by the government. The king's speech last week contained no new measures to tackle rising homelessness and lack of affordable social housing. However, Labour's deputy leader, Angela Rayner, has said the party will create the biggest increase in affordable housing "in a generation" by getting tough on developers and reforming planning rules, if it wins the next general election.

The Guardian | 13 November 2023

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