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irfa dispatch

THE RETIREMENT INDUSTRY NEWSLETTER

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Clearing up the confusion about annuity products

It seems there is a lot of confusion among consumers about the various retirement products, and, considering the terminology, I am not surprised. There are essentially three “annuity” products on the market, of which one contains the word “living” and another the word “life”. That in itself is confusing. Living and life annuities are post-retirement products that use the term “annuity” in its strict sense of something that provides regular income payments - in other words, a pension. The third “annuity” on the market is not a pension product at all, but a pre-retirement savings vehicle.

1. Living annuity: An investment-linked living annuity (illa), to give it its full name, is a pension product that you “buy” with your retirement savings when you retire. It sits on an investment platform that offers a choice of underlying funds. You have full control over both the underlying investments and your drawdown (the percentage of capital you draw annually as income, which can be paid to you in monthly instalments), within limits. You take on the investment risk and the risk of running out of capital before you run out of life. Because you buy the product with the proceeds of a retirement fund (to which contributions are tax-deductible), you pay income tax on your income. Whatever capital is left over when you die goes to your beneficiaries.

2. Life annuity: So called because it is a pension product provided by a life insurance company, a life (or guaranteed) annuity is literally a life insurance policy in reverse: you give the insurer a lump sum (your retirement savings or a sum from discretionary savings) and the insurer pays you an income for the rest of your life. This may be a fixed rand amount, or it might be inflation-linked, and it may also cover your spouse. It gives you and your spouse the security of never having to worry about your income for the rest of your days. But a life annuity dies when you (or your spouse) dies - there’s nothing left over. If bought from retirement fund savings, you pay income tax on your pension.

3. Retirement annuity (RA): This is a pre-retirement product in which you accumulate savings. It’s basically your own personal retirement fund, and was designed primarily for the self-employed, but now used by many to supplement their retirement savings. It enjoys the same tax status as retirement funds, with your contributions being tax-deductible up to certain limits. You cannot draw an income from an RA - at age 55 or at any later age you can take one-third of it as cash (on which there are tax implications), but the other two-thirds must be used to buy a pension in the form of a living or life annuity.

In none of these products are investment returns and capital gains taxed. There are variants among the first two, including hybrid products, such as a with-profit annuity, which is essentially a life annuity that gives you increases related to the returns of its underlying investments, over which you may have a certain amount of choice.

Living to life

A living annuity can be converted to a life annuity, but not the other way around. Once you are in a life annuity you are literally in it for life. Personal Finance put the following questions to Segabe Ditodi, head of legal and compliance at Just in South Africa, about converting your living annuity to a life annuity:

Can you outline the procedure involved in transferring from a living annuity to a life annuity with a different provider?

You or your adviser must notify the provider (Provider A) of your intention to transfer out of the living annuity. This is usually accompanied by a signed quote and application form from the life annuity provider (Provider B). Provider A drafts a set of annexures which is sent to Provider B, who in turn also drafts a set of annexures. Both sets of annexures must be signed by the client.

What transfer costs are involved?

None. Regulations stipulate that there can be no costs associated with transfer of a living annuity to a life annuity. Your adviser can charge a fee, but it should be invoiced separately and settled by you.

Can you convert a portion of the living annuity to a life annuity or must it be the entire amount?

No, you cannot transfer a portion of a living annuity to a conventional life annuity. However, if you transfer the full amount to a living annuity where a life annuity is available as a portfolio (often referred to as a blended living annuity offered by some product providers), you can allocate a portion of retirement assets to the lifetime income portfolio in tranches at any time.

How long does it take?

The timing of the process varies between providers and depends on factors such as delays in tax directives or the signing of annexures. The best-case scenario is two to four weeks, but it can take about eight weeks.

If the provider with which you have the living annuity also offers a life annuity, is the process easier?

Not necessarily. The process still needs to follow the same steps.

IOL | 18 May 2020

How a court ruling will change living annuities in divorce cases

A 2016 ruling by the Johannesburg High Court that a living annuity cannot be taken into account for the purposes of calculating the assets on divorce has been overturned on appeal by the Supreme Court of Appeal (SCA). The SCA ruled in the case of *Montonari v Montonari* that the right to the income of a living annuity formed part of the assets of a marriage for the purposes of divorce.

The 2016 Montonari Judgment The judgment of the High Court in the Montonari case ruled that the underlying assets of a living annuity, underwritten by an insurer, are owned by the insurer and not the

annuitant. They cannot be included as assets in the annuitant's estate available for distribution in a divorce. Although an actuary gave evidence that the income of the living annuity had a value, which could be capitalised, this was disregarded by the court. The court ruled that the monthly or periodical income from the living annuity could only be considered in respect of a maintenance claim by the other spouse, together with other income sources.

The case of ST v CT in 2018

The case of *ST v CT* (2018) was the first time the issue of whether a living annuity forms part of the assets of a divorce had come before the SCA. The court reached a similar conclusion. It accepted that the capital backing a member held living annuity is owned by the insurer and does not fall into the assets of the annuitant. The monthly income derived from the living annuity, forms part of total income and has a bearing on whether the annuitant has the means to pay maintenance to the other spouse. The court did not have to consider the issue of whether the right to a future annuity is a right capable of valuation because evidence was not lead by the parties on this.

The 2020 Montonari Judgment – SCA

Leave to appeal the 2016 judgment was granted to the spouse of the annuitant, which succeeded.
The SCA made an order that:

- The value of the annuitant's right to future annuity payments under a living annuity is an asset in his estate for the purposes of calculating the accrual in his estate.
- The matter must be remitted to the trial court for the admission of evidence on the value of the annuitant's right to receive future payments in respect of the living annuities.

The findings of the SCA The SCA pointed out that in the 2016 High Court hearing, the parties failed to define the issue properly. The SCA noted that the High Court judgment and declaratory order perpetuated the misunderstanding that the applicant's target was solely the underlying capital value of the annuities. The witnesses gave evidence that the capital is owned by the insurer and the annuitant is entitled to an income stream equal to between 2.5% and 17.5% of the capital.

The High Court should have determined that the annuity, and not the capital, is the asset that would be reflected in the annuitant's balance sheet. The actuary who gave evidence ventured an opinion when pressed, that a market value could be placed on the income stream generated at any given time. To that end, regard would be had to variables such as the investment return assumptions, and the annuitant's mortality. The court acknowledged that the living annuity enjoys the protection provided by 37A and 37B of the Pension Funds Acts so an annuitant cannot give part or all of the living annuities to an ex-spouse in terms of a divorce order or agree to split the annuity income with the ex-spouse.

The SCA noted that the High Court in 2016 took the evidence of the actuary into account that future annuity income which the annuitant draws is an asset which can be valued, but then it erroneously considered the annuity income to be relevant only for purposes of a maintenance claim. It should have found it to be an

asset in the respondent's estate, which is subject to accrual, and have allowed the actuary to provide a valuation of that income stream.

The case of De Kock v Jacobson 1999

The SCA relied on the decision of *De Kock v Jacobson*,1999 where a husband's pension was seen as an asset in the joint estate of a couple married in community of property. Upon his retirement, prior to the divorce, he ceased to be a member of the pension fund to which he had belonged and his pension benefit was converted into a pension. His right against the pension fund had two components; a right to a cash payment (which he conceded fell within the community of property) and a right to monthly payments by way of pension.

In this case it was not a living annuity. The court in De Kock concluded that there was no logical or legal reason why both the cash component and the accrued right to the pension should not form part of the community of property existing between the parties prior to the divorce. The SCA agreed with the reasoning and its wider application to this case which was not in community of property.

Comment

While the legal principle is sound that a right is capable of valuation and capitalisation, the practicalities of applying this to living annuity income is extremely difficult. In the case of *ST v CT* mentioned above, it was noted that in valuing living annuity income regard would be had to variables such as the investment return assumptions, the level of drawdowns between 2,5% and 17,5% and the annuitant's mortality. (The right to receive any particular annuity instalment is subject to a condition of survivorship, namely that the annuitant should be alive on the date on which the next annuity instalment becomes payable.

If the annuitant does not survive to the next date, the right to the annuity would cease.) These factors would need to be considered in the valuation of the right. The case was referred back to the high court for valuation of the right to future payments. While it would be very educational to see the way the living annuity is valued by actuaries, the parties might potentially reach a settlement on the valuation of the right as the cost and delay of proceeding to court might dictate this. This was the situation in the De Kock case.

It is important to note that this does not affect the obligations of the administrator to make payment of living annuity income to the annuitant only which is still protected in terms of section 37A of the Pension Funds Act. This case does not change that at all. Living annuity income can still only be paid to the annuitant. The actuarial calculation of the capitalised value of the right to living annuity income will need to be managed by the divorce attorneys. Financial advisers might be requested to help by providing them with the capital value of living annuity as well as a history of draw down rates for the purposes of valuation.

It will be interesting to see how actuaries approach this difficult exercise. Although this case dealt with the right to living annuity income, the principle would apply similarly to a right to income from a guaranteed annuity which might be easier to value than a living annuity. Despite the difficulties in valuation, this case is a step in

the right direction. There is a glaring inequity that during membership of a fund, the non-member spouse has a right to share in the pension interest. However, on retirement when a living annuity is purchased from an insurer that right ends. The solution to the inequity is legislative intervention which has been proposed by industry organisations. We hope that this will be considered in the near future.

IOL | 15 May 2020

INTERNATIONAL NEWS

Covid-19: Time for liberal withdrawal options for retirement funds

A crisis like the coronavirus pandemic makes retiral benefits important for the elderly, both for medical and economic reasons. We have an example in the Thrift Savings Plan (TSP), a retirement plan for American civil servants

We are in the midst of a severe economic and financial crisis. With the coronavirus disease (Covid-19)'s tendency to infect an unusually large number of elderly people, pension schemes become an absolute necessity – for medical support as well as to stave-off the resultant economic crisis. As the Nobel laureate, Milton Friedman, writes: "Only a crisis – actual or perceived – produces real change. When that crisis occurs, the actions that are taken depend on the ideas that are lying around."

Such a crisis exists in the delivery of retirement benefits for India's National Pension System (NPS) subscribers. We have an example in the Thrift Savings Plan (TSP), a retirement plan for American civil servants, which is an efficient and publicly-managed social security scheme. The account is managed individually for each subscriber, and contributions flow into exclusive accounts. And the risk is borne by the subscriber. It offers three ways to withdraw money on retirement, with an option to choose any or a combination of the three. One, lump-sum withdrawal. Lump-sum withdrawals are large and a member of the TSP can take single or multiple withdrawals on retirement.

It is akin to full provident fund (PF) withdrawal on retirement from service by the Employees' Provident Fund Organisation (EPFO) subscribers or up to 60% withdrawal of total corpus by an NPS subscriber. Two, instalment payments. TSP enables a civil servant to receive payments on a monthly, quarterly, or annual basis till the total amount in the TSP account lasts. The participant has the option to start, stop, or change instalment payments at any time. The Employees' Pension Scheme (EPS), one of the three schemes administered by EPFO that enables a subscriber to receive monthly pension payments. The pension contributions continue to be invested in the fund.

While the PF account is managed separately for each individual, the pension contributions flow in a pooled pension fund. The risk is shared by the employers and the central government. Pension is guaranteed by the EPS. At present, it doesn't have a provision of monthly pension payments for an NPS subscriber. Three, life

annuity. An annuity pays a benefit to the participant for life. A TSP account holder purchases an annuity from a TSP-empanelled insurance company. In NPS, a minimum of 40% of the corpus has to be compulsorily used to buy an annuity at retirement to secure a regular income during the period of retirement. There is no annuity in EPFO.

It doesn't change the accumulated pension corpus, it merely redefines the ways the retiral benefits are used. Among the three alternatives available to a TSP subscriber, the most popular is the lump-sum withdrawal at the time of retirement. Its downside risk, however, is that retirees often outlive their pension wealth. An important factor affecting retirement benefits in the future for DC plans like TSP or NPS is the annuity conversion factor (the annuities which are effectively paid to a subscriber in retirement), which for OECD countries stands at 90%.

The annuity conversion factor is much lower in India. The annuity market is not well-developed anywhere in the world, and India is no exception. It accounts for less than one-fifth of the total investment of the Indian insurance business. The reward to annuity providers appears to be disproportionate to the risks taken by them for a guaranteed income. The adequacy of benefits is also an issue in life annuity plans and particularly in a low-interest environment. ***Full Report*****: *https://www.hindustantimes.com/analysis/covid-19-time-for-liberal-withdrawal-options-for-retirement-funds/story-R9zj5ttT3d6PqXEi8QYRdM.html***

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Avoid making rash decisions, pension fund members told

PEOPLE with defined contribution pension plans are being advised not to panic as their fund has lost value this year. It comes as the company pension funds of some of the largest companies in the State saw their deficits unchanged in the first three months of the year.Peter Gray, corporate consulting leader with Mercer, said that members of defined contribution schemes will have likely seen the value of their retirement funds fall since the beginning of the year.

With a defined contribution scheme, employees and employers pay into a fund, with the final pension amount based on the amount put in and the fund performance. Mr Gray said Mercer has seen an increased level of queries from members and interest in switching investment strategies. "We would caution against any knee-jerk reactions, especially when the market is so volatile, as it may ultimately only serve to lock in losses." He said those furthest from retirement have time for markets to recover and those closer to retirement will have benefited from de-risking if they have adopted a lifestyle-investment approach. Members were strongly encouraged by Mr Gray to seek advice before making any decisions. Recent figures from Rubicon Investment Consulting show that over the first four months of 2020, Irish pension managed funds have lost an average of 8.5pc. In the past twelve months, those funds have delivered a 2.8pc loss on average.

The average managed fund return has been 2.4pc per annum over the past three years. Mercer said the pension funds of the largest firms in the State saw their deficits unchanged in the first three months of the year. This is despite the extreme volatility in financial markets caused by the Covid-19 pandemic. An analysis by Mercer shows that defined benefit pension deficits for Iseq-listed companies have remained unchanged at €1.2bn from year end to the end of March.

A defined benefit pension is one where a specific benefit will be paid to the member when they retire, with the amount based on the number of years an employee has worked and their final salary. There was a sharp fall in stock markets in the first three months of the year. But this was offset by a decline in scheme liabilities fuelled by soaring corporate bond yields, according to research by pensions advisers Mercer. Pension liabilities are the difference between the total amount due to retired scheme members and the actual amount of money the pension scheme has to make those payments. Liabilities are calculated with reference to the interest on bonds.

The higher the rate, the lower the pension liabilities. Mercer has advised pension fund trustees of DB schemes and sponsors to plan for the possible economic disruption of a second lockdown, or the possibility that the current lockdown will be extended. The consultants also advised trustees to consider the investment opportunities of buying assets at reduced prices due to the falls in stock markets.

Independent.ie | 15 May 2020

Trump's pension fund ban could split global markets

Order to federal retirement fund to drop investment in an index that includes Chinese companies under US sanctions and export bans could have sweeping ramifications.

By ordering the main US federal government pension fund to shun Chinese stocks, President Trump has opened a new front in America's wide-ranging confrontation with China that risks fragmenting global capital markets. Until now the Sino-US clash has mainly been over trade and technology. Trump, eager to demonise Beijing to help his re-election chances, has slapped tariffs on imports from China, tightened curbs on the export of sensitive goods and banned US firms from doing business with Huawei, China's leader in 5G mobile telecommunications.

Washington has also made it harder for Chinese firms to put down roots in the US: new Chinese investments in America plunged to just $200 million in the first quarter, down from $2 billion a quarter in 2019. The result has been a decoupling between the world's first- and second-biggest economies. Even before the coronavirus pandemic broke out, globalisation was giving way to the bifurcation of the global economy into two main camps: one led by the US, the other by China. Trump is now accelerating this process by expanding his campaign against China to the capital markets.

The president this week ordered the Federal Retirement Thrift Investment Board to drop its investment in an MSCI index that includes Chinese companies under US sanctions and export bans. On the face of it, the move is of limited significance. Potential flows of up to $6 billion into China could be affected. But the signalling effect of the ban is much greater, especially as Trump explicitly blames China for covering up the outbreak of Covid-19. Tellingly, as the US death toll from the disease rises fast, calls from both the administration and Congress to punish Beijing are multiplying.

Sanctions possible for Covid-19 'cover-up' The US national security adviser, Robert O'Brien, and Trump's national economic adviser, Larry Kudlow, warned against the investment of federal retirement dollars in Chinese firms given "the possibility that future sanctions will result from the culpable actions of the Chinese government" over the spread of the virus. Those sanctions could be financial as well as diplomatic. A bill introduced by Senator Lindsey Graham, a close ally of Trump, envisages curbs on loans to Chinese businesses by US institutions and a ban on Chinese firms from listing on US stock exchanges if China does not allow a full outside investigation into the cause of the outbreak.

The push to cut Chinese firms off from Wall Street is gathering momentum from another source – an accounting scandal at Nasdaq-listed Luckin Coffee, which admitted last month that most of its 2019 revenue had been fabricated. The firm was worth $12 billion before it fell to earth. Senator Marco Rubio, who introduced a bill a year ago with bipartisan support that would force Chinese firms to abide by federal auditing rules and disclosure requirements, said the Luckin fraud was "a major wake-up call for policymakers and regulators that the time for action is now".

US regulators have never been able to examine audit documents from Chinese firms – something Beijing considers a breach of its sovereignty. "If Chinese companies want access to the US capital markets, they must comply with American laws and regulations for financial transparency and accountability," Rubio said. China might be tempted to play down the warnings out of Washington as election-year noise, but the US has punished errant foreign companies in the past.

In 2018 it imposed sanctions on Hong Kong-listed Rusal, a Russian aluminium producer controlled at the time by Oleg Deripaska, a tycoon close to President Vladimir Putin, over Moscow's alleged meddling in the 2016 US presidential election. US money managers had to divest from the stock. So, although the White House has dismissed wild talk of punishing China by cancelling the US Treasury securities it owns, Beijing faces a real threat of attack on the capital markets front.

Fixed income next?

Will other pension funds come under political and public pressure to follow the administration's lead? If equities are the target today, what about fixed income? After all, China is now included in the main global bond indices. ***Full Report:https://asiatimes.com/2020/05/trumps-pension-fund-ban-could-split-global-markets/***

ASIA TIMES | 18 May 2020

OUT OF INTEREST

Rand firmer as Covid-19 vaccine hopes boost risk demand

The local currency was 0.65% firmer at R18.22 per dollar in midday trade.

The rand strengthened modestly on Tuesday, extending a rally from the previous session sparked by growing hopes of a Covid-19 vaccine, while investors looked ahead to local mining and manufacturing data. At 12:07 the rand was 0.65% firmer at R18.2224 per dollar, holding at a four-session best reached on Monday in a strong day for emerging currencies after encouraging results from the trial of a vaccine for Covid-19. The rand was 0.27% firmer against the pound at R22.3023 and 0.32% against the euro, at R19.9537.

"Growing optimism around a Covid-19 vaccine that is showing promising results helped to restore some positive market sentiment, while the Federal Reserve's unwavering support for the US economy was also perceived as risk-on by the market," said Bianca Botes of Peregrine Treasury Solutions. "The rand continues to be driven by sentiment, which is essentially a balancing act as it switches between risk-on and risk-off as the pandemic unfolds," Botes added in a note. US biotech firm Moderna has produced protective antibodies in a small group of healthy volunteers during a safety trial launched in March.

Locally, releases of mining and manufacturing figures for February, albeit for the period before the nationwide coronavirus triggered lockdown, will be eyed for the likely extent of the economic slowdown already reflected in high frequency data. Bonds extended their healthy rally, with the yield on the government issue due in 2030 down 9 basis points at 9.050% early on Tuesday, after falling 46.5 bps in the previous session.

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