

Technical Discussion Paper B for public comment

Enabling a better income in retirement

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National Treasury

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1. Introduction

This paper is one of a series of technical discussion papers following the release on 14 May 2012 of the *Strengthening Retirement Savings* overview paper of the 2012 Budget announcements by the Minister of Finance to promote household savings and reform the retirement industry. *Enabling a better income in retirement*¹ presents an overview of the current annuities market, examines the various products in detail and presents several options for reform. A related paper to be released within the next two months will analyse the costs of retirement saving during the accumulation phase, examining costs on products like retirement annuities, pensions and provident funds, before a person retires.

Two further papers on taxation of retirement and other savings will be released before the end of September, one on the uniform tax treatment of retirement funds, and the other on tax-incentivised savings vehicles. A paper on preservation and governance of pension funds has been released concurrently with this one. All the papers will be made available on the National Treasury website www.treasury.gov.za.

This paper is intended to promote public consultations on how the provision of an income in retirement can be improved, to assist South Africa in building a fair and sustainable retirement system. The paper also seeks to facilitate engagement with industry providers of retirement products on the analysis presented.

■ Executive Summary

Most members of pension funds who retire choose the products on offer without much advice, and often end up choosing an inappropriate product that leaves them even more vulnerable as they age, and are no longer as able to earn their own income. This paper examines the options facing a member of a retirement fund when she or he retires. It examines the products on offer that will provide an income post-retirement, and focuses on annuities.

Annuities are commonly understood as products which pay an income for life, with some form of guarantee provided by insurance companies. However, South African law also regards phased-withdrawal products, called living annuities, as annuities for tax purposes.

The Income Tax Act (1962, as amended) compels members of pension funds and holders of retirement annuities to use at least two-thirds of their accumulated balances to buy products that qualify legally as annuities. This is commonly referred to as mandatory annuitisation.

¹ In the overview paper, this paper B was initially referred to as *Providing a Retirement Income*, but has been re-named to take account of the content.

Under mandatory annuitisation rules, two main types of product qualify as annuities: a conventional life annuity and a phased-withdrawal product. This paper will refer to the phased-withdrawal product as a living annuity for short.

Conventional annuities provide an income for life, guaranteed by an insurance company or a pension fund, regardless of how long the purchaser lives. Living annuities are similar to a bank account: purchasers bear the risks of the underlying assets and the risk that they will outlive their assets. Both living annuities and conventional annuities can be paid by the fund from which members retire. Most funds, however, require members to buy annuities on the retail market. Retail annuities of both types can only be sold by registered life insurance companies.

Living annuities are growing rapidly, with conventional products in decline

The value of the annuities market has grown from about R8 billion in 2003 to R31 billion in 2011. Fewer individuals are choosing to buy conventional life annuities – the only products offering longevity protection. In 2003, 50 per cent of single premiums were used to buy conventional annuities, but by 2011 this had fallen to 14 per cent.

During an employee's working life, the retirement system provides a strong support structure that includes a savings obligation. Most South Africans do not save adequately for retirement. Employees are compelled to join a fund if their employer provides one. Contributions are deducted from salaries before they are paid. Investment choices are often made by trustees. Individuals can only access their funds under limited circumstances. Individuals receive substantial tax benefits when they contribute and investment returns in funds are free of tax.

Yet for the vast majority, this support structure is withdrawn at retirement. Many retirees are left to the retail market, where they must bear the risks of retirement on their own – including the risks of poor or commercially biased financial advice, and high charges.

South Africa needs regulatory intervention to build a well-functioning retirement product market

The National Treasury has reviewed annuities markets in several countries with retirement systems similar to our own. The main finding is that without some form of regulatory intervention, it will be difficult for South Africa to develop a functioning market in retirement income products that is suited to the country's needs. The review also suggests that both the tax incentives of different annuitisation options and financial incentives for market intermediaries play a central role in annuity market outcomes.

■ Living annuities

Living annuities are essentially investment accounts provided by life insurance companies. These products must pay an income of between 2.5 and 17.5 per cent of the account value to the policyholder each year. From the point of view of purchasers, however, they are complex products. Individuals who buy them must make and continually review decisions that involve difficult trade-offs, including how much income to draw down, what underlying

assets to invest in and which provider to choose. Getting any of these decisions wrong can have serious consequences that only become apparent many years later.

Charges on living annuities appear to be very high. Holders of these policies are subject to a complex, layered set of charges covering sales, financial advice, administration and asset management. There are no restrictions on the size or type of charges that may be levied, although brokers may be subject to maximum commission scales. A portion of these charges represents the implicit and explicit costs of providing investment choice, which few purchasers appear to use after their initial asset selection.

The median level of charges, excluding guarantee charges and performance fees, appears to be more than 2 per cent of individual balances a year. Charges may be much higher in some cases. This sharply reduces post-retirement income. For instance, a sustainable rate of drawdown for an individual aged 65 in good health may be no higher than 5 per cent per year. Annual charges of 2 per cent represent 40 per cent of the income that an individual is drawing from their living annuity, and, in present value terms, will consume 20 per cent of the policy's value over its life.

High charges significantly reduce post-retirement income

Despite the wide range of investment choices on offer, individuals appear to be investing their living annuity policies in broadly similar portfolios. Drawdown rates appear to be high, exposing the longer-lived to substantial risks of poverty. The median policy has a drawdown rate of 7.5 per cent per year before charges. After charges, this may be closer to 10 per cent. Drawdown rates at this level expose purchasers to substantial risks of declining real income. A randomly chosen living annuitant faces a two-in-three chance that their income will fall by 30 per cent in real terms while they are alive.

■ Conventional annuities

In broad terms, South Africa appears to have the conditions for a functioning market in life annuities, with a sufficient number of large market players in long-term insurance, substantial long-term assets and well-regulated insurance companies. However, suitable mortality data, disaggregated by market segment, may not yet be available, and greater quantities of inflation-linked bonds, particularly at the long end of the yield curve, may be necessary.

Today only about 20 per cent of retirees choose conventional annuities. Annuity purchase behaviour appears to be driven strongly by short-term considerations and sales incentives. In particular, the commission earned by brokers for selling a living annuity may be up to 10 times larger over the life of the product than the commission for selling a conventional annuity. Only about 10 per cent of policies sold by brokers are now conventional annuities.

Annuity purchase appears to be driven by short-term considerations

Large players in the conventional annuity market rate individual purchasers only by age and sex. As a result, poorer individuals, or those who are ill, may elect not to purchase conventional annuities

because they represent relatively poor value. For those who do purchase them, South African conventional annuities appear to be reasonably priced. Value for money may be lower for those buying consumer price index (CPI) linked products.

■ Policy options

Living annuity reform should reduce costs and the level of financial advice required

The National Treasury is investigating ways to reform living annuities, both to reduce the amount of financial advice they require and to reduce their costs. Options are provided, for further discussion and consultation with stakeholders.

One option is to create a new tax-free vehicle based on collective investment schemes out of which retirement income can be paid. This vehicle will not permit investment choice – although individuals will be able to choose between vehicles with different underlying investments, and to switch from one vehicle to another. Restrictions on permitted drawdowns will remain, must incorporate all charges and may be made age-related, but commissions for intermediaries will be more strictly regulated, and all arrangements will need to adhere to prudential investment regulations. Concurrently, reforms of existing living annuity policies will be necessary to improve their functioning.

Ways to increase the assistance provided to retirees are also under consideration. One option is to require all funds to select a default retirement income product. Funds must enrol members into this default product automatically, with at least two-thirds of their retirement funds below an upper threshold. Individuals may opt out of the default into other qualifying products if they wish. All default options should incorporate a minimum degree of longevity protection. Default products will also need to meet requirements on design, access, costs and terms. Options for the design of the default product are presented. Conventional annuities purchased from life insurers will qualify, provided that they meet certain conditions.

2. Background

About this paper

This is one of a series of technical discussion papers on promoting household savings and reforming the retirement industry. The need for such reforms is evident: most South Africans do not save adequately for retirement and only about half of the country's workers belong to a retirement fund.

Only about 50 per cent of South African workers belong to a retirement fund

Government is committed to increasing the financial security of all citizens, and wide-ranging proposals to reform social security and retirement fund arrangements are under consideration. The goal is a fair and sustainable social security system, supported by a mandatory statutory fund that provides pension, life insurance and disability benefits. Within this framework, government will encourage additional savings in approved retirement funds for those earning above the ceiling established for the national fund.

This paper reviews what happens when a person retires after saving before retirement. It focuses on the options faced at retirement by a member of a retirement fund, and on how to provide and extend retirement income, while ensuring that cost-effective, standardised and easily accessible products are available to retiring members of the public. It begins by summarising the South African retirement landscape and annuities market using publicly available data. This is followed by an international comparison, and analysis of the economics and finance of the markets for living annuities and conventional annuities. The paper closes with policy interventions that could be considered, but does not propose any particular approach. Rather, it is intended to inform discussions between the Government and all those with an interest in shaping the future of the retirement industry.

The retirement landscape

Well-functioning retirement systems encourage individuals to save sufficiently for old age, when they no longer work. This requires an efficient mechanism through which accumulated savings can be used to provide an income after retirement.

Over the past 25 years South Africa has moved from a largely *defined benefit* system to a largely *defined contribution* system. The main difference between the two is how they provide income after retirement. In defined benefit systems, retirement funds (or their insurers) typically pay pensions to individuals for life (although some might pay lump sums). In defined contribution systems, individuals use the accumulated balance of their savings accounts to provide an income when they retire.

South Africa uses a largely defined contribution system to provide retirement income

How effectively people use their accumulated defined contribution balances is an important determinant of how well the retirement system meets (or fails to meet) the needs of its members.

The legislative bases of South Africa's retirement system are the Pension Funds Act (1956, as amended) and the Income Tax Act (1962, as amended). With some public-sector exceptions, these acts regulate all retirement vehicles in South Africa.

All retirement funds – group, individual, single or multi-employer – are legal entities set up under the Pension Funds Act. However, the number and variety of funds is vast. In 2011, there were an estimated 2 500 active funds of 12 different types.

Table 1: Main types of South African retirement funds

| | Group arrangements | | Individual arrangements* |
|---------------------------------|-------------------------------------|-------------------------------------------------------|---------------------------------|
| | Single employer | Multi-employer | |
| Pension funds | Stand-alone employer pension fund | Bargaining council fund, umbrella fund, industry fund | Pension preservation fund |
| Provident funds | Stand-alone employer provident fund | Bargaining council fund, umbrella fund, industry fund | Provident preservation fund |
| Retirement annuity funds | | "Group" retirement annuities | Individual retirement annuities |

*Although marketed to individuals and called individual arrangements, members almost always join a single trust with many members.

Harmonising the tax treatment of funds will reduce the retirement system's complexity

Funds differ in two important ways. First, the tax treatment of contributions, investment income and benefits, and annuitisation requirements depend on whether a fund is classed as a pension fund, a provident fund or a retirement annuity fund. This distinction is codified in the Income Tax Act. Measures are being taken to harmonise the tax treatment of these funds, which will significantly reduce the complexity of the retirement system.

Second, the extent of employer involvement differs across vehicles. This has consequences because it influences how the fund operates – its marketing requirements, its implicit profit motive and its governance. The Pension Funds Act mainly codifies this distinction.

Table 1 illustrates the relative importance of fund type. It is based on a National Treasury analysis of data from the Financial Services Board (FSB).² The analysis was restricted to active funds.

The data are complex because they come from the latest fund accounts submitted to the FSB – which may refer to different dates – and because individuals may be members of multiple funds. Current estimates by the Association for Savings & Investment South Africa (ASISA) suggest that there are about 6 million individuals in the retirement system, implying significant double-counting in the table.

² http://www.fsb.co.za/HTML/Pensions/Reports/Active_Employers.zip, accessed 6 December 2011.

Single-employer funds still represent the largest stock of retirement assets, although multi-employer arrangements – in particular umbrella funds – are growing rapidly. By total assets under management, individual arrangements are marginally smaller than single-employer funds.

Multi-employer fund arrangements are growing rapidly

By the same measure, pension funds are slightly larger than provident funds or retirement annuity funds. But by number of members, provident funds are the largest retirement funding vehicle. Members of provident funds, however, have much lower average assets than members of pension funds. This may be the result of lower levels of preservation by lower-paid workers and the fact that, historically, provident funds were intended for this group.

Table 2: Assets under management and membership of active South African pure defined contribution retirement funds, by fund type, 2011

| Assets under management (R billion) | Single employer | Multi-employer | Individual | Total |
|--------------------------------------------|------------------------|-----------------------|-------------------|--------------|
| Pension funds | 234 | R137 | 46 | 417 |
| Provident funds | 152 | R130 | 26 | 308 |
| Retirement annuity funds | - | .* | 261 | 261 |
| Total | 386 | R267 | 333 | 986 |
| Members | Single employer | Multi-employer | Individual | Total |
| Pension funds | 801 735 | 937 863 | 118 530 | 1 858 128 |
| Provident funds | 1 612 156 | 2 747 283 | 95 399 | 4 454 838 |
| Retirement annuity funds | - | .* | 3 678 777 | 3 678 777 |
| Total | 2 413 891 | 3 685 146 | 3 892 706 | 9 991 743 |
| Assets per member | Single employer | Multi-employer | Individual | |
| Pension funds | 292 028 | 145 937 | 389 927 | 224 536 |
| Provident funds | 94 141 | 47 431 | 267 610 | 69 050 |
| Retirement annuity funds | - | .* | 71 049 | 71 049 |
| Overall | 159 866 | 72 500 | 85 576 | 98 701 |

Source: FSB

* “Group” retirement annuities are shown under the “individual” column as this is how the data are reported by the FSB.

■ Annuity products

South African law compels members of pension funds and holders of retirement annuities to use at least two-thirds of their accumulated balances to buy products that qualify legally as annuities. This is referred to as mandatory annuitisation. Members of provident funds may withdraw their entire retirement balance in cash when they retire, but can purchase annuities if they wish.³

By law, pension fund members and retirement annuity holders are subject to mandatory annuitisation

The term “annuity” is used in South Africa in many different ways, as shown in Table 3. Two main types of product qualify as annuities in terms of mandatory annuitisation rules: a conventional life annuity

³ Current proposals may harmonise the annuitisation requirement of these fund types, as well as their tax treatment, while respecting vested rights.

and a living annuity.⁴ Currently the law stipulates that both types must be sold under life licences,⁵ even though living annuities cannot, by law, provide any guarantees.

Table 3: Types of annuity products in South Africa

| | Description | Longevity insurance component | Notes |
|----------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Retirement annuity | Tax-deferred, defined contribution retirement savings account. Holders must purchase one of the two products below with at least two-thirds of their accumulated balance after age 55. | Only if individuals choose to purchase a conventional life annuity at retirement. Product may have a life insurance component for those who die before retirement. | Benefits can be taken only after age 55, at which point at least two-thirds of the retirement benefit must be annuitised and the balance can be taken as a lump sum. |
| Conventional life annuity | Insurance company pays an income to individuals until they die, pooling longevity risk across individuals. | Individuals are protected against the risk of living longer than they had expected or planned for. | Company uses its own capital to guarantee income in the event of mismatches between its assets and liabilities and unanticipated fluctuations in mortality. |
| Living annuity | A post-retirement phased withdrawal savings account. | None. | Individuals must withdraw between 2.5 per cent and 17.5 per cent ⁶ of the account each year. A wide range of investments is possible. Risk exposure can be substantial. |

Source: National Treasury research

Conventional life annuities

Conventional life annuities can only be sold by life insurance companies

Life insurance companies are the exclusive vendors of conventional life annuities. In exchange for a lump sum, the insurance company promises the buyer a regular income stream guaranteed to continue for at least as long as the buyer lives.

Conventional life annuities come in many forms in South Africa. Payments may be fixed or increase in line with CPI, with investment returns (typically the returns on a guaranteed bonus portfolio), or at a fixed rate (such as 5 per cent annually). There may be a provision for the income to continue after the death of the primary holder until the death of a nominated spouse (although possibly at a reduced rate). To protect the dependants of individuals that die very soon after buying the annuity, there may be a guaranteed period during which the annuity income is paid whether or not the buyer is alive.

Annuity risk exposure is reduced through diversification

Insurance companies manage the risk of annuities mainly through diversification. They are able to pool the longevity risk of thousands of people and, in so doing, reduce their exposure to particular individuals. They also use their own capital to guarantee annuity payments in the case of mismatches between their assets and

⁴ Although it is recognised that living annuities (also known as investment-linked living annuities) are not annuities in the strict sense, these terms are in common use in the South African market.

⁵ To sell long-term insurance in South Africa, a firm must be licensed by the FSB. This is known as a life licence.

⁶ Current proposals would reduce the minimum withdrawal rate to 0 per cent.

liabilities. However, since annuity income may be paid for 30 years or more, people who buy conventional life annuities run the risk – even though it may be a small risk – that the company guaranteeing their payments could become insolvent.

Insurance companies do not pay tax on income earned by assets held in life annuity portfolios, but individuals pay income tax at standard rates on the full amount of each payment.

Living annuities

South Africa's living annuities market was worth an estimated R26.5 billion in 2011. Legally, these are life insurance policies and must be sold under life licences, even though it is prohibited to provide guarantees. In the past, they were mostly sold directly by life insurance companies, but in recent years linked investment service providers run by asset management firms under rented life licenses have come to dominate the market.

Living annuities give holders control over underlying assets, but expose them to the risks of outliving those assets

Living annuities are tax-protected phased-withdrawal products. Each purchaser has a separate account, to which asset holdings and returns are allocated and out of which benefits are paid. Purchasers must choose a drawdown rate between 2.5 per cent and 17.5 per cent of the total assets, which is paid to them as an income each year. When individuals die, any remaining capital reverts to their beneficiaries.

Individuals have a wide range of choices for the underlying asset portfolio, and there are no individual or portfolio-level investment restrictions on the assets that may be held inside living annuities. Insurers that sell annuities, however, must abide by exchange control regulations set by the Reserve Bank, and broad prudential asset limits assessed at enterprise level.

At present there are no individual-level restrictions on the investment portfolio in living annuity policies

Companies selling living annuities are currently forbidden from providing any form of guarantee. The underlying funds in which the assets are held, however, may provide some form of guarantee. No tax is paid on income earned by assets held in living annuity portfolios, but individuals pay income tax at standard rates on the full amount of each drawdown payment.

Understanding Regulation 28 of the Pension Funds Act

Regulation 28 frames the investment strategy permitted by all assets held inside retirement funds. Assets held under living annuity policies are not currently subject to this regulation.

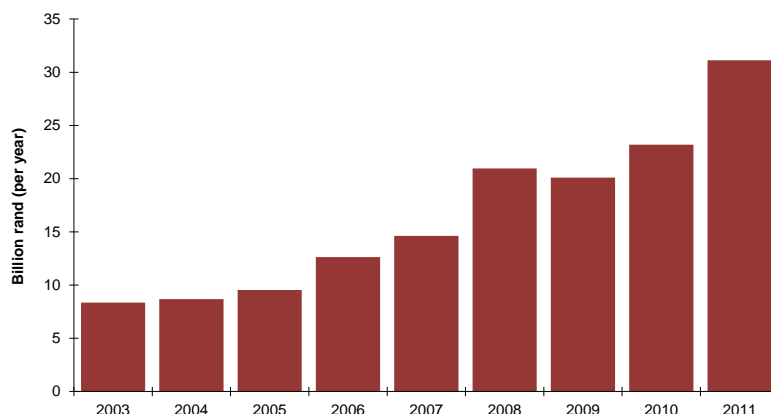
The regulation specifies asset limits for different asset classes and issuers. It also sets out principles that trustees must use to guide investment strategies. These include the need to match assets and liabilities; to perform due diligence on investment managers; to consider the need for transformation of the economy; and to take into consideration environmental, social and governance factors.

Retirement funds must comply with the prescribed investment limits on a "look-through" basis, and on an individual level for each member in the fund. The regulation restricts funds from concentrating too much in single issuers and particular asset classes. The entire fund may be invested in debt issued by or guaranteed by government, and 75 per cent of the fund may be invested in other listed debt, including debt issued by a South African bank and guaranteed by its balance sheet. Listed equities are limited to 75 per cent of the total portfolio; fixed property to 25 per cent; private equity and hedge funds to 15 per cent; commodities to 10 per cent; and securities issued by participating employers in the fund to 5 per cent.

■ Annuities market

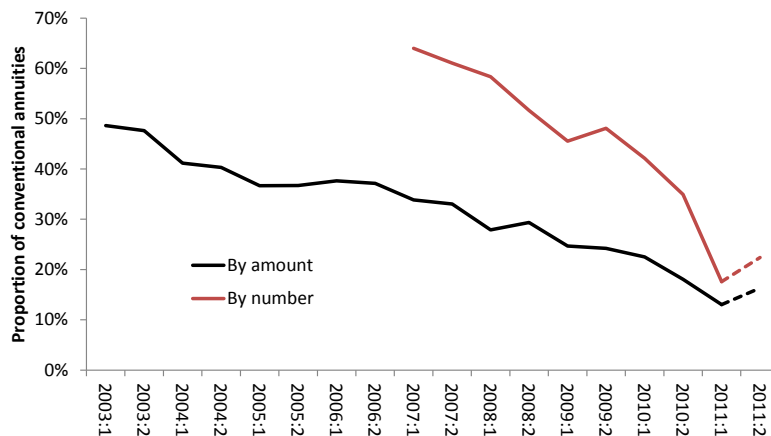
South Africa's annuities market nearly quadrupled from total purchases of about R8 billion in 2003 to a provisional R31 billion in 2011.⁷ FSB data (see Table 2) shows that pension fund and retirement annuity funds had R678 billion under management in 2011

Figure 1: Volume of single premiums for compulsory purchase retirement annuities (including living annuities), 2003-2011



Source: ASISA

Figure 2: Proportion of compulsory purchase annuities that are conventional life annuities



Source: ASISA

⁷ ASISA provides two sets of statistics on the size of living annuities market. One relates to linked investment service providers and the other to life offices. There are significant differences in magnitude between the two. With guidance from ASISA, the life office series has been used, acknowledging the possibility of slightly understating the size of the living annuity market. In addition, there appear to be statistical reporting delays, so the 2011 figure may be understated.

Besides this exceptional growth, there have also been major changes in the structure of the industry. Fewer individuals are choosing to buy conventional life annuities – the only products offering longevity protection. The proportion of single premiums used to buy these annuities fell from 50 per cent in 2003 to about 14 per cent in 2011, as shown in Figure 2.

Conventional life annuities – the only product with longevity protection – are becoming less popular

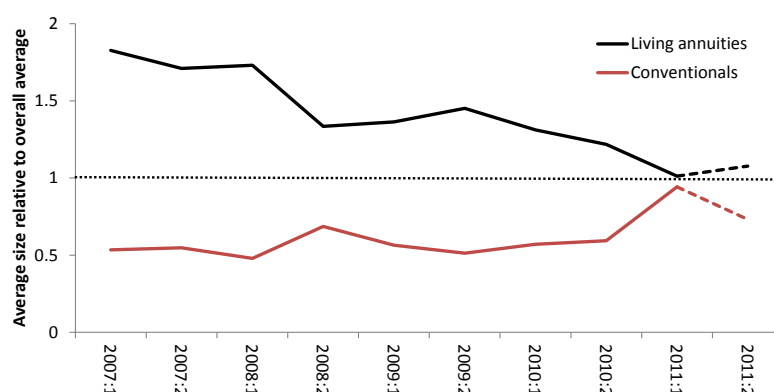
By number of policies, the decline in the proportion of individuals buying conventional annuities has been even steeper. Data are only available since 2007, but since then the proportion of life office annuity policies that are conventional annuities has fallen from about 65 per cent to 20 per cent.

One important factor influencing the change may be the level of interest rates. Some individuals may be choosing to delay the purchase of conventional annuities in response to low interest rates.

Low interest rates may be causing individuals to delay the purchase of conventional annuities

Figure 3 suggests that growing numbers of middle- and lower-income individuals are choosing to purchase living annuities rather than conventional annuities when they retire. In 2007, the average living annuity had a single premium nearly 1.8 times larger than the average single premium of both types of annuities, although this had fallen by 2011 to around only 1.1 times the overall average.

Figure 3: Average size of single premium for living annuities and conventional annuities, expressed as a proportion of the overall average of single premiums for both for life offices, 2007-2011



Source: ASISA

International comparison

The National Treasury has reviewed the annuities market in Australia, Chile, Sweden, the United Kingdom and the United States, which have the following characteristics in common:

- Substantial and mature DC systems
- Annuitisation choice is made at retirement, instead of deferred annuities being sold to current workers

- Inter-generational transfers are not made between workers and retirees through annuities markets.⁸

Regulation is vital to developing the retirement product market

The results of the review are summarised in the table below. The main observation is that without some form of regulatory intervention – mandation, or quasi-mandation through appropriate defaults, tax incentives or regulation to standardise products – a market in suitable retirement products will struggle to develop. In addition, paying close attention to tax and market incentives is crucial to understand annuity market outcomes in different countries.

Table 4: Annuities market in selected countries

| Country | Regulatory intervention | Tax treatment | Conventional life annuities market | Comments |
|-----------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| United Kingdom | In 2011, the requirement to buy a conventional life annuity with 75% of one's retirement balance before age 75 was removed and the maximum drawdown rate was reduced to 100% of conventional annuity income. Individuals with a minimum secured income of more than £20 000 can withdraw more. | Phased withdrawal or annuity income taxed as earned income. | Largest annuities market in the world, with about 450 000 policies sold annually. Sophisticated rating based on age, sex, health and postcode. | The 2011 reform may pose long-term risks for the existing UK annuity market. |
| Chile | Individuals have a one-off choice between a phased withdrawal product (paid from their pension fund), and a life annuity with set features, including inflation and spouse's protection. Retirees receive a standardised, computer-generated list of quotes from major providers. | Phased withdrawal or annuity income taxed as earned income. | Significant market, with 60% of retirees choosing conventional life annuities. | Other than a state-provided minimum income guarantee and a new "solidarity pension", there is no longevity protection from the state. |
| Sweden | Public pension was partly made a funded defined contribution system in 1995. All benefits must be taken as an annuity (fixed or variable annuities), and individuals can elect a spouse's pension. No mandatory annuitisation for benefits from occupational schemes. | Annuity income taxed as income. | Public sector is monopoly provider for benefits, but annuities are fully funded. Implicit state guarantee. Inter-generational transfers not allowed. | Annuities rated only by age, not by sex, health status or occupation. High replacement rates. Few individuals choose life annuities with occupational pension balances. |
| Australia | No regulatory intervention other than age-dependent minimum withdrawal rates to protect the fiscus. | All withdrawals tax free. | Fewer than 30 life annuities are sold each year. | State-provided age pension is means tested and equal to about 25% of average male earnings. |
| United States | No regulatory intervention other than age-dependent minimum withdrawal rates to protect the fiscus. | Phased withdrawal or annuity income taxed as earned income. | Active but small market relative to size of social security system or occupational defined benefit pension system. | Significant longevity protection provided by social security system. |

Source: National Treasury research

■ Understanding long-term market trends

Nearly R1 trillion is invested in South Africa's retirement market, largely in defined contribution private-sector funds. In 2011, annual single premiums in annuities exceeded R31 billion.

⁸ These conditions exclude countries such as Denmark, Germany, Belgium and the Netherlands, which operate guaranteed deferred annuity markets (Rusconi, 2008).

An unusual feature of this market is that after a lifetime of participating in retirement savings vehicles where decisions are largely automated, on retirement most individuals are left to the retail market, where there is a wide choice of products and providers. Individuals must pay retail charges and most need to obtain expensive financial advice to find their way. Most people, even those who are not well off, choose to draw down their assets through living annuities, rather than buying conventional life annuities. These features warrant more detailed investigation to determine:

On retirement, many South Africans are left to buy financial products in the retail market

- Why the market for conventional life annuities has declined, and to assess the implications for individuals.
- How people are managing the risks of living annuities – in particular, outliving their assets and poor investment returns.
- How costs affect market functioning.

3. Living annuities

This chapter examines the economics and finance of living annuities.

■ Product complexity

Living annuities are complex and most buyers will need substantial and ongoing financial advice

Living annuities pose few prudential difficulties because providers face no mismatch between assets and liabilities. Their product design is transparent, with the available balance and the underlying investment mix visible at any time.

From the purchaser's perspective, however, living annuities are highly complex, especially in comparison with conventional life annuities, which function automatically once purchased. In contrast, purchasers of living annuities must make or review several choices, at least every year. These decisions could have serious consequences that only become apparent after many years.

Buyers of living annuities must:

- Elect an investment mix from potentially thousands of options
- Choose a drawdown rate
- Select a provider or change their existing provider.

Such decisions are dependent on a wide range of factors that vary from individual to individual, including:

- The level of support they can expect from family
- Access to post-retirement medical aid cover
- Risk aversion
- Bequest motives
- Life expectancy

This list is by no means exhaustive, but it should make clear that most individuals who buy living annuities will need substantial and continuing financial advice.

Costly financial advice makes living annuities inappropriate for low-income earners

Individually-tailored financial advice is expensive. A financial adviser who sells a living annuity to an individual might charge as much as 1 per cent of the assets under management annually for the ongoing advice that the product requires. For a drawdown rate of 7 per cent each year, this represents 14 per cent of the income that the individual is receiving themselves, purely for providing financial advice, *before* all other charges associated with the product. For people on low incomes, the need for financial advice alone makes living annuities inappropriate.

■ Product charges

The living annuities market is characterised by the layering of charges for different services. There may be charges when the investment is first made, and recurring charges for the life of the

investment. Holders of living annuities are subject to the following charges, most of which are paid out of their fund balances:

- Costs of financial advice and brokerage fees
- Platform fees to the provider
- Asset management fees to the asset manager
- Performance fees on investments to the asset manager
- Audit fees, trustee fees, brokerage, VAT, securities transfer taxes (usually these are not disclosed, but simply reduce the return on the underlying funds).

Recurring fees exert a substantial effect on the income that individuals can obtain from their living annuities.

Recurring charges reduce living annuity income

There are no restrictions on the size or type of charges that may be levied, although brokers may be subject to maximum commission scales.⁹ Providers can choose how to balance initial and recurring fees. Fees are often negotiable, allowing individuals with larger balances to secure more favourable terms.

As Table 5 shows, there is a wide dispersion in each of these charges, although the data provided by ASISA do not allow the dispersion in total charges to be calculated. However, an average reduction in yield of 2 per cent to 2.5 per cent, and a range from 1 per cent per year to 3.5 per cent per year is not unreasonable based on the data. Initial fees are low, and falling, and might now be less than 1 per cent of the initial premium for most investors.

Table 5: Annual living annuity charges as a percentage of assets under management from a large linked investment service provider

| | | Charge type | | | |
|---------------|-----------------------------|-------------|------------|--------------|-----------------|
| | | Broker fee* | Agent fee* | Platform fee | Asset mgmt fees |
| Annual charge | 5 th percentile | 0.00% | 0.00% | 0.42% | 0.00% |
| | 25 th percentile | 0.00% | 0.00% | 0.66% | 0.53% |
| | Median | 0.50% | 0.50% | 0.81% | 0.71% |
| | 75 th percentile | 0.75% | 0.50% | 0.84% | 1.03% |
| | 95 th percentile | 1.00% | 1.00% | 0.84% | 1.58% |
| | Average | 0.53% | 0.45% | 0.48% | 0.76% |

Source: ASISA

* Individuals pay either the broker fee or the agent fee, but not both.

As with charges on other types of financial products, individuals might be more sensitive to initial fees than to recurring fees. This would give providers, asset managers and brokers an incentive to reduce the former and increase the latter. Yet for long-term products, small recurring fees can add up dramatically and significantly reduce benefits.

Individuals might be more sensitive to initial fees than to recurring fees

A simple measure of charges shows the fraction of lifetime pension contributions made by individuals that are used to pay charges on

⁹ In practice, these can be evaded by labelling commission as 'fees for financial advice' or 'consulting fees'.

living annuity policies rather than to provide a retirement income. If a living annuity policy with no charges was available, individuals could reduce their lifetime retirement fund contributions¹⁰ by this amount while receiving exactly the same income in retirement. This fraction is shown in Table 6 for different drawdown rates and annual charge levels.

Table 6: Proportion of lifetime pension contributions used to pay charges on living annuity policies

| | | Annual drawdown rate | | | | | | | |
|---------------|------|----------------------|-----|-----|-----|-----|-----|-----|-----|
| | | 3% | 4% | 5% | 6% | 7% | 8% | 9% | 10% |
| Annual charge | 1.0% | 25% | 20% | 17% | 14% | 13% | 11% | 10% | 9% |
| | 1.5% | 33% | 27% | 23% | 20% | 18% | 16% | 14% | 13% |
| | 2.0% | 40% | 33% | 29% | 25% | 22% | 20% | 18% | 17% |
| | 2.5% | 45% | 38% | 33% | 29% | 26% | 24% | 22% | 20% |
| | 3.0% | 50% | 43% | 38% | 33% | 30% | 27% | 25% | 23% |
| | 3.5% | 54% | 47% | 41% | 37% | 33% | 30% | 28% | 26% |

Source: National Treasury calculations

These figures calculate charges only as a proportion of assets that are actually drawn down as income from the policy. Many individuals die before they exhaust their funds, leaving the rest to their heirs, and might choose living annuities precisely for this reason.

Prospective charge ratios for living annuities are very high, suggesting that cutting charges is a priority

To take this effect into account, the present value of charges is expressed as a proportion of the initial balance (rather than the present value of income actually drawn). All charges are assumed to stop when the individual dies. Table 7 expresses this measure, which can be thought of as a forward-looking charge ratio. The charge ratio falls as the drawdown rate rises because the earlier funds are withdrawn, the lower are fees paid to manage them. For an annual drawdown rate of between 7 per cent and 8 per cent, close to the median in the ASISA sample, total charges of between 2 and 2.5 per cent annually will result in an expected 15 per cent to 19 per cent of the initial balance being paid in fees over the life of the product.

Table 7: Prospective charge ratio as a function of the annual drawdown rate and the annual total charge for living annuity policies

| | | Annual drawdown rate | | | | | | | |
|---------------|------|----------------------|-----|-----|-----|-----|-----|-----|-----|
| | | 3% | 4% | 5% | 6% | 7% | 8% | 9% | 10% |
| Annual charge | 1.0% | 12% | 11% | 10% | 9% | 9% | 8% | 8% | 7% |
| | 1.5% | 17% | 16% | 14% | 13% | 13% | 12% | 11% | 10% |
| | 2.0% | 22% | 20% | 19% | 17% | 16% | 15% | 14% | 13% |
| | 2.5% | 26% | 24% | 22% | 21% | 19% | 18% | 17% | 16% |
| | 3.0% | 30% | 28% | 26% | 24% | 23% | 21% | 20% | 19% |
| | 3.5% | 34% | 31% | 29% | 27% | 26% | 24% | 23% | 21% |

Source: National Treasury calculations

Both measures demonstrate that at current levels, living annuities fees significantly reduce the benefits that can be paid to retirees.

¹⁰ The reduction would apply only to the portion of contributions earmarked for retirement – so after charges for risk benefits and administration are removed.

Investment mix and investment choice

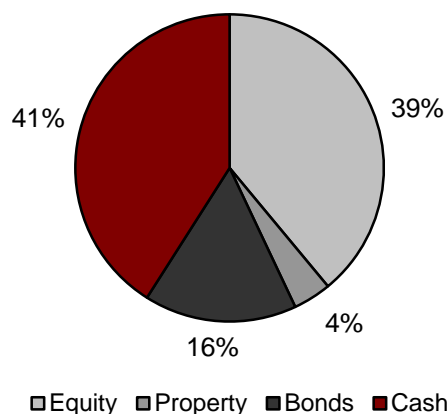
Almost all living annuity policies offer substantial investment choice to members. In part, this is a response to perceived demand by individual investors for retirement investment options. In principle, offering choice increases the welfare of retirees by allowing them to adjust their asset mix to match their financial circumstances.

In principle, wide investment choice is beneficial for retirees

Figure 4 gives an idea of how individuals, on average, choose to allocate assets in their living annuities. About 57 per cent is invested in bonds and cash, with the balance in property and equities.

Even with the large amount of investment choice now on offer, many (if not most) living annuities appear to be invested in similar underlying portfolios. This is consistent with the experience of investment choice internationally: few people use investment choice where it is offered.

Figure 4: Average asset allocation in book, large ASISA member, April 2011



Source: ASISA

Yet investors pay for investment choice in at least three ways:

- Directly through platform fees levied by investment service providers on retirement assets. Platforms offering fewer investment options have lower operating costs and can charge lower fees.
- Indirectly through conflicts of interest between platform providers and members that reduce the returns on investments after fees. It is common practice for investment managers to pay platform providers a rebate, which is a portion of the management fee they charge investors. This represents a bulk discount on asset management charges to reflect that linked investment service providers bear some of the distribution costs of the asset manager. Yet these rebates may not be passed on to investors.

- Investment choice increases the cost of financial advice, particularly for those individuals who choose not to exercise it.

Investment choice in living annuities may therefore represent a substantial subsidy from the majority of retirees who do not exercise investment choice to the few who do.

■ Distribution channel

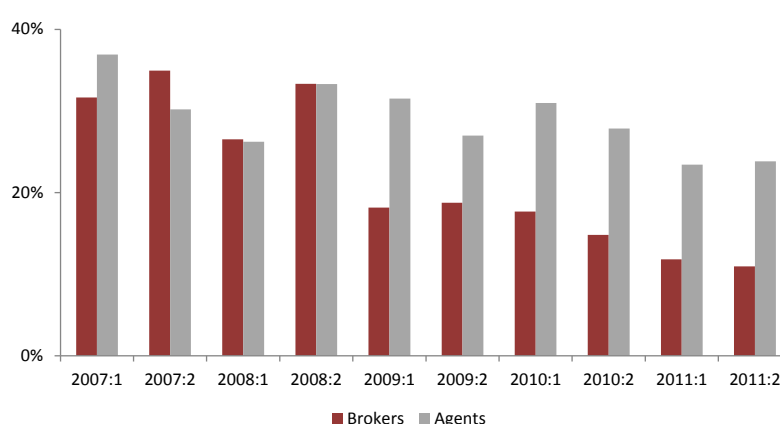
Living annuities are primarily sold through retail distribution channels, including agents tied to asset managers or insurers, and independent financial advisers. About half are sold by brokers, who are not tied to selling a single provider's products. Available data suggests that broker-sold policies are slightly larger, on average, than those sold by agents, who are tied to certain companies.

The commission structure may dispose brokers to sell living annuities rather than conventional life annuities

The distribution channel selling living annuities can have a significant effect on individuals' choices. Financial advisers may charge up to 12 per cent of the initial policy value in exchange for financial advice. In contrast, a financial adviser who recommends a conventional annuity is subject to maximum commission scales of 1.5 per cent of the initial purchase price, although some insurers may pay additional commissions. This suggests that financial advisers have strong incentives to recommend investment-based products rather than conventional life annuities.

Conventional life annuity sales are declining. While they accounted for about one-quarter of retirement income products sold by tied agents in the second half of 2011, they made up only 10 per cent of the products sold by brokers or financial advisers. Figure 5 shows the trend over time, using available data from ASISA.

Figure 5: Proportion of single premiums that are conventional life annuities by distribution channel, 2008-2011*



Source: ASISA

*The figure shows half years. The balance is living annuities.

Although this is only indicative evidence – because brokers and agents may sell to different markets and sell different products – the

data suggests that there may be a strong financial incentive to sell living annuities, which may not be appropriate for many clients.

■ Drawdown rates

Concern about inappropriate sales has prompted ASISA to issue a living annuities standard. It requires sellers to show potential buyers wording highlighting the long-term consequences of various levels of income drawdown and investment risks.

Living annuity sellers must explain long-term consequences and risks

The data in Table 8 allows for an analysis of the drawdown behaviour of individuals, although limited information regarding their investment strategy is available.

Table 8: Distribution of the number of living annuity policies by age and drawdown percentage, 31 December 2011

| Age band | Drawdown percentage, before fees | | | | | | |
|----------|----------------------------------|-------------|--------------|---------------|---------------|---------------|----------------|
| | 2.5% - 5.0% | 5.0% - 7.5% | 7.5% - 10.0% | 10.0% - 12.5% | 12.5% - 15.0% | 15.0% - 17.5% | 17.5% - 20.0%* |
| < 55 | 0.98% | 0.50% | 0.69% | 0.28% | 0.16% | 0.44% | 0.79% |
| 55 – 59 | 6.44% | 2.02% | 3.06% | 1.21% | 0.45% | 2.39% | 1.41% |
| 60 – 64 | 8.29% | 4.14% | 4.74% | 1.96% | 0.81% | 2.33% | 2.22% |
| 65 – 69 | 8.29% | 5.01% | 5.15% | 2.12% | 0.95% | 2.00% | 2.89% |
| 70 – 74 | 4.80% | 3.15% | 3.08% | 1.51% | 0.73% | 1.14% | 2.58% |
| ≥ 75 | 2.75% | 2.11% | 1.64% | 1.07% | 0.55% | 0.78% | 2.40% |
| All | 31.55% | 16.93% | 18.36% | 8.15% | 3.65% | 9.08% | 12.29% |

* When the upper limit was reduced to 17.5%, existing policies which were drawing over 17.5% were permitted to stay at this level.

Source: ASISA

According to these figures, the median policy has a drawdown rate of between 7.5 per cent and 10 per cent per year; the average policy has a drawdown rate of 9.05 per cent annually.¹¹ Note that these drawdown rates are before fees, which may add up to 3 per cent to these values each year.

The median policy has a drawdown rate of more than 7.5 per cent annually before fees

The National Treasury designed a financial model to understand the implications of these drawdown rates. The model is based on the following assumptions: drawdown percentages are independent of mortality and remain constant;¹² individuals have mortality equal to the most recent Actuarial Society of South Africa investigation of annuitant mortality for males;¹³ long-term real interest rates on bonds, net of expenses, are 2 per cent per year; inflation is 6 per cent annually; the equity risk premium is 4 per cent yearly; the annual standard deviation of equity returns is 25 per cent; and all

¹¹ The existence of some policies with very large drawdown rates pushes the average higher than the median. ASISA reported an average drawdown rate of 7 per cent, but their figure was an average across funds invested, rather than across policies, and was thus biased toward larger policies. Further, their figure was reported without any allowance for charges.

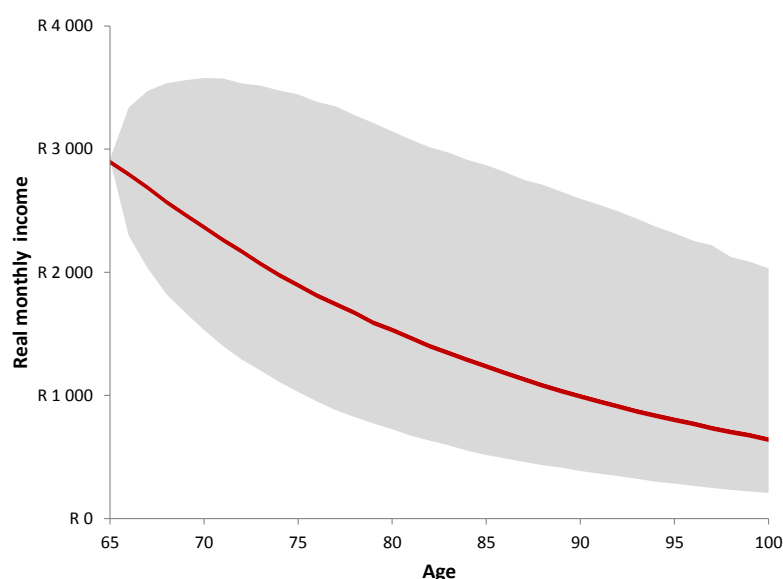
¹² Individuals with lower life expectancy may justifiably have higher drawdown rates since their funds need to last for a shorter time. Individuals may also increase their drawdown rates as they age, raising their income, but increasing the chance of lower income at older ages if they survive.

¹³ To the extent that these mortality rates represent a sub-sample of the population with lower life expectancy, risks may be understated by using this table.

individuals, regardless of age or drawdown rates, have the same underlying investment strategy of 50 per cent equities and 50 per cent bonds. The expected investment return, net of charges, is therefore assumed to be 4 per cent in excess of inflation per year.

The range of possible outcomes for an individual who purchases a living annuity policy with R500 000 at age 65 and elects an annual drawdown rate of 7 per cent is shown in Figure 6. In 90 per cent of cases, the monthly income from the living annuity will lie within the grey area; half the time it will lie above the red line.

Figure 6: 5th and 95th percentiles of real monthly income from a living annuity with initial deposit R500 000*



Source: National Treasury modelling

*Grey area shows 7% annual drawdown, with red line as median.

Older individuals and those with lower drawdown rates are less likely to outlive their assets

The model is then used to calculate, for each combination of age and drawdown rate, the probability that an individual with a living annuity policy would face a fall in income of more than 30 per cent in real terms at some point before death. The results are shown in Table 9. The older individuals are, and the lower the drawdown rate, the smaller the probability of outliving their assets. An individual between the ages of 65 and 70, with an annual drawdown rate of between 7.5 per cent and 10 per cent, faces about an 80 per cent chance of their real income falling by more than 30 per cent while they are still alive.

67 per cent probability of income decline in real terms of 30 per cent

The information in Table 9 was used to calculate the probability that a randomly selected living annuitant would face an income fall in real terms of at least 30 per cent before death. This probability turned out to be 67 per cent.

This calculation was repeated for different levels of falls in income. The results are shown in Figure 7. The horizontal axis shows the fall in income, in percentage of the initial income after adjusting for inflation, and the vertical axis shows the probability that a randomly selected living annuitant will experience a fall of this level from their initial income level while still alive.

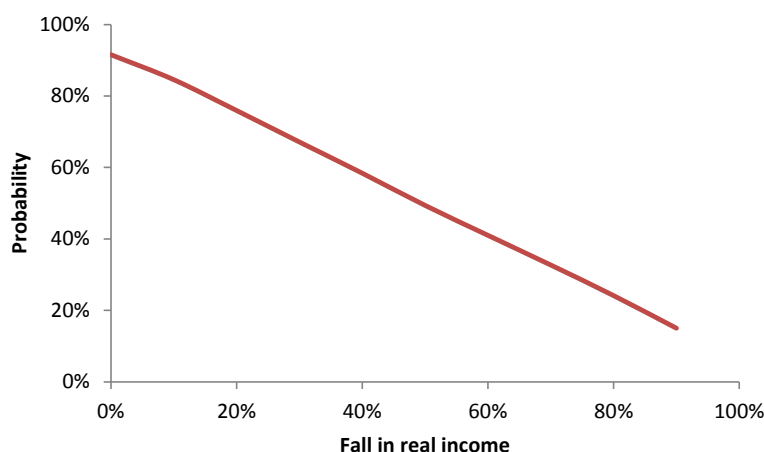
Table 9: Probability of a greater than 30% fall in real income while individuals are still alive

| Age band | Drawdown percentage | | | | | | |
|----------|---------------------|-------------|--------------|---------------|---------------|---------------|---------------|
| | 2.5% - 5.0% | 5.0% - 7.5% | 7.5% - 10.0% | 10.0% - 12.5% | 12.5% - 15.0% | 15.0% - 17.5% | 17.5% - 20.0% |
| < 55 | 54% | 80% | 92% | 95% | 96% | 97% | 98% |
| 55 – 59 | 49% | 76% | 87% | 92% | 94% | 95% | 96% |
| 60 – 64 | 44% | 71% | 85% | 90% | 93% | 94% | 95% |
| 65 – 69 | 37% | 63% | 79% | 86% | 90% | 92% | 93% |
| 70 – 74 | 32% | 55% | 71% | 80% | 85% | 88% | 90% |
| ≥ 75 | 22% | 39% | 54% | 66% | 74% | 78% | 82% |

* When the upper limit was reduced to 17.5%, existing policies which were drawing over 17.5% were permitted to stay at this level.

Source: National Treasury modelling

Figure 7: Probability that a randomly selected living annuitant will see falls in real income of various amounts while still alive



Source: National Treasury

Although the model rests on a large number of assumptions, the calculations suggest that the vast majority of South African living annuitants are exposed to a substantial risk of falls in real income as they age.

A further concern is the trend in drawdown rates over time. According to data from Alexander Forbes,¹⁴ the average drawdown rate in their Member Watch sample of retirees has increased from just over 8 per cent annually in 2007 to about 11 per cent each year in 2011. This is substantially higher than the average drawdown rate of 9.05 per cent yearly reported by ASISA. Yet this increase in drawdown rates has happened despite declining interest rates and equity returns, which might have suggested that prudent holders of living annuities would cut, rather than raise, their drawdown rates.

Drawdown rates appear to be increasing over time, despite declining interest rates and equity returns

¹⁴ Alexander Forbes, 2011, *The 1st Annual Alexander Forbes Hot Topics Summit: The Future of Benefit Design*, p. 30 and p. 31.

One survey finding states:

“...there are clear behavioural issues prevalent in the annuity choices being made by individuals. This is a result of the significant level of choice on annuities at retirement, (and) the fact that generally people have not saved sufficient amounts for their retirement”

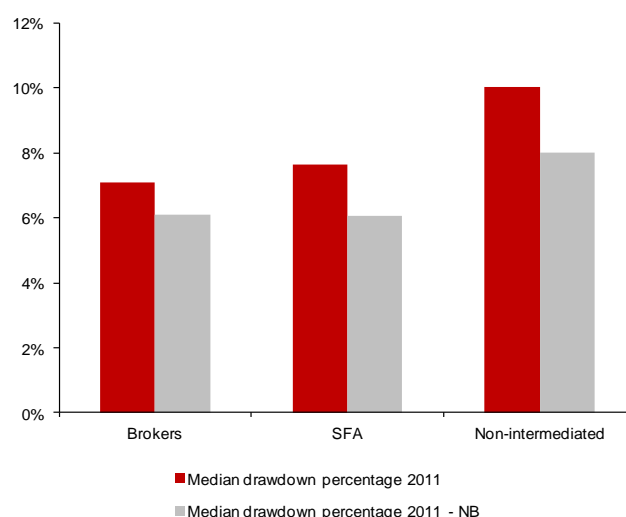
The survey calls for an improvement in options for individuals or for a regulatory environment limiting individual choice.

Financial advice and drawdown rates

The quality of financial advice holders receive seems to influence their drawdown rate

The rate at which individuals draw down their living annuities appears to be correlated with the distribution channel that sold the products. People who buy their policies directly rather than through brokers seem to have the highest median drawdown rate, of about 10 per cent of the capital each year, while policies sold through tied agents have lower drawdown levels of between 7 and 8 per cent annually. Of course, this difference should be reduced by annual charges paid to financial advisors, which may be as much as 1 per cent of assets each year.

Figure 8: Median drawdown percentages, April 2011



Source: ASISA

According to ASISA, possibly in response to lower anticipated interest rates, business sold in 2011 looks to have a slightly lower annual median drawdown rate of 8 per cent for non-intermediated (broker) business and 6 per cent for intermediated (agent) business. Again, these figures seemingly contradict the trend in drawdown rates shown in Alexander Forbes figures.

It seems that many existing policy holders are not reviewing their drawdown rates

Whatever the actual trend, however, differences between the drawdown rates of new and old policies raise other concerns about how much individuals with living annuities are adjusting these rates in response to changes in the financial environment. Even though interest rates – and, arguably, expected returns on all other financial assets – have fallen because of the financial crisis, it would appear

that many individuals with existing policies have not reviewed their drawdown rates.

■ Conclusion on Living Annuities

This review of living annuities concludes as follows:

- Most South African retirees who purchase living annuities face a substantial risk of outliving their living annuity assets, largely as a result of high drawdown rates and high charges.
- Average charges of living annuity policies are high, with potential for significantly reduced annuitant income.
- Part of these charges – in particular platform fees and part of fees for financial advice and investment management – represent the implicit and explicit costs of providing investment choice, which relatively few living annuitants use.
- The requirement that living annuities be provided under a life licence appears unnecessary, especially because they cannot provide a guarantee of any kind.
- There seems to be some desire for protecting capital in the event of early death, although the balance varies from individual to individual.

Most South African retirees who purchase living annuities risk outliving their living annuity assets

4. Conventional annuities

About 90 per cent of conventional life annuities expose individuals to significant inflation risk

This chapter examines the conventional annuities market in detail.

A wide range of conventional annuities is available, with varying levels of payment increases, guarantee terms and levels of income for spouses after holders have died. Although there is no industry-wide breakdown of the market by product type, evidence suggests that about 90 per cent of conventional life annuities sold are “level” annuities where payments do not increase over time. “With-profits” annuities, which make payments linked to investment returns on an underlying portfolio, are available, but these have fallen out of favour, perhaps as a result of poor transparency and high capital costs for insurers.

Buyers of fixed-payment products are heavily exposed to inflation risk. If, for example, inflation continues at about 6 per cent a year, their purchasing power will be halved every 12 years. By the time an individual reaches the age of 90 (about 20 per cent of men who retire at 65 will reach this age, according to Actuarial Society of South Africa tables), their purchasing power will be one-quarter of what it was when they retired. If inflation is higher than expected, purchasing power might well be much lower.

Tied agents and brokers each sell about half of conventional life annuity policies, although the share sold by agents appears to be increasing as more brokers recommend living annuities. There is not much difference between the average size of conventional life annuity policies sold by brokers and by agents.

■ Demand

Worldwide annuity sales are very low, despite their potential value

Benefits of conventional life annuities

In theory, demand for conventional life annuities should be high given their substantial potential economic value to consumers. In practice, however, sales of such annuities are very low worldwide.

The primary benefit of conventional annuities is that they protect individuals against the risk of outliving their assets by pooling mortality risk. Individuals with conventional life annuities do not need to prepare for the risk of outliving their assets, and will not leave unintended bequests.¹⁵ Compared to lump sum payouts, conventional annuities also postpone the payment of income tax, since each annuity payment is treated as income in the year it is paid, and so average tax rates could be lower.

Individuals who buy conventional life annuities face low levels of risk, since the insurance company guarantees a fixed or contractually

¹⁵ Unintended bequests arise when individual have no specific inheritance plans but die before consuming all of their assets.

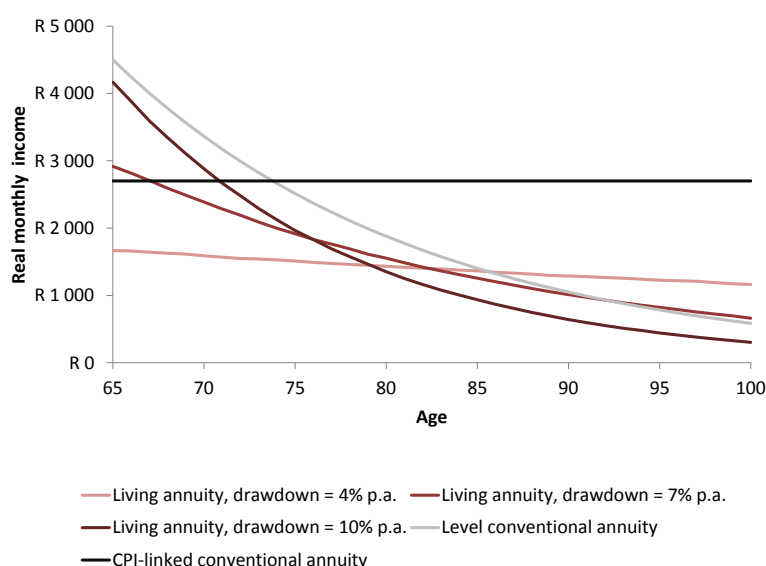
increasing payment stream regardless of future economic conditions (although with-profits life annuities might offer an increase partially dependent on investment returns). However, even though the FSB closely monitors solvency and capital adequacy, annuity holders bear the risk of potential insurer insolvency.

This protection against investment risk comes at a cost: insurers typically invest in long-term bonds to back annuity liabilities, meaning that purchasers of annuities are not able to obtain the rates of return that may be available in equities and other assets. Of course, they are not exposed to the risks of investing in equities.

Annuity holders cannot obtain the rates of return available in equities and other riskier assets

Overall, the benefits of fairly priced conventional life annuities can be substantial. Figure 9 shows the monthly income over life – in real terms – for a male who retires at age 65 with a lump sum of R500 000 and who chooses different retirement income options. These are median income paths developed from the National Treasury model referred to earlier. In the case of conventional and index-linked life annuities, the figures are taken from actual quotes, provided by ASISA, and exclude capital guarantees.

Figure 9: Median income paths of different annuity options at retirement, in real terms



Source: Treasury modelling, ASISA figures

Buying a conventional life annuity would provide a falling real income, starting at R4 500 per month. In real terms, this income falls at the rate of inflation, by our assumptions 6 per cent each year. This is the light-grey line in the figure. A high level of income can be paid because when the individual dies, no residual capital will be passed on to heirs: the buyer is using the life annuity to consume all of his or her capital while alive, while still insuring against the risk of living too long.

The individual could also choose to buy a life annuity where payments escalate in line with inflation. This produces a lower initial income of R2 700 per month, but these remain constant in real terms. This is the black line in the figure.

Life annuity payments escalating with inflation produce a lower initial income

The three red lines show the median income path if the individual chooses a living annuity with different drawdown percentages. The higher the drawdown percentage, the higher the initial income but the more steeply it falls. In all cases, it is assumed that half of the individual's living annuity portfolio is invested in equities and half in bonds. The range of income produced by this policy is quite high; half the time, income will be greater than that shown here, and half the time it will be less.

In general, living annuitants pass the remaining capital in policies to their heirs when they die, but conventional annuitants (at least those who have purchased annuities without guarantees) leave nothing to their heirs. This explains why conventional annuities appear to produce much higher income than living annuity policies.

Conventional life annuities remove the need for the elderly to make difficult financial decisions

Besides risk pooling, there are other advantages to annuitisation. There is evidence that the average person's ability to manage their financial affairs declines with age. By paying a regular income, conventional life annuities remove the need for the elderly to make financial decisions that might become increasingly difficult.¹⁶

There is also evidence that those who purchase conventional life annuities value the financial security that they bring.¹⁷

Finally, conventional life annuities allow individuals to control their bequests. By splitting their retirement assets between living and conventional annuities – so annuitising only a portion of their assets – individuals can ensure that if they live longer than expected, they do not exhaust any funds that they intend leaving to their heirs.

Factors underlying low demand

South Africa appears to be following most countries, where individuals do not voluntarily buy life annuities

Despite the clear benefits of fairly priced conventional life annuities, few people buy them where they are available, and most countries do not have substantial voluntary conventional life annuity markets. Demand is probably reduced by the protection afforded by public old-age pensions. In South Africa, state old-age support is limited to a means-tested grant that is paid from age 60.

The means-testing rules are complex and may be applied inconsistently in practice. The thresholds were raised dramatically in 2011. Currently, individuals who earn less than R47 400 per year qualify for the grant (the thresholds are double this for married couples). For individuals with pension accumulations below about R300 000, and no other income in retirement, means-testing does not affect retirement savings or annuitisation.¹⁸

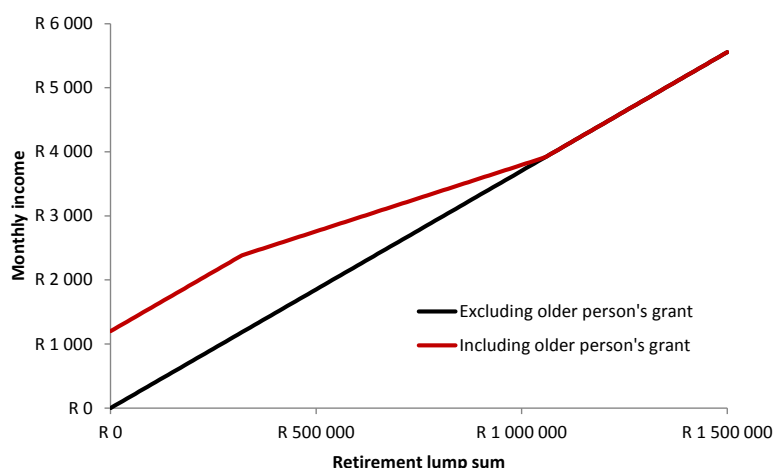
¹⁶ Banks, James and Zoe Oldfield, 2006, *Understanding Pensions: Cognitive Function, Numerical Ability and Retirement Saving*, The Institute for Fiscal Studies, Working Paper 06/05. IFS, London.

¹⁷ Mitchell, Olivia S. and Steve Utkus, 2004, 'Lessons from Behavioural Finance for Retirement Plan Design'. In *Pensions Design and Structure: New Lessons from Behavioural Finance*, eds. O. Mitchell and S. Utkus. Oxford: Oxford University Press, pp-3-41.

¹⁸ There is both an income test and an asset test. The threshold level of assets above which single individuals do not qualify for the grant is R792 000, excluding the family home, whereas the income test is phased in from an income of R1 200 per month to R 3950 per month for a single person. The values are double for married couples.

For those retiring with pension assets between R300 000 and about R1 million, means-testing becomes important, as shown in Figure 10.¹⁹ For these individuals, the means test represents an implicit tax of 40 per cent on retirement savings, which might significantly discourage many South African workers from saving for retirement.

Figure 10: Monthly income for a single male aged 65 for different lump sums*



Source: National Treasury modelling

*Assumes two-thirds of retirement lump sum used to purchase a CPI-linked conventional life annuity.

The means test could also discourage people from purchasing conventional annuities with provident fund money, and might encourage low-income workers to choose living annuities and withdraw their assets quickly in order to qualify for the grant at a later date.

The means test could encourage low-income workers to choose living annuities and withdraw their assets

For individuals above the means-testing thresholds, though, the level of the grant (currently R1 200 per month) might be too low, and the phase-in too slow, to provide a significant incentive for them to either spend down their assets or hide them to qualify for the old-age grant.

There are other reasons why individuals may not purchase life annuities:

- If low-income workers expect to die soon after stopping work, they could perceive – correctly – that annuities represent poor value.
- Individuals can pool mortality risk privately, with their spouse and families, and other informal support networks.
- Retirement money from one family member could be used to invest in the education or health of younger members. Once they are earning, they would in return support the retiree.

¹⁹ These figures are derived by taking the income levels at which means-testing starts and ends (R1 200 per month and R3 950 per month) and applying approximate annuity factors to them.

- In general, most people prefer liquid assets and are unwilling to lock up their money with an insurance company for a long time. This is particularly relevant here, because many retirees in South Africa pay for private health care rather than rely on medical aids or the state.
- Many individuals prefer to take on investment risk when they retire in exchange for higher expected returns. Two factors influence that choice. First, many retirees aged 65 can expect to live for another 20 years. Over these time horizons, some higher-risk investment may be appropriate. Second, conventional life annuities force individuals to invest implicitly in the assets insurers use to back their promise – usually in low-yield, long-term bonds.
- Individuals may elect not to purchase a conventional annuity if interest rates are very low, preferring to wait until rates rise.

From a policy perspective, it is necessary to recognise that individuals may choose to not buy conventional annuities for reasons that are not in their long-term interests. Many of these may be behavioural, or the result of distortions induced by distribution channels.

Policy intervention may be required because individuals underestimate their longevity

One such factor that could require policy intervention is underestimation of longevity. Many people contemplating the purchase of a conventional life annuity probably do not know that the apparently low income paid by the annuity reflects, in part, the amount of money they can afford to spend given their expected longevity and current rates of return on financial assets. This lack of understanding might cause them to undervalue the protection that conventional life annuities offer. The high proportion of individuals that appears to buy level – rather than escalating – conventional annuities seems to support this view.

Why fairly priced conventional annuities are a sensible option for low-income households

For low-income workers, fairly priced conventional annuities could be the most sensible purchase to provide a retirement income.

- The annuity provides a secure income, no matter how long the individual lives.
- Once purchased, the annuity runs automatically, and requires no decisions, financial advice, knowledge or management.
- Lower-income individuals are likely to rely on the public health system, meaning that unforeseen medical expenses might not be a deterrent to annuitisation.
- Individuals with pension accumulations under R300 000 will retain access to the old-age grant.
- Low-income individuals are less likely to invest in equities, meaning that the investment strategy underlying the annuity is less of a deterrent.

■ Supply

Some factors underlying the low demand for conventional annuities are related to market structure.

The financial structure of an annuity portfolio

Insurance companies selling conventional annuities pool mortality risk across many people. As a result, the cash flows they owe their annuitants as a group are much more predictable than the cash flows associated with any one individual. To meet these cash flows, insurers invest in a portfolio of assets – usually long-term, high-quality bonds – with a payoff structure that broadly matches their outgoing liability.

Yet insurance companies selling annuities are still subject to some risks. Annuities are a long-term product, which makes these risks potentially substantial. Risks include:

- Uncertain mortality. The mortality experience of individual annuitants may be correlated, and this risk cannot be eliminated by diversification. For instance, a whole age-cohort's mortality may improve together, or there may be a large-scale epidemic. Estimating such developments is difficult.
- Inadequate diversification. Insurers that sell too few annuities may face random residual risk.
- Investment-related risks. These include reinvestment risk on the unmatched portion of liability cash flows and unanticipated changes in interest rates. The less matched the assets and liabilities, or the greater mortality uncertainty, the more significant investment risk is likely to be.

To guarantee promised annuity payments against these risks, insurance companies hold capital, on which they expect a return. The greater the level of risks, the more capital required and the higher the price insurance companies need to charge for annuities to generate the required return on capital.

Insurers must hold capital to guarantee payments against remaining mortality risks and investment risk

Competition between insurers, or new entrants if entry barriers are low, should drive annuity prices down. At this point, the return on capital used to guarantee annuity promises would constitute commensurate compensation for the level of risk.

Requirements for a functioning market

A functioning market in conventional life annuities requires, at a minimum:

- A supply of high-quality long-term bonds that insurers can use to back their annuity liabilities without exposing them to high levels of interest rate or reinvestment risk.
- Mortality data of sufficient quality to allow insurance companies to price their annuities reasonably accurately.

- A competitive insurance market, or sufficiently low barriers to entry, to ensure that annuities are fairly priced.
- A regulatory environment that ensures an appropriate level of insurer solvency.

Broadly speaking, all of these requirements appear to be present in South Africa, with two important exceptions.

The National Treasury is investigating increasing the number and size of major long-term bond issues

First, there may be an insufficient number of high-quality bond issues at the long end of the yield curve, particularly in the inflation-linked segment. There are currently only six major issues maturing between 2024 and 2041. The National Treasury is investigating the feasibility of increasing the number and size of these issues. In addition, the introduction of Basel III may result in a new asset class – long-term deposits or exchange-traded notes – as South African banks try to increase the duration of their liabilities.

South Africa lacks accurate, detailed mortality data

Second, mortality data at a sufficiently disaggregated level to permit accurate rating for all segments of the population may not be available. The Actuarial Society of South Africa investigated annuitant mortality in 2000 and again in 2004, producing one set of standard tables.²⁰ However, neither investigation examined the underlying heterogeneity of mortality in great depth.

The absence of suitable mortality data of sufficient quality may have hindered the introduction of more accurate rating policies.

■ Pricing and rating

The National Treasury has examined the pricing and rating of conventional annuities, focusing on three issues:

- Do purchasers get good value on average?
- Does the market's dominant pricing structure reflect its true underlying heterogeneity, allowing purchasers with different characteristics to obtain good value?
- Is the pricing of annuities somehow excluding particular groups of purchasers?

Average value for money

"Annuity money's worth" depends on purchasers' average mortality and prevailing interest rates

A standard measure of annuity pricing is "annuity money's worth" (AMW). This is the percentage of the initial single premium that individuals can expect to receive back in annuity payments, in expected discounted present value terms. The AMW depends on the average mortality of purchasers and on prevailing interest rates. The longer individual purchasers expect to live on average, and the lower the interest rates, the better value they will obtain.

²⁰ See Dorrington R, and S Tootla, 2007, "South African Annuitant Standard Mortality Tables 1996-2000", *South African Actuarial Journal*, 7: 161-184. A more recent investigation of annuitant mortality between 2001 and 2004 has also been published, although it was decided not to produce a new standard table based on this investigation. See Ingram, Jenny, Karl Schriek and John-Craig Clur, *Annuitant mortality 2001-2004*, CSI Committee of the Actuarial Society of South Africa, 2012.

To measure AMW in South Africa, the National Treasury obtained a set of annuity prices from Masthead, a consultant to financial intermediaries. The data covers males and females aged 55 with R1 million to spend for 10 November 2010. The average mortality of annuity purchasers was obtained from standard tables produced from industry data by the Actuarial Society of South Africa. Annual mortality improvements of 1 per cent were assumed.

The results of the review show that the AMWs for level annuities do not compare badly with international benchmarks, provided that the risks of insurer insolvency are small.²¹

Reflection of underlying heterogeneity

Does South Africa's dominant pricing structure adequately reflect the underlying heterogeneity in purchasers or potential purchasers?

Accurate pricing by sub-group is important, because it ensures that individuals are able to obtain insurance at a price that fairly reflects their own risk. Accurate rating also ensures that there are no *expected* cross-subsidies between policyholders with different risk characteristics.²² This is especially important in South Africa, where underlying population heterogeneity is large. Inadequate rating could, for example, make annuities expensive for the poor and the sick, who may either subsidise the rich and healthy if they purchase annuities, or may be excluded from the market entirely.

Inadequate policy rating can make annuities expensive for the poor and sick

In general, there are several ways that markets can rate policies.

The first, and most transparent, is explicitly to alter the pricing basis so that those with higher life expectancies pay more for annuities than others. Large South African companies at present appear to rate conventional annuities explicitly only by age and sex. This is not a requirement. For instance, one new entrant to the South African market rates annuities by occupation and health status. In the United Kingdom, annuities are rated not only by age and sex, but also by health status and postal code.

However, companies may rate annuities using other, implicit, methods:

- By using information correlated with life expectancy. For example, if buyers of smaller policies have lower life expectancy, companies could grant more favourable rates to everyone buying a smaller policy.²³

²¹ For an international review, see Estelle James and Dmitri Vitas, 2001, "Annuity Markets in Comparative Perspective: Do Consumers Get Their Money's Worth?", in OECD 2000 Private Pensions Conference, Paris, France, OECD. Rob Rusconi found similar results for 1 July 2005; see "Thoughts on South African Annuities", Actuarial Society of South Africa, 2006.

²² All insurance involves some cross-subsidisation, since resources are transferred from those individuals to whom the event insured against does not happen to those for whom the event does happen. However, the issue discussed here relates to cross subsidies in expectation, before the insured event has occurred.

²³ In order for this to work, insurers would need to verify that individuals have not purchased multiple policies.

- By specialising in market segments, with implicit barriers preventing consumers from one segment purchasing annuities from companies specialising in others.
- By designing products for different market segments and pricing them accordingly – for example, annuities with increased payments priced for individuals with higher life expectancy.

Companies may rate implicitly in several ways, although evidence for this is weak in South Africa

The National Treasury has tested the market for these types of implicit rating. There appears to be little rating by factors associated with mortality, and evidence for rating by product design is weak. However, there is some evidence of market segmentation by company. This may raise concerns about the extent to which the annuities market is competitive, although price differentials between companies may only reflect strategic quoting,²⁴ rather than a lack of competition.

Although the available data is slightly outdated, it appears that apart from one new entrant that *does* rate on health and occupation, and market segmentation by company, the large players in the South African annuities market do not rate different individuals of the same age and sex either implicitly or explicitly.

High interest rates can reduce mortality's influence on annuity prices

Historically high interest rates may be one explanation for this. The higher the level of interest rates, the less the influence of mortality on annuity prices, and the less profitable rating becomes. This happens because the annuity payments that are affected by rating are only due over the long term. Higher interest rates lower the present value of these payments and reduce the effect of rating on price.

Another possible explanation is that the current annuitant pool is relatively homogenous, made up mainly of poor individuals who retire with relatively small balances. This argument is undermined in three ways:

- The emergence of a recent market player that has elected to rate on the basis of occupation and health status.
- The recent convergence in the initial size of living annuities and conventional annuities, which suggests that there may no longer be such a large difference in the wealth of the individuals making up the two pools.
- The underlying pool may only be homogenous because prices have excluded those individuals for whom annuities may appear to represent poor value.

More accurate rating may be possible in the group market for annuities, where pension funds approach life insurance companies directly and purchase annuities for all of their retirees. However, few funds appear to do this.

²⁴ Companies may deliberately offer uncompetitive quotes for insurance if they do not wish to sell that business at a particular time.

Exclusion from the market

A standard concern about annuity markets worldwide is asymmetric information between buyers and sellers. If sellers choose not to rate, then people with lower-than-average life expectancies may choose not to purchase conventional annuities because they (correctly) perceive them to represent poor value. This discourages people from obtaining insurance against outliving their assets, and simultaneously makes annuities more expensive for everyone else, compounding the problem. Without detailed individual-level datasets, there is no way of knowing how many individuals have found themselves in this predicament.

Uneven data between buyers and sellers is a concern in all annuity markets

■ Conclusion on conventional annuities

The main conclusions of this review of conventional annuities are:

- The proportion of people choosing conventional annuities declined, and the proportion choosing living annuities has increased.
- South African conventional annuities appear to be reasonably fairly priced for those who purchase them, at least for the large market players analysed here.
- Annuity purchase behaviour appears to be driven strongly by short-term considerations, and significant distortions are caused by distribution channels.
- The conventional annuity market rates mainly by age and sex, with little or no allowance for other factors known to affect mortality, despite high population heterogeneity. More accurate rating may be possible in the group market.
- In broad terms, the conditions for a functioning market in life annuities exist in South Africa. However, sufficient mortality data, disaggregated by market segment, may not yet be available.

5. Policy options

Three primary policy options are suggested in order to improve the retirement income system

This chapter discusses potential policy suggestions for areas of the South African retirement income system that do not appear to be functioning effectively. The various proposals may have both beneficial and detrimental effects, but these are not dealt with in detail. Rather, they provide the basis for further discussion and engagement with stakeholders, and it is through such a consultative process that such effects will be determined.

The main overall conclusion is that current shortcomings in the annuities market are structural, requiring significant regulatory reform and consequent shifts by all key players.

The main suggested options are as follows:

- Reforming living annuities to increase competition, to reduce the amount of financial advice they require and to reduce their costs.
- Increasing the degree of automation in the retirement process by requiring all retirement funds to choose a default product into which all retirees must be enrolled.
- Increasing the degree of longevity protection for most retirees, without unduly sacrificing their ability to invest in risky assets or to protect capital for their heirs, should they so wish.

Reforming living annuities

The sale of living annuities should not be restricted to life insurance companies

The requirement that living annuities be sold by life insurance companies appears to be unnecessary, given that they cannot offer any guarantees. In addition, living annuities have high charges associated with distribution and financial advice. Investment choice also adds directly and indirectly to costs, despite the fact that most policies appear to be invested in broadly similar portfolios.

The first proposal is to introduce a new type of legal vehicle from which retirement income can be paid, called a retirement income trust (RIT). Accounts held in these trusts will:

- Receive the same tax treatment provided to current living annuity policies.
- Not permit investment choice, in order to reduce charges (individuals may choose to split their funds between RITs with different underlying investment strategies).

- Be subject to age-dependent drawdown limits, which will include all recurring charges.
- Pay death benefits to the member's nominated beneficiary that equal the value of the member's account at death.
- Be subject to prudential asset limits similar to, but possibly more conservative than, the current Regulation 28.
- Strictly limit commission fees payable to intermediaries.
- Not pay advice fees or consulting fees from the fund.
- 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.

The legal structure of RITs could be modelled on that of collective investment schemes, which offers a high level of transparency and protection to investors, and is well understood by both providers and consumers.

Existing living annuities

To address the problems with living annuities described in this paper, the National Treasury proposes to reform existing living annuity policies, making them broadly consistent with the proposed RIT accounts. This may include introducing age-dependent drawdown limits which include all recurring charges, subjecting them to the same prudential asset limits as RITs, limiting investment choice, and limiting commission and advice fees that can be paid from the fund.

The National Treasury proposes to reform existing living annuity policies, making them broadly consistent with the proposed RIT accounts

Given the regulatory arbitrage that could arise from running several legal structures that all support the same underlying objective, consideration will also be given to entirely removing the ability of life insurance companies to receive tax-protected money other than to pay conventional or with-profits life annuities. Consultation is invited on this point.

Increased automation

To ease the transition of most members at retirement, all retirement funds will be required to choose a single default retirement product for all their members, and to enroll members into this product. Possible designs for the default product are discussed in a subsequent section, but it will have greater prescribed longevity protection than that currently offered by living annuities. Individuals may opt out of the default if they wish, subject to taking advice. However, they must choose another product that meets the requirements for selection as a default product, or into a conventional life annuity.

Retirement funds will have to choose a qualifying retirement income product to default their members into at retirement.

The requirement to default members into the retirement product will only apply to retirement balances between a lower and an upper threshold, although funds may apply the default to balances in excess of the upper threshold if they so wish. The objective of the

The default option will only be required on two-thirds of retirement balances up to a threshold

lower threshold, similar to the current *de minimus* threshold,²⁵ is to prevent individuals who would be dependent on state benefits in any case from being forced to maintain very small annuity accounts with high charges.

A tentative value for the lower threshold is R150 000, higher than the current *de minimus* requirement, acknowledging the increase in the means-tested thresholds, and falls in annuity prices.

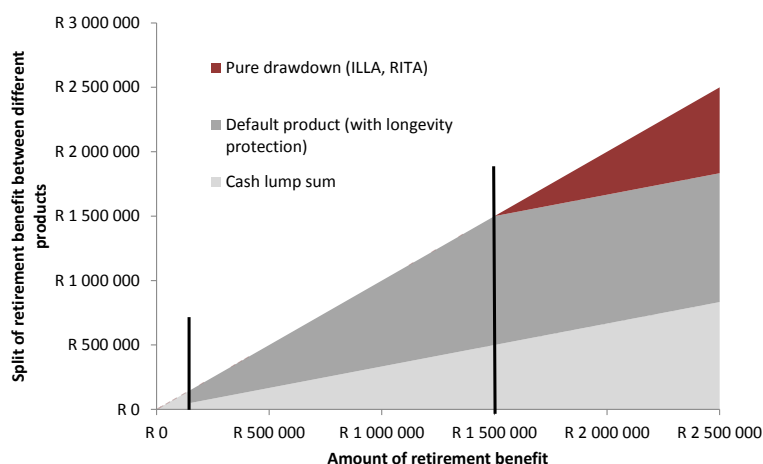
The upper threshold is intended to act as a ceiling on the amount of longevity protection required to ensure that retiring individuals have adequate cover against living too long, and to protect the public finances against individuals from spending down their retirement assets quickly to qualify for the means test.

A level of about R1.5 million is suggested. At current annuity prices, this is enough to buy a monthly income of R5 000 to R7 500 per month, increasing with inflation, well above the old-age grant, which is about R1 200 per month. Above the upper threshold, individuals may elect phased-withdrawal policies, such as the proposed RIT accounts, which contain no longevity protection, or reformed living annuity policies.

The ability of individuals to withdraw one-third of their retirement benefits in cash upon retirement will remain.

These proposals are summarised in Figure 11.

Figure 11: Proposed split of retirement benefits between cash, a default product and pure income drawdown accounts



Increased longevity protection

Conventional life annuity is the simplest default product

Increasing longevity protection for individuals will be achieved through the design of the default product. The product must:

- Provide members with some degree of longevity protection, possibly through purchasing life annuities from life insurers.

²⁵ The requirement to annuitise assets is currently waived if the rand value of the portfolio is below R75 000.

- Operate largely automatically, with individuals being required to make few, if any, choices.
- Bar investment choice, but may invest in risky assets to some degree, obeying prudential requirements on asset holdings.
- Not permit assets to be withdrawn too rapidly.
- Maintain transparent charges, and a simple design, with total and actual expense ratios lower than a certain threshold.
- Offer members the ability to transfer their funds to another qualifying default product, or to a conventional life annuity.
- Not pay death benefits to members' dependants that are greater than a certain threshold, to support risk pooling.
- Avoid imposing a large regulatory burden on providers, including solvency, administration and product design constraints.
- 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.

Some possible designs are described below.

Conventional life annuities

The simplest default choice would be a conventional life annuity. Retirement funds could be required to obtain quotes for a conventional life annuity from several providers, and the retiree could be required to choose from among those quotes. If no choice is received within a certain time, the fund could automatically elect a quote on a best-execution basis. Ideally, the features of the required life annuity would support accurate comparison by members.

The following standards should apply:

- Capital preservation on death (a guaranteed term of about five years might be appropriate)
- Fixed-level increases in payment set below the inflation rate – such as 3 per cent a year, or 50 per cent of CPI. Variable annuities, such as with-profit annuities targeting a particular rate of increase, could also be considered.
- Spouse's protection, which could be mandatory at two-thirds of the benefit level for the surviving spouse.

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.

Although mandating conventional life annuity purchase would provide all retirees with some degree of longevity insurance, the viability of this option rests on the willingness and ability of insurance companies to introduce a rating system that accurately reflects heterogeneous life expectancy. To some extent, this problem may be managed through the bulk purchase of conventional annuities by retirement funds, which already occurs.

Mandating life annuity purchase depends on insurers' willingness and ability to introduce an accurate rating system

One option is an automated sequential hybrid of living and conventional annuities

Default retirement income trust account

A second option would be a variant of a retirement income trust account. These default RITs would be a sequential hybrid, starting off as phased-withdrawal products, but shifting individuals into conventional life annuities as they got older. They would not offer investment choice, but could invest in risky assets.

Default RIT accounts would be required to:

- Pay an income to members, between minimum and maximum limits, to be specified in regulations.
- Monitor members' balances relative to the amount required to purchase a promised level of income on the conventional annuity market. This income level would be set in relation to the member's balance, family circumstances and interest rates at the time of retirement, and would increase over time.
- Purchase conventional life annuities on behalf of members, either gradually or when their account balances fall to within a set percentage of this amount.

These products would have the following advantages:

- They would rely on existing infrastructure and regulations to provide longevity protection, since private insurance companies would offer this through the purchase of life annuities.
- They would permit investment in risky assets, allowing greater flexibility to members in the early years of their retirement.
- They could be designed to postpone (or phase in) the purchase of life annuities until individuals are in their mid-seventies, cutting the costs of providing longevity insurance, and reducing the consequences to individuals of the variability of annuity rates.

The effective operation of retirement income trusts depends on a competitive market in life annuities

Even if default RIT accounts are designed to meet these specifications, however, their effective operation depends on a competitive market in life annuities that rates individuals effectively. The impact of imperfect rating is lower here than in the mandated annuity purchase option, since individuals will be buying annuities later, with less of their money.

The automatic purchase of annuities by trusts might cause pricing distortions in the market for life annuities. Preventative measures and continuous monitoring of the market may be required.

Another potential difficulty is variations in annuity income caused by timing issues. Obtaining quotes and member consent would take time, which could lead to members receiving a lower income than expected. Although trusts could prevent this to some extent by hedging annuity prices, by investing in long-term bonds, and by obtaining annuity quotes well before breaching any thresholds, this may still present difficulties. Care would need to be taken in managing these risks.

Another issue is the level of death benefits that trusts would provide and the distribution of any consequent mortality profits between surviving members. Ideally, death benefits would be standardised

across trusts, and the method of distribution of profits, if any, would be prescribed to prevent adverse selection²⁶ between trusts.

Variable annuities

A final option presented is a variable annuity. This is a form of insurance policy in which purchasers share risks with the insurance company that writes the products.²⁷ The policyholders take part in the long-term risks through changes to the income that they receive.

Variable annuities, where purchasers' share risk with insurers, is another option

Variable annuities:

- Pay an initial income to purchasers depending on the amount of their premium, their expected mortality and the expected investment returns to be earned on assets.
- Adjust this income (up, and possibly down), in line with the investment returns and mortality experience of the cohort.
- May pay death benefits to members' dependants.
- Cannot be redeemed by members for fear of adverse selection.

A key design feature is how risks are shared between buyers and sellers. Standardising risk-sharing rules may be desirable to assure a minimum level of mortality protection, to allow enough comparability between products, and to promote price competition.

However, choosing a standardised risk-sharing rule would be difficult, particularly if insurance companies are permitted to compete for business on the open market. If policyholders take on too much risk themselves, moral hazard can result as insurance companies:

- Attract new policyholders by paying existing members unsustainably high incomes on the basis of unearned investment returns, transfers from future members or unreasonable mortality expectations.
- Expose policyholders to excessive long-run investment risks in order to pay existing members a high income.
- Fail to process the deaths of policyholders correctly, since pensioners themselves and not the insurance company would be bearing a great deal of mortality risk.

If policyholders bear too little risk, the relative advantages of variable annuities over conventional life annuities begin to fall away.

One mechanism to share risk between members and insurance companies could be to require variable annuities to provide some form of guaranteed income to members. However, it would be difficult to assess value-for-money, since the company writing the policy would be granted a monopoly on providing the guarantee for that policy. In this respect, at least, the retirement income trust option described above, where guaranteed income is purchased on the open market, could represent a superior alternative.

Variable annuities could be required to provide a guaranteed income to members

²⁶ Individuals with higher than average mortality may select trusts that pay higher death benefits, eliminating the effects of risk pooling.

²⁷ Variable annuities may also be written by pension funds, in which case the guarantee is provided by subsequent generations of pensioners or the pension fund sponsor.

Table 10: Comparing designs for default longevity products

| Principle | Conventional life annuities | Retirement income trust | Variable annuities |
|---------------------------------------------|------------------------------------------------------------------------------|------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------|
| Provide longevity protection | Yes, subject to effective and competitive functioning of life annuity market | Yes, subject to effective and competitive functioning of life annuity market | Yes, but risks are shared between policyholders and insurance company; requires substantial standardisation |
| Automatic operation | Yes | Yes, subject to individual consent for annuity purchase(s) | Yes |
| Permit investment in risky assets | No | Yes | Yes |
| Drawdown restrictions | Yes, implicit | Yes, explicit initially | Yes, implicit |
| Transparent charges and simple design | Yes, subject to effective, competitive functioning of life annuity market | Yes, subject to effective, competitive market functioning | No, requires complex risk-sharing rules, with potential moral hazard |
| Permit transfers to other products | No | Yes, until life annuities are purchased | No |
| Protect capital in the event of early death | Yes | Yes | Yes |
| Low regulatory burden | Uses existing insurance company regulation | Largely uses existing regulation but requires monitoring | No, may require substantial additional insurance regulation |

Source: National Treasury research

Variable annuities, if not paid by life insurance companies or pension funds, may require substantial new regulatory architecture to be put in place.

It should be noted that a small number of South African pension funds currently offer variable annuities to their members, paid from within the fund. While these have generally worked well up to this point, few trustees are willing to offer them.

Government may be willing to share long-run longevity risk with the private sector

Under some of the options proposed, insurance companies may struggle to bear significantly more long-term longevity risk than they currently do at a reasonable price. Government is willing to explore ways in which the long-run longevity risks borne by the private sector can be shared by the public sector. Possibilities include some form of reinsurance, along the lines of SASRIA, or selling longevity-linked bonds.

6. Conclusion

This discussion paper identifies several shortcomings in the current retirement income architecture:

- Annuity purchase behaviour appears to be driven strongly by short-term considerations. In particular, purchasers of both conventional and living annuities appear to opt for high initial income or drawdown rates.
- Distribution channels cause significant distortions. The commission structure appears to give financial intermediaries substantial incentives to drive individuals into living, rather than conventional annuities.
- The conventional annuity market rates mainly by age and sex, making little or no allowance for other factors known to affect mortality, despite high heterogeneity in the population.
- Most South African retirees who purchase living annuities face a substantial risk of outliving their living annuity assets.
- Average living annuity policy charges are high, potentially reducing annuitant income by as much as 20 per cent.
- A substantial part of these charges is created or magnified by the provision of investment choice, which relatively few living annuitants appear to need.
- The requirement that living annuities be provided under a life licence appears unnecessary, especially considering that these policies cannot provide a guarantee of any kind.

Annuity purchase behaviour appears to be driven strongly by short-term considerations

International experience suggests that without some form of regulatory intervention that includes a mandatory element, it will be difficult to develop a market in suitable retirement products.

A three-tier structure for annuitising retirement balances is proposed

In light of these considerations and market analysis, the National Treasury proposes a three-tier structure for annuitising retirement balances:

- The first one-third of retirement balances may be taken in cash, as at present.
- 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.
- Any other retirement funds may be used to purchase drawdown products such as RITs or living annuities. RITs will not permit investment choice, must obey prudential asset requirements, and will be subject to drawdown limits. Concomitant reform of living annuity policies will be considered to ensure fair competition.

7. Comments

The public is invited to comment on the draft proposals contained in this discussion document by no later than **16th November 2012**. Comments may be submitted to:

Attention: Mr Olano Makhubela, Chief Director: Financial Investments and Savings, Private Bag X115, Pretoria, 0001. Or by fax to 012 315 5206; or by email to retirement.reform@treasury.gov.za.

Further consultations will be held once the proposals are refined and during the legislative process. Consultative meetings will also be convened with trade unions, employers, retirement funds and other interested stakeholders.

The paper released by National Treasury on 14 May 2012 titled *Strengthening retirement savings: An overview of proposals announced in the 2012 Budget*, (http://www.treasury.gov.za/comm_media/press/2012/2012051401.pdf) listed the following technical discussion papers for release during the course of 2012:

A. *Retirement fund costs* – Reviews the costs of retirement funds and measures proposed to reduce them.

B. *Providing a retirement income* – Reviews retirement income markets and measures to ensure that cost-effective, standardised and easily accessible products are available to the public

C. *Preservation, portability and uniform access to retirement savings* – Gives consideration to phasing in preservation on job changes and divorce settlement orders, and harmonising annuitisation requirements. The aim is to strengthen retirement provisioning, long-term savings and fund governance

D. *Savings and fiscal incentives* – Discusses how short- to medium-term savings can be enhanced, and dependency on excessive credit reduced, through tax-preferred individual savings and investment accounts. It also discusses the design of incentives to encourage savings in lower-income households.

E. *Uniform retirement contribution model* – Proposes harmonising tax treatment for contributions to retirement funds to simplify the tax regime around retirement fund contributions.

Papers B and C have been released and are available on the National Treasury website (www.treasury.gov.za). Note that paper B above has been renamed as *Enabling a better income in retirement*. Paper E also has a different title, *Simplifying the tax treatment of retirement savings*.

Papers D and E will be published before the end of September.