Default strategy already in place at 20% of funds

Head of Annuities at Sanlam Employee Benefits, Karen Wentzel FIA, FASSA, CFP® answers Money*Marketing's* questions about default annuities

What are the advantages of a default annuity?

For the last 20 years, individuals in defined contribution schemes were left to make important decisions about their retirement. Too many people, retirement funds and financial advisers focused on building wealth before retirement, paying little or no attention to what should happen in retirement. Members often fell prey to unscrupulous advisers or made the wrong investment decisions. To address this issue, in August 2017, the National Treasury published revised default regulations which set out requirements for establishing default strategies.

These regulations stipulate that all defined contribution retirement funds, including retirement annuity funds, will be required to have in place a trustee endorsed default annuity strategy that is appropriate and suitable for the members who will be enrolled into it. The regulations are an 'opt in' arrangement, rather than an 'opt out' one.

The specific requirements relating to a default annuity are set out in Regulation 39 of the PFA Act and are as follows:

- **The proposed annuity strategy must be appropriate and suitable for the members of the fund.** Although there is not one annuity that will be suitable for all members, an annuity strategy may include a few options for members with different risk profiles and income levels. Most members will benefit from having a part of their annuity in a guaranteed income stream for life to cover their compulsory monthly expenses and medical aid contributions. A composite annuity, combining a guaranteed life annuity and a living annuity may be a great option for higher earners.
- **The fees and charges of the proposed annuity or assets must be reasonable and competitive.** Currently individual members don't have access to institutionally priced annuities, both as guaranteed life and living annuities. Default regulations will force boards of trustees to negotiate reasonable and competitive fees and pricing with insurance companies. This will ensure that members have a cost effective annuity option at retirement to consider with other options available in the market. Sanlam (and some other insurers) have developed a new institutionally priced living annuity to address these requirements.
- **The annuity strategy needs to be reviewed annually and may include traditional life annuities and living annuities being paid from the fund or an external provider.** The investment choice for living annuities is limited to four investment portfolios that are compliant with regulation 28 and 37. The prescribed standard for drawdown rates is in a draft format with the Association for Savings and Investment South Africa (ASISA).
- **Members are given access to a retirement benefits counsellor not less than three months before their retirement date.** Choosing an annuity can be a daunting task. Most members make the choice without enough financial knowledge and insight about financial markets and the effect of longevity (living longer than expected) on their financial planning. Members will at least need to consider a trustee endorsed, competitive priced annuity strategy and will have access to a retirement benefit counsellor, which will hopefully improve retirement outcomes. These requirements will not only impact on the wallet of South Africans, but will also possibly affect the focus of annuity products and trends in the insurance industry.

When the default annuity is adopted by all retirement funds, does this mean that fees will decrease?

The default regulations set out that the annuities chosen must have reasonable and competitive fees, which will definitely have a focus on fee structures.

In a perfect world, all members may want personal advice and an annuity tailored to both accumulated funds and lifestyle expectations. The ultimate objective is to enable every member in a fund to get as close to this ideal as possible. The key is to balance the level of advice and choice offered with an appropriate fee structure. Another crucial factor is that it should be a scalable proposition that works for the trustees of a fund that has thousands of members.

The fund will thus need to realise that the closer their offering is to an individualised retail offering, the closer the fees will also be to retail fees. Some companies are offering different levels of flexibility and choice at different fee structures.

Do most funds already have a default strategy in place?

From Sanlam's 2017 Benchmark survey for stand-alone funds in May 2017, around 20% of funds indicated that they have already determined an appropriate default annuity strategy, 26% indicated that they've been working on it and the bulk of the funds were waiting for the default regulations to be finalised before starting. During the last six months, after the publication of regulations in August 2017, Sanlam experienced an increased number of requests for proposals for default annuity strategies.

According to *The Benchmark Survey*, trustees named the most important features of a default annuity strategy as:

1. Annuity income which keeps pace with inflation
2. Longevity protection and an income for life

Of annuity products selected for a default annuity strategy, the three most popular products were:

1. Living Annuities
2. Inflation linked annuities
3. With profit annuities.

The choice of products correlates well with the most important features that trustees want to address.

Additional services and features, over and above the annuity products that were important for trustees in appointing a provider for their default strategy, were:

1. The offering of member advice pre-retirement
2. The security of the product provider.

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Boards of trustees face challenge

Several new regulations to the Pension Funds Act became law in August 2017. These 'default' regulations have far reaching implications for all funds. All funds registered before 1 March 2018 were granted a blanket 18-month extension, meaning they only have to comply with the requirements by 1 March 2019. The three key pillars of the regulations are:

1. **Default investment portfolio(s)** – boards of trustees must implement one or more default investment portfolios into which a member's retirement savings will automatically be invested, unless and until the member opts out and chooses a different portfolio.
2. **Default preservation and portability** – unless and until a member, who leaves a fund before retirement, instructs the fund to transfer their exit benefit to another fund or pay the benefit out in cash, the fund must retain/preserve the member's benefit in the fund and convert the member to a 'paid up' member.
3. **Annuity strategy** – boards of trustees must devise an annuity strategy that provides retiring members with pension (annuity) options.

Funds may intend to apply for an exemption from a specific provision in the regulations due to the nature of that particular fund, but they need to ensure that the outcome of the exemption application is received well before the implementation date.

In assisting funds with their implementation procedures, we have already identified some practical difficulties that require detailed consideration, including:

- In what format should exemption applications be lodged?
- What will be the impact of the default preservation provisions on deferred pensioner arrangements that already exist in some funds?
- What information must be contained in a 'paid-up membership certificate' that is intended to follow a member from one fund to another?
- How and when is a fund required to conduct 'retirement benefits counselling' as required in terms of the legislation?
- How will the provisions in the Pension Funds Act relating to the distribution of lump sum death benefits apply to paid-up members or to in-fund living annuitants?
- Where do funds stand in relation to cost implications of the implementation of the regulations, particularly with regard to system development by their respective administrators?