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JUST.

DEFAULT ANNUITIES – ARE TRUSTEES SETTING UP THEIR MEMBERS FOR FAILURE?

Many trustees are establishing default annuity strategies which inadvertently set up their members for failure by giving them little to no guidance about the sustainability of their income in retirement and by not providing an option to secure a guaranteed Lifetime Income.

This is according to Scott Harvey, Distribution Executive at Just, who says that the default annuity regulations provide the opportunity for trustees to positively engage with the process of offering their members lifetime sustainability of income, rather than treating this as a simple "minimum requirements" compliance exercise.

Trustees of all pension funds and of those provident funds that allow the election of an annuity at retirement are required to have an annuity strategy in place by 1 March 2019, in terms of the default regulations added to the Pension Funds Act late last year.

The legislation spells out a list of explicit considerations for trustees, but there are also a number of implicit considerations which deserve trustees' attention. Three we highlight in this article are:

- The annuity strategy should be appropriate and suitable for members, taking account of the risks inherent in post-retirement income (Regulation 39 (2) (a)).
- This should also consider income protection to beneficiaries when the main member dies (also Reg 39 (2) (a)).
- Where an in-fund living annuity is chosen, the fund should monitor sustainability and inform members if their rate of drawdown is deemed unsustainable (Reg 39 (3) (b)).

A key risk is the risk of a member outliving their assets in retirement and seeing income fall dramatically in the final years of life. Harvey adds that very few members are able to assess this longevity risk for themselves. In fact, data shows the average drawdown rate on living annuities is 6,6% which is above the sustainable drawdown rate recommended by ASISA – and to make matters worse, this average is skewed by the fact that some people with large retirement savings pots draw very little.

By extrapolation, this means that the majority of living annuitants are drawing at an unsustainable level and there is a risk that trustees perpetuate this scenario in their default annuity strategies if only standard living annuities are offered.

The default regulations were designed to ensure that trustees apply their minds to providing appropriate retirement income solutions. This is a significant responsibility. Most of the focus to date on improving sustainability of retirement income has been to use the collective buying power of a fund to drive down fees. Whilst this is very helpful, it does not guarantee sustainability of at least essential income needs for life for the main member or their surviving spouse. The only way to do this is to pool that portion of the retirement savings pot required to cover essential expenditure, in an insurance pool.

"We think essential expenditure includes food, accommodation, utilities, medical costs, transport and insurance – this would be 'JustEnough' for survival – and the good news is that there are tools available to trustees to allow their members the option of securing a guaranteed Lifetime Income to cover their essential expenditure needs, and those of the surviving spouse in the event of their death," continues Harvey.

These tools are available regardless of the main annuity type chosen by trustees: in-fund or out-of-fund and even within a living annuity. Given that such tools are available, trustees can provide members with the option to sustain a level of income for life, which will cover, in part or in full, the "JustEnough" level they will need to survive. Without offering this option, trustees will need to find other ways to show they have discharged their responsibilities listed above. The ways trustees can provide these tools are as follows:

A life annuity alongside a living annuity – hybrid solution

In-fund

Pros:

- Provided fund rules allow for this, can split retirement savings pot at retirement and/or transfer from living to life annuity at any time post retirement.

Cons:

- Generally members can't consolidate other retirement savings pots e.g. RAs or preservation funds.
- Trustees explicitly carry responsibility for ongoing sustainability of living annuity drawdown – this is complex to assess, because it should take account of any other sources of income.

Out-of-fund

Pros:

- Can consolidate other retirement savings pots.
- Less explicit trustee requirements.

Cons:

- Once-off option at retirement to split retirement savings pot between life and living annuities.
- If life annuity top-up is required post retirement this is either:
    - an all or nothing transfer from the living to the life annuity; or
    - if a lifestage hybrid has been selected at retirement, top-ups are set at specific ages or other trigger points and are administratively intense.

A life annuity inside a living annuity - blended solution

Harvey states that Just has uniquely made Lifetime Income available as an additional investment portfolio within living annuities. This Lifetime Income portfolio can be selected at retirement or any time post retirement to guarantee at least essential expenditure needs. Once essential expenditure needs have been guaranteed for life, the balance of the retirement savings pot, used for flexibility and bequests, can be invested more aggressively for long-term growth.

Pros:

- Can be used as an in-fund or out-of-fund solution.
- Allows at least essential expenditure to be guaranteed for life.
- Can split retirement savings pot at retirement and/or seamlessly top up Lifetime Income portfolio at any time post retirement.

- Sets a guaranteed minimum drawdown rate (to cover essential expenditure) that can be sustained for life only with the insurance of the Lifetime Income portfolio – without this component, the annuitant is at risk of running out of savings during their lifetime.
- Introduces a diversifying asset class with a return profile that increases the longer the individual lives – this is known as mortality credits.

Cons:
- Some of the capital invested in the Lifetime Income portfolio can be lost at death before the member's life expectancy – but that is why you set two different retirement savings pots within the blended living annuity: one to sustain your essential expenditure for life, and the other for flexibility and bequest.

"The default regulations have broadened the scope of trustee responsibilities and with the implementation deadline just over 12 months away, trustee boards need to start considering appropriate annuity strategies for their members. Being such a vital component of each member's retirement journey and the only opt-in default, the annuity strategy is arguably the most important of the default regulations," concludes Harvey.

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