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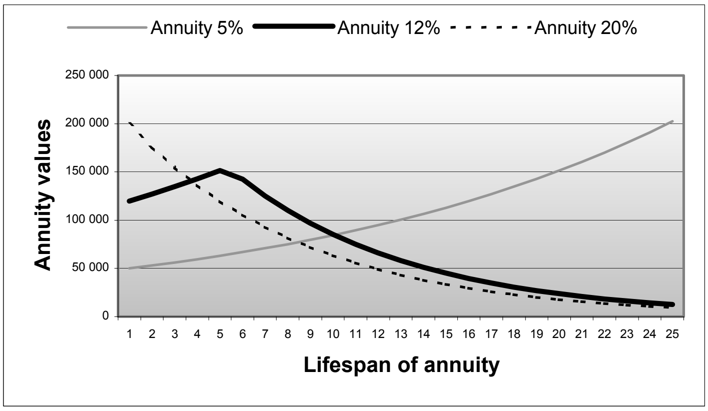
Living annuities: What income level is sustainable for the rest of your life?

Investment linked living annuities were introduced as an alternative to guaranteed annuities (pensions). At the time, guaranteed annuities often offered poor value for money, little flexibility and when the annuitant died, so did the pension. However, flexibility without control can have unintended consequences and the inherent flexibility of the new living annuities brought two new risks to bear:

1. In giving investors the flexibility to select the income level they preferred, many investors could, and indeed many did, draw a pension that exceeded the return on the investment – causing pensioners to run out of money before they died.
2. More dependence on the underlying investments: If markets fall or inappropriate investments are made, it is less likely that your pension will beat inflation or that your capital will last until the day you die.

In the nineties the South African Revenue Service (SARS) became concerned about the above risks and that, as a result of high monthly withdrawals (as a percentage of the capital) and volatile underlying investments, pensioners with living annuities would not have a sustainable income, and would become dependent on a state pension. They therefore issued Practice Note RF1/96.This practice note states that Inland Revenue had, "in principle, no objection to flexible annuity arrangements…" but that "the purpose of a compulsory annuity is to provide a life annuity for a member…". The note proceeded to set out parameters within which all flexible living annuity arrangements must operate. One of these parameters was that "income levels must be based on a minimum of five (5) per cent simple interest rate of return calculation and a maximum of twenty (20) per cent simple interest rate of return calculation, and must at all times produce a life annuity." In so doing, SARS instructed the life assurance and linked investment product industries to ensure that investment-linked living annuities provide pensions that are sustainable throughout a pensioner's life.

Almost 10 years have passed since this note was issued, and inflation levels and (as a result) expected nominal investment returns have gradually reduced so that they are now substantially less than the high double-digit figures of 1996. However, many flexible annuities continue to be issued at income levels close to 20%. SARS issued Addendum A to RF1/96 in June 2004, which emphasised the requirement that a flexible annuity must at all times produce a life annuity. However, the practice of issuing flexible annuities at very high income levels has continued. It was therefore considered in the industry that it would be appropriate that the income level parameters of RF1/96 be adjusted to reflect investment return and inflation level realities. After several submissions had been made to SARS by various industry organisations, SARS issued a draft addendum B to RF1/96 proposing reduced income levels of 3% - 12%. This addendum has not been finally signed off by SARS, but SARS has stated from the start that the purpose of a compulsory annuity is to provide a life annuity for a member or an annuity for dependants or nominees of deceased members. They have also made it clear that if an annuity is provided that is not a life annuity (for the life of the annuitant), then the fund that purchased such an annuity could effectively lose its tax approved status.



The graph alongside shows an amount of an annual annuity received by an annuitant given an initially selected drawdown percentage of 5%, 12% and 20% of their initial R1m capital value. An underlying investment return of 10% is assumed. Inflation is assumed to be 6% and an increase of 6% is applied to the initial drawdown percentage selected on an annual basis. Due to the fact that the maximum drawdown percentage permitted is 20%, this increase of 6% is not applied (and where necessary the annuity is in fact reduced) to ensure that annual withdrawal rates do not exceed 20% of the opening asset balance in each year. As the graph illustrates, when the drawdown percentage selected is 20%, the nominal annuity amount reduces quite significantly from R200 000 in year 1, to less than half of this by year 7 and by year 12 is less than a quarter of its initial value. For an annuity of 12%, by year 8, the nominal annuity value is reducing each year and is less than the initial R120 000. Of the three scenarios illustrated, only the annuity values for a 5% drawdown percentage (+ 6% annual increases) are sustainable under the conditions assumed.

The appropriate income rate to be applied will therefore depend on the individual annuitant's probable life expectancy. One of the ways of dealing with the responsibility placed on intermediaries, administrators and trustees by RF1/96, is to base draw-down rates on the equivalent level of income that can be obtained from a guaranteed annuity for the same client, (with some leeway for greater flexibility). This would suggest that the drawdown should vary based on the client's age, and their state of health. These limits should be monitored, and amended in line with changes in guaranteed annuity rates and the annuitant's circumstances.

Under FAIS legislation, an intermediary who is advising trustees is expected to comprehensively inform the trustees of the implications of RF1/96, and to advise them to ensure where members are permitted in the fund rules to retire with flexible annuities, that the product providers from which such annuities are purchased have measures in place to ensure that the principle of an annuity for life is followed. An intermediary who is advising a retiree regarding the appropriate annuity/annuities for his/her retirement should explain the implications of RF1/96 to the client and what limitations on the income drawdowns exist. It is not good advice to increase an income level to that which may result in an annuity that is not considered by SARS to be an annuity for life.

Allan Gray has taken account of the provisions of draft Addendum B to RF1/96 and has urged both investors and financial advisers to carefully consider the choice of income level. This warning is repeated to new clients at inception and to all clients on each anniversary of their Allan Gray Living Annuity so that the most prudent and sustainable income level particular to each individual is selected.

Commentary by Johan de Lange, Director, Allan Gray Investor Services