



Legal Services

FINANCIAL SERVICES



ON THE SCALES 6 OF 2019

Exemption for living annuities forming part of a fund's annuity strategy

The so-called “default regulations” have introduced a requirement for funds to implement an annuity strategy (Regulation 39).

Funds can include a living annuity in their annuity strategy, provided the living annuity meets the conditions in the regulations.

Funds are exempted from one of the requirements, until the Financial Sector Conduct Authority ('FSCA') issues a final conduct standard prescribing the drawdown levels applicable to a living annuity.

Summary

- Regulation 39(3)(a) has requirements for funds offering a living annuity as part of their annuity strategy.
- The requirements include limits on the investment portfolios offered and the drawdowns applicable to those living annuities.

- The FSCA has exempted funds from having to comply with the prescribed drawdown levels, as the conduct standard which prescribes the drawdown levels has not been finalised yet.
- Trustees should exercise their fiduciary duty in determining reasonable and prudent drawdown levels.
- Regulation 39(3)(b) which requires trustees to monitor the sustainability of the living annuity income is still in place.

What does Regulation 39(3) say about living annuities?

Funds can include a living annuity paid directly from the fund and/or through a fund-owned policy and/or from an external provider in their annuity strategy.

Regulation 39(3)(a) says following requirements must be complied with by 1 March 2019:

1. The living annuity investment choice is limited to a maximum of 4 investment portfolios;
2. The investment portfolios offered must comply with regulations 28 and 37 (which govern default investment portfolios); and
3. The living annuity drawdown levels must comply with a prescribed standard.

Regulation 39(3)(b) says following requirements must be complied with by 1 March 2019:

1. Funds must monitor the sustainability of income for a living annuity paid directly from the fund and/or through a fund-owned policy;
2. Funds must make members aware if the income level is not sustainable.

What exemption has been granted by the FSCA?

The FSCA issued PFA Notice 2 of 2019 ('the notice') on 20 February 2019.

The notice grants a general exemption to funds from having to comply with a prescribed standard on the drawdown levels, because the standard has not been finalised yet.

The requirements regarding investment portfolios and monitoring the sustainability of income are still applicable from 1 March 2019.

Draft conduct standard on living annuities

On 7 November 2018, the FSCA released a draft conduct standard for comment.

The conduct standard prescribed how a fund had to measure and monitor the sustainability of the income provided by a living annuity. There were two methods put forward to measure sustainability:

1. The monetary amount at the outset that is likely (with a 90% probability) to continue to be paid, with annual inflationary increases, for the expected lifetime of the individual, based on the capital available at inception and assuming reasonable returns earned; or
2. Sustainable income may be measured as the expected number of years until the capital can no longer support a given monetary drawdown, where the monetary amount increases with annual inflationary increases.

The draft conduct standard also prescribed maximum drawdown rates as follows:

Age	Males	Females
▪ 55	4.5%	4%
▪ 60	5%	4.5%
▪ 65	5.5%	5%
▪ 70	5.5%	5%
▪ 75	6%	5,5%
▪ 80	7%	6%
▪ 85	8%	7%

Feedback on the draft living annuity conduct standard

Through the industry bodies that Alexander Forbes participates in, we submitted comments to the FSCA. The submissions to the FSCA included the following feedback:

- Concern was raised about a fund being responsible for out of fund living annuities, where an insurer provided a living annuity to an annuitant;
- The conduct standard goes further than the regulations do in terms of imposing conditions;
- The drawdown levels are too restrictive, which could result in members opting out of the fund annuity strategy, possibly to their detriment;
- The draw down levels did not permit funds to take into account the retiring members personal circumstances;
- Additional costs would be incurred by funds in implementing the conduct standard;
- The timeframe for implementation was onerous.

The FSCA confirmed that it received extensive comment on the draft conduct standard and it is not ready to release the final version of the conduct standard. Therefore the notice was issued last week granting the exemption to funds while we wait for the final conduct standard to be issued.

What should funds do in the meantime?

Funds have not been exempted from monitoring the sustainability of income where they have an in fund or fund owned living annuity. However they do not need to use the methods suggested by the FSCA in the draft conduct standard, as that conduct standard has not been finalised yet.

Comment: trustees that have implemented an in fund or fund owned living annuity as part of their annuity strategy in conjunction with consulting advice from Alexander Forbes will be aware that they have applied their minds to the communication and information that will be provided to annuitants regarding the nature of a living annuity, sustainability of income and the importance of getting financial advice. We believe that funds should not change their framework at this stage and they should wait until the final conduct standard is released before reviewing their annuity strategy.

The FSCA has said that trustees should exercise their fiduciary duties in determining the drawdown levels. Also, they should take into account the nature of the fund and the circumstances of the membership.

Drawdown levels cannot exceed the rate prescribed in the Income Tax Act, which is a maximum drawdown of 17.5%. Whilst exceptional personal circumstances, such as critical ill health, may justify a high drawdown rate, general consensus would be that a drawdown of anywhere close to 17.5% would result in the pensioners running out of money before they die.

Comment: trustees that have implemented a living annuity as part of their annuity strategy in conjunction with consulting advice from Alexander Forbes will be aware that they have applied their minds to a reasonable drawdown levels that should be communicated to all retiring members. Extensive research and consideration have been taken into account as to what constitutes appropriate draw down levels. Funds have also encouraged members to obtain financial advice, to ensure that retiring members get advice specific to their own personal circumstances. We believe that funds should not change their framework at this stage and they should wait until the final conduct standard is released before reviewing their annuity strategy.