Investment Options for Your Pension Upon Retirement, & Cytonn Weekly #34/2019

Focus of the Week

For many, the idea of retirement means transitioning into a more relaxed lifestyle, and having time to enjoy all the things we did not have time for before retirement, such as our hobbies, family and friends, travel, and recreational activities. It is therefore important to protect what you have saved or invested to ensure that you will have enough income throughout your retirement; after all, you worked hard to get to retirement.

To guarantee income upon retirement, it is important to join a Retirement Benefits Scheme while still in your working years and contribute towards your retirement. On retirement, one should aim to have an income replacement ratio of about 75%. Currently, the average income replacement ratio in Kenya is below 40% and there is need for people to enhance their retirement savings. Depending on the type of Retirement Benefits Scheme you belong to, you may access your retirement benefits as either a lump sum, or a combination of a lump sum and periodic payments, depending on whether you were in a pension scheme or a provident fund:

- Members of pension schemes can access up to one third of their retirement benefits as a lump sum, and the balance can either be utilized to buy an annuity, or is transferred into an Income Drawdown Fund.
- On the other hand, members of provident funds access the whole of their retirement benefits as a lump sum.

For more information on the difference between pension funds and provident funds, see our note on Pension Funds vs Provident Funds.

Once you receive your retirement benefits, you have many options at your disposal. You might decide to take your lump sum, purchase a rental property and enjoy rental income, you might decide to use your benefits to start a business, or even take that hard-earned vacation that you have been waiting for; the options are endless. However, as you do this, keep in mind that the retirement benefits are supposed to provide for you for the rest of your life and cater for any unforeseen emergencies or needs. It is therefore important to choose an option that will protect your savings and afford you a sustainable income throughout your retirement years. Currently, most people are not comfortable with their retirement savings with statistics showing that 40% of retirees continue to work after retirement with the number of retirees who are financially independent at retirement being less than 5%. It is therefore important that as a retiree, one consider a passive way of investment as source of their retirement income. The two main options recommended for members are: (i) purchasing an annuity, or (ii) transferring your benefits into an Income Drawdown Fund. This note seeks to analyze these two options and as such, we will cover;

i. Definition of the Terms ‘Income Drawdown’ and ‘Annuity’ and How They Work,

ii. Comparisons Between Income Drawdown Funds and Annuities, and
iii. Conclusion and Factors to Consider When Choosing Between an Income Drawdown Fund and an Annuity.

Section I. Definition of the Terms 'Income Drawdown' and 'Annuity', and How They Work

A. **Income Drawdown**

An income drawdown is an option that allows members of Retirement Benefits Schemes to access their accumulated retirement benefits as a regular income, through reinvesting their benefits in an Income Drawdown Fund registered by the Retirement Benefits Authority (RBA), from which periodic payments are drawn. At the point of retirement, the member transfers their accumulated benefits to the Income Drawdown Fund. The member then draws regular payments from this fund for a minimum of 10-years. The member, depending on their retirement needs, determines the frequency and amount of the withdrawals. Once the member makes a withdrawal, the fund balance remains invested and continues to earn a return. This option allows a member to benefit from income generated from investing his retirement benefits and in turn, it expected to translate into higher regular payouts to the member.

How Income Drawdowns Work

1. Upon retirement, the member transfers their accumulated benefits into an Income Drawdown Fund registered by the RBA. Currently funds registered by RBA include: -
   i. Cytonn Income Drawdown Fund,
   ii. Enwealth Kesho Hela Income Drawdown Fund,
   iii. Octagon Income Drawdown Fund,
   iv. Platinum Drawdown by Britam,
   v. Milele Income Drawdown by GenAfrica, and,
   vi. Zimele Income Drawdown Plan.
2. The member then draws regular payments from this fund depending on his or her needs and can be as frequent as monthly, quarterly, half-yearly or yearly. The maximum amount that a member can withdraw is 15% of the fund balance per annum, and this is to protect and ensure the funds are not exhausted during the lifetime of the member thereby providing cover from the risks associated with their longevity.
3. The remaining balance is invested by the Fund Manager and continues to earn interest.
4. The minimum drawdown period is 10-years as per regulations. On expiry of the drawdown period, the member has the following options:
   i. Purchase an annuity with the remaining fund balance, or
   ii. Continue with the drawdown arrangement, or
   iii. Access the fund balance as a lump sum.

B. **Annuity**

An annuity is a contract between an insurance company and an individual where in return for a lump sum of money, in this case your accumulated retirement benefits, the insurance company/approved issuer will give you a periodic income with the choice of monthly, quarterly, half-yearly or yearly.

How Annuities Work

1. At retirement, a member chooses an insurance provider to purchase an annuity. Annuities are strictly provided by insurance companies and the 2018 issue of the Pensioner Magazine by RBA lists 19 insurance companies that offer annuities. Upon retirement, a member is allowed up to 12 months to make a decision on which annuity provider to go with.
2. Once the member chooses the provider, they then choose the annuity type that suits their needs. There are different types of annuities and one should engage an adviser when making this

decision. It is good to note that unlike in an Income Drawdown Fund, you cannot change the annuity once you choose for the rest of your life. The options available include but are not limited to;

a. **Single Life Annuity -** This choice allows you to receive payments your entire life and is limited to the lifetime of the annuitant with no survivor benefit. If an annuitant dies soon after taking the annuity, the beneficiaries do not get anything from the insurance company.
b. **Life Annuity with a Guaranteed Period** - These are similar to single life annuities but with a minimum period that the annuity will last, say 10-years. If the annuitant dies before the end of the period, the payments for the rest of that time will go to his/her beneficiary. However, adding the fixed period results to lowering the amount of your regular payments.
c. **Joint and Survivor Annuity** - A joint and survivor annuity guarantees payments will last the lives of both the annuitant and another person, typically a spouse. This choice reduces the amount of each payment you receive.
d. **Systematic Annuity Withdrawal** - In this method, you choose the amount of the payments and how many payments you want to receive. This option does not include a guarantee it will last your entire life. It is entirely dependent on the amount of money in your annuity account.

3. The amount of income payment you will receive will depend on several factors including:
   i. The amount paid to purchase the annuity,
   ii. Age at the time of purchase, and,
   iii. The benefits options chosen.

   Insurance companies may use other subjective factors when determining your income such gender, as women tend to live longer than men meaning their annuity rates are lower than the rates for men.

4. Like in an Income Drawdown Fund, you can also choose to have your income paid every month, quarterly, half-yearly or yearly.

For annuities, the more conditions you have, such as including a guaranteed period, adding a spouse to the annuity, etc. the lower the monthly payments that you will receive.

Section II. Comparisons Between Income Drawdown Funds and Annuities

i. **Flexibility -** Income Drawdown Funds are widely considered more flexible than annuities. With an Income Drawdown Fund, you choose how much you want to withdraw from your fund and the frequency. You can also change the amount of drawdown at a frequency that will be agreed on with your provider. An annuity provides certainty in retirement, but lacks the flexibility that income drawdown provides. Once you purchase an annuity there is no turning back, and you cannot change it.
ii. **Investment Income** - An Income Drawdown Fund allows a member to benefit from income generated from investing their lump sum and this is expected to translate to higher regular payouts to the member. It offers stable investment returns since the funds are invested conservatively with the aim of preserving capital, and achieving modest growth over the long-term to ensure that at the end of the drawdown period, you have funds left in your account to continue providing for you during retirement. Based on the returns offered by the fund manager and the drawdown percentage, your fund could end up growing and thus offering even higher payout and growing your retirement savings to last even longer. It is therefore important to select an Income Drawdown Fund that offers you attractive returns. The table below show the difference in your fund value after 10 years depending of the returns offered by different Income Drawdown Funds, all other factors held constant.

Income Drawdown Fund Value after Drawdown Period- Based on Returns from Different Funds

	Fund A	Fund B	Fund C
Annual Interest Rate	10.0%	11.0%	12.0%
Annual Withdrawal Percentage	11.0%	11.0%	11.0%
Initial Fund Value	5,000,000	5,000,000	5,000,000
Monthly Drawdown Amount for 10-Years	45,833	45,833	45,833
Fund Value After 10-Years	**4,146,479**	**5,000,000**	**5,958,494**

Values in Kshs

For annuities, the interest rate is determined at the point of purchase, usually being the prevailing interest rates, currently the rates for the 1-year government papers being about 9.2%, and is used when determining the periodic payments.

iii. **Longevity** - With an Income Drawdown Fund, there are no guarantees the income you draw will be last life, as when you reinvest your retirement benefits they become vulnerable to market performance. Annuities, on the other hand, can be used to guarantee an income for a given time period. A lifetime annuity is used to provide a regular income for life, and will continue paying out no matter how long you live.
iv. **Inheritance -** Income Drawdown Funds give the member the opportunity to leave an inheritance in the event of demise as the beneficiaries you nominate can inherit whatever money is left in your Income Drawdown Fund. On the other hand, the type of annuity you purchase will determine whether it continues to pay out after you die. If you purchase a single-life annuity, it will only pay an income to you, the sole beneficiary, and after you die all remaining funds will be kept by the insurer.
v. **Risk.** Income Drawdown Funds are considered riskier compared to annuities. There is a risk of running out of money if your investment returns are not able to sustain your withdrawals.

The factors listed above can be summarized as in the table below;

	Income Drawdown Fund	Annuity
Flexibility	**More flexible**	**No flexibility**
Investment Income	Investment Income could translate to a bigger fund after the drawdown period	No investment income
Longevity	Income is not guaranteed to last as the invested fund may be affected by market performance	Some annuities can pay out for the rest of your life no matter how long you live
Risk	More risky	Less risky
Inheritance	In case of death, your fund balance is accessed by your nominated beneficiaries	If you die soon after retirement, all remaining funds will be kept by the insurer

Section III. Conclusion and Factors to Consider When Choosing Between an Income Drawdown Fund and an Annuity

It would be misleading to generally conclude that one option is better than the other is, and therefore suitable for all members. As such, it is important to seek professional advice when making this important decision because your standard of living in retirement depends on it. People have different needs at retirement and should make decisions that suit their needs. The features of the two options covered in this focus note are to guide you and enable you to formulate a retirement plan that will enable you to enjoy a sustainable lifestyle in retirement. Some factors that you can consider when making this decision include:

1. **Dependents -** As seen when comparing income drawdown and annuities, income drawdown is more suitable for members who have dependents as it allows for inheritance. In case of death, a member may leave their funds to their beneficiaries. On the other hand, the type of annuity that you choose determines whether the payment is only to the annuitant or the spouse in case of death;
2. **Size of the Retirement Pot -** We would recommend income drawdown for members with a large fund at retirement. RBA had initially set this at a minimum of Kshs 5.0 mn but this has since been removed from the guidelines. Our opinion is that with a large fund at retirement, say more than Kshs 1 mn, a member will be in a position to take up investment risk and at the same time enjoy the higher returns and higher payout compared to annuities. Members with smaller funds at retirement, say below Kshs 1 mn, cannot afford to take the risk and should join annuities;
3. **Health Status -** The status of your health will most likely determine how long you will live post retirement; good health will mean that you are likely to live long after retirement. You do not want a scenario where you outlive your retirement savings. One might therefore consider a combination of annuity and income drawdown, the annuity would ensure certainty that you have income no matter how long you live, income drawdown will give you a better payout translating to improved life at retirement;
4. **Other Income Sources -** Retirees with other income sources, such as property and investments are able to take up more risks and therefore the income drawdown may be the better option;
5. **Risk Appetite –** Retirees have varying risk appetite. With the normal retirement age in Kenya being between 50 years and 75 years, people who retire at 50 are able to take up more risk and should join an Income Drawdown Fund, while those who retire later than 70 years are not able to take up much risk.

For more information on Options for Your Pension Upon Retirement, email us at pensions@cytonn.com

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