CHOOSING THE MOST PREFERABLE PENSION PAYOUT METHOD

INTRODUCTION

Pensions uptake in the region has significantly increased over time. The Retirement Benefits Authority estimates the assets under management in Kenya to have increased from Ksh 1,576.22 bn in December 2022 to Ksh 1,703.69bn in June 2023 which represents an increment of 8.087% for the 6 month period. However, there still exists a big knowledge gap on the methods of pensions payout and alternatives that individuals can use.

This article will look at the two main methods of pensions payment and review the legislative frameworks governing the methods. In addition, we will look at some of the considerations to make when choosing a payout method.

Commutation Lumpsum

The retirement benefits regulations for occupational schemes provide that an indiviual may receive one quarter of his retirement benefits upon retirement if the employee did not make contributions and a third of their scheme credits if the employee made contributions. The remaining portion of the retirement benefits is then expected to be paid through out the life of the individual.

Pension Payments

The Retirement Benefits Act (the Act) requires that the remaining portion of retirement benefits should be sufficient to make regular payments for the life of the individual. If the board of a scheme determines that the funds are insufficient to make the payments, then the board has the authority to issue the sum out as a trivial pension.

There are two methods of pension payout recognised by the Authority in Kenya and they include;

1. **Annuities**
2. **Income Draw Down Fund**

ANNUITIES

An annuity is a financial contract between a financial institution and an individual where the institution partakes to make regular payments to an individual for a pre-specified period of time upon receipt of an agreed payment to the financial institution. Annuities in Kenya are regulated by the Insurance Regulatory Authority.

Pension schemes have the option to provide in house annuities or to outsource from an insurance company. For this case, the annuities have to be life annuities and are determined by annuity factors determined by an actuary. It is recommended to have the factors reviewed regularly for suitability and sustainability.

An annuity can be either deferred or immediate. When a retiree has attained the normal retirement age but they still have other sources of income, then they have the option to defer their annuity until a later date when the recomputations will be done to detemine the adjusted regular payments. Immediate annuity is an annuity where the payment begins immediately.

Annuity Regulations In Kenya

The Insurance Regulatory Authority (IRA) is responsible for supervising and regulating annuities in Kenya. Some of its roles include;

1. **Licensing & Overseeing** - This oversight involves verifying that these institutions adhere to precise financial and operational criteria to safeguard the welfare of both policyholders and annuitants.

2. **Risk Management** - The regulatory body evaluates the financial stability and risk management strategies of insurance firms and pension providers, verifying their capacity to fulfill commitments to annuity policyholders.

3. **Consumer Protection** - The IRA consistently evaluates and revises regulations and guidelines associated with annuities to respond to evolving market conditions and ensure the safeguarding of consumer interests.

4. **Member Education** - The IRA undertakes members' educational initiatives aimed at enhancing consumer awareness and comprehension of annuities.

The table below gives a brief description and some advantages and limitations of an annuity.

Annuity Type	Description	Pros	Cons
Fixed Annuity	It guarantees a fixed rate of return for a predetermined period of time.	- Tax deferred growth - No Market risk - Assured interest rate - Protection of principal	- Inflation Risk - Limited flexibility - Tax implications on liquidation
Variable Annuity	Returns are dependent on market forces.	- Tax deferred growth - Potential for higher returns - No contribution limits hence growth of the retirement savings.	- Complex - Tax implications on liquidation - Early withdrawal penalties.
Indexed Annuity	Payouts are dependent on the value of a market index.	- Tax deferred growth - Principal protection - Potential for high returns	- Complex - Relatively expensive - Early withdrawal penalties

INCOME DRAW DOWN FUNDS

Income drawdown is a retirement arrangement that permits a member to receive their retirement benefits in periodic instalments, while the remaining balance is kept invested within the fund. With income drawdown, you have the flexibility to receive your retirement income while your benefits continue to be grow as part of the scheme's investments. In kenya, the minimum draw down period has been set at 10 years with the maximum amount withdrawable per period at 15% of the initial fund value.

Advantages Of Income Drawdown Funds

1. **Flexibility -** Income drawdown offers retirees the flexibility to determine the level of income they wish to withdraw from their pension savings. They have the freedom to adjust the income amount, enabling them to respond to fluctuations in their financial requirements.

2. **Potential For Higher Investment Returns** - Unlike annuities or periodic payments, this method allows your retirement savings to remain invested in the financial markets. If the market performs, it gives them the opportunity to potentially profit from investment growth.

Disadvantages Of Income Drawdown Funds

1. **Market Volatility -** Pension fund's value in income drawdown may change depending on the state of the market. Inadequate investment performance can erode the value of the fund and lower a retiree's income, particularly in times of economic recession. Additionally, if poor investment decisions are made and there is under-performance, it will cause erosion of the savings.

2. **Uncertainty Of Income** - The income from income drawdown may fluctuate due to it's dependence on the performance of the investment.

3. **Responsibility For Investment Decisions** - The choice of investments for your retirement savings is a retiree's responsibility, and if those investments yield unfavorable results, the accountability falls squarely on the retiree as an individual.
4. **Fund Balance Depletion** - There is a risk of depleting funds in an income drawdown fund. This exposes the member incase they do not have an alternative source of income.

Considerations When Choosing Between An Annuity And An Income Drawdown Fund

1. **Expectation of Life** - Choosing an annuity will be more prefarable when a member expects to live beyond the life expectancy. This is because the annuity protects the member from longevity risk and guarantees an income through out the life of the member. An Income draw down fund however does not guarantee an income once the fund has been depleted.
2. **Amount of retirement benefits** - When the member has a sizeable retirement benefit, a product mix will be more advisable. Taking an annuity with a portion of the retirement benefit to guarantee an income throughout the life of an individual protects the retiree from outliving his benefits. The remaining portion can be spent on an income drawdown fund to give higher returns. When the amount of retirement benfits is not significant, then the member is advised to choose an annuity.

3. **Investment Literacy** - An individual who is well acquainted with concepts in investments is in a better place to take an income drawdown. They will know how to regulate their withdrawals and how to re-invest the balance upon the end of the initial ten years. An individual who is not conversant with matters in investments is advised to take a guarnteed life annuity as it has minimal risks attached to it.

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