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CAUGHT OUT

Unearthing the maggots in your Financial Plan – RSA edition

We often unwittingly sabotage our financial future because we don't know any different. This booklet will give you some valuable insider information to help you root out the rot.

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CHAOTIC STATE OF AFFAIRS ON DEATH OR INCAPACITY

It is a cliché found in loads of soapies and B grade movies where someone is told to 'go home and sort out your affairs' when given the news of a terminal illness. In reality few of us are given that forewarning and our friends and family turn the house upside down to even find a will, let alone details of your investments etc. This can add months or even years to the winding up of your estate. On death accounts are frozen and while you may have thoughtfully provided liquidity by way of a life policy the policy document is likely to be electronic and so unlikely to be found by a manual search of the filing cupboard.

Recommendations: Having copies of all your important information in one place (I call it the RED FILE) makes a lot of sense. A simple filing system that covers all your bases from medical aid data, short term house and car cover, life policies, investment details, will, estate plan, copies of ID and other important certificates. If you would like an editable word document of this which our clients use extensively click here : Please send me the RED FILE template

POORLY STRUCTURED WILLS

A Life policy contract has a number of parties and it is important to know how you fit in. Firstly there is the owner, If you are taking the policy out on your own life this is probably you. If you cede a policy to the bank you change this ownership. In corporate buy-and-sell polices then the partners are usually the owners on each other's lives, juristic persons and companies can own life policies. Secondly there is the life assured – the natural person who's life is being assured, the person on whose death the policy will pay out to the beneficiaries. You cannot assure a trust or a company – only a natural person. You can get joint policies for spouses, but one of the spouses is usually the designated owner. Thirdly you get beneficiaries, these are the people to whom the policy will pay out and can only be changed by the owner. The fourth party is the payer, the person who pays the premium. The fifth party is the provider – the insurance company. A life policy is a contract between the provider and the owner of the policy and supersedes anything you have written in the will – unless you nominate "my estate" or "in terms of my will" as the beneficiary.

If the proceeds are left to a natural or juristic person (like a trust) then the proceeds are 'deemed property' in your estate. Sounds like semantics right? The definition is important, executors can only get paid on property they handle in the estate, **not deemed property**. The maximum executor's fee of 3.99% (inc VAT)- doesn't sound like much. Think on this: The proceeds will only be paid out to your dependants after the estate has been wound up – usually some 18 months later whereas the average life policy will pay out directly to a beneficiary within weeks. By turning the policy into deemed property – on say a R2m policy – you will be increasing the fees to the executor by about R80 000, for doing nothing (except making his/her life easier). It is a good idea to create 'liquidity' in the estate to pay for outstanding debt, income tax, CGT, estate duty etc. One can get around the automatic fee levy by the executor by leaving that decision up to your surviving spouse or children who can then negotiate a flat fee with an executor – then leave the amount required as identified by your estate plan to the estate. If you have an undertaking that you or your children will be nominated in a life policy, be aware that it takes minutes to change the beneficiary and you may be none the wiser. Total cession of the policy is a much safer idea, then no changes can be made without your permission.

There are a number of other pitfalls in a will. Ensure that any proceeds of a will are outside of a marital regime. In other words if a beneficiary is married in Community of Property or ANC with

Accrual then the proceeds will not be in the 'joint' estate. If you do not have minor beneficiaries but any of your beneficiaries have minor children that may inherit in the event of the death of one of the beneficiaries then make provision for a testamentary trust with the basic conditions of the trust including how the proceeds may be paid before majority/ nominated age. Ensure that the witnesses have nothing to do with the will. No beneficiaries, executors or even author of the will (unless it is a testator or testatrix).

Recommendation : Have your will drawn up by an independent person and put the decision to nominate the executor in a beneficiaries hands and make sure they understand that the fee is negotiable . If you nominate a bank or lawyer, the maximum will be charged and there will be zero incentive to get a move on. Pay fairly according to the amount of work required, but don't be fooled. If a house has to be sold, the executor will call in an estate agent to do all the work (and he or she will likely charge full commission). Changing beneficiaries is a simple one page exercise, ask your advisor for the form. If you have deliberately created liquidity by ways of a life policy leave it to a beneficiary who is the co-executor and make these instructions very clear in your RED FILE . Keep a copy of the will right at the front of the RED FILE with clear directions on where to find the original.

OLD ENDOWMENTS

For many years endowments were the investment vehicle of choice - especially for so called 'education policies', this is because they were sold as "tax-free" and with the advent of CGT there was a booming trade in 'second hand' policies (till SARS got wise to it). Yes, it is tax free in your hands at maturity – that is because it has already been taxed at 30%. Make no mistake, the taxman takes his pound of flesh somewhere in every single transaction. If you get a tax break on premiums (like an RA) you will pay tax on the proceeds. However, as an individual you get certain deductions on both interest and CGT (trusts don't). Then there is the penalty for early surrender or withdrawal. The regulations stipulate that endowment has to be in place for 5 years. Most insurance platforms today however have a 10 year minimum (LISPs don't – see HERE under investment FAQs if you aren't sure of the difference between an insurance company and a LISP). Old (prior to 2007) endowments had terms as long as 50 years and 'early' surrender will attract a 30% penalty of the fund value. Why? Brokers on insurance platforms get paid upfront (as opposed to as-and-when) commission on the entire term of the investment and the insurance companies want to get that back – from you mostly. To give you an idea, if you took out an endowment or RA on an insurance platform prior to 2007 of say R1000 pm your broker would have been paid commission of around R20 000 (it is now ¼ of that but still a sizable chunk) . If you're unlucky enough to have been given poor investment advice and the fund selection has not been managed, you may be lucky to get your premiums back, less the 30% of course.

Recommendations : I have never made secret of my dislike of endowments on Insurance platforms but there are some exceptions: Investment in a trust which is taxed at 40% and high net worth individuals with average tax over 30% and have maxed out their personal deductions. In both instances the investment should be on a LISP platform or insurance platform where the penalties are waived (usually due to a concession by the broker on the commission structure or by cross subsidisation to life products). Make sure you have a wide choice of funds, 5 year maturity (insurance platforms will try and lure you in with bonuses to extend this), and scrutinise the Total Expense Ratio of the investment.

Inflexible Retirement Annuities

Retirement Annuities (RAs) can be a highly effective way to save for your retirement but much of the bad press revolves around the same issues as endowments on insurance platforms – punitive penalties, poor fund choice ad high costs. In addition to the tax deductions you can claim (this amount is currently under review) within the fund no tax is levied on interest or CGT and the dividend withholding tax is rebated back into the fund. These tax breaks within the fund will mean that if you have an RA and a flexible investment invested in exactly the same funds, the RA will have a higher internal rate of return (as long as the fees are the same). HOWEVER – If your RA is on an insurance platform you are likely to have onerous penalties for early termination (making it 'paid up'), missing premiums etc. On policies sold pre 2007 the penalties can be as high as 30% of the fund value – which can eclipse the value of the commission paid to the original broker by several orders of magnitude. As with endowments, this is thanks to the policy – still practiced by insurance companies- of paying brokers upfront commission for the full term of the investment (or 27 years). Even new RAs can have a penalty of as much as 15% of market value.

Recommendation: Unless there is a very compelling reason (or the penalties have been waived by the insurance platform as a result of change in commission structure by the broker) then place your RAs on a LISP platform. Most insurance platforms (Liberty, Momentum etc) have LISP platforms so even 'tied brokers" should be able to offer you this alternative. A 'tied broker' is a broker that can only use one insurance provider. The alternative is an 'independent financial advisor' who will be accredited to use a number of different providers. This should be clearly disclosed on the advisor's letter of introduction.

Non-performing Retirement Annuities

All your investments should be monitored and analysed frequently – ideally putting all of them into a single report so that you can also determine the 'asset allocation' of your entire portfolio. Today you can usually pull your own statements off the web using a login. Even smallish investments should be looked at least once a year in the annual review you have with your financial advisor/s. The most useful analysis to request is an Internal Rate of Return (IRR). This gives a far more accurate indication of the true performance of your investment, after all fees have been stripped out. You can then determine the REAL rate of return by deducting inflation (say 6%). I am always coming across long term investments that have never been analysed and are sitting in funds that haven't performed for years. If the REAL IRR is less than 5% you should be taking a closer look at the funds you can switch into. If you don't have a decent fund choice, get a quote on moving it to another platform or provider.

Recommendation : Get your advisor to consolidate all your investments in one place (he or she can probably take over the responsibility for them and be paid the annual fee). Switch into the optimal fund for your needs and years to retirement.

AGGRESSIVE PREMIUM PATTERNS

One of the classic methods used by brokers to churn your policy to another provider is to get you a 'cheaper' premium. One of the easiest ways of doing this is to use a more aggressive premium pattern. Although most providers now tabulate the projected annual increases they don't put percentages in there (or you'd run for the hills). There is nothing like a bit of understanding how this works to help you decide if you really are getting a better deal or the broker is just looking for more commission.

Benefit increase versus premium increase. Logically one might assume that for every 1% increase in benefit you would get a 1% increase in premium. Not so. Although the difference between these two will vary significantly from provider to provider, the increase in premium is usually at least 2 to 3% above the benefit increase. This is because you are more expensive to insure as you get older (greater chance of dying and all that) so that small percentage 'extra" cover you are getting is costed at your new, older age. Some providers claim to have a one to one increase, but will then admit that the 'underwriting' differential is just factored into the initial premium so in an 'apples for apples' quote they will be more expensive. The only time you get a direct one to one correlation is when the benefit increase is zero. It is important to get clear financial advice on the implications of this from your advisor or broker.

Level premium. This premium, if set at zero benefit increase, will have the same premium for the entire term.

Age rated :This premium will start below the level of a level premium (for the same benefit) but increase every year. The increase is usually between 5 and 7%. When you plot the premium increases in a level versus age rated premium on the same graph, the age rated premium equals the level premium after about 7 years (on average) and thereafter continues to increase.

Stepped : This is similar to level but with a substantial increase of around 25% or so every 5-10 years. This premium pattern is not popular.

Recommendations: Be aware of the premium pattern on your policies. Most providers will have a table showing you what the premium increases will look like over 10-20 years - without the percentages. Work out the percentage increase or ask your advisor to help – even better put them on a graph. If the increase is way above inflation, they could well become affordable. If you are obliged to take out life assurance for your bond, make it separate from your family policy and consider making it termed and with no benefit increase. If the policy has been integrated with other things like investments or loyalty programs, make sure you know the 'worst case' scenario of these added changes.

In most risk policies life cover is the core benefit and the other benefits like dread disease, lump sum disability will be 'accelerated life cover" - in other words pay out your life cover early, and reduce the life cover by the same amount. For example if you had R1m life over and R500k disability cover and were paid out the disability cover then your life cover would reduce to R500k. The 'opposite' of this is 'stand-alone' cover which will pay you out the disability without impacting your life cover, it is understandably more expensive. Some provider have a blend of these, for example Discovery's Minimum Protected Fund. Income protection benefit is usually stand alone.

Recommendations: Accelerated life cover may make sense when it comes to disability cover (as your life expectancy unfortunately is likely to have been reduced), but not necessarily in the case of dread disease (where the likelihood of living a long life if you are 'cured' is good). Check the 'reinstatement clause' in other words if you have made a dread disease claim - whether stand alone or not - and die in less than (say) 14 -30 days later, you may not be paid both even if the benefit is stand alone.

CEDING A LIFE POLICY

In most life polices taken out by individuals they will also be the owner of the policy and can therefore make any changes they want and nominate the beneficiaries. If you take out a bank loan today you may be asked to take out life cover for this amount and cede the policy to the institution. You can also cede a policy to another individual/company/trust. This cession can be full or partial. You are no longer required to take out the life policy belonging to the institution – no more – but these are still available. By all means get a quote, but get your advisor to give you a comparative quote and highlight the differences in the benefits. Ceding an existing policy may sound like a simple way to solve this problem but be warned: If it is a full rather than a partial cession then the entire amount will be tied up by first the institution and then by the estate until it is wound up. Left over proceeds may then attract executors fees that they would not normally. Once the debt is paid off, getting back the cession can be a mission, and if it is forgotten about then the proceeds will go to the estate (eventually).

Recommendations: Take out separate insurance for the finance institution. If it is for a bond for example it may make sense to take it out on the reducing bond balance and only for the term of the bond. However take your home-buying philosophy into consideration – are you likely to keep buying up over time and increase your bond to match your improved earning ability? If so take out cover that allows for a partial cession of the proceeds (in other words only enough to pay for the outstanding bond) and allow the cover to increase naturally over time to keep up with your aspirations. Most finance providers require that permanent disability be added, some even insist on critical illness cover (usually the smaller loans).

NON-DISCLOSURE IN OCCUPATION OR LIFESTYLE CHANGES

The single biggest reason for claim repudiation (refusal to pay) is non-disclosure and statistically is most prevalent in the call-centre environment. This may be because in a telephonic interview neither the call centre agent or the client understands the medical terms of the conditions they have. In traditional questionnaires the questioning usually follows body system by body system and if you or your advisor is unsure, then notes can be made and medical personnel will investigate and assess. Please don't rush through this process and disclose everything fully without having a pity party. What is the difference? Clinical depression is a medically diagnosed condition and is usually treated with a mixture of prescription medication and therapy. Waking up in a bad mood from time to time is life. Don't self-diagnose. If you significantly change occupation (a nanny to a sales rep), travel to 3rd world countries (Iraq, Afganistan are obvious - the dozens of other African and Asian countries may not be), take up smoking or a dangerous hobby (like marriage - just kidding - but flying, scuba) then inform your advisor.

Recommendations: Full disclosure, ask for a summary of the medical questions if the underwriting was done on the phone. If you remember something later, phone and add it (I have heard of clients forgetting about triple bypasses). If you aren't sure, ask your advisor – in writing. In most cases the providers will send you a questionnaire asking for more details and it may or may not affect your premium. The repudiation is not automatic – if you forgot to disclose that you had picked up smoking and died in a car accident which was totally unrelated, then the claim is likely to still get paid. In some instances there is a penalty imposed equal to the difference in premiums you would have paid.

PERMANENT DISABILITY – CLEAR AS MUD

In older polices the distinction was made between 'own occupation' and 'own or similar/reasonable' occupation. Although his came with a premium difference, this distinction was one of the major culprits of giving disability cover a bad name. For example if you were an architect and lost the use of your hands, it could be argued that being a lecturer would be a similar occupation (professionals were the first to be given a category of their own exempting them from this). This distinction is falling away, but it is important to understand how your provider determines <u>how</u> and <u>when</u> you will be paid out your disability cover. Some will add 'activities of daily work' or 'activities of daily living' or both for example. Some providers will pay out on diagnosis, others on prognosis and then in severity bands. If you not paid out because the provider has determined that you could do another similar job – the company you work for may not have a position available. You may also be required to 'rehabilitate' yourself – at your own expense, this may also require retraining.

Recommendations: The relative cost of this cover is not high, don't have an inferior product. Ask your advisor or the call centre agent the how when and why questions. Specifically ask about the 'occupation' clause and how it will be determined. If you still don't understand ask for the technical specifications and get a second opinion from another advisor. The small print will probably not tell you enough for you to know what it is you are buying but your advisor will probably be able to give you an electronic brochure that gives you more detail. If you have an old policy with 'own or similar' definitions, look at upgrading it.

Temporary disability is usually initially paid just on a doctor's note (your own doctor) with the doctors employed by the provider only getting involved after 3 months. Thereafter you may be asked to prove the income you are claiming, and/or prove the loss of income. If your income is in a delayed form - commissions or royalties which are only going to reflect in the future, this can be problematic. Permanent disability usually has to be verified by a panel of doctors employed by the provider, and the measurements used can vary significantly. In general temporary disability usually lasts a maximum of 2-3 years before it is declared permanent.

Recommendations: If you are self-employed or a large component of your income is from commissions then get your advisor to find cover that suits your needs and spelled out the small print. Specifically ask : Do you require proof of loss of income? Is this underwritten upfront or at claim stage? How do you take residual (historical) income into consideration and how do you determine permanent disability? Is this income aggregated and how. This cover is relatively expensive, when in doubt get a second opinion even if you have to pay a fee for it.

DIVORCE AND RETIREMENT FUNDS

When the amended section 37D of the Pension Funds Act which came into effect on 13 September 2007 it stipulated that any amount granted to a non-member spouse, may be deducted from the member's pension benefit in terms of section 7(8) of the Divorce Act. The intention of this amendment is to allow pension funds to deduct any amount due to a non-member spouse as a result of divorce <u>on the date of the divorce order</u> and no longer from the date the benefit accrues (in other words at retirement) to the member as was the case prior to 13 September 2007. This is often the biggest unencumbered asset in a divorce but even now 6 years later too many divorce orders are incorrectly worded and become unenforceable.

Recommendations: Get the wording on the divorce order checked by a legal representative at the provider with the help of your advisor. If you are the owner of the retirement annuity please be aware that penalties may apply and you will be liable for them, not the other spouse and this needs to be factored into the calculation.

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