Consider paying off debt prior to retirement

Coming to the end of your working career requires a step up in terms of financial planning.

Florbela Yates, Head of Equilibrium

Florbela Yates is the head of Equilibrium in the Momentum Metropolitan group. Equilibrium is an independent discretionary fund manager that partners with financial advisors to help them enable their advice outcomes. Equilibrium brings balance to an advice practice by delivering services and investment solutions to help clients achieve their defined investment goals.

You need to ensure you have sufficient means to afford a comfortable retirement. But as we know, despite having a well-thought-out budget and a tax-efficient financial plan, most South Africans still retire without having saved enough and often go into retirement with large debt burdens. Research conducted by the South Africa Reserve Bank and Stats SA shows that South Africans spend 75% of their take-home pay on refinancing debt, and one in three South Africans retire with debt.

Planning for retirement takes time. If your clients leave it until the day that they retire, it will be too late. Some of the considerations that your clients will need to think about are:

- How much money will I need to meet my monthly financial needs?
- Will my emergency fund be able to supplement any unforeseen expenses?
- Will sufficient cash be available to meet my funeral costs or estate duty if I die prematurely?
- Is my current medical aid plan still going to suit me and be affordable post-retirement?
- Do I want to leave a legacy for my family?

In addition to the above considerations, it also depends on what stage your clients find themselves in their retirement years, being the initial retirement stage, the second stage of retirement, or the third or final stage of retirement. Regardless of the stage, additional circumstances will affect each person differently during each of these.

One of the aspects not considered is being in debt in retirement. I asked a colleague who spent much of his career as a valuator and advisor to retirement funds how trustees tend to guide their members. Rowan Burger, head of strategic finance at Momentum Metropolitan and a regular commentator on regulatory and investment matters, says that it starts with how you consider your house in your retirement plan.

A house should not be considered a capital asset but rather that it reduces the required retirement income as you do not need to pay rent. Banks extend debt to those who have income to cover the debt. In retirement, you don't have a salary to cover the debt repayments. But in the event you have debt at retirement, should you pay it down immediately?

Rowan suggests this is the wisest course of action. If you consider that a typical bond rate is a bit less than the prime rate, then currently it could be about 11%. Your investment return after fees would then need to be around 13% to cover the interest cost (as share growth attracts capital gains tax). It is very difficult to get a return of 13% in the current environment, and at an older age, you certainly do not want to be taking on unnecessary investment risk. For that reason, taking one-third of your retirement fund as a lump sum (as clients are allowed to do) to settle any debt is a good idea (and even more essential for more expensive debt such as credit cards).

Debt must be paid down as quickly as possible in the retirement savings plan. In future, there will be less scope for cash at retirement to bail out debt. This is a result of the introduction of compulsory annuitisation, which can be made worse by the two-pot retirement system if clients consume their one-third lump sum before they get there.

At Equilibrium, we bring improved balance into your financial advice practice. Our unique advice-led model portfolios are designed to be efficient and optimised through market cycles, so your clients stay invested and achieve their investment goals. As an independent discretionary fund manager (DFM), we enable you to do what matters – spending more time with your clients so that you can help them make the right decisions for their retirement. ■