



# **THE SWEDISH ANNUITY MARKET: WHERE IT IS AND WHERE IT'S HEADED**

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# Overview of the Talk

- n **Swedish Pension Landscape**
- n **Determinants of the Demand for Annuities**
- n **Development of the Financial Market and Household Financial Investment Sophistication**
- n **Pension Benefit Profile among Today's Pensioners**
- n **The Market for Annuities**
- n **The Changing Profile of Products and Risk**
- n **The Future Direction of the Swedish Market**



# Overview of the Pension Landscape in Sweden

# Reform of the Public System – 1994 Legislation

- n Created *two autonomous, mandatory, earnings-related, defined contribution* old age pension schemes:
  - **Non-financial defined contribution (NDC) pay-as-you-go**
  - **Financial defined contribution (FDC)**
- n **Disability and survivor benefits → general budget**
- n **Guarantee → general budget**
- n **Non-contributory rights → general budget**

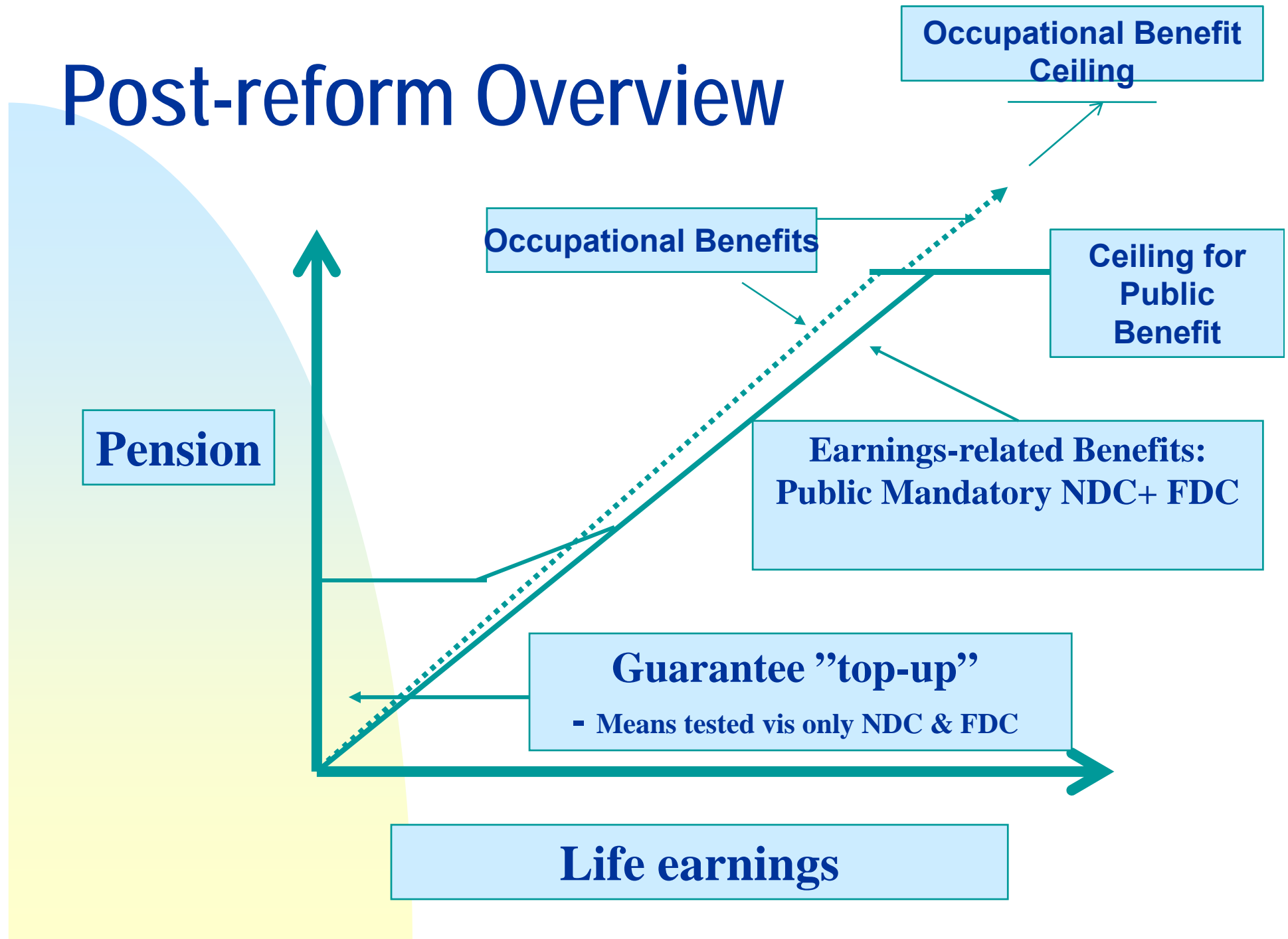
# NDC and FDC – The General Set-up

- n Individual contributions are noted on individual accounts.
  - **NDC** – contributions pay for benefits of current pensioners
  - **FDC** – contributions are prefunded
  
- n Accounts earn a rate of return:
  - **NDC** – based on covered per capita wage & covered labor force growth
  - **FDC** – financial market rate of return
  
- n Retirement from any age after the minimum age (61).
  
- n A life “annuity” based on individual’s account balance and cohort (unisex) life expectancy at retirement.
  - **NDC** – annuities indexed to real per capita wage growth and inflation.
  - **FDC** – adopts the Danish/Swedish method with a guarantee & a bonus, which resembles indexation; unit-link alternative.

# Conversion of Occupational Schemes to FDC

- n Private blue-collar employees, 1996  
(industry, commerce, etc.)  
- 43 % of employees
- n County council and municipal employees, 1998  
(including medical, educational, care professionals)  
- 20 % of employees
- n Employees of the Swedish state, 2003  
(including higher education, social insurance)  
- 6 % of employees
- n Private white-collar workers, 2007  
- 16.5 % of employees

# Post-reform Overview



# Post-reform contribution rates

## n **Public Earnings-related System**

Universal, mandatory system that covers earnings up to a ceiling of all employees and self-employed. Ceiling (2008) 360 000 SEK or 60 000 USD.

- **NDC – 16 %**
- **FDC – 2.5 %**

## n **Occupational Earnings-related Schemes**

n – **3.5-4.5 % (under ceiling for public schemes; more over)**

Cover ca 90 % of all employees.

- **FDC: Supplement below public benefit ceiling**
- **FDC: Whole benefit above ceiling, private sector workers**
- **FDC, NDB: Above ceiling, public sector workers**

## n **Individual voluntary insurance**



# Replacement Rates

**Table 2. Replacement Rates. Annuity as a per cent of last earnings.**

Age	PAYG. Contribution rate of 16 %	Public Second Pillar (2.5%) + Group Occupational (3.5%)			Total. Public PAYG and Second Pillar plus Group Occupational		
		Return of : 2%	5%	8%	Return of: 2%	5%	8%
61	0.32	0.12	0.23	0.47	0.44	0.55	0.79
62	0.33	0.13	0.25	0.52	0.46	0.58	0.85
63	0.35	0.14	0.27	0.57	0.49	0.62	0.92
64	0.37	0.15	0.29	0.63	0.52	0.66	1.00
65	0.39	0.15	0.31	0.69	0.54	0.70	1.11
66	0.42	0.16	0.33	0.76	0.58	0.75	1.18
67	0.44	0.17	0.36	0.83	0.61	0.80	1.27
68	0.47	0.18	0.39	0.92	0.65	0.86	1.39
69	0.50	0.19	0.42	1.01	0.69	0.92	1.51
70	0.53	0.20	0.45	1.12	0.73	0.98	1.65

Note. The individual's earnings are assumed to grow at a real rate of 2 % per year throughout the earnings career. The rate of growth used for indexation of capital in the PAYG system is 2 %. The pay-as-you-go, second-pillar and occupational annuities are all based on unisex life expectancy and a real rate of return on capital from retirement of 1.6 %.



# Determinants of the Demand for Annuities

# Individual Voluntary Insurance and Annuitization of Savings – Constraints on Demand

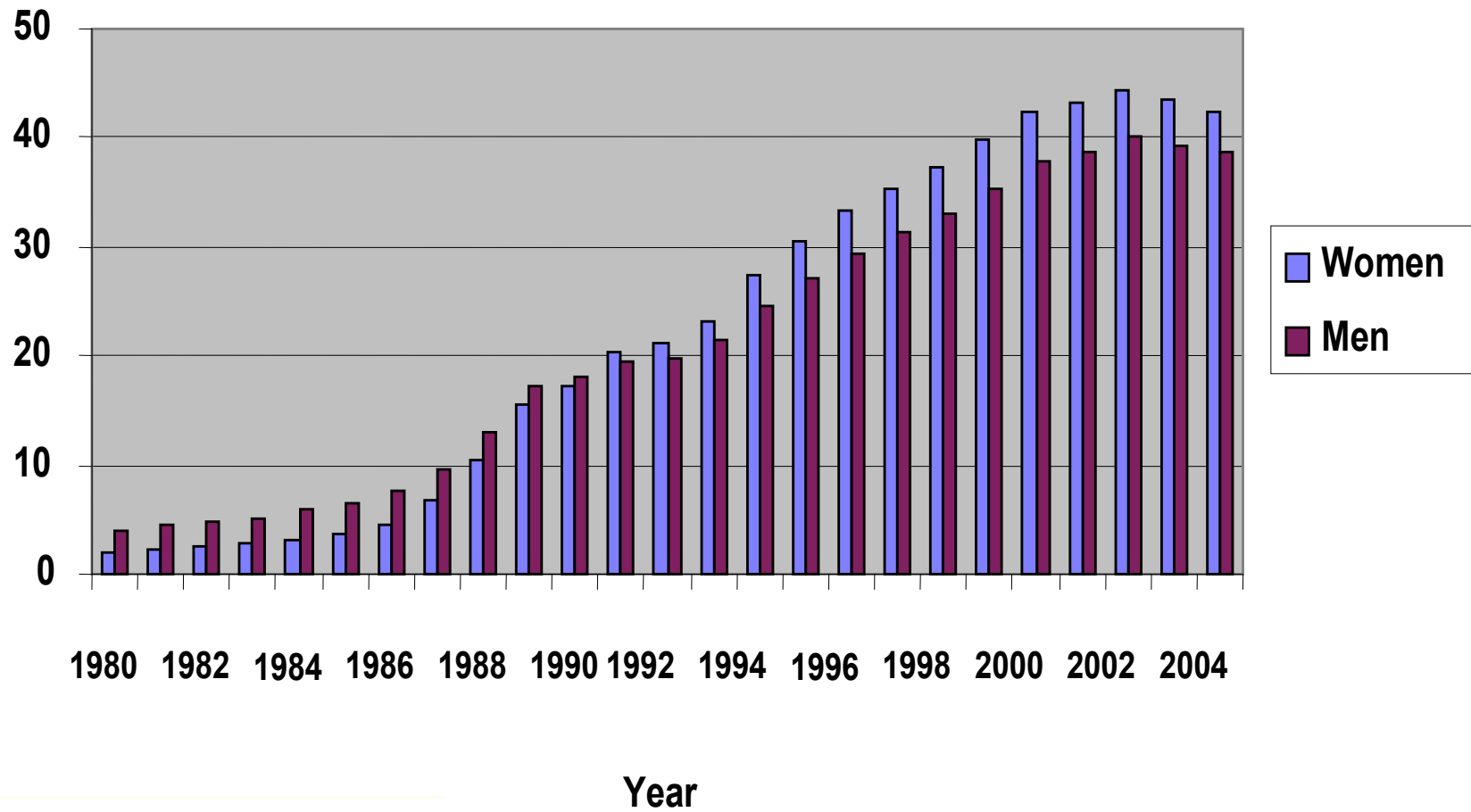
- n Extensive public + occupational commitment – pensions and health care
- n Inflated perception of the sufficiency of public + occupational coverage
- n Desire to remain liquid to leave bequests
- n Poor understanding of the potential advantages of annuities
- n Time preference for consumption in the present
- n Absence of products which cover the elder elderly

# Recent Structural Changes of Importance

- n **1988 – Legislation abolishing the widows' benefit for persons born 1945 and later**
- n **1993 – Unit-linked insurance introduced**
- n **1994 - Individual retirement saving (IRS) accounts**
- n **1994 – Legislation of NDC & FCD public schemes**
  - **Put a limit on the public commitment**
  - **Increased financial market literacy**
- n **1995 – Tax deductible amount halved**  
**(9 000 → 4 500 USD)**

**Figure 1. Persons utilizing a tax deduction for voluntary insurance.**

**Percent of the population 20-64, 1980-2005.**





# Development of the Financial Market and Household Financial Investment Sophistication

# Financial Market Development

- n **Comprehensive financial market restrictions were lifted and the market was “free” by the mid-1980s.**
- n **From the mid-1980s the market grew in scope and depth.**
- n **By the mid-1990s over half of all Swedes 20-70 years old had invested money directly in the stock-market or in market funds.**

## Table 1. The Financial Portfolio of Households

	1980		2005	
	Billions of SEK	Per cent of total assets	Billions of SEK	Per cent of total assets
Individual insurance	34	9 %	657	26 %
Equities	36	10 %	565	22 %
Mutual funds	**	**	484	19 %
Bank deposits	182	50 %	619	25 %
Bonds	43	12 %	107	4 %
Currency	28	8 %	87	3 %
Other	44	12 %	2	0 %
<b>Total financial assets</b>	<b>367</b>	<b>100 %</b>	<b>2521</b>	<b>100 %</b>
<b>All financial assets as a percent of GDP</b>		<b>67 %</b>		<b>94 %</b>

Sources. Palmer 2008.

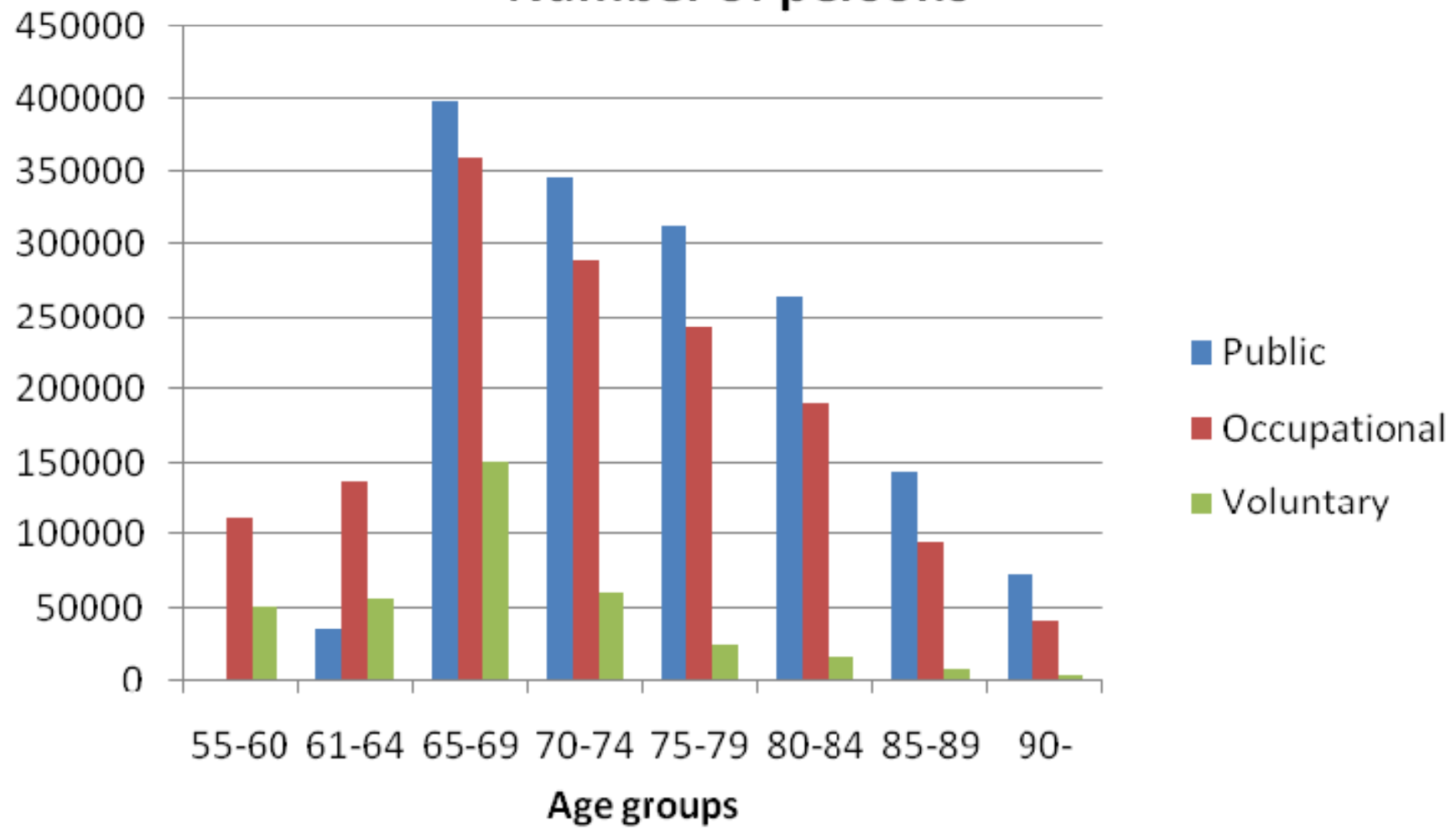




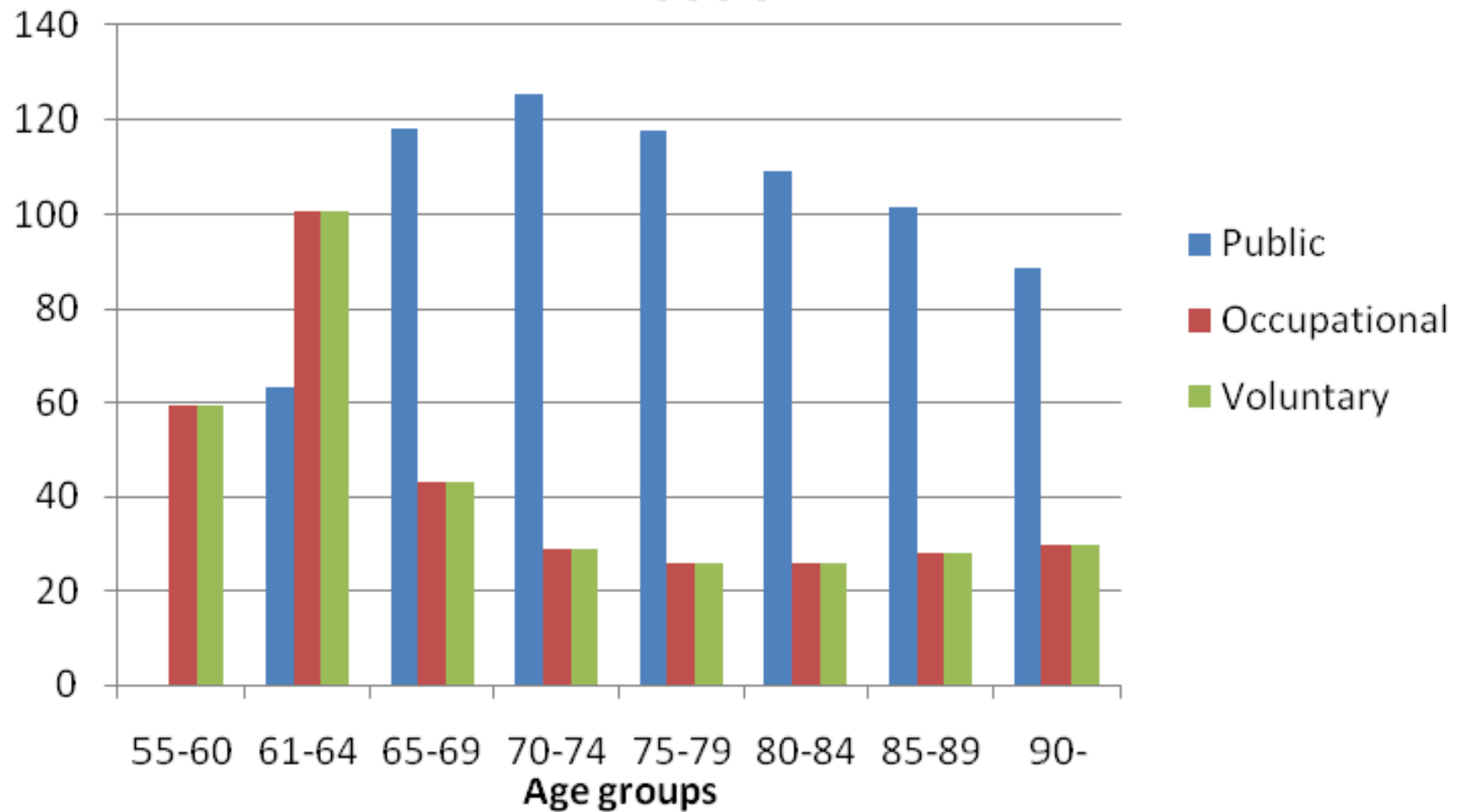
# Pension Benefit Profile among Today's Pensioners

# Age Distribution of Benefits.

Number of persons



## Average Amount of Benefits 1000 SEK



# Voluntary Pension Benefits among Today's Pensioners

## n Pensioners 55-59

- No public. Occupational or private voluntary, seldom both

## n Pensioners 60-64

- Small number of public recipients. Mainly occupational or private voluntary, seldom both,

## n Pensioners 65-69

- Normal public + occupational & large voluntary

## n Pensioners 70+

n - Normal public + occupational & small voluntary



# The Market for Annuities

# Structure of the Market

- n **44 insurance companies: 95 % life and pensions; 5 % is health and accident.**
- n **Over 800 registered investment funds**
- n **Seven insurance companies**
  - hold 97 % of all insurance assets
  - receive 95 % of premium payments
  - manage 45 % of the mandatory public FDC schemes accounts
- n **Two additional insurance companies specialized in management of the white-collar and public employee occupational schemes, respectively.**

**Table 4. Assets and premium payments to occupational, individual voluntary and PPM plans, 2006**

	<u>Assets</u>	<u>Premiums</u>
<b>All occupational and individual voluntary insurance, billions of kronor</b>	<b>2 270</b>	<b>193<sup>*</sup></b>
<b>Percent of GDP</b>	<b>80 %</b>	<b>6.8 %<sup>*</sup></b>
<b>PPM</b>	<b>267</b>	<b>26</b>
<b>Percent of GDP</b>	<b>9 %</b>	<b>0.9 %</b>

**\* Voluntary individual insurance accounted for about 15 %.**

**Source. Palmer (2008), based on data from the PPM and Financial Supervisory Authority**



# Changing Profile of Products and Risk



## Overview of products by category of provision

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	<u>PPM</u>	<u>Occupational</u>	<u>Individual</u>
Lump-sums	No	No	Yes
Phased withdrawals	No	Yes	Yes
Annuities	Yes	Yes	Yes

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## Forms of Insurance in the Swedish Market and Risk Bearing

Type of plan	Who bears the investment risk?	Who bears the longevity risk?
<b>1. Financial defined benefit</b>	<b>The insurer</b>	<b>The insurer</b>
<b>2. Financial defined contribution</b>		
<b>a. Accumulation phase</b>		
- Traditional	<b>The insured</b>	<b>The insured</b>
- Unit-linked	<b>The insured</b>	<b>The insured</b>
<b>b. Payout phase</b>	<b>The insured</b>	<b>The insured</b>
- Traditional	<b>The insured</b>	<b>The insured</b>
- Unit-linked	<b>The insured</b>	<b>The insured</b>



# The Future Direction of the Swedish Market

# What's Holding Back Annuity Demand?

- n **Annuitization is rational from age 75-80, e.g. Milevsky (2001), but there are no products offered with this perspective.**
- n **Presently, Swedes have a very myopic view of insurance and utilize predominantly 5-10 year withdrawals when they can.**
- n **What will the public care commitment be in the future? Will income inequality & demographic pressure on public finances create private care insurance for disability in old age?**
- n **Elder elderly Swedes, especially single women, are bound to be relatively poor. A reason to shift consumption/annuity patterns?**



**The End**

# Coverage Rules – Mandatory Earnings-related NDC & FDC

- n **Minimum age for coverage 16**
- n **Mandatory coverage of all income from employment and/or self-employment, above a minimum threshold and up to a ceiling.**
- n **Minimum threshold: Annual income above minimum for tax declaration (~1 000 Euro)**
- n **Ceiling: Wage indexed ceiling on Annual income of (2009) ~400 000 SEK (~36 000 Euro)**
- n **Minimum pension age – 61 years**
- n **No upper age limit for retirement**