ORGANISATION DE COOPÉRATION ET DE DÉVELOPPEMENT ÉCONOMIQUES

Forms of Benefit Payments at Retirement and Policy Options for the Payout Phase

Pablo Antolin, OECD, Financial Affairs Division

International Conference on Annuity Markets: Structure Trends and Innovations

Tokyo, 29-30 January 2009

Motivation

- Shift from DB (PAYG and funded) to DC.
- Countries introduced DC pensions (accumulation) need design payout phase.
- In DC plans, retirement wealth depends on how much workers save and how successfully the assets accumulated are allocated.
- The efficient allocation depends on
  - Type of options and products available
  - The regulatory environment
  - Managing risks (longevity, inflation and timing of annuitization)

Structure of the presentation: Questions

- What type of retirement payout options should a country allow?
  - What type of retirement payout options are available?
  - The country context
  - The market context (annuity markets)
- Which entities should be providers of annuity products (regulatory framework)?
- Which type of annuity products should be allowed?
  - Guarantees involved in different products
  - Risks associated with annuitization

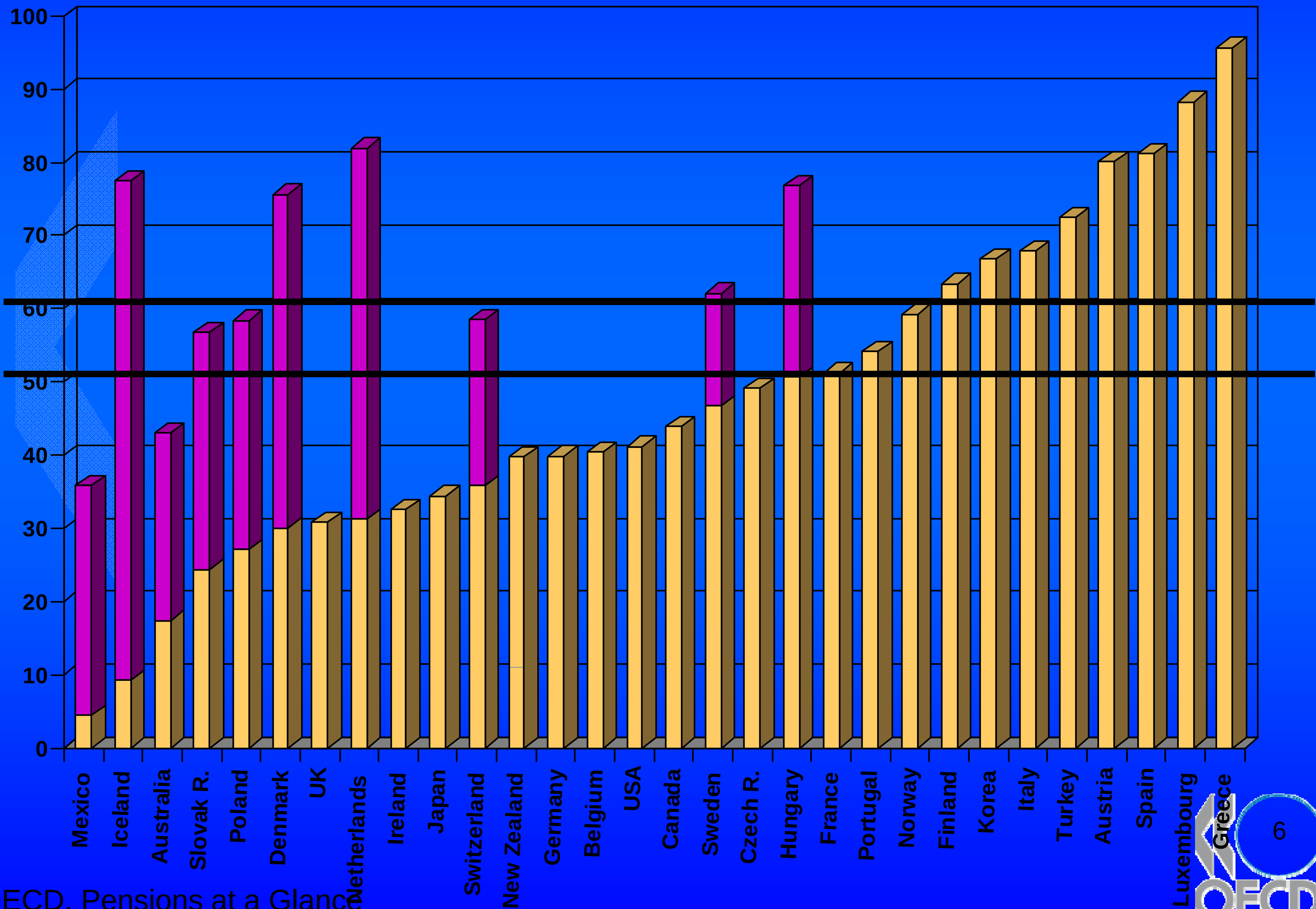
What payout options a country should allow?

- Decision determined by:
  - – Balance to strike btw flexibility/liquidity and protection from longevity risk (LR).
  - – The country context.
- Life annuities protect from LR, but illiquid and lack flexibility to address contingencies (pay down debt, health care).
- Lump-sums and programmed withdrawals more flexible, but no protection from LR

The country context and payout options

- Countries provide significant level of retirement income already annuitized from PAYG-financed public (and DB) pensions (in absolute as well as relative replacement rates) ➔ better off allowing for more choice and flexibility permitting people allocate their DC balances as they please.
- Countries DC pensions are the main source of retirement income ➔ retirees need to annuitize a larger share of their accumulated assets.

Gross replacement rates: Mandatory Plans



Source: OECD, Pensions at a Glance

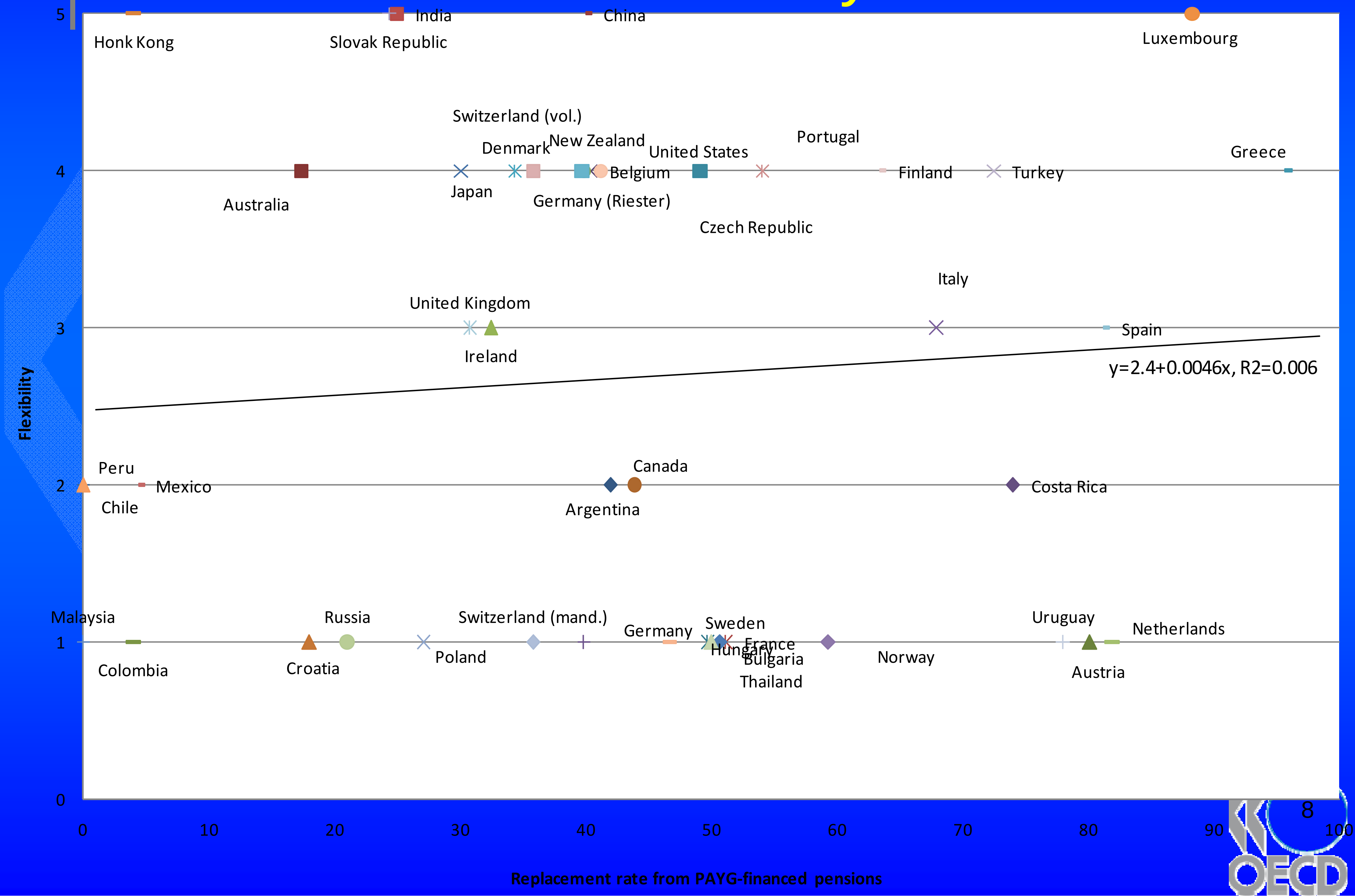
Country practices

- Lump sums only – HK, India, Thailand, Luxembourg.
- Programmed withdrawals only – none.
- Life annuities only – many European countries, Colombia.

- Lump sum or programmed withdrawals – China, Malaysia.
- Lump sum or life annuity – Belgium, Japan, Spain, USA.
- Partial lump sum + annuity - Ireland, Italy, Portugal, SA, UK.
- Life annuity or programmed withdrawals – Canada*, Chile, Costa Rica, Mexico, Peru, Russia.

- All options – Denmark (private plans), Australia.

Relationship btw PAYG-financed pensions and flexibility



Evidence?

- Relationship btw PAYG-financed pensions and flexibility.
- Relationship btw housing ownership and flexibility.
- Penetration of life insurance mkts and flexibility
- Main conclusion: countries may need to reconsider the way their payout phase is structured, as the evidence does not suggest that countries where retirees have other sources of annuitized retirement income than DC have wider choice of payout options.

Balance btw flexibility & protection LR

- Combined arrangements: Use accumulated DC assets to buy at the time of retirement a deferred life annuity that will start paying at a later age (e.g. 80).
- It may costs around 15% of accumulated assets at retirement.
- Use the remaining balance for programmed withdrawals.

- Programmed withdrawals → flexibility
- Deferred annuity → protection from LR

Annuitization

- Annuity markets may not be fully develop or not exists at all. Chile experience is positive here.
- Annuity markets suffer constraints:
  – Demand: dichotomy btw straightforward annuity products and products address as many needs as possible (trade-off cost and easy to understand); lack of enough financial literacy; tax disadvantages, etc.
  – Supply: adverse selection, lack of competition among providers, dealing with longevity risk.
- How to promote then annuitization?

Promoting annuitization

- **Compulsion**: deal with adverse selection and pricing problems.
- **Soft-compulsion**: automatic annuitization, default option with and opt-out clause.
  - Behavioural economics importance of inertia or passive decisions
- **Tax incentives**: care their design (deduction or credits) and relationship with income
- Improve financial literacy.

Longevity risk

- Despite measures to promote annuitization, some people may lack longevity protection
- Solution: Mandate deferred life annuity to be bough at the time of retirement to begin paying at later ages (e.g. 80).
- Supply side: tackle the problem of hedging longevity risk (we will talk about this later this afternoon).

Who should provide annuities?

- Balance to strike btw competition and safety of retirement savings.
- The general argument: allow as many providers as possible in order to promote competition, lower prices and lower costs.
- However, in order to protect retirement savings from bankruptcies of providers: sound prudential framework. Allow only providers that would be subjected to solvency and capital adequacy requirements.

Providers?

- On practical terms, … insurance companies are better prepared: experience, expertise, work on both sides of the market (sellers life insurance (mortality) and life annuities (life expectancy) possibility of offsetting both effects).
- Disadvantages: life insurance companies do not seem interested in selling annuities.
  - No financial instruments to hedge against LR (?)
  - No enough very long-term instruments to match liabilities

Providers?

- Pension funds
- Separate financial institutions
- State annuity fund or centralized annuity provider: reduce costs, general public distrusts private sector financial institutions.

Providers

- Countries with small or non-existent annuity markets could institute a centralised annuity provider, but should allow insurance companies and other providers to enter the market, guarantee full equal competition, and the role of the centralise annuity provider should dwindle down as market develops.
- Countries that decide for pension funds providing annuities should make sure that appropriate prudential regulation is in place to protect ret. Income.

Providers: Dissemination of information

- One concern as regards choosing a suitable annuity provider is the lack of appropriate information available to retirees and their lack of expertise.
- Solutions: third party arrangements
  - UK Open Market Option
  - The Chilean Electronic Quotation System

What type of annuity products?

- Trade-off btw choice, risk and costs
- The cost of annuities increase directly with the amount of protection and guarantees provided.
- There are many different type of annuity products providing different levels of guarantees and risks.

Annuity products, risks and guarantees

	Investment risk	Longevity risk	Inflation risk	Interest rate risk	Partner's protection	Provision of bequest	Facilitates accumulation
Programmed withdrawals, term annuity or annuity certain	No	No	No	No	Yes	Yes	No
Life annuity (single, fixed, nominal, immediate)	Yes	Yes	No	No	No	No	No
Joint and survivor life annuities	Yes	Yes	No	No	Yes	No	No
Guarantee life annuities	Yes	Yes	No	No	No	Maybe	No
Life join annuities with bequest	Yes	Yes	No	No	Yes	Yes	No
Variable annuity	No	Yes	No	No	No	No	No
Fixed indexed life annuity	Yes	Yes	Yes	No	No	No	No
Deferred life annuity	Yes	Yes	No	No	No	No	Yes
Deferred joint indexed life annuity with bequest	Yes	Yes	Yes	No	Yes	Yes	Yes

What type of annuity products?

- Again, situation large part retirement income already annuitized → allow individuals to buy different annuity products, even if entailing greater risks (e.g. variable annuities access to stock market gains, but investment risk).

Risk associated with buying an annuity

- The risk associated with the time of annuitization.
- Deferred life annuities, protects from longevity risk and (partially) addresses the risk associated with the time of purchasing an annuity

Policy recommendations: payout & annuities

- Countries should allow full choice and flexibility to allocate assets in DC pensions when a large part of retirement income is already annuitized.
- Countries where assets accumulated in DC pensions are the main source of retirement income, should mandate that part of their assets are used to buy a deferred life annuity that starts paying at old age (e.g. 80). Rest of assets full flexibility and choice.
- Having mandated a deferred life annuity allow any type of annuity products.

Policy recommendations: providers

- Allow any provider as long as they are sufficiently regulated and competition is guaranteed.
- Countries small or not existent annuity markets institute a centralised annuity fund provider. Allow insurance companies and other providers to enter the market and guarantee full equal competition. Centralised annuity fund should dwindle down.
- Countries that decide for pension funds providing annuities should make sure that appropriate prudential regulation is in place to protect retirement income.

Policy recommendations: other measures

- Unnecessary to have tax incentives when participation and annuitization is mandatory. When voluntary, tax incentives can play a useful role. Yet, care it is needed with its design.
- On financial education, need to implement programs aiming at improving the financial literacy of individuals as well as improving the qualification of pension and annuity intermediaries using, for example, certification programs.

Policy recommendations: other measures

- Financial institutions should be encouraged to develop annuity products that address needs such as health care contingency expenses.
- Mortality and life tables should include stochastic forecasts of future improvements in mortality and life expectancy.
- Government should encourage the development of a market for longevity hedging products by developing a reliable longevity index. Countries small liabilities from PAYG, governments should consider issuing longevity-indexed bonds.

OCDE ORGANISATION DE COOPÉRATION ET DE DÉVELOPPEMENT ÉCONOMIQUES

THANK YOU

pablo.antolin@oecd.org

www.oecd.org/daf/fin

www.oecd.org/daf/fin/wp