Options and Challenges for the Payout Phase

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Pablo Antolin
DAF/FIN OECD, Private Pension Unit
OECD project: Payout Phase and Annuities

- Policy makers pose a large battery of questions as regard the payout phase
- Need to organize these questions
- Build a framework of thought to address these questions.
- Answers are open to discussion and questioning.
Payout Phase: Questions

- What payout options are available?
- How the regulatory framework should be designed?
- Which type of annuity products? Which technical parameters?
What payout options are available?

- What options are available?
- Which form of retirement payout is more appropriate?
- Should we annuitize?
- Should annuitization be compulsory?
- How can annuitization be promoted?
Regulation? Annuities?

- Who should provide annuities?
- What type of solvency and capital adequacy requirements should be required?
- What type of annuity products should be allowed?
- How to handle longevity risk?
- Mortality tables: who should provide them? Should they incorporate future improvements?
What Retirement Payout Options are available?

- Lump-sum: single payment.
- Programmed withdrawals: series of fixed or variable payments
- Annuities: Periodic fixed or variable payment until the end of the annuitant life.
- Combined arrangements. E.g. Programmed withdrawals with a deferred annuity (to start paying at very old ages).
Pros and Cons

- **Flexibility** about allocating the monies (e.g. pay debt, health care, etc.)
- **Protection against longevity risk** (LR): who takes on LR?
Combined arrangements

- A combination of programmed withdrawals and deferred annuities. It allows for flexibility and protects against LR simultaneously.
- Use the DC balance at retirement to buy a deferred annuity that will start paying at later ages (e.g. 80). It may require only around 15%. Use the remaining balance for programmed withdrawals.
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.
Which Form of Retirement Payout?

- Depends on structure of pension arrangements in the country.
- The objective is to have a large share of retirement income annuitized to protect people from running out of resources at retirement: insure against longevity risk (LR).
- Whether to annuitize all DC balances depends on
  - The share of retirement income needed to annuitize to protect against LR.
  - The amount of retirement income already annuitized through other sources (PAYG system, DB)
Should a country annuitize their DC payments?

- Mandatory annuitization when PAYG-finance pensions provide already a relative high level of annuitization of retirement income may not be adequate.

- Most of retirement income comes from DC balances, mandatory annuitization a fraction of DC balances at retirement and allow programmed withdrawals for the remaining balance. Flexibility.
Promoting annuitization

- **Compulsion**: avoids moral hazard. No flexibility.

- **Soft-compulsion**: automatic annuitization, default option with and opt-out clause.
  - Behavioural economics importance of inertia or passive decisions

- It partially offset moral hazard and allows for some flexibility.

- **Combine** programmed withdrawals with mandatory deferred annuitization: flexibility, protects for LR, avoid moral hazard.
Other approaches

There are additional approaches to promote annuitization:

- Tax incentives
- Increase eligibility: people in companies offering DC plans and annuities attached to them
- Better information disclosure
- Improving financial education. National awareness campaigns (increase understanding need to save).
- More competition to reduce prices and costs (Providers?)
Who should provide annuities?

- The general argument: allow as many providers as possible in order to promote competition, lower prices and lower costs.
- However, allow only providers that would be subjected to solvency and capital adequacy requirements.
Providers?

- On practical terms, … insurance companies are better prepared: experience, expertise, sell both life insurance and life annuities (offset effects).

- Disadvantages: life insurance companies do not seem interested in selling annuities.
  - No financial instruments to hedge against LR (?)

- State annuity fund or centralized annuity provider: reduce costs, general public distrusts private sector financial institutions.
Competition in annuity markets

- The Chilean Electronic Quotation System
- Competitive quotes
What type of annuities?

- There are many different types of annuity products out there. We are trying to produce a coherent taxonomy to examine them based on the type of guarantees they provide.
- At least life annuities and deferred annuities.
## Several dimensions to classify annuities

<table>
<thead>
<tr>
<th>How they are financed</th>
<th>Primary purpose</th>
<th>Nature of the promised pension payments</th>
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</thead>
<tbody>
<tr>
<td>Single premium</td>
<td>Immediate pay-out</td>
<td>Fixed</td>
</tr>
<tr>
<td>Flexible premium</td>
<td>Deferred (accumulation)</td>
<td>Variable (equity indexed)</td>
</tr>
<tr>
<td>(contributions)</td>
<td></td>
<td>Indexed (e.g. inflation indexed)</td>
</tr>
<tr>
<td>Fixed</td>
<td></td>
<td>Annuities linked to life expectancy</td>
</tr>
<tr>
<td>Variable</td>
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<td></td>
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</tbody>
</table>

### Duration of the pay-out commitment
- Fixed-term or annuity certain
- Life annuity
- Temporary annuity
- Guarantee annuity

### Providers (accumulation or payout phase)
- Qualified
- Non-qualified

### People covered
- Single
- Joint-and-survivor

### Way the annuity is purchased
- Individual
- Group

### Others
- Tax advantages
- Enhanced vs impaired annuities
One main arguments that annuity providers express as deterring further provision of annuities is how to deal with LR.

Annuity providers bear the full impact of LR.

There is a lack of financial instrument to hedge against LR.
Solutions to LR

- Index annuity payments partially to life expectancy: sharing the risk.
- But, reduces the main motive to buy annuities.
- Governments could issue longevity indexed bonds (LIB).
- But governments already heavily exposed to LR through their PAYG system.
- Nevertheless, government could help in promoting a market for LIBs by producing a longevity index (Antolin&Blommestein, 2007)
How to handle longevity risk?

- Governmental agencies (National statistical institutes) have technical capability to produce mortality/life expectancy tables and projections.
- Change the regulatory framework requiring market players to fully account for future improvements in life expectancy.
- Use a stochastic approach (Antolin, 2006; Antolin & Blommestein, 2007). Permits to gauge the uncertainty (LR) because it attaches probabilities to different outcomes.
How to handle financial education issues?
Thank you!

www.oecd.org/daf/fin

Pablo.antolin@oecd.org