ORGANISATION DE COOPÉRATION ET DE DÉVELOPPEMENT ÉCONOMIQUES

Options and Challenges for the Payout Phase

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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 annuitizes?
- Should annuitization being compulsory?
- How can annuitization being 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)

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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 type 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

How they are financed
- Single premium
- Flexible premium (contributions)
  - Fixed
  - Variable

Primary purpose
- Immediate pay-out
- Deferred (accumulation)

Nature of the promised pension payments
- Fixed
- Variable (equity indexed)
- Indexed (e.g. inflation indexed)
- Annuities linked to life expectancy

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

Longevity Risk and 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!

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