

Annuities in Denmark: Risk-Sharing in Accumulation and Payout Phases

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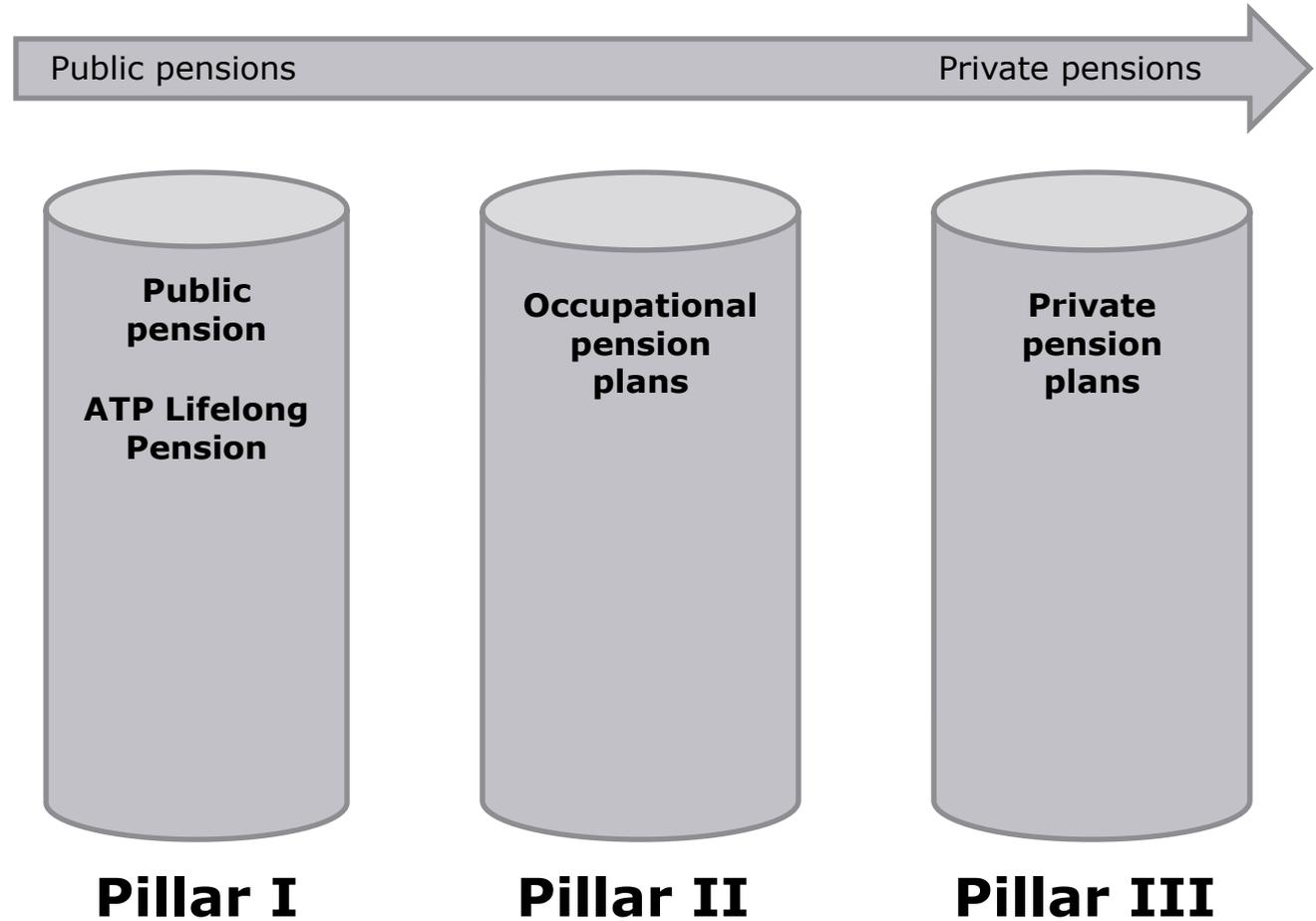


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Agenda

- The Danish pension system – background information
- Risk Sharing – active workers and pensioners, pension institutions, the government (the public purse)
- Unit linked products
- The case for welfare reform

The three pillars of the Danish pension system



The three pillars of the Danish pension system - funding

Pillar	Type of pension	Financing
Pillar I	Public Pension	Tax financed: pay-as-you-go
	ATP Lifelong Pension	Fully funded: employer and employee contributions
Pillar II	Occupational pension plan	Fully funded: employer and employee contributions. Defined contribution. Tax deductible.
	Pension schemes for certain civil servants	Unfunded: tax-financed defined benefit plan
Pillar III	Private pension plan	Fully funded: private contributions. Tax deductible



The three pillars of the Danish pension system – short description

Pillar I

Public Pension	<ul style="list-style-type: none">-Pays benefits to people older than age 65/67.-Two parts: a flat universal pension and an income dependent supplement-Subject to a residency test: full benefits if more than 40 years residency in Denmark
ATP Lifelong Pension	<ul style="list-style-type: none">-Established by law and entails social security features.-Pays benefits to people older than age 65.

Pillar II

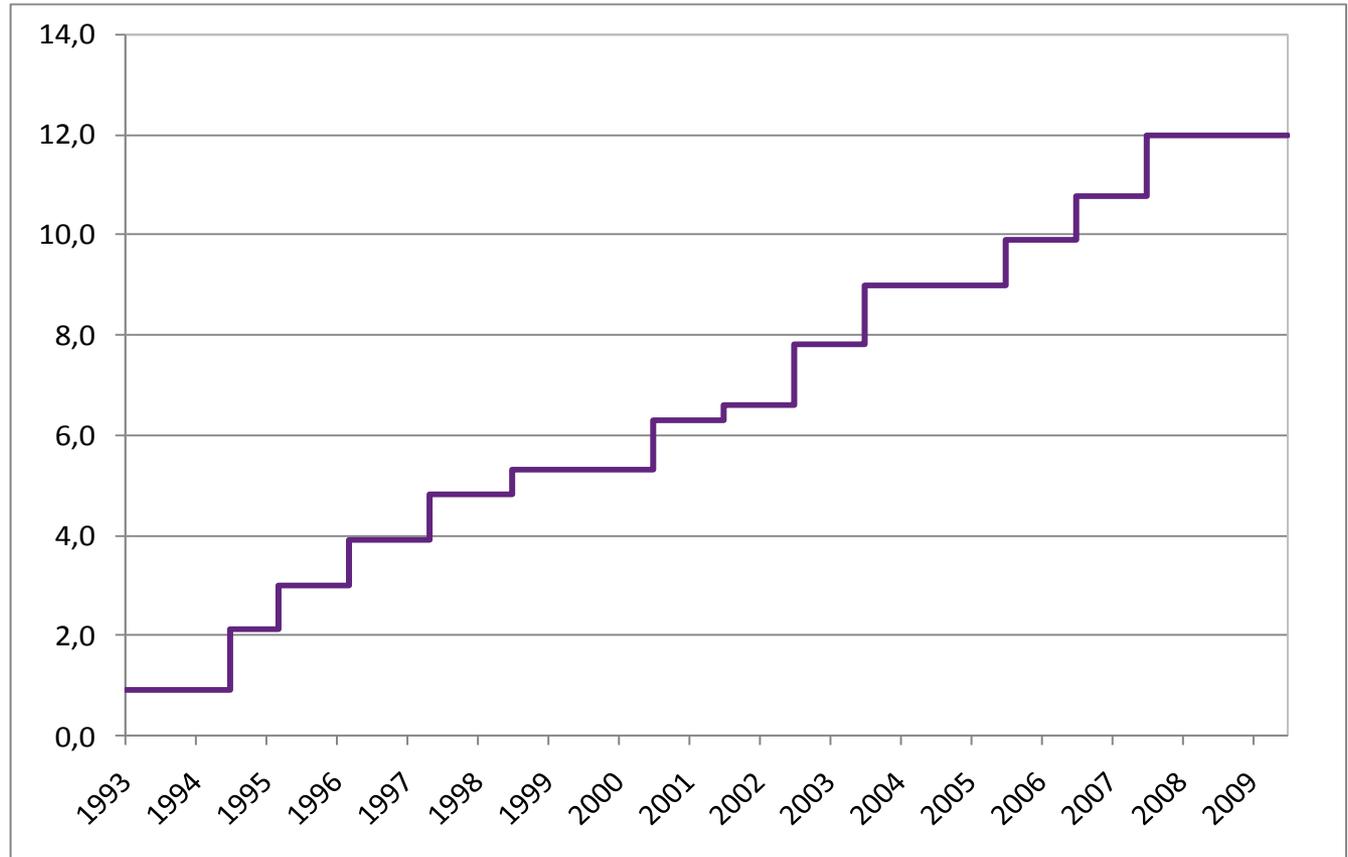
Occupational pension plans	<ul style="list-style-type: none">-Established by collective labor agreements between employers and labor unions-Supplement to the publicly provided pensions-Pays benefits to people older than age 60 as annuities, phased withdrawals or lump sum transfer-Death and disability benefits.
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Pillar III

Private pension plans	<ul style="list-style-type: none">-Supplement to pillar II savings-Pays benefits to people over age 60 as annuities, phased withdrawals or lump sum transfer-Death and disability benefits.
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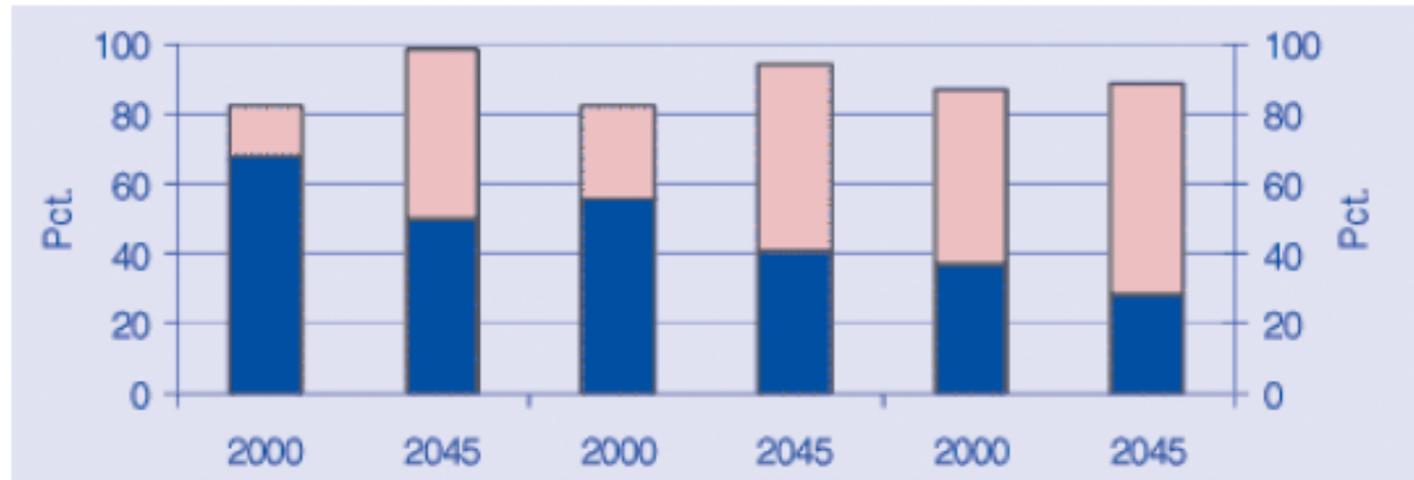
Occupational Pension Plans – Contribution Rate

Pct. of gross salary



Economic significance of pension payouts – replacement ratios

Average expected replacement ratios for different groups of education in 2000 and 2045



Less educated

Skilled

Highly educated

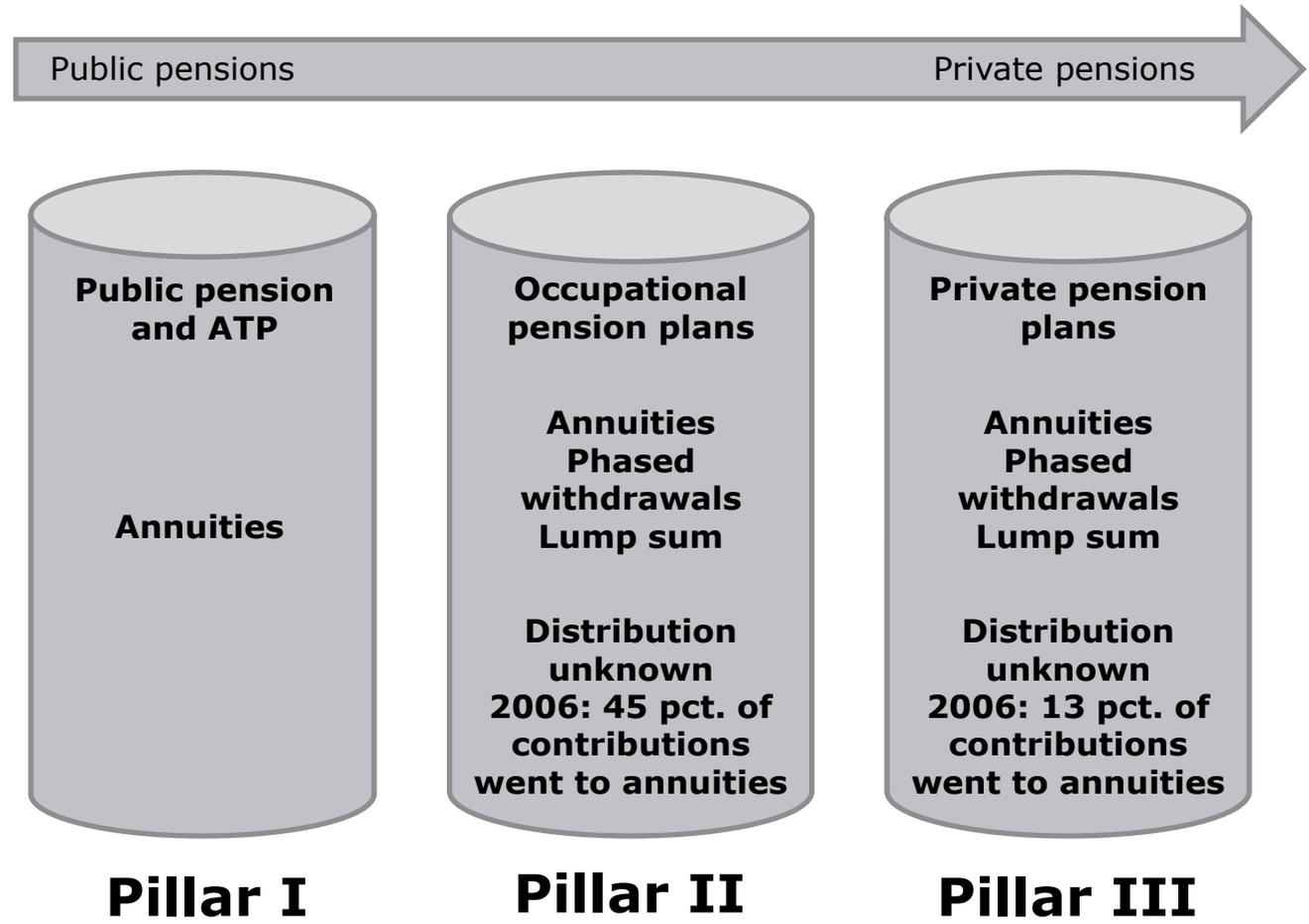
The blue part is public pension and the pink part is private pension.

Source: Ministry of Economic and Business Affairs (2003).



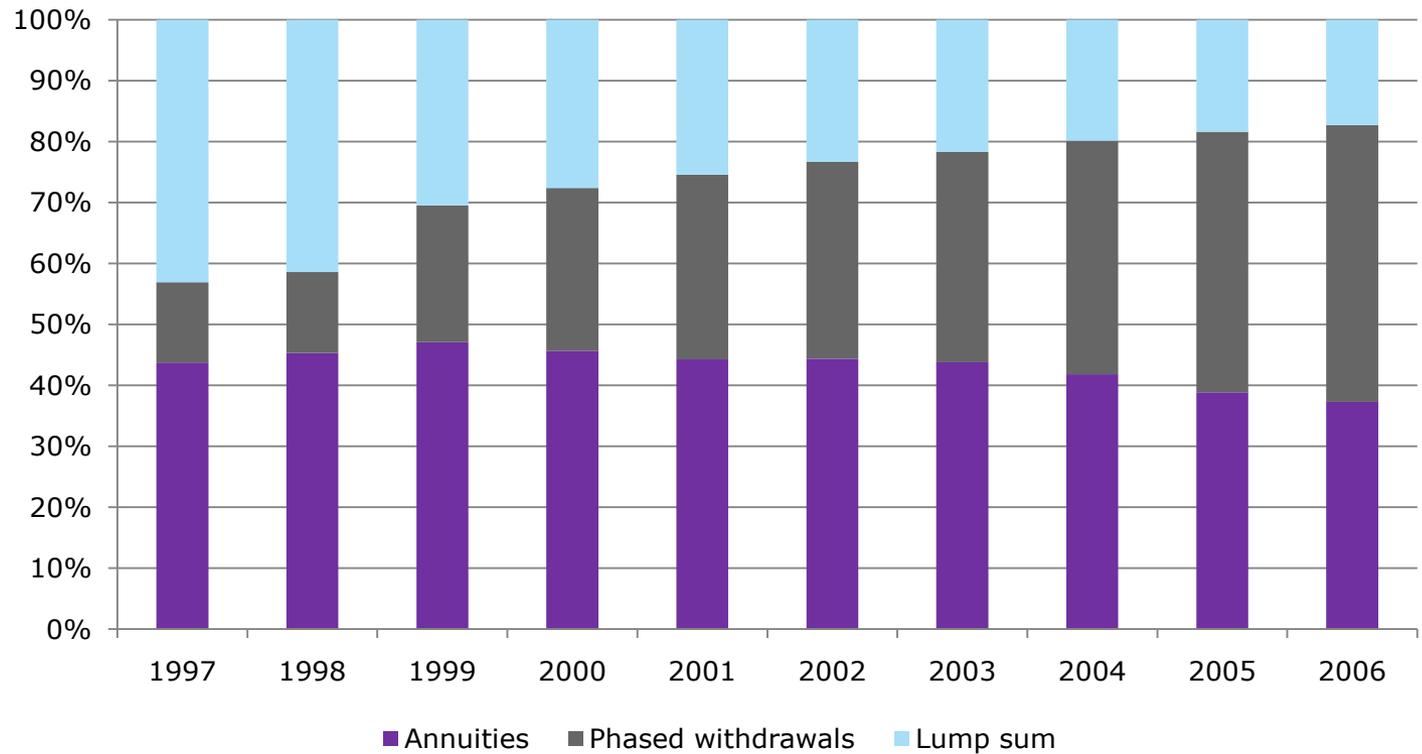
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Annuities in the Danish pension system



Annuities in the Danish pension system

Distribution of tax-deductible contributions to pension schemes



Risk-Sharing in Denmark

Active workers and pensioners – Pillar I

- Political
 - basic state pension
 - financial (demography)

Risk-Sharing in Denmark

Active workers and pensioners – Pillar II and III

- Financial
 - investment risk during accumulation phase
 - annuitization risk
 - inflation risk
- Insurance risks
 - early death, disability, longevity
 - reliance on phased withdrawal
- Guaranteed benefits - can the pension institution deliver?
- Tax system

Risk-Sharing in Denmark

Pension institutions

- Commercial
- Political
- Guarantees
 - interest rate – falling/rising
 - investment risk – shared with the insured
 - cost
- Duration mismatch

Risk-Sharing in Denmark

The government

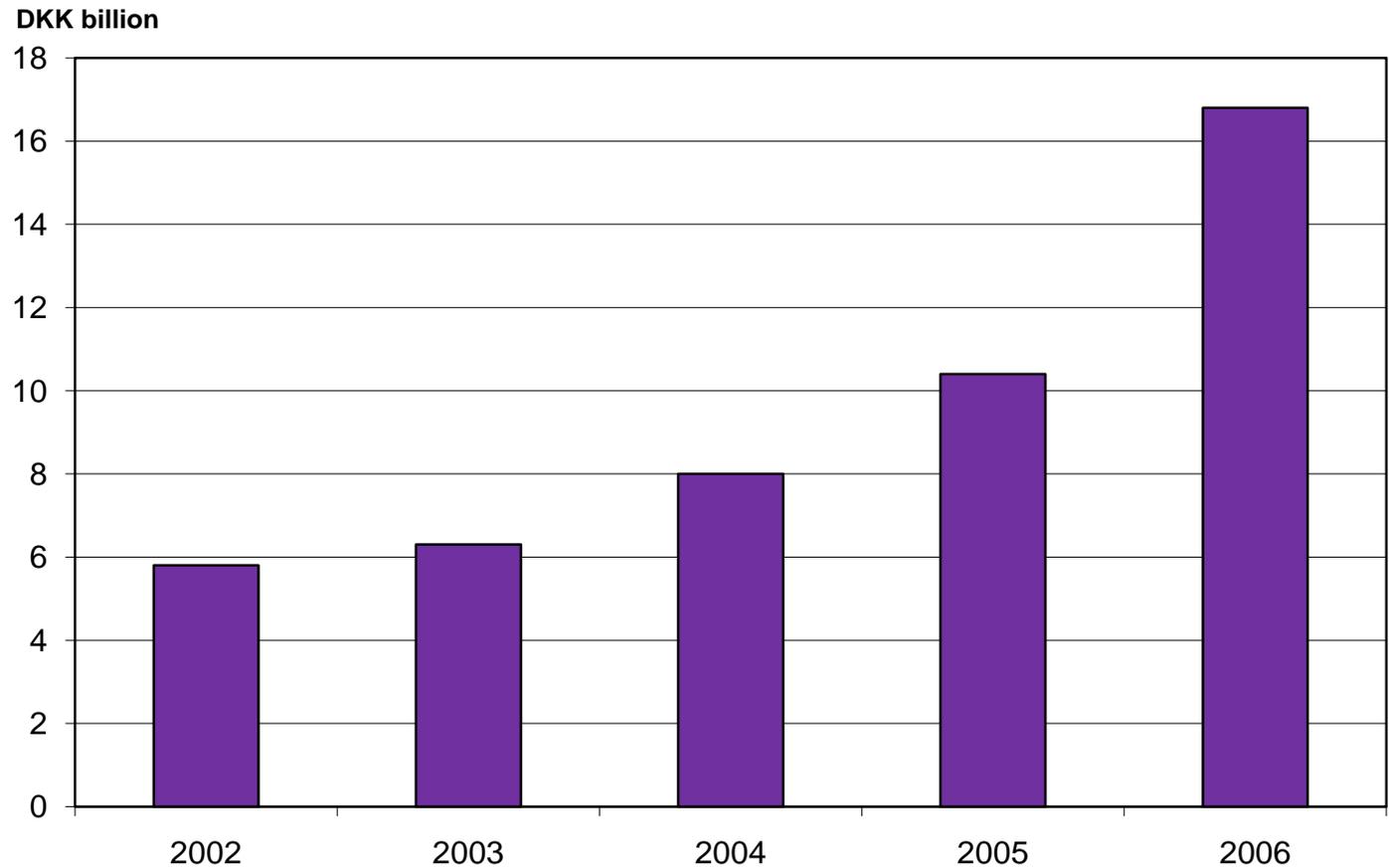
- No formal obligation for pillar II and III
- Deferred wealth (deferred taxes)
- Social poverty (Pillar I)
- Low savings rate
- Financial instability (demography). Pillar II and III alleviate this problem and puts discipline on public expenditure
- Pension provider bankruptcy

Unit linked products

- A relatively recent feature of the Danish pension industry.
- Prompted by the reduction in guaranteed investment returns and preference for individual choice.
- Unit-linked products are part of the solution to the problems with the guaranteed pension environment

Unit link products - development

Gross premiums for unit linked products



Conclusions regarding the Danish pension system

- The 3 pillars support each other
- Overall vulnerability reduced by 3 pillar approach
- Basic income distribution objectives are met
- Supplementary pensions fully funded
- Vulnerable towards increasing longevity

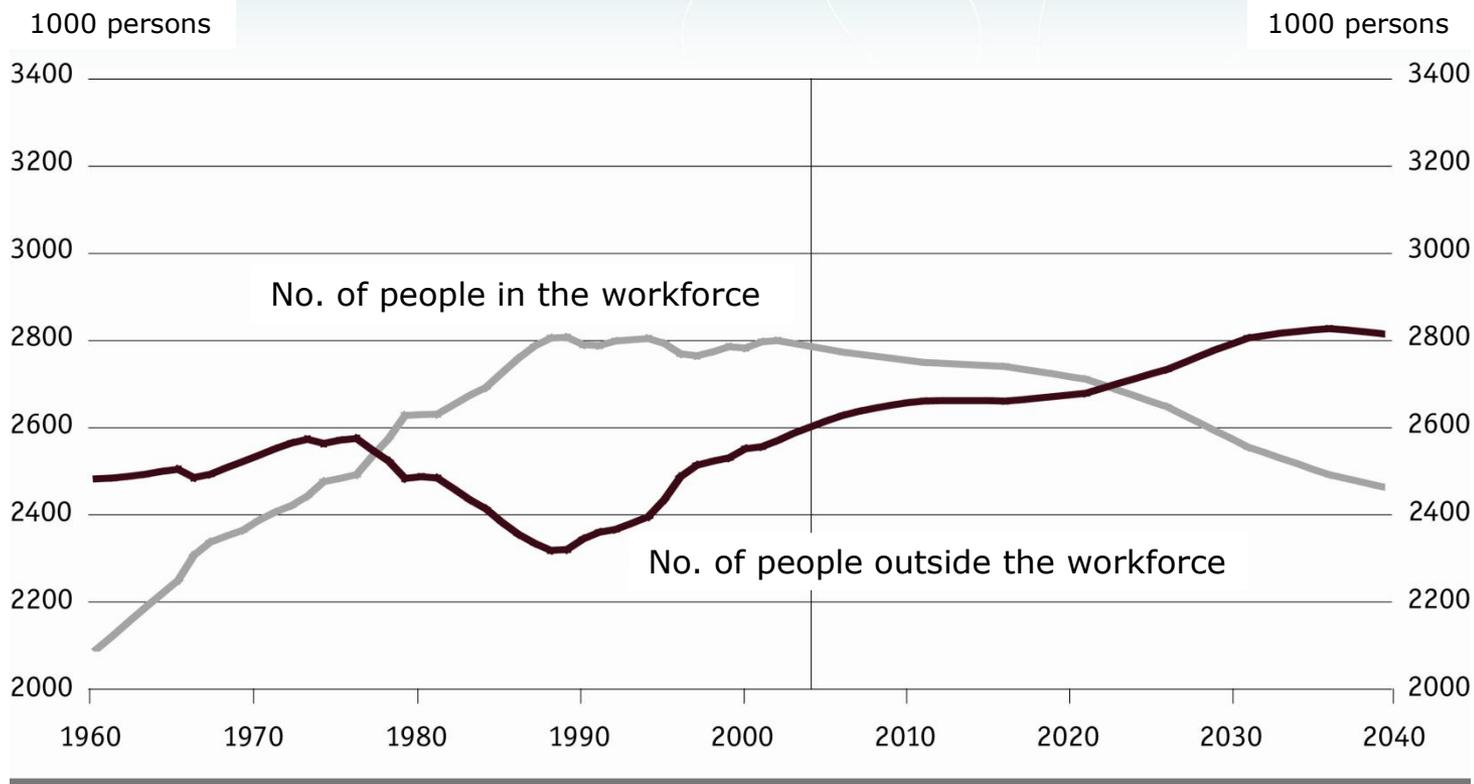
Welfare reforms

- The Danish government set up a Welfare Commission to analyze the challenges posed by the demographic changes to come.
- The Welfare Commission expressed support for the three-pillar pension system in its 2005 rapport .
- Recommendation: introduction of some obligatory pension savings for people falling outside the scope of the present pillar II and III.
- Recommendation: expand the incentives to rely more on annuities as the preferred payout method.

Welfare reforms

- why are they necessary?

Fewer people in the workforce to provide for people outside the workforce



Source: Welfare Commission

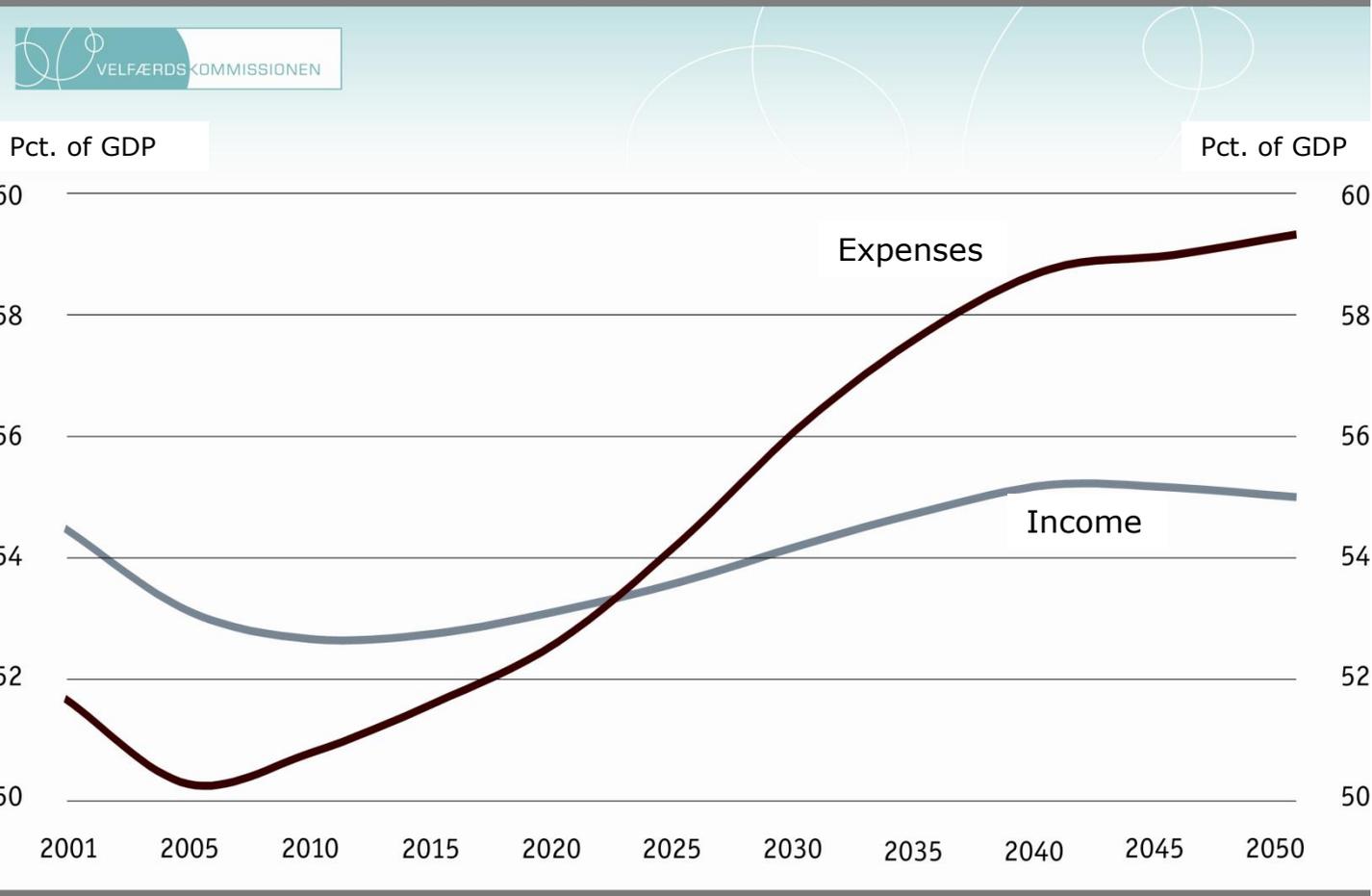


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Welfare reforms

- why are they necessary?

No reforms: Development in public income and expenses



Source: Welfare Commission

Welfare reforms – what happened?

- Relatively little!
- Planning for the long term future is politically difficult
- But reform *will* be on the agenda