Designing the Payout Phase: Main Policy Issues and Options

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Structure of the Presentation

The Payout Phase

• Where do we stand today?
• Where are the most relevant experiences?

Regulation of Payout Products

Regulation of Payout Providers

• Institutional Arrangements
• Pricing/Marketing Regulations
• Prudential Regulations
• Risk-Sharing Arrangements

Main Policy Options
The Payout Phase: Where do we Stand?

Design of payout phase remains a relevant issue

- Despite recent reform reversals, several countries have preserved their second pillars, payout phase approaching
- Some countries are introducing complementary DC schemes for civil servants

Design of payout phase remains a challenge

Need to balance the needs and risks of pensioners

- Needs: Adequate retirement income, bequests, liquidity
- Risks: Longevity, investment, and inflation risks (plus annuity risk, bankruptcy risk)

Many different options to design the payout phase

- 5 countries probably provide the most relevant experiences
The Payout Phase: Where are the Most Relevant Experiences?

- Australia, Chile, Denmark, Sweden and Switzerland
- All 5 countries have large DC-based second pillars
  - Mandatory or quasi-mandatory
- But there are important differences:
  - in the structure and role of different pillars of the pension system
  - in the regulation of payout options
  - in the levels of annuitization
  - in institutional arrangements
  - in pricing/marketing regulations
  - in prudential regulations
  - in the use of risk sharing arrangements
- The 5 countries provide a rich combination of experiences and lessons for other countries
The Payout Phase: All the Selected Countries Have 2\textsuperscript{nd} Pillars

<table>
<thead>
<tr>
<th>Country</th>
<th>Pillar 0</th>
<th>Pillar 1</th>
<th>Pillar 2</th>
<th>Pillar 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Chile</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Denmark</td>
<td>Yes</td>
<td>No</td>
<td>Yes (2) (Central + Occupational)</td>
<td>Yes</td>
</tr>
<tr>
<td>Sweden</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes (2) (Central + Occupational)</td>
<td>Yes</td>
</tr>
<tr>
<td>Switzerland</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>
The Payout Phase: All Second Pillars Have a Meaningful Size

Retirement Assets (% of GDP)
(Assets of DC Pensions Funds + Insurance Companies)
But the Levels of Annuitization are Very Different (reflecting primarily the regulation or plan rules of payout products)

Levels of Annuitization (%)
Regulation of Payout Products

• There are many different payout products
  • Lump-sums
  • Phased withdrawals (PWs) with different rules
  • Annuities: Term/Life; Fixed/Escalating/Variable; Nominal/Real; Single/Joint; Period-guaranteed/or not

• No single product can address all needs and risks
• Most countries restrict lump-sums to achieve minimum levels of annuitization
• Real fixed life annuities are only widely offered in Chile
  • Although other countries offer conditional price indexation
• Most countries have allowed riskier products (term and variable annuities, PWs) but only with minimum annuity
• Variable annuities are part of risk-sharing arrangements
• Period-guaranteed annuities are popular when offered (Chile)
# Properties of Different Payout Products

<table>
<thead>
<tr>
<th>Flexibility Protection</th>
<th>Protections Offered</th>
<th>Other Benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Longevity Risk</td>
<td>Investment Risk</td>
</tr>
<tr>
<td>Lump-sum</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Term annuity</td>
<td>No</td>
<td>Possible</td>
</tr>
<tr>
<td>Lifetime phased withdrawal (PW)</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Variable life annuity, minimum payment guarantee + bonus</td>
<td>Possible/Shared</td>
<td>Shared</td>
</tr>
<tr>
<td>Variable life annuity, unit-linked</td>
<td>Shared</td>
<td>No</td>
</tr>
<tr>
<td>Fixed nominal life annuity</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Escalating nominal life annuity</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Fixed real annuity</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Fixed real annuity, period guarantee</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>
# Illustration: Menu of Products in the Five Countries
(More restricted in Chile and the centralized schemes of Denmark and Sweden)

<table>
<thead>
<tr>
<th></th>
<th>Lump-Sums</th>
<th>Term Annuities</th>
<th>Lifetime PWs</th>
<th>Fixed Nominal Life Annuities</th>
<th>Fixed Real Life Annuities</th>
<th>Variable Annuities</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Australia</strong></td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Chile</strong></td>
<td>No *</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>Yes (combination)</td>
</tr>
<tr>
<td><strong>Denmark</strong></td>
<td>(1) No</td>
<td>(1) No</td>
<td>(1) No</td>
<td>No</td>
<td>No</td>
<td>Yes (conditional)</td>
</tr>
<tr>
<td></td>
<td>(2) No</td>
<td>(2) Yes</td>
<td>(2) Yes</td>
<td>(guaranteed benefit only)</td>
<td>(conditional benefit only)</td>
<td></td>
</tr>
<tr>
<td><strong>Sweden</strong></td>
<td>(1) No</td>
<td>(1) No</td>
<td>(1) No</td>
<td>No</td>
<td>No</td>
<td>No (conditional)</td>
</tr>
<tr>
<td></td>
<td>(2) No</td>
<td>(2) Yes</td>
<td>(2) Yes</td>
<td>(guaranteed benefit only)</td>
<td>(conditional benefit only)</td>
<td></td>
</tr>
<tr>
<td><strong>Switzerland</strong></td>
<td>Yes *</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

* Restrictions apply by regulation or plan rules
Regulation of Providers: Institutional Arrangements

• Centralized provision, as adopted in Denmark and Sweden, offers many advantages, but also risks:
  • Possible advantages:
    • Large risk pooling
    • Scale economies
    • Facilitates adoption of risk-sharing arrangements
  • Possible disadvantages:
    • Political interference in annuity pricing
    • Political interference in asset management

• Decentralized provision as adopted in Chile also offers advantages and risks
  • Pensioners can benefit from competitive and more innovative annuity market
  • But can also be harmed by oligopolies, lack of transparency, high brokerage fees
Regulation of Providers: Pricing/Marketing Regulations

- Switzerland has regulated annuity pricing through rules for annuity conversion factors
  - May have addressed annuity risk and ensured a “good deal” for couples but has resulted in large transfers across pensioners
  - Rigidity in price rules also jeopardized the resiliency of providers
- Chile has regulated marketing through caps on brokers’ commissions and an electronic quotation system
  - Regulatory response to abuses in the 1990s
  - Relevant example for decentralized and open (non-occupational) payout systems
- Other countries have forbidden brokerage activity
  - E.g., Colombia
Regulation of Providers: Prudential Rules

- Early efforts to introduce risk-based supervision including risk-based solvency rules penalizing mismatches
  - “Calce” rule in Chile, traffic light system in Denmark and Sweden

- Trends in insurance regulation reinforce this approach (e.g., Solvency II)
  - Fair valuation, use of market discount rates, use of cohort tables, buffers for investment and longevity risks

- Adoption of a modern risk-based supervision approach is challenging in many countries
  - Lack of adequate capital market instruments, lack of accurate and updated mortality tables, lack of risk management skills, and lack of supervisory skills
Regulation of Providers: Risk-Sharing Arrangements

- Some payout products have risk-sharing properties
  - Some variable annuities entail the sharing of risks between pensioners and providers

- More comprehensive risk-sharing arrangements have been adopted in Denmark and Sweden (and TIAA-CREF in the US)
  - The whole pool or specific cohorts can share longevity risk
  - Investment/inflation risks can be shared or shifted to participants

- Risk-sharing arrangements operate more easily in centralized arrangements or large occupational schemes
  - But have also been adopted in competitive markets (Denmark)
  - They always require very transparent rules/operating procedures
Main Policy Options: Payout Products

• Policy makers should target an adequate level of annuitization but avoid excessive annuitization
• Lump-sums should be subject to reasonable restrictions
• Real fixed annuities are in principle the best option for annuitization, but require good inflation hedges
• Escalating nominal annuities are an attractive alternative
• PWs with life expectancy formula are also an attractive product (slow depletion of balance)
• Policy makers should favor a combination of payout options
• Joint annuities should be required for married couples
  • Especially when unisex mortality tables are adopted
• Annuities with guaranteed periods provide an element of bequest and should be allowed
Main Policy Options: Institutional Arrangements

• Centralized provision of annuities and other products merits consideration, especially in countries with downsized second pillars
  • Central agency needs to be ring-fenced
  • Asset management can be decentralized

• Decentralized structures have worked well in Chile but require vigilance over growing oligopolies
  • Annuities market needs to remain contestable
  • Marketing activities need to be regulated (see next slide)
Main Policy Options: Pricing/Marketing Regulation

• Pricing regulation à la Switzerland should be avoided
  • May lead to very large and unintended transfers and/or jeopardize the solvency of providers
• Countries with decentralized and open (non-occupational) annuities markets should consider adopting electronic quotation systems (Chile)
• Broker activity/financial advice needs to be regulated, (and fees possibly capped) to prevent abuse
• Avoid abuses in brokerage activity
Main Policy Options: Prudential Regulation

• Adoption of risk-based approach to supervision
  • Adoption of risk-based strategy with long-run objectives
  • Start with simple risk-based solvency rule encouraging matching
  • Examine variants of traffic light systems
  • Develop updated/dynamic mortality tables
  • Develop/implement regulations on internal risk management

• Related capital market agenda for the payout phase
  • Public debt management: provision of long duration bonds, including inflation-indexed bonds
  • Development of private fixed income instruments, including inflation-indexed instruments
  • Development of derivatives markets, especially interest rate swaps
  • Development of longevity bonds
Main Policy Options: Risk-Sharing Arrangements

• Risk-sharing arrangements are an attractive option
  • Helps address complex risks such as longevity and market risk, strengthen resiliency of providers, especially in the absence of an adequate supply of instruments

• However, risk-sharing arrangements also introduce challenges
  • Effective pricing rules (e.g. through aggressive cohort mortality tables) to minimize subsequent adjustments
  • Transparent rules to avoid transfers of income across different cohorts
  • Transparent rules to avoid excessive appropriation of profits by shareholders
Thanks!

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