Designing the Payout Phase in CEE Countries: Policy Options

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Designing the Payout Phase: Policy Options

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- Joint Life Annuities and Guaranteed Periods of Payments
- Default Options and Transparency
- Centralized versus Decentralized Systems
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- Government Guarantees
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Introduction

- The main rationale for life annuities is to protect retirees from outliving their savings.
  - It is not the same the type of retirement instruments to be selected
- Risk tolerance, longevity, regulatory framework, role of unions and syndicates, role of regulatory and supervisory framework, financial literacy, cross subsidies...multiple elements need to be considered.
- A liberal approach with no restrictions on payout options is not consistent with a mandatory pension pillar
- Adopting an integrated threshold replacement rate from the public and private pillar would introduce flexibility to the system without causing a significant reduction in the level of desired annuitization.
Examples of Life Annuity, Term Annuity, Lifetime PW Paths
(premium = 2,000 UF; interest rate = 4.5%, mortality table = Chilean RV-04)
## Menu of Main Retirement Options

<table>
<thead>
<tr>
<th>Retirement Product</th>
<th>Protection Against</th>
<th>Provision of Bequest</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Investment Risk</td>
<td>Inflation Risk</td>
</tr>
<tr>
<td>Lump–sum</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Phased Withdrawal</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Term Annuity</td>
<td>Maybe</td>
<td>No</td>
</tr>
<tr>
<td>Variable Annuity</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Fixed Nominal Life Annuity</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Fixed Indexed Life Annuity</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>
Fixed Annuities

<table>
<thead>
<tr>
<th></th>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1A. Fixed Annuities</strong></td>
<td>They provide protection against longevity and investment risks.</td>
<td>They prevent participation in the higher, though more volatile, returns on equities and other real assets.</td>
</tr>
<tr>
<td></td>
<td>They provide certainty of monthly payments.</td>
<td>They are exposed to annuitization risk.</td>
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<tr>
<td></td>
<td></td>
<td>They suffer from wide dispersion in annuity prices.</td>
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<tr>
<td></td>
<td></td>
<td>They are exposed to potentially misleading broker influence and marketing campaigns.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>They require a robust and effective system of prudential regulation and supervision to ensure provider solvency.</td>
</tr>
<tr>
<td><strong>1B. Fixed Real Annuities</strong></td>
<td>They provide protection against inflation risk.</td>
<td>They start with relatively low initial payments but these grow over time.</td>
</tr>
<tr>
<td></td>
<td>They appeal to retiring workers who have a long life expectancy and a low level of risk tolerance.</td>
<td>The cost of inflation protection may be high.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>They require access to inflation-linked long-duration debt instruments issued by both the public and private sectors for risk-hedging purposes.</td>
</tr>
<tr>
<td><strong>1C. Fixed Nominal Annuities</strong></td>
<td>They start with relatively high initial payments.</td>
<td>They are exposed to inflation risk.</td>
</tr>
<tr>
<td></td>
<td>They appeal to retiring workers who have a short life expectancy or underestimate their longevity.</td>
<td></td>
</tr>
</tbody>
</table>


# Variable Annuities

<table>
<thead>
<tr>
<th>2A. Variable Annuities</th>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Protection against diversifiable longevity risk, while sharing non-diversifiable longevity risk among annuitants.</td>
<td>They are exposed to investment and inflation risks. They may start with relatively low initial payments. Annuity payments may fluctuate widely from year to year.</td>
</tr>
<tr>
<td></td>
<td>Participation in higher returns on equities</td>
<td>They are exposed to potentially deceptive or even perverse marketing policies, affecting their risk-sharing arrangements.</td>
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<tr>
<td></td>
<td>They avoid annuitization risk.</td>
<td>They require a robust and effective system of regulation and supervision.</td>
</tr>
<tr>
<td></td>
<td>They avoid the wide price dispersion</td>
<td></td>
</tr>
<tr>
<td></td>
<td>They appeal to retiring workers who have a long life expectancy and a high level of risk tolerance.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>They require lower capital requirements for provider</td>
<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>2B. ‘Guarantee and Bonus’ Annuities</th>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>They are supported by the offer of minimum guaranteed benefits.</td>
<td>Annuity payments depend on future investment performance and the declaration of bonuses. Depending on how bonus reserves are funded, their creation may cause an unfair transfer from older to younger cohorts.</td>
<td></td>
</tr>
<tr>
<td>Annual bonuses provide protection against inflation. Stable-value asset allocations mitigate exposure to investment risk.</td>
<td>Depend on profit-sharing policies of providers.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2C. ‘Unit-linked’ Annuities</th>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>They are more transparent than ‘guarantee and bonus’ variable annuities. They do not depend on the profit-sharing policies of annuity providers.</td>
<td>They may be exposed to greater volatility of investment returns and annuity payments.</td>
<td></td>
</tr>
<tr>
<td>They may benefit from minimum guaranteed rates of return.</td>
<td>The pricing of the minimum rate-of-return guarantees faces difficult challenges.</td>
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</tbody>
</table>
Joint Life Annuities and Guaranteed Periods of Payment

• Joint Life Annuities (JLA)
  • JLA protect nonworking spouses after the death of the primary beneficiary
  • Most countries do not mandate JLA (voluntary)
  • JLA help to mitigate the distorting effects of adopting unisex mortality tables
    • The distortion is because of the difference in expectancy from men and women, and the tendency of annuity providers to target male retirees

• Guaranteed Period of Payment
  • Annuities with guaranteed periods of payment provide protection to the dependents and heirs from beneficiaries if death occurs during guaranteed period
  • Protection is not as effective as JLA, but can be offered at low cost.
Mandating a single retirement product for all retiring workers is simple…but it runs the risk of imposing suboptimal solutions on those retirees whose risk preferences and financial circumstances may favor a different type of product.

- For example, poorer workers have shorter life expectancy than richer ones.
- By imposing fixed annuities as the only retirement product, there is a cross subsidy from low income to high income retirees.

Role of the state in providing a default option:
- Providing transparency and disclosure.
- Evaluating performance of different retirement alternatives (data).
- Selecting a default option for retiring workers who are unable or unwilling to make timely decisions.
  - Temporary versus permanent decision.
  - Centralized or decentralized agency.
Centralized Provision

- Larger base for risk pooling
- Scale economies
- Avoids heavy marketing costs
- Weaker incentives for innovation and operational efficiency
- Examples Denmark’s ATP and Sweden’s PPM

Decentralized Provision

- Promote competition, innovation and efficiency
- Risk of oligopolistic structures
- High administrative and marketing expenses
- Regulatory framework to avoid providers, brokers and agents from engaging in deceptive practices and market abuses

The case of decentralized structure is weakened when regulation imposes strong restrictions on products, prices, use of common life tables. Competition is limited to asset management and marketing. Possibility of combining decentralized account management with centralized account administration and longevity risk.
Regulation of Pricing Policies

Fixed Annuities
- Pricing is determined based on their assumptions of longevity, investment returns, and operating costs
  - Brokers and selling agents do not necessarily help a proper competition
  - Wide price dispersions: greater than 20% (UK, Chile)
- Annuity Conversion factors avoids price dispersion, but if not properly calibrated may generate large income transfers
- Centralizing annuity quotations is an alternative

Variable Annuities
- Much more complex and room for irresponsible behavior with consumers
- Regulation on initial payments and caps on fees.
- Competition should be restricted to the level and stability of perspective bonuses
  - These are a function of investment returns, operating costs, longevity experience and policy of profit distribution
- Switching policies and exit fees
Prudential Regulation

- It addresses the levels of technical reserves and risk capital that are required to support the risks undertaken by different providers.
- Same for centralized and decentralized systems.
- Providers of Phased Withdrawals and Unit Linked products without any guarantees do not assume investment risks or longevity risk, therefore do not need to build technical reserves.
- Regulation of risk management of institutions that assume investment, inflation and longevity risks faces greater challenges:
  - Fair value (ALM)
  - Stress testing.
    - Stress test indicate the size of the buffer funds required to ensure solvency.
    - Major challenge for countries with low volumes of trading.
- Management of Longevity Risk:
  - Annuitants, the cohort, or the government (longevity bonds?)
Government Guarantees

Bankruptcy risk
- Very important in the case of life annuities (non revocable nor portable contracts)
- In variable annuities providers assume risk of minimum guaranteed benefits
- Prudential supervision is important…but not sufficient

Guarantee schemes
- The authorities should also establish guarantee schemes covering most, if not all types of annuities and phased withdrawals, especially in mandatory funded systems
- Guarantees need to cover up to 100% up to specified basic threshold, and then a high percentage (75–90%) of amounts above the threshold with an upper limit
- Guarantees on variable annuities should cover fraud and negligence only.

Annuitzation Risk (AR)
- AR is high when accumulated balances are invested in instruments other than LT fixed income (for fixed annuities)
- Governments may address AR by promoting the use of lifecycle funds.
Main Conclusions

- Planning for an integrated threshold replacement rate
- Constrained choice of retirement products
- Avoid lump sums and nominal fixed annuities
- Real fixed annuities are optimized when market offers private and public inflation indexed instruments
- Public guarantees are necessary
- Marketing and pricing of annuity providers need to be closely regulated and monitored
- Electronic quotation systems of annuities are advisable
- If variable annuities are selected, consider centralized account administration and longevity insurance and decentralized asset management centralized
- Decentralized variable annuities systems have not been tested in countries with open pension funds.
Thank You!

See also

*Designing the Payout Phase of Funded Pension Pillars in Central and Eastern European Countries.*


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