



Round Table on Annuities and Pensions

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Structure of the presentation

- Why do we need for annuities for pensions?
- How much needed to annuitize (DC balances)?
- What is the problem with annuity markets?
 - The share of annuity markets (Rusconi, 2008).
 - Constraints to annuity markets. Focus on supply constraints: longevity risk
- Who should provide annuities?
- What type of annuity products?
- Conclusions

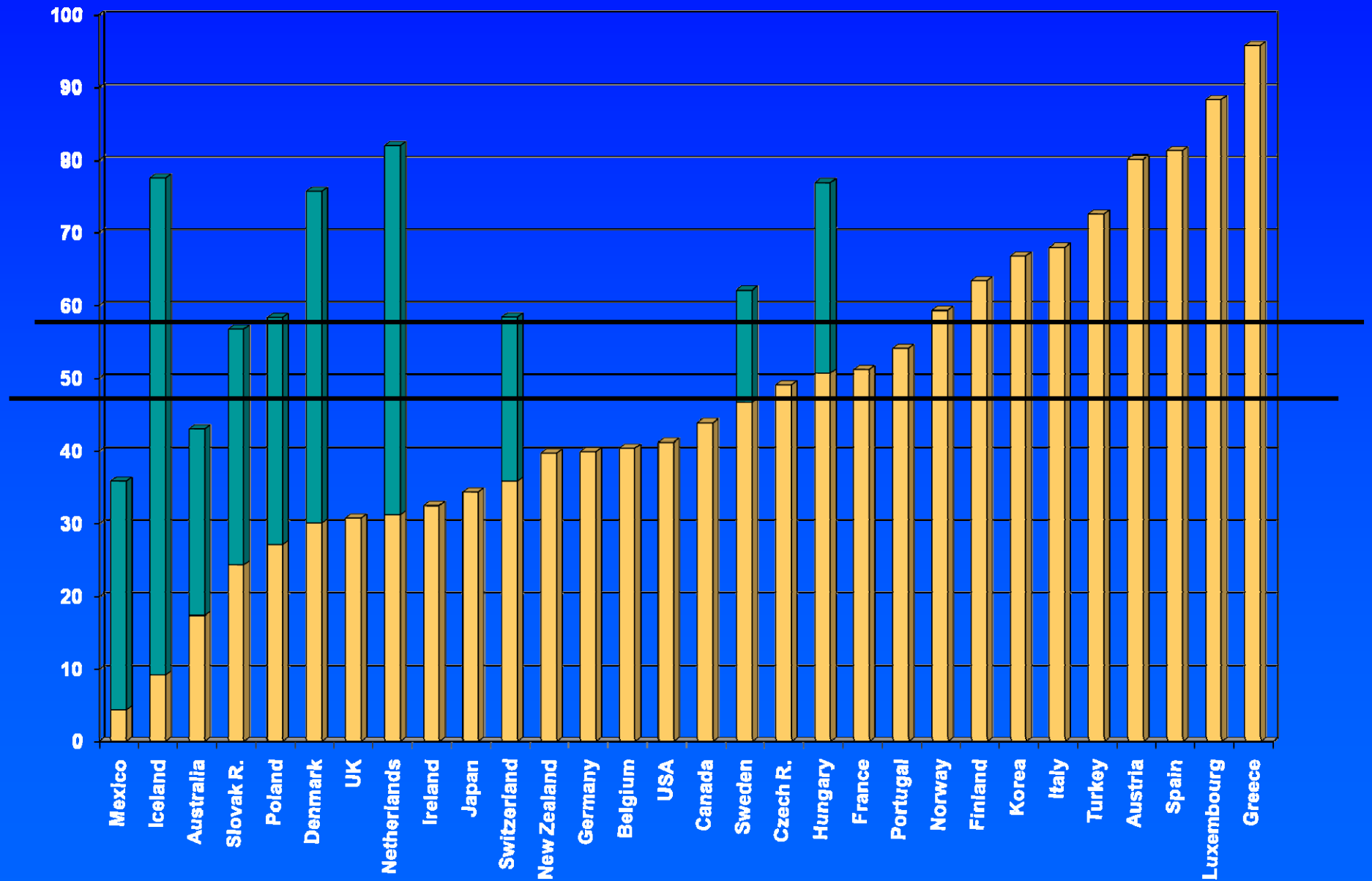
Why Do We Need Annuity Products?

- Life annuities provide annuitants protection from longevity risk (LR)
- Economic theory suggest that people will annuitize as much as possible of their accumulated wealth (Yaari, 1965). However, this only holds under certain assumptions (e.g. no bequests).
- However, life annuities are illiquid and less flexible than phased withdrawals (drawdown plans).
- People with private pensions, esp. DC plans, need to annuitize part of the balances accumulated at retirement in order to provide protection from LR.

How much we need to annuitize?

- How much to be annuitized depends on structure overall pension system, i.e. amount retirement income already annuitized via public pensions?
- Countries provide significant level of retirement income already annuitized from PAYG-financed public (and DB) pensions (in absolute as well as relative replacement rates) → no need for much annuitization, better off allowing for more choice and flexibility allocate DC balances.
- Countries DC pensions are the main source of retirement income → retirees need to annuitize a larger share of their accumulated assets.

Gross replacement rates: Mandatory Plans



The country context

- Western Europe: replacement rates from PAYG-financed public (and DB) pensions (in absolute as well as relative replacement rates) high → no need to annuitize balances in DC pensions, better off allowing for more choice and flexibility permitting people allocate their DC balances as they please.
- LatAm & CEE: DC pensions are the main source of retirement income → retirees need to annuitize a larger share of their accumulated assets.

National Annuity Markets

- The reality is that individuals fail to annuitize large part of their retirement wealth.
- As a result, the size of annuity markets is relatively small.
- The UK annuity market is the largest and more diversified market for annuities, followed by the USA, and Switzerland.

National Annuity Markets

- Three broad categories to describe national annuity markets
 - Markets of the immediate annuity type (UK, USA, Canada, South Africa, recently Chile)
 - Deferred annuity markets (Denmark, Belgium, Germany)
 - Other annuity markets (E.g. Switzerland: fix conversion factors at retirement for mandatory pension savings)

What is the problem with annuity markets?

- There are demand and supply factors that hinder annuity markets.
- Demand factors include:
 - Crowding out by public pensions and DB pensions
 - Bequest motive
 - Personal circumstances (family support, need to cover the cost of medical care, etc.): precautionary savings
 - Dichotomy btw straightforward annuity products (easy to understand) and products that address as many needs as possible (costly): tradeoff
 - Tax disadvantages
 - Lack of enough/adequate financial knowledge/literacy.

Supply factors for low annuitization

- Adverse selection
- Lack of competition among providers.
- Exposure to the uncertainty surrounding future mortality and life expectancy outcomes (i.e. longevity risk).
- Lack of financial instruments to hedge longevity risk.
- Concern with regulatory capital requirements given the risks involved.
- Incomplete markets: lack inflation protection, lack of exposure to equity markets.

Focus on supply constraints

- One of the factor behind the annuity “puzzle” is that annuity providers may not be able to supply adequate or enough annuity products.
- This results from the fact that providers of annuity products have to bear important risks (e.g. longevity and investment risk).
- Additionally, there is a lack of adequate or enough financial instruments to enable providers to hedge considerable parts of the associated risks

Solutions

- Solutions include to encourage the provision of financial instruments to hedge those risks and/or alternative annuity products that allow for risk sharing between annuitants and providers.
- Hedging financial products include longevity-indexed bonds (OECD, 2007/8) and ultra long-term financial instruments (30-yr government bonds).
- Alternative annuity products that permit sharing risks btw annuitants and providers may need to be backed by lower capital promoting annuitization.

Who could provide annuities?

- Balance to strike btw competition and safety of retirement savings.
- The general argument: allow as many providers as possible in order to promote competition, lower prices and lower costs.
- However, in order to protect retirement savings from bankruptcies of providers: sound prudential framework. Allow only providers that would be subjected to solvency and capital adequacy requirements.

Providers?

- On practical terms, ... insurance companies are better prepared: experience, expertise, work on both sides of the market (sellers life insurance (mortality) and life annuities (life expectancy) possibility of offsetting both effects).
- Disadvantages: life insurance companies may have problems in offering annuities.
 - Lack of appropriate financial instruments to hedge against LR
 - Insufficient very long-term instruments to match liabilities

Providers?

- Pension funds
- Separate financial institutions (asset managers)
- State annuity fund or centralized annuity provider:
reduce costs, general public distrusts private
sector financial institutions.

Providers

- Countries with small or non-existent annuity markets could institute a centralised annuity provider, but should allow insurance companies and other providers to enter the market, guarantee full equal competition, and the role of the centralise annuity provider should dwindle down as market develops.
- Countries that decide for pension funds providing annuities should make sure that appropriate prudential regulation is in place to protect retirement income.

What type of annuity products?

- Trade-off btw choice, risk and costs
- The cost of annuities increase directly with the amount of protection and guarantees provided.
- Again, situation large part retirement income already annuitized → allow individuals to buy different annuity products, even if entailing greater risks (e.g. variable annuities access to stock market gains, but investment risk).
- Countries retirement income mainly from DC plans → 1st straightforward annuity products to protect from LR w/o assuming other risks, then remaining balance (if any) any type of annuity products

Different type of annuity products

- There are different type of annuity products.
- Trade-off between guarantees and costs.
- They can be classified according to different criteria and different dimensions (horizontal not hierarchical)

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), with profit.
- 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

Conclusions

- We need annuities to protect people from longevity risk.
- How much needed to annuitize depends on the overall structure of the pension system in each country: large part retirement income from DC → annuitize.
- Unfortunately, the lack of or insufficient financial instruments available for annuity providers hedge LR hinders annuity market

Conclusions

- Allow any annuity provider as long as they are subjected to solvency and capital adequacy requirements.
- Countries with less developed annuity markets: Centralized annuity provider, but should allow insurance companies and other providers to enter the market, guarantee full equal competition, and its role should dwindle down as market develops.
- Type of annuity products: 1st protection from LR, once achieved, full flexibility with the remaining of the balances accumulated.



THANK YOU

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