

THE PAY-OUT PHASE OF FULLY FUNDED PENSIONS

OPTIONS, PROBLEMS AND ACTUAL INTERNATIONAL PRACTICE WITH
RELEVANCE FOR AZERBAIJAN

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“Support to the State Social Protection Fund on the introduction of funded element within the insurance – pension system, establishment of non – state pension funds and development of legal framework for regulating their activity”

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OVERVIEW

Contents of the Presentation

- Role and tasks of pension schemes
- Retirement products in the private market
- Capital market agenda for the pay-out phase
- Regulations of annuity providers
- Policy options for the regulation of the pay-out phase

PAY-OUT PHASE

Pension Products have Special Features

- Role and tasks of pension schemes
 - Support the management of financial risks of individuals (families) related to retirement and old age (surviving dependents, invalidity)
 - Retirement products are at the crossroads of societal values (social policy targets) and market imperatives
- Conclusion: Retirement products are different from financial instruments for pure wealth creation
 - More regulation is recommended

Financial risk during the pay-out Phase

	Financial risk
Liquidity	Flexibility to meet unforeseen expenditures, e.g. medical treatment, long-term care
Adequate income	Alleviate poverty, provide adequate replacement of earnings
Life-long income	Longevity risk
Common risk	Inflation
	(Re-)Investment risk
	Bequests (?)

Types of products for the pay-out Phase

	Type of product
Liquidity, Bequest	Lump-sum (single) payment
Adequate income	Programmed withdrawals: series with fixed or variable instalments
Life-long income	Periodic fixed or variable payment until the end of the annuitants live: Annuity or life pension
Combined arrangements	Programmed withdrawals combined with a deferred annuity starting at very old age, e.g. at age 80
CONCLUSION	NOT EVERY PRODUCT SERVES ALL NEEDS

Types of Annuities

- Fixed nominal annuity: no protection against inflation
- **Inflation indexed (real) annuity: requires indexed bonds**
- Substitute: escalating annuity: requires long-term bonds
- Fixed annuity with profits: risk sharing between policy holder and insurance company
- Variable annuity: exposure to the volatility of financial markets
- Joint annuity for married couples

Summary: Risk features of retirement products

	Risk Protection			Other Benefits	
	Longevity	Investment	Inflation	Flexibility	Bequest
Lump-sum payment	No	No	No	Yes	Yes
Term annuity	No	Possible	Possible	No	Yes
Life long withdrawal plan	No	No	No	No / Yes	Yes
Variable life annuity + minimum payment guarantee + bonus	Possible / shared	Shared	Shared	No	No
Variable life annuity, unit linked	Shared	No	No	No	No
Fixed nominal annuity	Yes	Yes	No	No	No
Escalating nominal annuity	Yes	Yes	Partial	No	No
Fixed real life time annuity	Yes	Yes	Yes	No	No

Distribution of DC Balance between Retirement Products

- Combined arrangements at retirement
 - Deferred annuity, starting payments at age 80 (15 per cent of your DC balance)
 - Programmed withdrawals from remaining balance
- Assessment
 - Simultaneous provision of flexibility and longevity risk coverage, no inflation protection

Distribution of DC Balance between Retirement Products (1)

- Flexibility to deal with unforeseeable events
- Protection against longevity risk
- Promoting annuitization
 - Compulsion: mandatory annuitization
 - Default option with opting out
 - Tax incentives
 - Competition between annuity providers to reduce prices and costs

Economics of Annuities (1)

- Why are annuities so unpopular? Despite Mortality gains
- Price
 - Actuarially fair price
 - Market price of annuity: equilibrium and distorted
- Demand
 - Asymmetric distribution of information: adverse selection bias
 - Income-longevity correlation
- Mortality tables for pension calculation: Life expectancy:
 - Life expectancy: Gender specific,
 - Life expectancy: Income class specific,

Regulation of Annuity Providers (1)

- Beyond prudential regulation and risk based supervision
- Centralized Annuitization (Denmark, Sweden)

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

Regulation of Annuity Providers (2)

- Decentralized annuitization by competing companies e.g. Chile and most other countries

Possible advantages:

- Cost competition; transparent quotations required
- Product innovation

Possible disadvantages:

- Oligopoly structure (high barriers to entry)
- Lack of transparency and high brokerage fees

- Regulation on marketing activities, fees and (the quality of) financial advice to prevent abuse

Capital Market Agenda for the Pay-out 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

Economics of Annuities (2)

- Funding and portfolio composition
 - State guarantees: constraints on portfolios
 - Hedging of inflation risk: long-term indexed government bonds
 - Incomplete hedging of inflation through equity investment
- Distributional implications
 - Redistribution from poor to the rich (CPI indexation)
 - Redistribution from persons with short to those with long life-expectancy: Gender, income group

Policy Options: Pay-out Products

- The target should be an adequate level of annuitization; excessive annuitization should be avoided.
- Lump-sum payments 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

Policy Options: Pay-out Products

- Phased Withdrawal Plans with **life expectancy formula** are also an attractive product (slow depletion of balance).
- A combination of payout options should be offered.
- 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.

Sağ olun!

Thank you very much!

Vielen Dank!

ANNEX

Dimensions of Annuity Design

- Tax regimes
 - No common standard

Taxation at the level of ...	Tax regime EET	Tax regime ETT	Tax regime TTE	Tax regime TEE
Contributions	Exempt	Exempt	Taxed	Taxed
Interest and Profits	Exempt	Taxed	Taxed	Exempt
Benefits	Exempt	taxed	Exempt	Exempt