INTER-AMERICAN DEVELOPMENT BANK

Best practices for the Design and Implementation of the Payout Phase - IDB PLAC Network: Webinar on first draft

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Webinar

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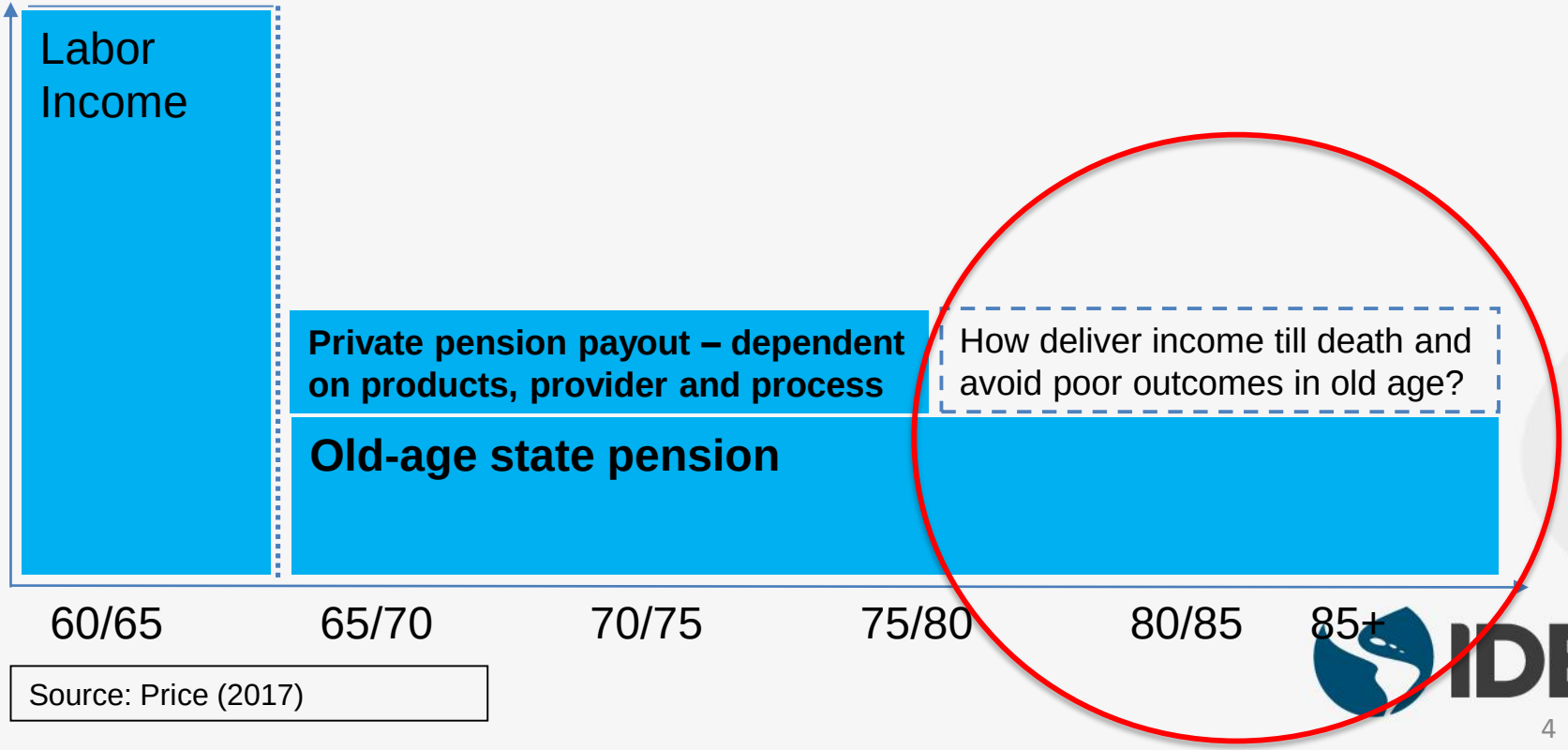
AGENDA

1. Recap on project aims and timeline
2. The problem of the pay out (decumulation) phase
3. Draft Principles (following structure of PLAC Guidelines on Supervision)
    - Strategic approach and regulatory design
    - Data, analysis and risk assessment
    - Supervisory actions to mitigate risks and improve the payout phase
    - Resources, Tools and Organization for effective supervision of payout phase
4. Comments raised so far by reviewers
5. Questions and Next Steps

IDB-PLAC Pay out project aim

“The aim of the Best-Practice Guidelines is to deliver practical recommendations to assist regulators and supervisors as they design and implement the legal and regulatory framework for their country and deliver the supervisory oversight of that framework”

The problem of the payout phase is how to provide sufficient income until a person dies – given that most countries now - and even more in the future - will not have sufficient income from public or government pensions



Source: Price (2017)

Project Milestones

Milestones so far

- March 6 2019 Introductory Webinar
- March 6 2019 Circulation of questionnaire to countries
- April 9-11 International Seminar and Technical Meetings on Pay out phase
- June 14 first draft report circulated for comments – including spreadsheet with all country answers to questionnaire
- June 14 – July 14 first round comment period by countries, IDB team and external reviewer
- 18 July webinar on draft report

Milestones to come

- End July - revised draft report and guidelines following webinar
- August - second round of comments from countries and IDB
- End August / early September - final revision

The (draft) guidelines were developed with many inputs

- Comments from PLAC members and IDB staff – including from the Uruguay conference
- Responses to the pay out phase questionnaire
- OECD DC Roadmap Guidelines
- OECD Core Principles
- World Bank Group 'Outcomes Based Assessments'
- International Organisation of Pension Supervisors (IOPS)
- International Association Insurance Supervisors (IAIS) Insurance Core Principles (ICPs)
- CFA Mercer An Ideal Retirement System 2015
- Melbourne Mercer Global Retirement Index
- World Bank Group 'Annuities & Other Retirement Products'
- Product developments from market participants
- Experience from countries globally as well in the LAC region.

Pay out guidelines developed to complement the approach from the first PLAC-IDB guidelines on supervision

1. Start with the **long-run outcome focused objectives** for the supervisor;
2. Focus on key **system-wide and specific pension fund risks** – which requires obtaining and using the right data;
3. Use a **range of tools to assess and understand risk** – including quantitative tools – and have a range of tools to deliver solutions;
4. **Enhance pension fund governance and risk management** as a central way to reduce risks – and shift first line of defense to (well-run) funds;
5. Ensure **risk-based selection of pension funds and subjects for supervisory focus**; and
6. **Prevention and remediation first with sanctions and enforcement for persistent or critical issues** – making sure enforcement not forgotten.

Structure of the Guidelines (following guidelines on supervision)

1. Strategic approach and regulatory design
2. Data, analysis and risk assessment
3. Supervisory actions to mitigate risks and improve the pay-out phase
4. Resources and Organization for effective supervision of pay-out phase

Strategic approach and regulatory design

Strategy and design: Guidelines 1-3

1. Regulators and supervisors should create clear outcome-focused objectives to deliver retirement income until death not only assets at retirement, with clarity on targets for adequacy, efficiency, sustainability, coverage and security.

2. Regulators should use all possible policies to help deliver income in old age - including (automatic) adjustments of retirement age as longevity increases, reducing early withdrawals or early retirement, tax and matching incentives supporting income products, increasing state pensions when people delay retirement and boosting employment for older workers.

3. Regulators should ensure a clear, simple, low-cost and efficient market structure to deliver pay-out products, with innovations including auctions and new capital market instruments encouraged where this enhances retirement objectives.

Strategy and design: Guidelines 4-6

4. Supervisors should ensure only organizations that have (or can achieve) the scale, expertise and governance to become efficient, trusted and sustainable providers are part of a simple, low-cost pay-out value chain.

5. Supervisors should mandate simple default solutions for retirement income, tailored to the level of capital market development and old-age income available from other sources, with intelligent phased withdrawals at a minimum and then considering (deferred) annuities plus phased withdrawals, or life annuities or variable life annuities.

6. Supervisors should restrict access to assets in the accumulation and pay-out phase until the core retirement income objective or a minimum asset balance is achieved, and not allow lump sums before full retirement age except for death and disability. If savings are needed for other purposes like housing or education, different accounts should be created.

Data, analysis and risk assessment

Data, analysis and risks: Guidelines 7-9

8. Supervisors should integrate risk assessment for the pay-out phase into their overall (risk-based) supervision model so that they can make the right risk and resource trade-offs across their different functions.

9. Supervisors should assess pay-out risks across all elements of the product, process and providers – proactively sharing data and risks assessments with the Insurance supervisor or department where relevant.

10. Supervisors should collect, improve and publish data including on mortality to assess and mitigate risks to their objectives.

Supervisory actions to mitigate risks and improve the payout phase

Supervisory actions: Guidelines 10 - 13

10. Supervisors must set out required standards of governance for all entities involved in the pension pay-out phase, assess performance relative to these standards and take corrective action as needed.

11. Supervisors should ensure that investment regulations for the accumulation and pay-out phase are consistent so asset allocations can adjust to match future liabilities or to match asset allocations backing default or other pay-out products.

12. Supervisors should ensure pension products with promised benefits are backed by prudent funding levels or regulatory capital for both employer sponsored DB pensions and insurance company delivered annuity products, and encourage risk sharing in DB plans.

13. Supervisors should focus education of members on clear and basic messages linked to simple choices, with the main consumer protection tool being good overall design of the product, process and providers rather than relying on members having deep understanding and making informed, active choices.

Resources and Organization for effective supervision of payout phase

Resources and Organization: Guidelines 14-16

14. Supervisors must understand actuarial concepts related to retirement income and employ or have access to actuarial inputs for regulatory design, data collection and periodic risk assessment.

15. Supervisors should develop IT capacity (SupTech) for automatic data collection and analysis along with tools for retirement income projection to facilitate price monitoring, risk assessment, external publications and performance monitoring of long and short run objectives.

16. Supervisors should explore how FinTech solutions can support simpler and safer access to better value products but ensure proper review and supervision – ensuring they have the capacity to assess risks first rather than enable products they do not understand.

Some comments so far from reviewers

- Should guidelines apply to all public sector pensions – even Pay As You Go?
- Clarify that raising retirement ages needs to be fair to those with lower life expectancy
- More material on behavioral economics and choice architecture and to bring out the risks faced by savers at retirement and throughout the pay out phase more directly
- Provide more quantified definitions of ‘clear, simple, low-cost and efficient’
- Include a direct recommendation to create deeper financial markets
- Add comments on climate change, sustainable development and economic, social and governance (ESG) objectives for (long-term) investment
- More material on mortality and precise data and tables that need to be developed
- More on funding of Defined Benefit pension plans section
- Add box on Mexican move from multi-funds to life-cycle investment funds
- Add box on Colombia (and similar cases) with constitutional as well as legal issues
- More detail on SupTech and RegTech guidelines (15 and 16)
- But cut back on other sections/simpler language to reduce overall length

Next steps

- By 21st July – any final comments on first draft to complete the mid-June to mid-July comment round
- By end July - revised draft report and guidelines following this webinar and all comments received
- August - second round of comments from countries and IDB
- End August / early September - final revision

Annex

Brief background on nature of the problem

(please refer to presentations from 6 March, 10 and 11 April and draft report for more background and explanations)

Problem of the Pay Out Phase

- The theory behind the pay out phase is often based on the lifecycle theory where individuals aim to smooth consumption by savings when working to fund consumption when working less or not at all
- Human behaviour seeks bequests and access to savings for other purposes – from 'rainy-day' funds to a new business, paying for housing and children education – but how to also ensure income
- Lots of focus in the literature on problems and products – not enough on mechanics of who delivers products, how do members choose and how to cut costs and reduce risks
- Terminology complex and used in confusing ways in different countries – especially for annuities
- Much of the complexity can be avoided with good design (particularly for members) but important for regulators and supervisors to understand the core mechanics of how to price an annuity
- Easy for wrong policy messages from study of annuity markets in large developed countries with different history, capital markets and target groups
- Important to (re)focus on central issue of how to achieve policy objective? How do most people to a decent outcome given limitations in capital markets, governance and member understanding.
- Allowing proliferation of solutions to fit everyone can lead to system that does not deliver core purpose and is expensive due to costs of adverse selection, delivery and confusion.

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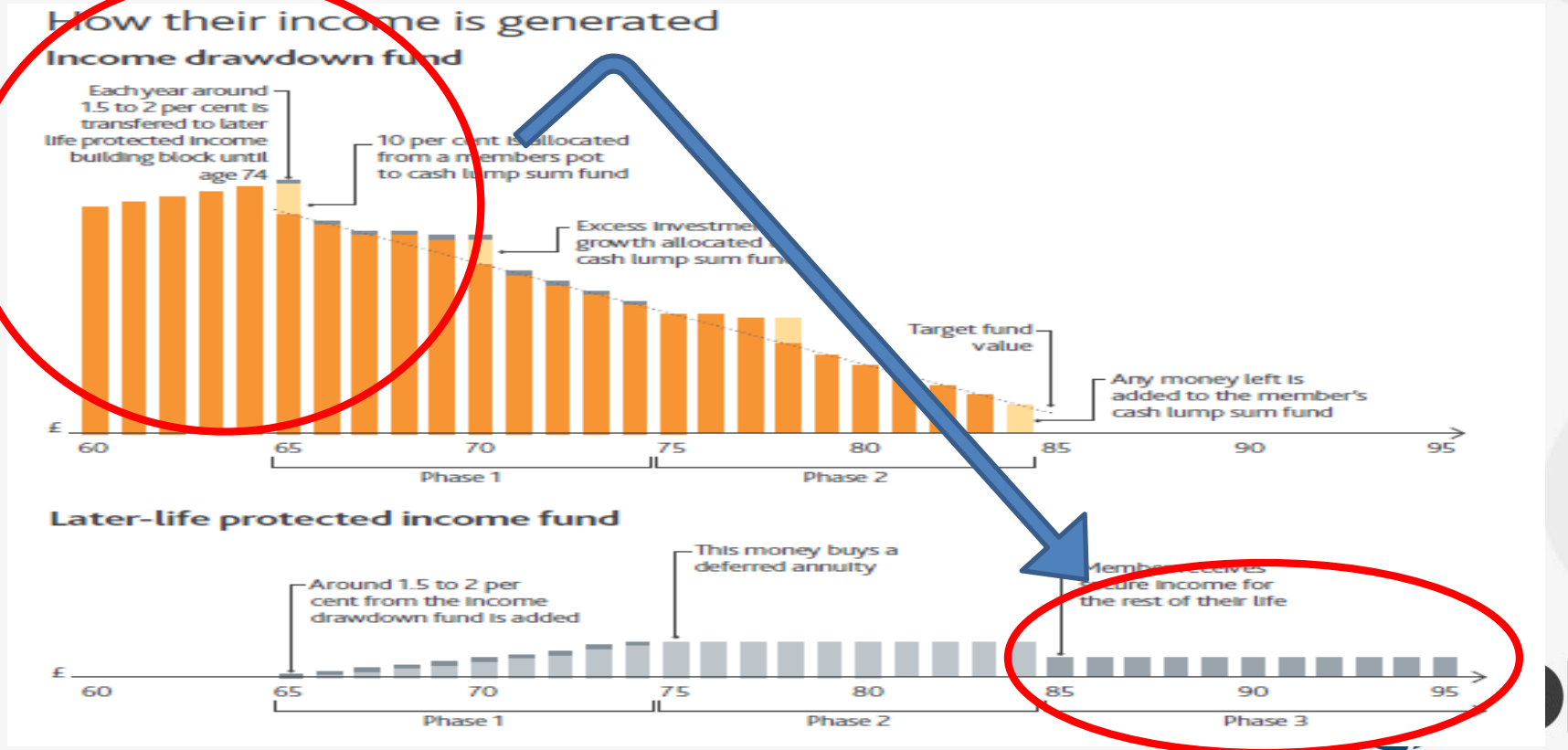
Pricing and pay out product features

- Core products (sometimes used in combination) are **annuities** (sometime paying income until death), **phased withdrawals** (some simple or naïve, some based on sophisticated decision rules) and **lump sums**.
- Annuity pricing descriptions not simple or intuitive to understand – even for regulators
- At heart is the 'annuity factor' – how much must I pay now for $1 of income until I die starting at a given date
- Typical numbers range between 10 and 20 e.g. you need $20 now to buy $1 of income for life. So $100,000 in home currency will buy you $5,000 a year for life if annuity factor is 20 and $10,000 a year for life if it is 10.
- But there are a **huge** range of factors that can impact this 'price' for future income – across different products and groups within a country and between different countries – to be explained (partially) later
- Key drivers include mortality or life expectancy – the longer you expect people to live the higher with be the annuity factor – the price of future income
- Essential to measure mortality right – but many countries have poor data and many use 'static' not dynamic mortality tables that underestimate change – but possible to make progress at any development level
- Central driver of better pay outs per $1 from an annuity compared to an individual investment fund is the 'mortality credits' – the future income of the group is shared among the surviving members.
- Without mortality credits pay outs only reflect investment returns and do not provide any guarantee there will be income to death. If large groups are not in the annuity the value falls due to adverse selection
- Along with mortality the investment portfolio and costs are very significant
- With preparation regulators can use the 'Moneys Worth Ratio' to shine a clear light on the value of pay outs

Human behaviour must be considered …

- Myopia
- Discounting / under-forecasting life expectancy
- Why do people love effective annuities from state pensions but hate annuities from funded pension
- People often want an impossible combination of certainty, high pay outs, no downside, share in the upside, access to money and a lumpsum ….
- Examples in UK, Malaysia and US among others show how strong is the desire for lump sums – and how damaging this can be to achieving the long-term objective of adequate income until death.
- Behaviour partly based on Consumption Frame v Insurance Frame
- Understand, adapt, but do not give in to all demands from members
- Fortunately, many of same problems in the accumulation phase and many similar solutions
- Strong role to use centralised quotation or auction systems (and playing around with options on a quotation platform is a good way to understand what drives costs of annuities)

A mix of phased withdrawal, some lump sum and a deferred annuity has the potential to provide solutions to the 3rd and 4th age of retirement



Source: NEST Pensions UK 'A Blueprint for Retirement Income'