



ANNUITY PRODUCTS

Project outline 2013-2014

The OECD's Insurance and Private Pension Committee has agreed to a coherent multi-year project on annuities for the program of work 2013-2014. What follows describes the project on annuities as agreed by the IPPC in its meeting of June 2012.

Background

The OECD Insurance and Private Pension Committee (IPPC) and its Working Party on Private Pensions (WPPP) have conducted a considerable amount of work on annuities over the last few years. The main message from this work is that annuity products are essential instruments for the structuring of the pay-out phase, in particular for defined contribution pension plans, as they may be able to provide protection against longevity risks.

Unfortunately, the work of the IPPC and WPPP also shows that the market for annuity products is fraught with problems, particularly given the multiplicity of types of annuity products available on the market. On the demand side, annuities are often, given their structure (e.g., linkage to market returns), viewed as investment instruments and as such they may be perceived to be unattractive, for instance given the cost of built-in guarantees may be passed on to consumers. Yet annuities are "insurance" products in that they provide some form of costly protection against risk, be it longevity, mortality, or financial risk.

The classical fixed pay-out deferred annuity is designed, for instance, to protect people against outliving their resources. Such annuities also help to smooth out consumption as an individual moves from working life into retirement. Unfortunately, people underestimate their life expectancy and thus may not value longevity risk protection, which raises general issues regarding the perception of annuities and the costs of underlying protection.

On the supply side, annuity markets may suffer problems of adverse selection affecting pricing, incomplete markets (e.g., lack of inflation protection), concerns with regulatory capital requirements for the risks involved, as well as exposure to uncertainties surrounding future mortality and life expectancy and the lack of adequate financial instruments to help in hedging longevity risk.

Most of the OECD's work has focused on the supply-side problems of annuity markets, and in particular the management of longevity risk and potential capital market solutions to hedge longevity risk. While future work could address supply issues, it should also address demand factors such as the impact of tax treatment and the lack of innovative products that could address some of the needs of potential annuity buyers. Future work could also examine both demand and supply considerations in annuity design, for instance how recent innovations in annuities could be involving a shifting of risks, possibly to the detriment of consumers.

The IPPC programmed of work for 2011-12 envisaged some work on annuities and the pay-out phase, given the role of annuities as a key product that can meet the needs of those in the pay-out phase of defined contribution pension plans. The programmed of work for 2013-14 foresees further work on annuities. For instance, interest has been expressed in undertaking a global survey of annuities to obtain a better understanding of their availability, design features, and pricing. There is also interest in improving market

conduct and disclosure practices surrounding the sale of annuities. Further, the role of annuities in the pension pay-out phase continues to remain a topic of interest, although combined with interest in the operation of financial products such as reverse mortgages that allow housing wealth to be tapped for current income.

Main objective

The purpose of this project would be to improve an understanding among OECD countries of the problems facing annuity markets by focusing more closely on the nature of the guarantees provided by annuity products and their costs for insurance companies and consumers.

The main objective is to assess the different types of annuity products and the nature of the guarantees involved, identify the exposures and costs of annuity products for insurers and consumers in light of their characteristics and guarantees, and comprehend better insurer risk management of annuity products and the regulatory framework governing annuity products given the guarantees provided. Separately, but linked to such a structured examination, an objective is to review the fiscal treatment of annuity products, including the treatment of income from these products.

Structure for project

i) Stocktaking of annuity products

Consequently, the first component of the project would be to examine the different types of annuity products in different countries, particularly those with the largest annuities markets. This study would seek to build a robust taxonomy of annuity products based on the features of annuity products and particularly on the nature of the various guarantees or protections offered.

This component could examine products that are structurally equivalent to annuities but not labelled as such and could also examine more recent, innovative products that for instance involve a greater degree of risk sharing between annuitant and annuity provider or that combine different benefits, such as pension annuity payments and long-term care coverage.

This component could assess some of the advantages and disadvantages of different types of annuity products, including more recent innovations. For instance, annuity markets and prospective annuitants may benefit from innovative annuity products such as variable annuities that provide access to capital gains at retirement, reverse annuity mortgages that permit tapping into housing wealth, participating annuities where risks are shared by annuitant and providers, and products that combine several features. However, the advantages and disadvantages of these different types of annuities need to be assessed in light of their design features and the needs, objectives, and level of sophistication and risk tolerance of consumers purchasing these products.

Given the importance of risk management in the offering and structuring of annuity products, this component could begin an exploration of how the risks linked to annuity guarantees are managed by insurers, often actively through financial market operations. This examination could help in understanding the design features of annuities, the costs and pricing of guarantees, and possible misalignment of incentives given asymmetric information. It could also help in understanding how changes in financial market conditions and actuarial trends (e.g., longevity) have an impact on product design, with resultant impacts on consumers. For instance, the evolution of annuities products since the onset of the crisis may shed some light on insurer risk management of annuities and its impact on annuity product design.

Insofar as a sound taxonomy is established and operationalisable, it could provide the basis for a data collection effort. This effort would be voluntary in nature, involving interested companies and/or countries, and would be undertaken only should adequate resources be secured.

ii) Risk management, regulatory framework, and consumers

The second component could explore in greater detail insurer risk management of annuity products (particularly guarantees linked to these products), the regulations governing reserves and capital for different type of annuity products based on the nature of the guarantees, and consumer protection and financial education issues. For instance, such a study could seek to assess whether innovative products allowing for risk-sharing between annuitant and provider is being driven by risk-based capital requirements, enhancing its attractiveness for providers, but potentially introducing risks for consumers.

The component could explore possible tensions between imposing strong prudential and market conduct requirements on annuities and ensuring adequate supply of annuity products that meet the needs of consumers. Individuals may be attracted to products where they obtain stronger guarantees (although they may be more costly). A high degree of consumer protection and sound disclosures may, additionally, make prospective buyers of annuity products more likely to purchase them. However, annuity guarantees backed by high levels of capital may threaten supply and, through increased costs, reduce consumer demand.

iii) Fiscal treatment of annuity products

The third component of the project could examine the fiscal treatment of annuity products. It is important to understand the difference in tax treatment of annuities across countries. In some countries, there may be tax incentives to take accumulated pension assets out as lump-sums or to have programmed withdrawals, creating an implicit disincentive for annuity products. Moreover, income payments from annuity products could be treated as normal income and taxed at the same rate as other income, may be tax free, or may be taxed as capital income. Sometimes, the tax treatment of an income stream from an annuity held within personal assets (unrelated to retirement saving) may differ from the tax treatment of the same income stream from an annuity product linked to a retirement saving plan. The analysis in this section would draw on future work being planned on tax incentives and retirement savings.¹

iv) Policy recommendations

While policy issues and recommended policy measures could be identified within any one of these components, a final last step in the project could involve a distillation of outcomes through the development of policy recommendations and guidelines. In this context, the discussion could revisit previous work on the issue of whether the purchase of annuities at retirement with the accumulated assets in defined contribution plans should be mandatory or voluntary.

The OECD Insurance and Private Pension Committee (IPPC) and its Working Party on Private Pensions (WPPP) approved the project as part of their program of work in their meetings in June 2012 and June 2013, respectively

1. The European Commission (DG Employment) and the OECD are launching a project on tax incentives and retirement for 2013-2015.