Payout Solutions for Funded Pensions

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(EIOPA-Meeting, February 2017)

- Welfare implications of product choice regulation during the payout phase of funded pensions (Horneff/Kaschützke,Maurer/Rogalla 2014, JoPEF)
- Putting the pension back in 401(k) plans: optimal versus default longevity income annuities (Horneff/Maurer/Mitchell 2016)
Motivation

With $5$ trillions invested in defined contribution pension plans, “many retirees face the daunting task of determining an appropriate spending and investment strategy for their accumulated savings”. Prof. William Sharpe 2007 Meeting of the Wharton Pension Research Council.

What are basic risk categories?
• Investment risk, longevity risk, inflation risk, credit risk

Who stands to help retirees managing their money in retirement?
• Life insurers offering payout life annuities (pooled solutions);
• Asset managers offering systematic drawdown plans (non-pooled solutions);
• Integrated products using both

What is the role of the state as a regulator?
• Regulate product quality and product choice (mandatory annuitization?)
• Ensure steady tax income
Basic types of payout solutions for funded pensions

- **Pooled solutions** (life annuities):
  - **Idea**: Transfer retirement assets into a lifelong income stream
  - **Types**: Fixed-, participating-, investment linked-, immediate-, deferred annuity
  - **Pro**: (Guaranteed) lifelong income and “survival credit”
  - **Con**: Low flexibility & liquidity, no bequest & control over retirement assets, credit risk

- **Non-pooled solutions** (drawdown plans):
  - **Idea**: Keep retirement assets in mutual funds and make periodic withdrawals
  - **Types**: Asset Allocation (stocks, bonds, balanced), **Payout rules**: 4% p.a., 1/LE)
  - **Pro**: High liquidity & flexibility, bequest and control over assets
  - **Con**: No “survival credit”; could *(but not must)* be subject to longevity-/investment risk

- **Integrated Solutions** (drawdown plan + annuities)
  - Partial annuitization at retirement
  - Dynamic (gradual) annuitization
  - Deferred annuitization *(Longevity Income Annuity)* at advanced age (e.g. 85) are cheap and effective instruments to protect against longevity risk; US 401(k) plans; German Riester plans

- **Lump sum payments**
Optimal retirement strategy – integrated solutions can offer higher benefits while having efficient risk controls

- Economic research *(household finance)* on optimal retirement strategies shows the importance to consider the interaction between life annuities and drawdowns (including equity stock positions) during whole retirement period.

- Determinants of optimal payout strategies: Pre-existing lifelong retirement income (i.e. state pension), accumulated funds, health & family status.

- Regulation of product choice:
  - *Economic costs* of mandatory (full) annuitization could be very high (low interest rates; preferences, individual needs)
  - Allowing longevity income annuities (e.g. at age 85) as default solutions

- It is difficult for the average retiree to implement an optimal retirement strategy without professional help *(advice and/or cost-efficient integrated products)*

- Default solutions (opting out) are important and welfare enhancing
Next steps ……

- Part 1: Characteristics of payout solutions
- Part 2: Economic modelling of optimal payout solutions and international experiences
- Part 3: Implications for products (default options; regulation; advice)
Some literature

“Asset Allocation and Location over the Life Cycle with Survival-Contingent Payouts”, (Horneff/Maurer/Mitchell/Stamos) in: Journal of Banking and Finance 33, 2009, 1688-1699


“Deferred Annuities and Dynamic Portfolio Choice (Horneff/Maurer/Rogalla) in: Journal of Banking and Finance 34, 2010, 2652–2664”


“Lifecycle Portfolio Choice With Systematic Longevity Risk and Variable Investment-linked Deferred Annuities” (Maurer/Mitchell/Rogalla/Kartashov) in: Journal of Risk and Insurance 80, 2013, 649-676 (also NBER WP 17505)


