Panel 4: Routes to Delivering Sustainable Retirement Outcomes—Different Concepts for Differing Risk Appetites

Robert Higginbotham, Moderator
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More Centenarians than ever before!

Allianz

1. Globally we clearly notice continuation in longevity improvement.
2. While it is not new in developed world, the new trend for growing centenarians is at the rate of 4% to 5% as per various studies.

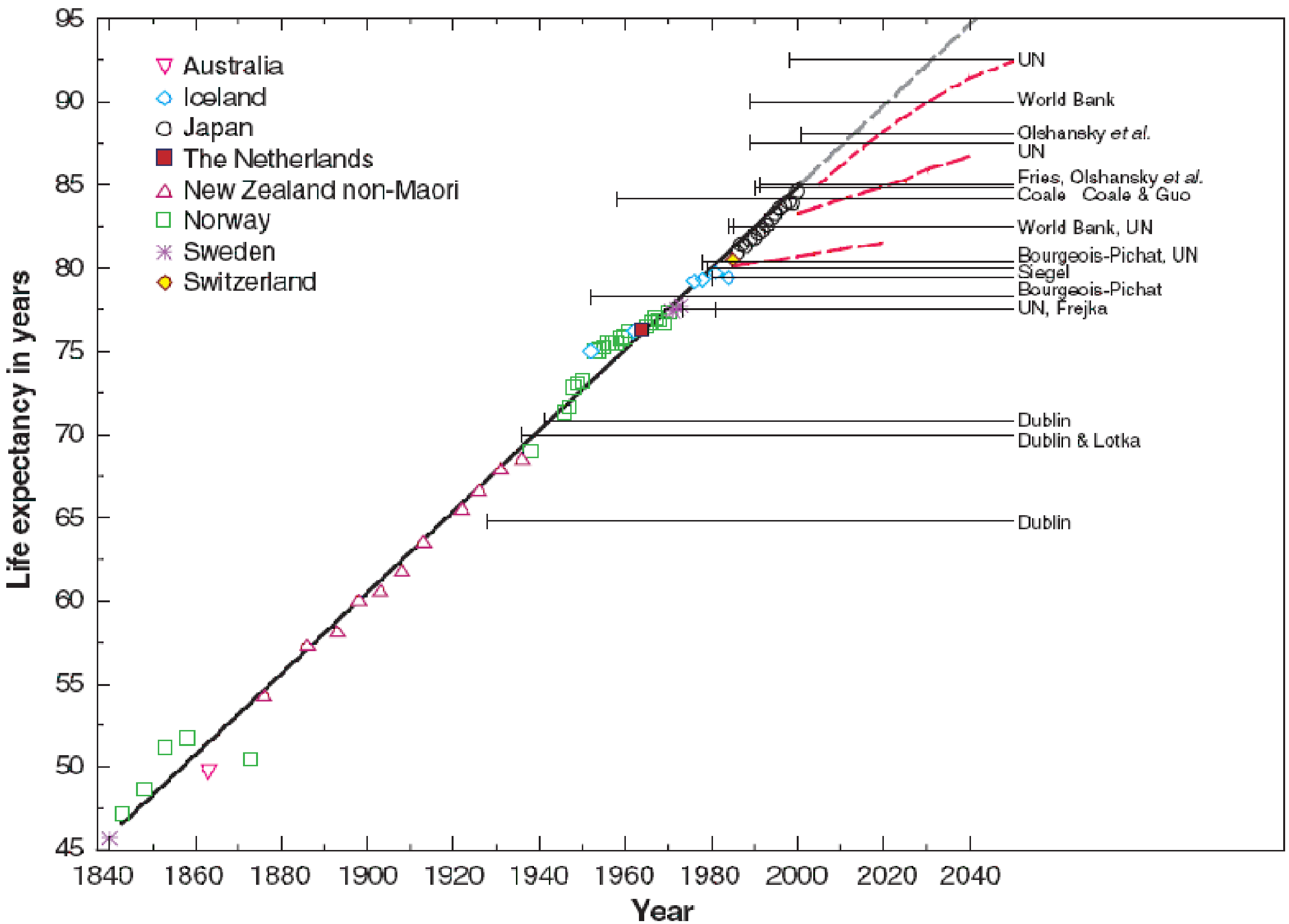
Robert Meier

- 109 when he died
- Retired for 46 years

Irving Kahn

- Oldest active investment banker.
- Have two siblings who crossed 100.

Increasingly people are outliving their life expectancy at retirement



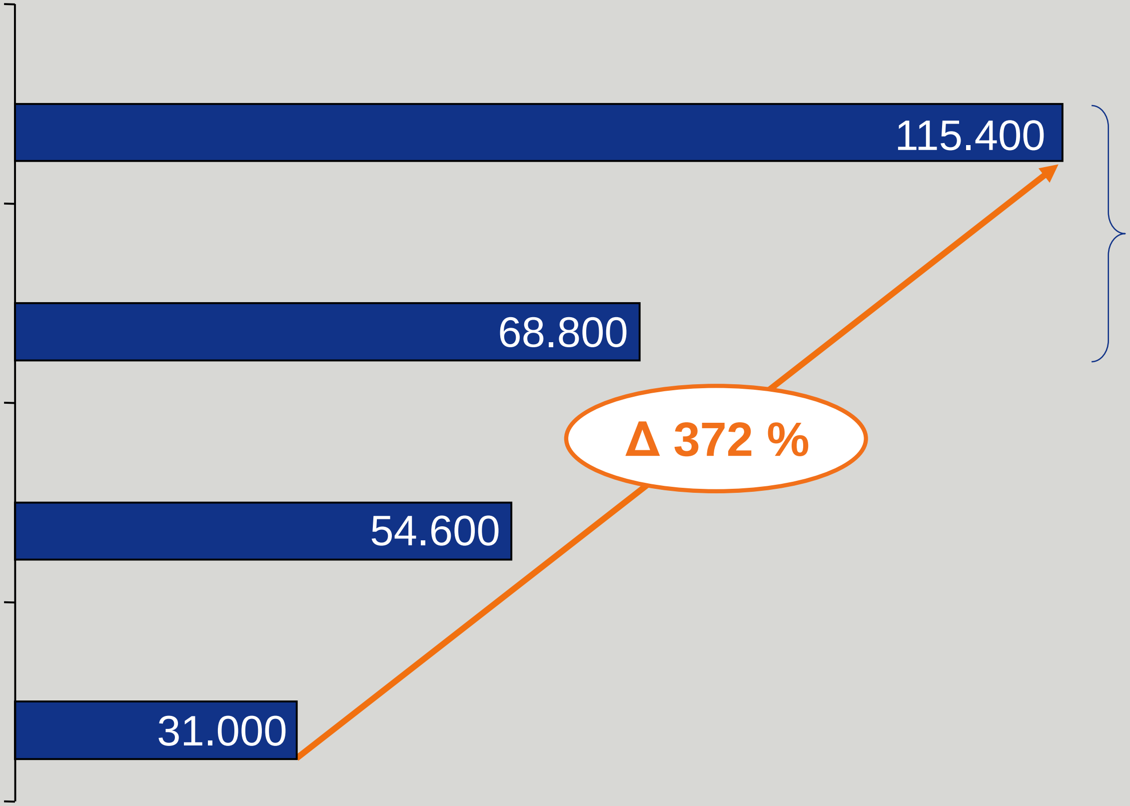
Source: Jim Oeppen, James Vaupel; Max Planck Institute for Demographic Research; (May 2002).

Cost and Risks in Long Term Retirement

Value of Robert Meier's fictitious pension (in €)

Retired with 63 years

Monthly annuity: **€ 250**



PV of payment over 45 years

PV of payment over 25 years

Single premium for buyout
(via an insurance solution)

Value of book reserves linked to life expectancy of age 63 in 1961 (§ 6a EStG)

What is the new normal: A € 1M ?

Retirement income duration sensitivity (German example)

Baseline	Event	Runs out of money at
▪ Couple retiring at age 65 with EUR 1 million in assets ▪ Real equity/fixed income returns of 3.9% ▪ Life expectancy of 86 years	3 years of a bear market (e.g. 2008 - 11)	78 years old
	3 years of 7% inflation	83 years old
	Husband admitted to a nursing home at 75	83 years old
	Husband and wife live on to 95	88 years old

Further assumptions: equity allocation 30% with 6% p.a. return, fixed income allocation 70% with 3% p.a. return, monthly redemption EUR 5,000, monthly nursing home costs EUR 3,000, inflation rate 1.5%.

Pensions are about carrying risks

Main risks

- Longevity risk
- Investment risk

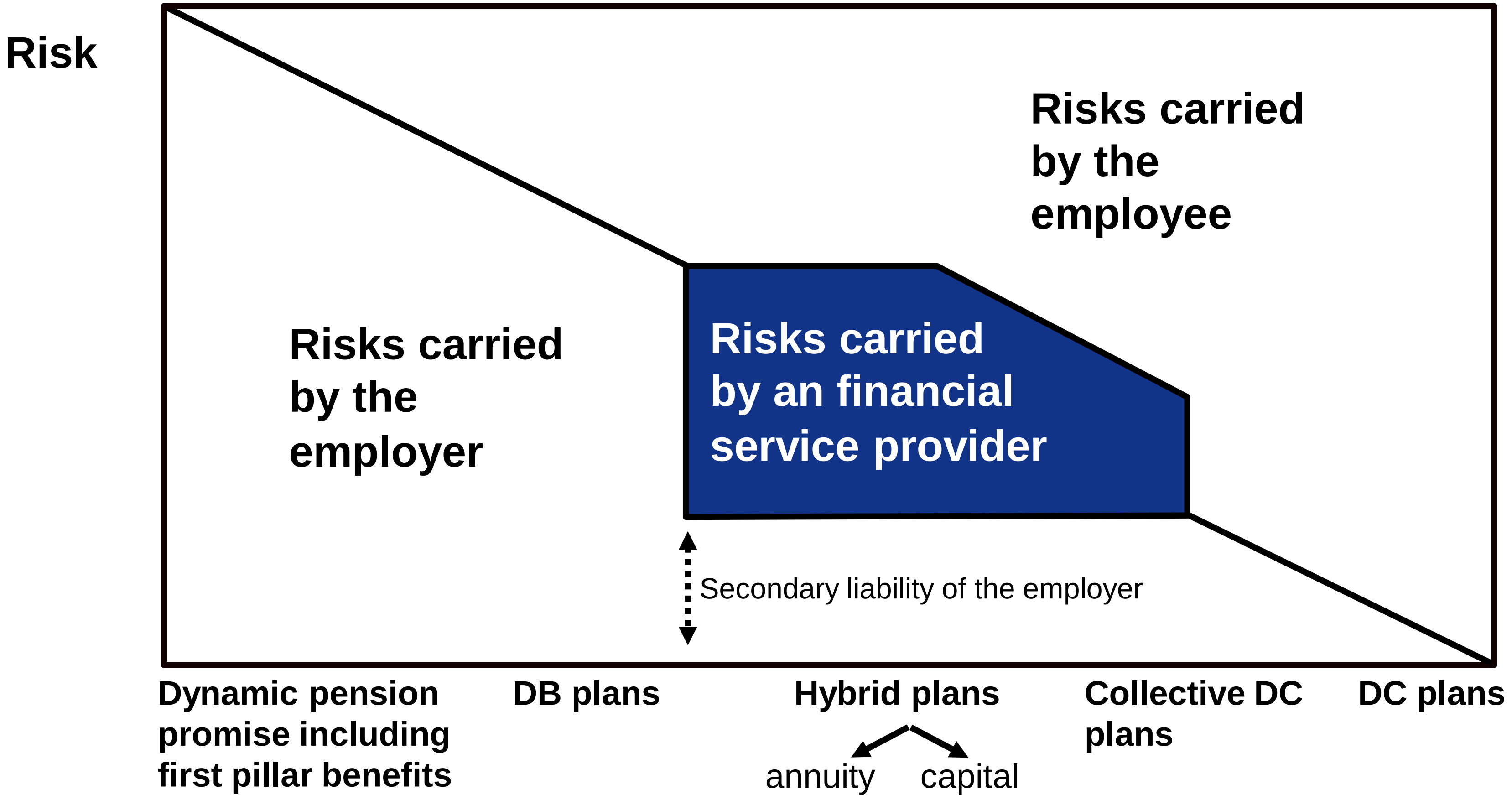
Secondary risks

- Taxation risk
- Legislative changes
- Death & disability
- Career breaks

Who is carrying the risks?

Risk distribution in 2nd pillar schemes

Collective solutions provide better risk management framework



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Solutions for variable pensions in Switzerland

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Swisscanto Holding AG
Gérard Fischer, CEO

Hotel President Wilson, Geneva, 18 June 2014

Swisscanto

Developments in Switzerland Tend to Favour Variable Pensions

Developments

- Longer payout period because of increasing life expectancy
- Financial transfer from active insured persons to pensioners

Existing Variable Pensions Models

1. Model based on gains and losses every three years:
   - Splitting of pension in a fixed and a variable part; slow reaction if returns are volatile
2. Old age pension in relation to the funding ratio:
   - Pension can be adjusted according to the financial situation of the pension fund
3. Old age pension in relation to recovery contributions:
   - Pension can be adjusted according to the financial situation of the pension fund and pensioners also contribute to the recovery
4. Old age pension in relation to the granted interest rate on the savings capital:
   - Old age pensions and interest granted on the savings capital are similar

New Variable Pensions Model for Switzerland

Existing variable pension models…

- … invest the pensioner's capital like the assets of the active insured persons

New model for variable pensions

- The pension fund offers different investment strategies for the capital of the old age pensioners
  1. Depending on the chosen investment strategy, the guaranteed pension is higher or lower according to the degree of risk of the investment strategy (the higher the risk the lower the guaranteed part)
  2. Investment strategies from conservative (focus on fixed income) to balanced to progressive (focus on equity) to risk-oriented (i.e. target risk)
  3. Pensioners can choose the appropriate investment strategy according to their risk ability and risk tolerance

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Payout-Solutions for Funded Pensions

Raimond Maurer

(Genf 2014)

Presented by Bernard Delbecque

(download see **Rethinking Retirement Income Strategies – How Can We Secure Better Outcomes for Future Retirees? By Raimond Maurer and Barbara Somova,** *http://www.efama.org/)*

Motivation

With trillions invested in self-directed 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.*

Who stands to help retirees managing their money in retirement?

- Insurance companies offering payout life annuities;
- Asset managers offering systematic drawdown plans;
- Both via integrated products?

Pooled versus non pooled payout solution: the key idea

- *Simple 1-period example:*
  - *Alternative 1: direct bond investment*
  - *Alternative 2: invest in bonds through annuity*

- *Interest rate: r = 2%, survival prob.: p = 80%*

Initial Investment	End-of-year payoff (RoI): Alive	End-of-year payoff (RoI): Dead
(1) 100 (in bond)	100(1+r) =102 (RoI = 2%)	100(1+r) =102 (RoI = 2%)
(2) 100 (in annuity)	100(1+r)/p =127.5 (RoI=27.5%)	0 (RoI= -100%)

Survival Credit = 25.5

Sufficient compensation for disadvantages ?

Basic types of payout solutions for funded pensions

- **Pooled solutions** (life annuities):
  - **Idea**: Transfer retirement assets into a lifelong income stream
  - Pro: Offer (guaranteed) life long income and “survival credit”
  - Con: Low flexibility / liquidity, no bequest, no control over retirement assets, etc.
  - Coverage: In Europe high; state pensions, DB-plans, DC-plans with mand. annuitisation
  - Voluntary use of life annuities is internationally very low

- **Non-pooled solutions** (drawdown plans):
  - **Idea**: Keep retirement assets in mutual funds (stocks, bonds, balanced, total return) and make periodic withdrawals based on rules (e.g. 4% per year, 1/LifeExpectancy, etc.)
  - Pro: High liquidity / flexibility, bequest, potentially higher benefits, control over assets
  - Con: No “survival credit”. Could (<u>but not must</u>) be subject to longevity-/investment risk
  - Coverage: In Europe relatively new arrangement. Many programs still in saving phase (Riester, Perco, etc.). USA: most retirement funds are used by periodic withdrawals
  - Increase in the survival prob. used to price annuities (discrepancy compared to general population life expectancy) has enhanced attractiveness of drawdown plans

- Non-pooled solutions are not inferior to pooled solutions.

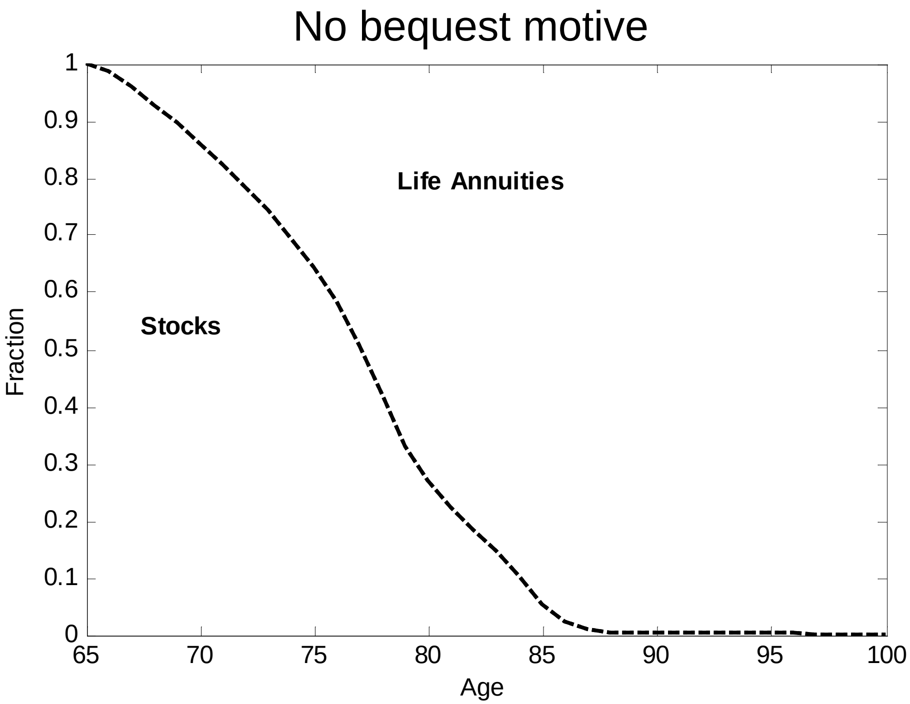
Integrated payout solutions combine characteristics of annuities and drawdown plans

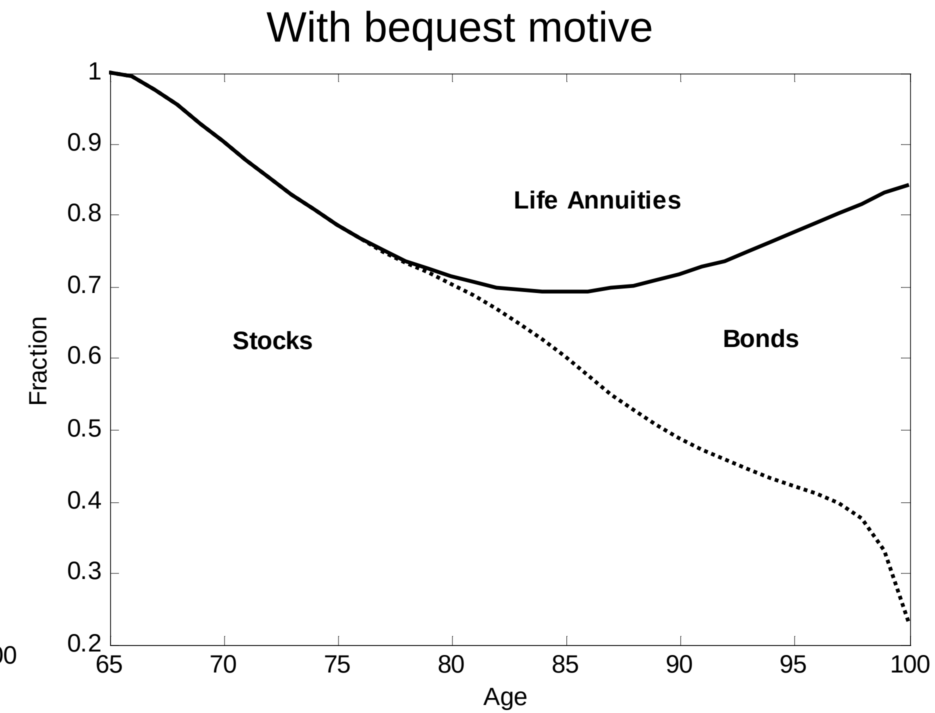
- **Partial Annuitization** :
  - Withdrawal Plan + Immediate payout annuity at retirement
  - Example: Invest 50% of assets in withdrawal plan based on mutual funds, invest 50% in life annuity

- **Switching Strategy:**
  - Start with withdrawal Plan than switch at later age to annuities
  - Example (old UK solution): retire at 65, make withdrawals until age 75, switch remaining assets into life annuity at age 75

- **Deferred Annuitization** (Longevity Risk Insurance)
  - Combine Withdrawal Plan and Deferred Annuity with payments starting late in life (e.g. age 85)
  - Example: At retirement at age 65 use about 25% of asset to buy a deferred life annuity starting payments at 85. Invest the rest in withdrawal plan using mutual funds

Results: optimal dynamic expected asset allocation





Moderate wealth/pension ratio (=5), moderate risk aversion; 10’000 life cycle, optimal feedback controls

- First 10 years of retirement predominantly invested in (well diversified) stock portfolio
- Gradual shift from stocks into annuities with increasing age
- Without bequest motive, almost complete switch to annuities at the age of 87
- With bequest motive maximum investment in annuities is 30 %
- THIS IS NOT A STATIC BUT DYNAMIC STRAGEGY (reaction necessary)
- How can we explain the <u>initial</u> high exposure to stocks?

Prof. Dr. Raimond Maurer

Prof. Dr. Dr. h.c. Raimond Maurer currently holds the Chair of Investment, Portfolio Management and Pension Finance at the Finance Department of the Goethe University Frankfurt. His main research interests focus on asset management, insurance, life-time portfolio choice, and pension finance. He received his habilitation, dissertation, as well as diploma in business administration from Mannheim University and has various experiences in policy and industry consulting (e.g for the Worldbank, European Central Bank, FED, Sozialministerium Baden Württemberg, EU-Commission, e.g.). Dr. Maurer holds several professional positions like at the Union Real Estate Investment (Member of the Supervisory Board), the Society of Actuaries (academic chairman of AFIR group), the Association of Certified International Investment Analysts (academic director and member of the International Examination Committee), and the Pension Research Council at the Wharton School of the University of Pennsylvania (member of advisory board). He holds a degree of a honorary doctor from the State University of Economics St. Petersburg. Dr. Maurer has published several books and more than forty refereed articles in various international journals, including Review of Finance, Financial Analysts Journal, Journal of Portfolio Management, Journal of Asset Management, Journal of Risk & Insurance, Journal of Banking & Finance, or the Journal of Economic Dynamics & Control. Prof. Maurer currently is Vicedean for Finance and Member of the Senate of the Goethe-University of Frankfurt.

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Coverage & Costs

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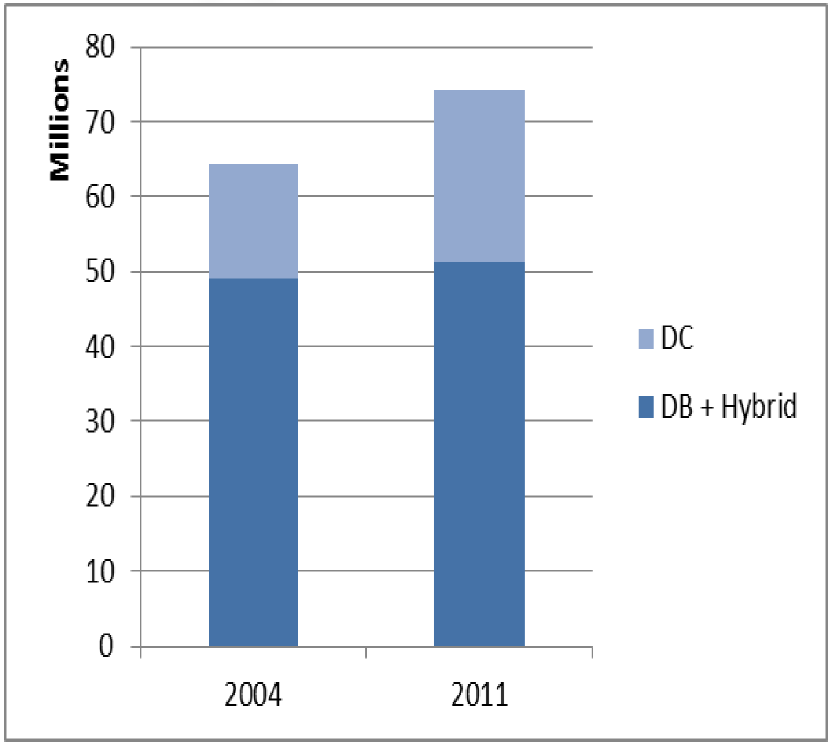
2014 Global Retirement Savings Conference
Common Principles for a Diverse World
17–18 June 2014
Geneva, Switzerland

Matti Leppälä, CEO PensionsEurope

COVERAGE

Membership in private pension schemes



Country	As a % of the working age population	As a % of the labour force
Australia	85.7	90.6
Germany	47.1	51.6
Netherlands	88.6	93.4
Spain	18.6	22.7
United Kingdom	43.3	53.0
United States	47.1	56.7

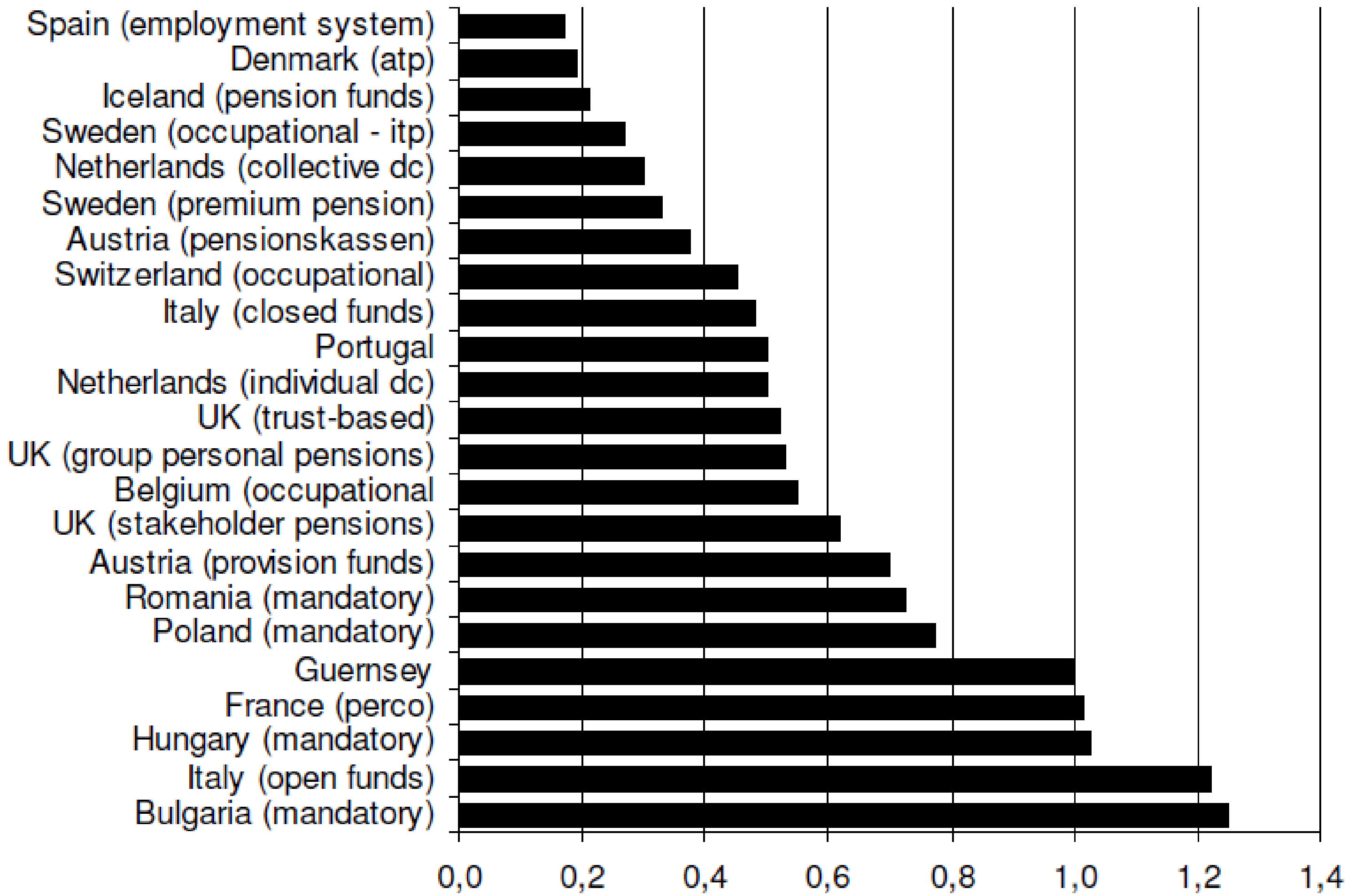
Different options:

- Mandatory
- Quasi-mandatory
- Voluntary

Sources: EC and OECD (Antolin, Payet and Yermo, 2012)

COSTS

Administration and investment costs, % of assets



Source: EFRP Survey 2010

IORP II proposal

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Article 49

Balance, contributions and costs

1. With regard to balance, contributions and costs, the pension benefit statement shall indicate the following amounts expressed in the currency relevant for the pension scheme:

(a) the sum of the costs deducted from the gross contributions paid by the sponsoring undertaking, where applicable, or by the member over the past twelve months, or, if the member has joined the scheme less than twelve months ago, the sum of the costs deducted from their contributions since joining;

…

(f) the costs referred to in point (a) broken down into the following separate amounts expressed in the currency relevant for the pension scheme:

(i) costs of administration of the institution;

(ii) costs of safekeeping of assets;

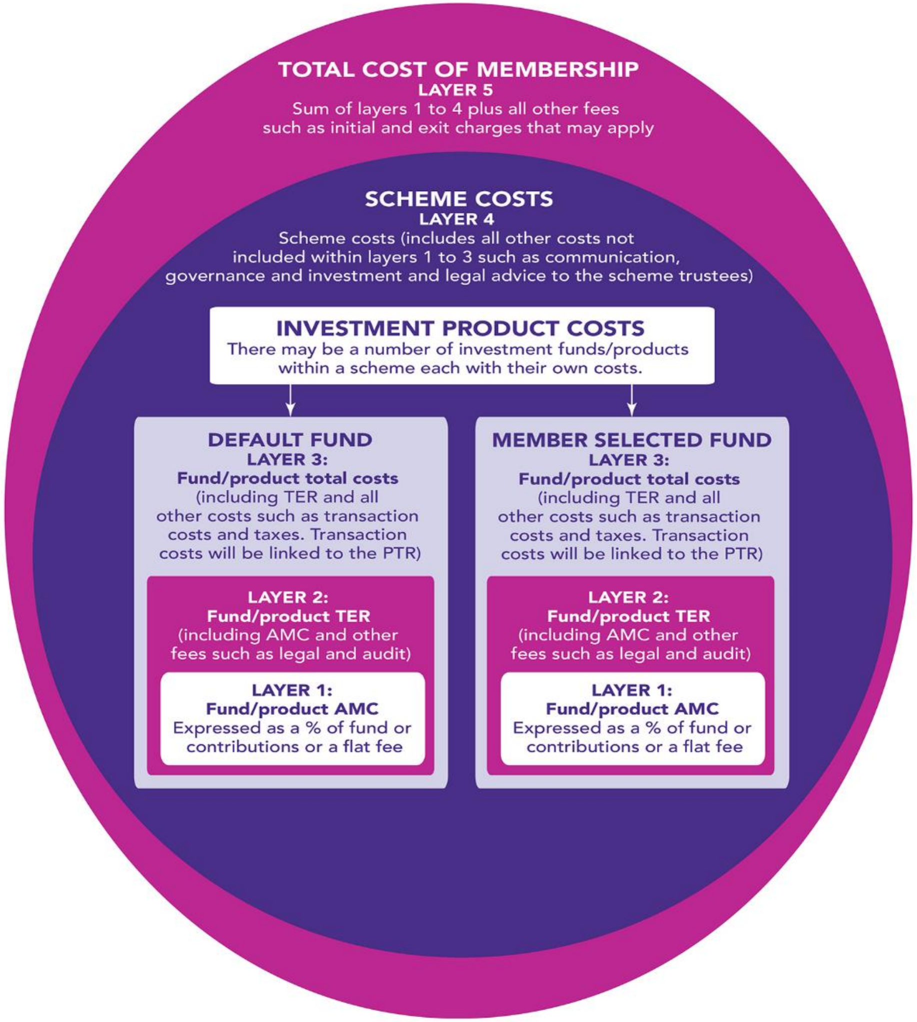
(iii) costs related to portfolio transactions;

(iv) other costs.

2. The 'other costs' referred to in paragraph 1 (f)(iv) shall be briefly explained where they account for 20% or more of the total charges.

Costs & Charges: UK example

Figure 1: The different layers of costs and charges on member savings



Source: The Pensions Regulator

- There are different ways of expressing pension scheme or investment fund costs and charges.
- Understanding the different terms will help you to assess the impact on member's pension pots and review value for money.
- Monitoring and reviewing costs and charges on scheme investment products is important in order to check that these are consistent with their investment strategies.

EU Code of good practice

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- Following the White Paper on pensions, the EC set up a Working Group on a code of good practice for occupational pension schemes.
- EC came up with the following elements of good practice:
  - Adequacy
  - Safety
  - Cost-Effectiveness and transparency
  - Flexibility
  - Governance

Existing codes: UK example

- Pensions Charges Made Clear: Joint Industry Code of Conduct – telling employers about DC pension charges

- Developed by a working group of cross-sector organisations, the Charges Code of Conduct sets the standard for providing clear and accurate information to employers about costs, charges and associated services when they are selecting a Defined Contribution pension in which to enrol their workers under the new pension reforms.

- The Code applies to all parties providing services to employers in setting up and administering pension schemes for the purposes of automatic enrolment.

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