CROSS BORDER BENEFITS ALLIANCE EUROPE

Brussels, the 11th of April 2019

Reflection paper on new strategies for decumulation

Preamble about the Cross Border Benefits Alliance-Europe (CBBA-Europe)

The Cross Border Benefits Alliance-Europe (CBBA-Europe), is a Brussels based advocacy organization (Belgian AISBL) promoting the creation of cross border and pan-European social benefits in the European Economic Area (EEA), including pensions (occupational and individual), healthcare insurance, unemployment benefits, long term care insurance, etc.

Indeed, CBBA-Europe considers the current excessive fragmentation of national social systems as detrimental to the creation of a European common market based on economies of scale and on the removal of costly and burdensome barriers in particular for citizens; but also detrimental to free movement of services, capitals and persons; and to the potential accumulation of huge capitals to be invested in the European economy, in accordance with the Capital Markets Union (CMU) to foster much needed growth and employment.

More generally, CBBA-Europe wishes the European Union to become a more interconnected economic and social area, where both economic competitiveness, with more efficiency in delivering benefits, and the protection of social rights assured to companies and citizens.

As for its structure, CBBA-Europe is a transversal Alliance made up of stakeholders with different backgrounds, including multinational companies, trade unions, asset managers, pension funds, insurance companies, consumers' organizations, national and international trade associations. Just created in October 2017, CBBA-Europe already has twenty members, and is still rapidly growing.

CBBA-Europe also relies on a Scientific Council made up of well-known experts and professors from the most prestigious Universities of Europe. The Scientific Council provides content for the half-yearly CBBA-Europe Review, which is available on the website of the Association.

Finally, in addition to its activities of monitoring and publication of position papers, CBBA-Europe organizes several public meetings throughout Europe with national and European decision makers and stakeholders.

For more information about CBBA-Europe, please visit our website: www.cbba-europe.eu

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Reflection paper

New Strategies for Decumulation[1]

As people live longer and several countries are reforming their pension framework, there is an increasing debate about the best solutions for the decumulation (after retirement) phase. For individuals, the choice between converting the accumulated capital into an annuity, taking it as a lump sum, or investing it is a crucial one. We start by discussing the pros and cons of the existing solutions, before setting out the foundations for what could be a flexible retirement savings solution tailored to the needs of every individual.

Polar-opposite solutions

In most European countries, two polar-opposite solutions are usually offered for the decumulation phase: savers can either convert their capital into a **fixed annuity** at retirement, or decumulate it by themselves or via **phased withdrawal strategies**. Each solution has its advantages and disadvantages, but neither, taken in isolation, is perfectly suited to an individual retirement savings solution.

The main attraction of a **life annuity** for individuals is that it allows them to insure against longevity risk, i.e. the risk of living longer than expected, while benefitting from "mortality credit", which is the gain resulting from the fact that the funds contributed by individuals who die early are shared between those who live longer. But life annuities guaranteeing a fixed income have been very expensive since several years because of the extremely low level of interest rates.

These products force the insurers who sell them to invest the corresponding capital in low-risk assets in order to provide the guarantee. Also, fixed annuities (offering guaranteed nominal income) offer no protection against inflation and no possibility of continuing to invest in risky assets in order to obtain a potentially higher level of income. Finally, life annuities are irreversible. They prevent, in their simplest form, any possibility of handing down part of the capital to one's heirs or of recovering it in the event of liquidity needs related to unforeseen expenses.

Individuals often prefer **phased drawdown strategies**, where they can choose a withdrawal formula for their funds throughout the retirement period. This could be a fixed percentage of the capital each year, or a variable fraction of the capital that may depend on residual life expectancy. Such strategies allow savers to continue to invest in risky assets and to bequeath capital to their heirs. But individuals run the risk of exhausting their capital before death, even if in practice this risk can be mitigated, for example by adopting investment

[1] *Many thanks to* Marie Brière*, Head of Investor Research Center, Amundi ; Affiliate Professor, Paris Dauphine University ; and Senior Affiliate Researcher, Université Libre de Bruxelles, for inspiring this CBBA-Europe paper.*

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strategies hedging against market drawdown or by adjusting withdrawals according to income and capital gains.

Little appetite for life annuities, or the Annuity Puzzle

In practice, in countries where the choice is offered between these two types of products for decumulation, people show little appetite for life annuities and prefer phased withdrawal strategies. In Australia, for example, where individuals are offered three choices, almost 50% choose to recover their capital, while 50% choose programmed payments that allow them to invest in risky assets. A small minority – less than 1% – choose to buy an annuity. In the United Kingdom, the 2014-2015 pension freedom reform eliminated mandatory annuitization and dramatically reduced the total value of contracts sold, in favor of planned withdrawal strategies. In France, mandatory annuitization also hindered the development of the PERP, and the new PACTE law currently under discussion should offer full flexibility for the decumulation.

One size does not fit all: Customization is key

Retirement needs are complex, evolving and heterogeneous, they can be grouped into three main objectives.

First, people want to secure their essential consumption needs. Consumption needs in retirement are also not constant over time. A first active phase must cope with higher consumption needs (ongoing projects, dependent children or grandchildren, etc.). Next, health can deteriorate while consumption needs usually decrease. At the end of life, health and dependency expenditures tend to increase again.

Second, they need to cope with liquidity needs, i.e. exceptional unforeseen expenses, with a “rainy day” fund.

Third, they may wish to transfer capital to their heirs. With this regard, we are well aware that a pension vehicle should be primarily about generating income in retirement and the ability to pass on assets should always be a secondary consideration. This is particularly so, given the level of pension accumulation is so low in many countries that most will not have enough for themselves let alone heirs. However, the question of capital transfers to heirs should be still taken into consideration.

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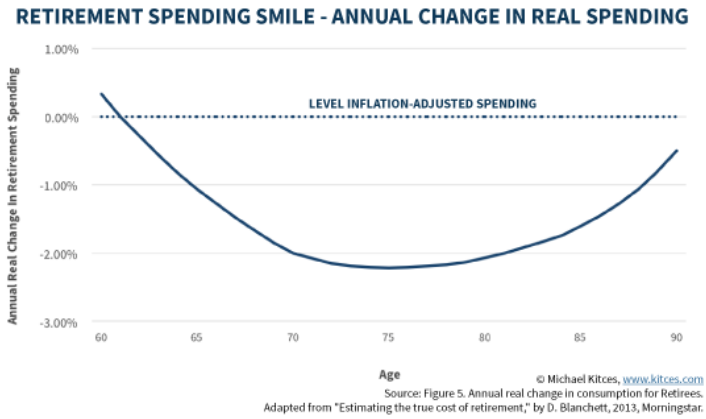
Fig 1: Consumption needs during retirement



But individuals' needs are multiple, and above all, crucially depend on personal situations. Retirement coverage of the first-pillar pension system can differ dramatically depending on the individual's situation (country, working status, etc.). Retirement needs are also shaped by consumption, other sources of wealth (for example housing equity), family situation (including bequest intentions), liabilities (mortgage, credit card debt), tax position, risk attitude and so on.

Some people, for example, still have ongoing loans and wish to reduce their debt when they retire. Others must finance their children or grandchildren. Couples have lower longevity protection needs than single people. Individuals with children often wish to bequeath part of their capital.

What is the best decumulation solutions?

The optimal strategy for retirement uses both **investment products and annuities**. First, it is crucial to continue to invest in risky assets after retirement in order to benefit from the associated risk premium (and hence the excess expected return). Theoretical work on the subject advocates a **gradual annuitization** strategy in which the individual continues to invest capital after retirement and converts it gradually into an annuity to secure late-life consumption needs. One important benefit of gradual annuitization is that it allows individuals to avoid having to take, on retirement day (or even before in some cases), an irreversible decision to convert all of their accumulated capital into an annuity. Flexibility also makes it possible to adapt the annuity conversion strategy more effectively to suit market situations. In particular, it means that the conversion into annuities can be temporarily halted when rates are low and annuities are particularly expensive, as is the case today.

The annuity market **lacks a diversified annuity offering**. Fixed immediate annuities that pay a nominal fixed rate have no capacity to protect against inflation and do not allow the saver to earn an equity risk premium. Inflation-indexed annuities are thus a key product for development, as are variable annuities whose payments are indexed to the value of a chosen investment portfolio. Finally, there is limited value for immediate annuitization (mortality credit is small in early retirement) and thus there is a real lack of deferred annuities.

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We are living longer, and the duration of retirement is increasing. In this context, which is combined with exceptionally low levels of interest rates and returns on low-risk assets, the retirement phase could be conceived of as an active investment phase, making it possible to continue implementing financial projects after retirement, while gradually securing essential consumer needs at the end of life. There is a need for adequate life cycle strategies.[2]

Going a step further with hybrid products

Institutions for occupational retirement are facing sustainability problems, as sponsor companies struggle to bear the risks related to their Defined Benefit (DB) pension funds. The individualization of pensions is a recent trend (switching from DB to Defined Contribution (DC), relaxation of certain guarantees, etc.). While DB funds place too much risk on sponsors, they contain effective risk-sharing mechanisms. Fully individualized solutions have the advantage of being flexible and can be adapted to the preferences of heterogeneous individuals but they also have the drawback that individuals are subject to multiple risks: investment, capital conversion into an annuity, but also longevity risk if individuals choose to decumulate their capital by themselves.

An individual facing an uncertain lifetime is exposed to **two types of risk: systematic longevity risk**, which is the risk of misestimating the population's probability of future survival, and **idiosyncratic longevity risk,** which is the risk that the individual's date of death is different from the expected date, given the population's known probability of survival. **Idiosyncratic risk** is the largest risk for individuals. There is strong heterogeneity in actual length of life within a given age group and it is hard for individuals to predict how long they will live. However, this risk can be easily diversified by life insurers or pension funds if the pool of participants is sufficiently large. Conversely, the **systematic longevity** component is relatively small in magnitude for individuals as life expectancy surprises tend to be moderate from one year to the next. However, for the financial institution managing it, the systematic component is the most serious one, as it cannot be reduced through diversification.

In a life annuity contract, both idiosyncratic and systematic longevity risks are covered by the insurer. But this protection **comes at a cost**. In practice, to credibly offer insurance against systematic longevity shocks, an insurer requires reserve capital, constituted either from contract loading or from **equity capital contributions** by shareholders, who need to be remunerated. Moreover, the insurance company is subject to default risk,[3] even if, in practice, capital requirements imposed by Solvency II or government guarantees limit that risk.

[2] Berardi, Tebaldi and Trojani, "Consumer protection and the design of the default option of a pan-European Personal Pension Product", Efama Working Paper, Feb 2018. https://www.efama.org/Publications/Public/Long-Term_Savings_and_Pension_Steering_Committee/Bocconi%20Study.pdf

[3] In the 1980s and 1990s, a number of life insurance companies defaulted (e.g. First Executive Corporation in the US). In June 2009, the Hartford Group was bailed out by the TARP program after significant losses on life annuity products.

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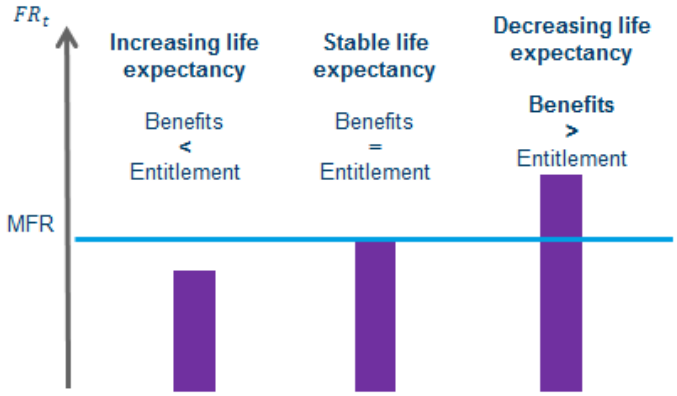
Pooled annuity funds,[4] in which idiosyncratic longevity risk is pooled but systematic longevity risk is borne by individuals, could be an attractive alternative to traditional life annuities. These funds offer lifelong payments during retirement that adjust to changes in life expectancy. Although benefits are marginally more variable than conventional annuity payouts, they are on average higher than those of an insurance solution involving a life annuity.

Fig 2: Benefit adjustments due to systematic longevity changes in a pooled annuity fund



*FR_t is the pension funds' funding ratio at date t, MFR is the minimum funding requirement

Key takeaways

We are living longer, and we continue to have projects after retirement. Retirement should be seen as an active investment phase.

Optimal decumulation strategies combine investment products to continue investing during the retirement phase and a gradual annuitization strategy to secure late-life consumption needs. Flexibility is key.

We are all different, so customization is also key. Decumulation strategies should combine different bricks (investment products, annuities) according to individual needs.

For occupational pension funds, efficient risk-sharing between sponsors and beneficiaries could be organized through pooled annuity funds that propose to pool idiosyncratic longevity risk and transfer the systematic components to individuals. Regulators and policymakers should consider authorizing their development.

[4] See the complete research paper: Boon L.N., M. Brière and B. Werker (2017), "Longevity Risk: To Bear or to Insure?", SSRN Working Paper No. 2926902. Also available on Amundi Research Center: http://research-center.amundi.com/page/Publications/Working-Paper/2017/Longevity-Risk-To-Bear-or-to-Insure

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Retirement decisions are complex. Tax rules and the first-pillar pension replacement rate are often uncertain. People need advice and solutions. Developing pension simulators, robo-advice, financial education and nudging through online tools can definitively help.

For the aforementioned reasons, CBBA-Europe thinks that regulators and policy-makers should be able to approve those innovative vehicles; that benefits should be taxed appropriately; and that useful norms should be drawn in order to strengthen the aforementioned advice and guidance, when such choices are at stake.

CBBA-Europe, from its part, will definitely mobilize its members to promote these solutions and it will help shape their delivery.

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