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Chapter 4

Policy considerations for life annuity products

This chapter discusses the issues that policy makers should consider to support life annuity products as a key instrument to finance retirement and protect individuals from the risk of outliving their assets. First, there is a need for consistency in the scope, definition and terminology used to refer to annuity products. There is also a need for coherence in the design of the framework of the pension system in order to further the role of annuity products to protect individuals from longevity risk. Continued innovation in product design highlights the need for regulatory requirements to adapt, but also for consumers and their financial advisors to be able to understand the complicated product features which may result. Finally, the appropriate incentives for annuity providers to mitigate the risks they face where necessary should be in place in order to ensure the sustainability of these products.

The shifting retirement landscape has led to increased risk borne by individuals in financing their retirement, bringing to the fore the importance of the role that annuity products can play. Annuity products provide a guaranteed income stream for life, protecting individuals from the longevity risk of outliving their assets and the investment risks from market downturns. As such, policy makers need to consider life annuity products in the design of the pay-out phase for pensions to mitigate some of the risks that individuals are facing in financing their retirement. Indeed, for countries where a significant proportion of retirement assets are invested in DC plans, the OECD recommends that individuals use part of their assets accumulated for retirement to purchase a life annuity in order to protect themselves from longevity risk.[1]

The menu of annuity products available is growing, often resulting in more complex features meant to appeal to the demands of consumers for increased flexibility or better value. While traditional life annuities protect individuals from longevity risk, they are often perceived as expensive and their illiquidity limits any flexibility to address contingencies such as the need to cover health care expenses. Moreover, individuals tend to be reluctant to give up a large part of their retirement savings in exchange for a fixed income stream. In response, annuity providers are developing products which offer more flexibility to access the underlying assets or lower cost through risk-sharing mechanisms that in turn reduce the level of the guarantee offered.

The increasing complexity of annuity product design presents a challenge for policy makers to establish appropriate policies to ensure the sustainability of these products as well as to make sure that the features of these products are understood by consumers. While higher guarantees and/or more flexibility make products more attractive for consumers, these features also come at an increased cost. Policy makers therefore need to understand these products and the types of guarantees and options that they offer in order to ensure that an appropriate balance is struck and that a regulatory framework is in place to encourage and support the use of annuity products.

This chapter discusses the main issues that policy makers should consider to support the role of annuity products as a key instrument in financing retirement. First, there is a need to clarify the definition of what constitutes an annuity product and to establish consistency in the language used to discuss them. There is also a need for coherence in the design of the framework for the pension system in order to further the role of annuity products to protect individuals from outliving their savings in retirement. Continued innovation in product design highlights the need for regulatory requirements to be flexible and able to adapt to future changes, but also the need for consumers and their financial advisors to be able to understand the more complicated product features which are resulting. Finally, new risks presented by these products also require that the annuity providers manage these risks, and policies need to provide the appropriate incentives to mitigate these risks where necessary in order to ensure the sustainability of these products.[2]

4.1. The need to define a common language: what is a life annuity product?

The definition of a life annuity product at first glance seems simple. It is a product which offers a stream of income payments to be paid to the individual for life. Nevertheless the literature and discussion of annuities, annuity income, and annuity markets is fraught with misunderstanding and a lack of comparability. For example, defined benefit (DB) pension arrangements provide a stream of income in retirement for life, yet would not generally be thought of as an annuity product. There are also annuity products (e.g. annuities certain) that provide a stream of income but do not protect individuals from the risk of outliving their assets. Other products like deferred annuities may never be converted into a stream of income payments for life, and instead may be taken as a lump-sum.

There is therefore a need to clarify what is meant by the term "life annuity product". The current lack of consistency with respect to the language and definitions used to discuss these products presents a large barrier for cross country comparison of annuity markets and products and any discussion around their role in retirement. This section presents some criteria with which to clarify the scope and define the concept of what an annuity product is, and introduces the terminology which will be used describe products and their features in this chapter.[3]

Clarifying the scope

The distinction needs to be made between annuity income and annuity products in order to define the scope of what is considered to be an annuity product. Policy makers often refer to a target level of "annuitisation" for individuals in retirement, in other words the appropriate proportion of available income in retirement which should be guaranteed. However, this proportion can also potentially include income received from public pensions and income received from defined benefit pensions in addition to income received from annuity products. Therefore, in order to assess the role annuity products play in providing retirement income, these different components of the overall level of annuitisation must be separated out.

Four criteria could be used to distinguish the scope of what is considered to be an annuity product among the various sources of income in retirement.

- An annuity product should be fully financed by the contributions or premiums put towards its purchase. This would exclude annuity income coming from PAYG financed systems, where current contributions cover current annuity pension payments.
- Annuity payments should be calculated on an actuarially fair basis, implying a direct link between contributions paid and the level of income received. Defined benefit schemes for which benefits are defined in terms of final salary or the number of years employed would therefore not be considered as an annuity product.
- The provider of the annuity product should be the entity which promises to make payments to the individual or member. This makes the distinction between instruments used for de-risking pension plans as opposed to functioning more directly as a solution to provide income to an individual in retirement. As a result, bulk annuities and reinsurance are out of scope of this discussion.
- The employer should not be the guarantor of the promised payments. This would exclude income which is provided by the employer as part of the employment contract from being considered an annuity product, such as "cash balance" hybrid pension plans or book reserve plans.

Defining an annuity product

The definition of an annuity product must also be clear in order to distinguish these products from pension savings products which may not provide for income in retirement and from other drawdown products which provide no longevity guarantees. This is necessary in order to assess the role of the income guarantees that annuity products offer compared to other types of pension and retirement products.

The first criteria to clarify the definition of an annuity product should be that it provides a longevity insurance component, as protection from longevity risk is one of the main benefits provided by annuity products. As such, drawdown products with no lifetime guarantees are not considered to be annuity products. Annuity certain products, where payments are only guaranteed for a specified number of years, are also not included as they can be more likened to fixed income investments.

In addition to including longevity insurance, the definition of an annuity product needs to address deferred savings products which include the option or mandate to be converted into annuity income at a future date, since whether these contracts are actually annuity products can be ambiguous. In some cases the product may never result in an annuity income being paid, and in others the contract covers only the accumulation phase. To clarify the definition, where receiving a future income stream from a deferred annuity is optional, the annuity conversion rate should be defined at the onset of the contract. Where this is not the case, the product could be better viewed as a savings vehicle with an immediate annuity purchased at the end of the accumulation period. Alternatively, where receiving a future income stream from a deferred annuity is mandatory, the provision of the future income should be established in the same contract that was established for the accumulation of the assets. As such, the annuity product could then be viewed as a whole, rather than a savings product with limited pay-out options at retirement.

Features of annuity products

Given this scope and definition of an annuity product, annuities can nevertheless vary widely in their structure and the guarantees and options they offer to consumers. The plain vanilla, traditional life annuity product provides guaranteed regular payments to an individual for life in exchange for a non-refundable upfront premium. This product thereby guarantees a stable income to the individual and protects them from the risk of outliving their assets in retirement. This basic annuity structure, however, can vary along several dimensions: the timing of the payments, the timing of the premiums, and whether the product is sold at an individual or group level.

Annuity products can either be immediate, with payments beginning right after the premium is paid, or deferred, with payments beginning at some future point in time. Immediate annuities tend to be bought with assets accumulated at retirement to provide payments through retirement. Deferred annuities are generally bought at younger ages to provide payments once the individual is retired, though they may also be bought at retirement to provide old age longevity insurance and ensure that the individual will have an income if they live longer than expected.

The premiums for annuity products can be paid all at once, in a single premium, or divided into regular premium payments. Single premiums are typical for immediate annuity products, while regular premium payments are more common for deferred products, allowing individuals to contribute over time and build up the level of future income, similar to other retirement savings products.

Finally, annuity products may be purchased at an individual retail level or for a group of individuals. Individual annuities are more commonly purchased by individuals within personal defined contribution pension schemes, for example, or other voluntary personal pension arrangements. Group annuities, on the other hand, are more commonly arranged by employers for a group of their employees.

Beyond the basic structures outlined above, annuity products can offer various guarantees for the individual annuitants. These guarantees can insure the individual against several risks, namely longevity, death, investment and/or the loss of purchasing power.

The insurance against longevity risk is the risk most commonly associated with annuity products, as annuity products which provide payments for the lifetime of the individual insure against the longevity risk of outliving their assets in retirement.

Annuity products may also offer a guaranteed payment to the surviving beneficiaries of an annuitant in the case of death. This can take the form of a lump-sum payout contingent on the death of the annuitant, the provision for a lifetime payment to the surviving spouse, or the provision of a guaranteed period during which payments continue for the specified number of years regardless of the survival of the annuitant.

Investment guarantees are also common guarantees provided by annuity products, either implicitly through the guarantee of a specified level of income or explicitly through a guaranteed minimum return on the assets underlying the annuity product. These types of guarantees provide insurance against the investment risk of a decrease in asset value which could significantly reduce the level of assets available for financing retirement.

Annuities can also provide protection against the loss of purchasing power from inflation by indexing the guaranteed payments to the inflation rate, guaranteeing a level of income in real terms rather than nominal terms.

In addition to guarantees, annuity products can also offer varying levels of flexibility to the consumer, providing options with respect to the access to underlying assets and the timing and/or level of payments. For the traditional annuity product, the consumer completely relinquishes the premium assets to the annuity provider, and has no ability to get out of the contract or change the terms on which the income will be received. Variations on this traditional product, however, can offer additional flexibilities to the consumer such as control over investment decisions, the ability to withdraw from or surrender the product, or the ability to vary the level or timing of income received during the pay-out phase.

A common terminology

In order to fully understand the features and risks of different types of annuity products and be able to discuss the role of policy in supporting these products, there is a need to establish a common terminology for different types of products. The lack of a common terminology is a particular problem, for example, when it comes to variable annuity products. The term "variable annuity" is commonly applied to a wide variety of products, therefore two policy makers from different jurisdictions or organizations can find themselves discussing the challenges and risks for "variable annuities", yet actually be referring to two different products with completely different risk characteristics and profiles. Therefore, policy makers need to have a common language in order to be able to have coherent discussions with respect to the risks presented by the products and the role of policy to ensure their sustainability.

Table 4.1 proposes to group the different types of annuity products into three different categories based on payment features and risk profile, and uses a terminology that could form a common basis for guiding the discussion around annuity products. While in theory various combinations of annuity types could be possible (e.g. inflation indexed enhanced annuity), these combinations are not commonly found in the market.

Table 4.1. **Classification of annuity products**

Product type	Annuity type	Product description
Fixed payment	Level/Escalating/De-escalating	Annuities which guarantee pre-defined payments beginning immediately or deferred to some point in the future. Payments can be level or be scheduled to increase (escalate) or decrease (de-escalate) over time by a defined amount.
	Advanced Life Deferred Annuity	Deferred annuities which are bought around retirement age with payments that are deferred to begin at a more advanced age, usually over age 75.
	Joint	Annuities with payments contingent on the survival of two lives.
	Enhanced	Annuities which pay out a higher income level to individuals deemed to have a shorter life expectancy due to health or behavioural factors.
Indexed payment	Inflation-indexed	Annuities whose payments are indexed to the level of inflation experienced in each period.
	Participating	Annuities which offer a minimum guaranteed level of income to the annuitant while offering additional bonus payments depending on an actual return or profit measure.
	Variable Payout	Annuities for which the initial payment is calculated using a reference rate of return defined in the contract and subsequent payments are adjusted by the ratio of the actual return on assets over the reference return.
Retirement savings with guaranteed income option	Variable Annuity	Deferred annuity products with a guaranteed income option which offer flexibility with respect to how the assets are invested or accessed by the consumer.
	Fixed Indexed Annuity	Deferred annuity products with a guaranteed income option which offer returns which are indexed to the market as well as flexibility with respect to how the assets accessed by the consumer.

The first category of annuity products includes annuities promising fixed payments to the annuitant which are clearly defined from the onset of the contract and for which the underlying return does not change over time. These types of annuities typically offer full longevity protection to the individual as well as an implicit guaranteed return on the premium paid. However, the annuitant generally has no flexibility with respect to the payments made or how the underlying assets are invested and no additional benefit is received if investment returns are higher than expected. The main risks for the annuity provider for these types of products are longevity risk and investment risk. With respect to investment risk, the largest risk is reinvestment risk to the extent that the duration of the liabilities exceeds that of the assets, and assets would need to be reinvested at rate lower than that which is guaranteed.

The second category of annuity products includes those with indexed payments which vary depending on an external measure. These products allow annuity payments to increase or decrease depending on factors such as inflation or profits. This also means that the underlying return can vary over time, though a minimum rate is usually guaranteed. Annuitants can be exposed to volatility and unpredictability in their annuity payments, but can also benefit from changes in market conditions while having a certain minimum level of security. For products in this category, the mechanism with which payments are indexed and the level of risk-sharing offered play major roles in the overall risk exposure and the way in which the risk is managed by the annuity provider.

The final category of annuities is somewhat of a hybrid category, and includes products whose primary function is arguably retirement savings but which also offer the option of electing to receive a guaranteed level of income during retirement. These types of products can therefore also offer longevity protection. The return on these products depends on market performance, though minimum guarantees are typically offered. Furthermore, they offer the highest level of flexibility to the annuitant, providing access to the underlying assets and participation in positive market returns, as well as potential flexibility in the level of annuity income that is received. Nevertheless, this flexibility results in an increased risk to the annuity provider in terms of unpredictability of consumer behaviour, which complicates the management of the underlying investment risks. Furthermore the dynamic nature of the guarantees involved necessitates a rather complex risk management strategy to mitigate the investment risk exposure for the annuity provider. These factors can increase the cost of such guarantees for the consumer.

Harmonising the language used to discuss annuity products could lead to the additional benefit of having a common standard for collecting and reporting data on annuity markets to be able to compare the size and trends of annuity markets across jurisdictions. There is currently no common standard for classifying annuity products, which also makes it difficult to understand the relative importance of the different types of annuity products across jurisdictions. However, the variables collected also need to be more comprehensive. For example it would be useful to have data on the rate at which deferred products with an annuity option are actually converted into an income stream in order to have a clearer view on consumer preferences and how these products are used in practice.

Once a common definition and language has been agreed upon, policy makers will better be able to define clear objectives with respect to the desired role of annuity products within the retirement landscape and implement policies to support this role.

4.2. Designing a coherent framework for retirement

Policy makers need to consider numerous elements in designing the framework to support the desired role of annuities within the retirement landscape. This first involves considering how annuity products fit in the pension system given the rules in place. Limits on product design and pricing may also potentially be considered in light of the needs of individuals and the risks they face for their retirement. Finally, encouraging the demand for annuity products can be a challenge, and policy makers must consider the most efficient way to do so given the potentially heterogeneous needs of the population.

Policy makers first need to identify where annuities should play a role in the retirement system by considering the existing pension gap and the risks that individuals will have to bear, particularly given the shift towards more individual responsibility. The risks faced will determine the types of guarantees and flexibilities which annuities could provide to add value and increased security for the individual. Protection from longevity risk may be most important for the payout phase, though some flexibility and liquidity may also be needed to cover unexpected expenses. Minimum return guarantees may be important particularly during the accumulation phase to protect the individual from the timing risk of retiring following a market downturn.

The rules relating to the accumulation and drawdown of pension savings need to accommodate the products which can fulfil the needs identified. For example, plan sponsors can be reluctant to make annuity products available within their plans due to duty of care requirements which could lead to legal action against the sponsor if the plan member feels the annuity product was not appropriate. This concern of plan sponsors was found to be an issue in Canada and the United States. Such requirements therefore need to be clearly defined particularly with respect to annuity products to avoid ambiguities as to whether the plan sponsor has fulfilled its responsibilities towards its members.

Another consideration is any minimum or maximum distribution or withdrawal limit imposed. These limits need to allow for the appropriate use of annuity products to manage investment and/or longevity risk. For example, until recently, advanced life deferred annuities purchased within qualified defined contribution plans[4] in the United States did not count towards the minimum withdrawal requirement and therefore could not be used optimally to manage longevity risk. Since 2014, these types of annuities have been allowed to count towards the minimum distribution requirement if the payments begin by age 85 and the annuity premium does not exceed the minimum of 25% of the account balance or USD 125 000. This allowance is expected to increase the demand for these types of deferred annuity contracts.

Limits on product features or design could potentially be considered where it is in the consumers' best interest and where the consumer may otherwise be less likely to protect themselves from the risk in question. One example could be requiring that married individuals be offered joint annuities, as is the case in Chile, in order to ensure that the surviving spouse will continue to receive income even after the death of their partner. Individuals may be less likely to choose a joint annuity on their own either due to a lack of awareness of the option or because it reduces the guaranteed income level. Another restriction could be to limit the guaranteed payment period, a feature generally preferred by consumers but which also limits the benefit of longevity risk pooling that annuities can offer. A ten year limit on the guarantee period was previously imposed in the United Kingdom.

Limits on the guarantees offered could also be potentially considered with the objective to limit the risk to the annuity provider. For example, restrictions could be imposed on the age at which guaranteed annuity conversion rates can be offered, as the risk of these guarantees significantly increases with the length of the deferral period for which they are offered. Israel has imposed such limits on annuity providers. Other jurisdictions, such as Germany, impose a maximum discount rate allowed to be used to price the annuity in order to ensure that the guaranteed rate is sustainable.

Nevertheless, any limits imposed should not unduly increase the risk to the annuity provider or the cost to the consumer. For example, requiring that annuities be indexed to inflation could certainly benefit the consumer as these types of annuities are generally not preferred over fixed level annuities due to the present-bias of consumers and a lack of foresight as to the effects of inflation on purchasing power. However, these annuities also tend to be relatively more expensive than fixed level or escalating annuities. Furthermore, if inflation-linked bonds are not widely available for the annuity provider to invest in to match this liability, an accumulated concentration of exposure to inflation risk could present a solvency risk. Another example of a limit on product features could be requiring that consumers are able to change their annuity provider. Given the long-term duration of the annuity contract, it could potentially be beneficial to allow the consumer to change their mind if they are able to get a better value elsewhere. However, such flexibility also increases the risk to the annuity provider and therefore the cost to the consumer. Transaction costs for the consumer could also be expected to increase. Alternative policy measures should therefore be considered if the objective is to encourage annuity providers to offer competitive rates.

Any limits with respect to market segmentation, where certain risk factors are used for pricing annuity products, should be implemented with caution, particularly where the purchase of an annuity is voluntary. Such restrictions can potentially result in certain subgroups of the population being excluded from the annuity market due to anti-selection, where only consumers having higher life expectancies will purchase annuities. The most prevalent restriction on market segmentation is the restriction on gender-based pricing, as is the case in Europe, where gender is not allowed to be used as a risk factor to price annuities. This increases the price of annuities for males, who could then decide that annuities are too expensive given their lower life expectancy compared to females and drop out of the market. Eventually if males continue to not purchase annuities, this could result in the price for all annuities converging to the price based on female mortality, eroding any intended benefits. This seems to have occurred in Germany, where pricing by gender has not been allowed since 2006. Annuity prices following this ban were closer to the prices charged to females prior to the new regulation (von Gaudecker and Weber, 2006). Furthermore, if regulation does not allow the annuity provider to adjust its mortality assumptions to reflect the actual mortality experience, the annuity provider could face solvency problems as the premiums paid would not be sufficient to cover the liability owed.

Experience in the United Kingdom has shown that market segmentation can be beneficial to consumers in some cases. Enhanced annuities, widely available in the United Kingdom, offer higher incomes to individuals having health or lifestyle conditions which reduce their life expectancy. This product provides a solution to a population sub-group who would otherwise have been disadvantaged from the purchase of a regular annuity. Nevertheless these products remain uncommon outside of the United Kingdom, so perhaps more could be done to encourage their development (OECD, 2016).

Any mandate for the purchase of an annuity should be considered with caution, as the need for the protection that annuities can offer is likely to differ significantly across socioeconomic groups. A one-size-fits-all approach may therefore not be appropriate. This would likely penalise the lower income groups who would likely not have saved enough to purchase a meaningful level of income. In 2012, for example, when the purchase of an annuity was still mandatory for defined contribution plans in the United Kingdom, approximately 16% of annuities sold to pensioners were for funds of less than GBP 5 000, which would translate into a monthly income of less than GBP 20 (Financial Conduct Authority, 2014).[5] It could also result in over-annuitisation of assets for other groups who need to maintain some flexibility and liquidity from their assets. These issues could partially be addressed by allowing more flexibility to withdraw accumulated assets when they do not meet or when they exceed certain thresholds. For example, while the purchase of an annuity is not mandatory in Chile, it is not allowed if individuals do not have enough assets accumulated to get an annuity payment above a minimum level of income. In this case, they have to take a programmed withdrawal and the government provides the longevity insurance when the account is exhausted.

Nevertheless, making the purchase of an annuity mandatory can be effective at increasing the demand for annuity products, and can also help to spur innovation from annuity providers looking to gain market share. This was seen to be the case in the United Kingdom, which now has one of the largest annuity markets, and competition for market share has resulted in the prevalence of enhanced annuities. However, given the sharp reduction in the purchase of annuities following the recent pension reforms which removed this requirement, it also presents a case study on the challenge of encouraging consumer demand for annuity products particularly when these products are perceived as a poor value. Indeed, annuity demand fell by 61% in the second quarter of 2015 compared to the second quarter of the previous year (ABI, 2015).

As an alternative to a hard mandate, policies are increasingly being used in the retirement landscape to "nudge" consumers towards the desired behaviour, namely with automatic enrolment to save for retirement and default investment strategies. This mechanism in particular relies on the inertia of individuals to go with the "default" option. These types of policies have been effective and useful for getting people to save during the accumulation phase. However, they need to be designed very carefully if applied for the purchase of an annuity in the decumulation phase. Experience in the United Kingdom presents evidence that providing a "default" annuity option, in this case the annuity provided by the individual's existing pension provider, resulted in consumer apathy and a disengagement from the process, and often resulted in consumers not getting the best product available to them. Furthermore, this tendency resulted in a lack of competitive pressure on annuity providers leading to lower value product for consumers (Financial Conduct Authority, 2014; 2015). Low-cost centralised default annuity providers could potentially be introduced to maintain competitive pressure among annuity providers. In Sweden, for example, the state Premium Pension Authority is responsible for providing the annuity. In Singapore, the Central Provident Fund provides a low-cost annuity option to compete with private annuity providers.

Rather than offering consumers the option to opt-out of a default, another approach is to make consumers actively compare products and make a choice. This approach seems to be effective at increasing engagement in the decision as well as competitive incentives for annuity providers. For example, once individuals have indicated that they plan to retire in Chile, the pension fund transmits their information to an electronic platform (the SCOMP) which then provides consumers comparable information regarding their options to take a programmed withdrawal from a pension fund or take a life annuity from an insurance company (Stanko and Paklina, 2014). The individual is therefore forced to choose an option, making them much less prone to the effects of inertia and staying with their current pension provider, and encouraging them to actively consider the option to purchase an annuity. Indeed, in 2015 approximately 50% of pensioners had life annuities provided by an insurance company (Superintendencia de Pensiones, 2015).

More traditional fiscal incentives can also be used to encourage individuals to purchase annuity products. For example, deferred tax treatment in the United States has contributed to the widespread use of variable annuity products as retirement savings vehicles. Both the Czech Republic and Estonia encourage the purchase of annuities over other payout options of pension plans by offering more favourable tax treatment for annuity payments (OECD, 2015). In Korea, annuitisation of retirement savings was found to be 15 percentage points higher for savings vehicles where lump-sums are taxed compared to vehicles were lump sums are tax-free (Lee, 2016). However, while preferential tax treatment has been effective in encouraging annuitisation in some cases, it is not always effective in overcoming individuals' preferences for lump-sums or for increased flexibility. In the United States, for example, guaranteed withdrawal benefits have remained the most popular option for payouts from variable annuities in the United States despite the taxation of the entire gain upfront (Geneva Association, 2013; IRI, 2011).

4.3. Keeping up with innovation: Ensuring sustainable and suitable annuity products

Product innovations by annuity providers may be part of the solution to encourage demand for annuity products. Much of these innovations have involved increasing the flexibility offered by the product or increasing its perceived value through risk-sharing. However policy makers must have a framework in place to keep up with these innovations and ensure that the products remain sustainable for the annuity provider and suitable for the consumer.

Product innovations involving more flexibility and risk-sharing have led to increasingly complex annuity products. Increased flexibility in particular introduces additional risk for the annuity provider which needs to be provisioned for, and reserving and capital requirements which can adapt to new product features are needed in order to ensure that the products are sustainable. Increased risk sharing, on the other hand, highlights the importance of ensuring that consumers themselves are able to understand the products they purchase and the costs and risks that they entail in order to select the most suitable product for their needs. Given product complexity, consumers may also need to rely on financial advice therefore this advice should also lead to a suitable recommendation for the consumer.

The evolution in the design and features of annuity products and the new risks which they present has made clear the need for capital requirements to be more flexible and comprehensive in the risks which are accounted for in these requirements. The increasingly dynamic nature of annuity products and their guarantees requires reserve and solvency capital requirements that are also more dynamic in order to reflect the underlying risks and ensure sufficient assets to back the annuity providers' liabilities. Static approaches based on formulas are no longer adequate for the new generations of annuity products.

Approaches based on principles for the calculation of reserve and solvency capital requirements are needed to allow for the flexibility in calculations to capture changing provisioning needs in light of innovations in annuity product design. This type of approach has been widely adopted in particular in light of the dynamic nature and risks presented by variable annuities, and allows for the use of stochastic scenarios and the recognition of the behavioural risks coming from increased flexibility offered by these annuity products. Reserve and solvency calculations could also be complemented with additional stress and scenario testing to ensure that the nature of all risk exposures and the interaction of these risks is recognised and understood.

The increased complexity and dynamic nature of annuity products also requires the communication of product features and risks to consumers through effective product disclosures in order to ensure that consumers understand the product that they are purchasing. This disclosure needs to clearly communicate the main features of the annuity product, any risks that this product entails for the consumer and all applicable fees relating to the product's purchase and use.

Disclosure requirements should therefore also move to an approach based on principles, focusing not only on the type of information which is included but also how it is included. Regulation often stipulates the minimum information that is required to be included in annuity product disclosures, but given the constant innovation with respect to product features and guarantees, minimum requirements could quickly become insufficient. The key features highlighted and metrics used should be presented in a manner which is in line with the goals of the product and the risks it is meant to insure against. To ensure that the consumer is aware of any risks from the annuity product, disclosures should convey not only the expected payments but also the potential negative outcomes to which the consumer could be exposed to in the event of low profits or poor market performance, particularly for annuity products with risk-sharing arrangements. All costs and fees for the annuity products should be fully and accurately disclosed at the onset of the contract as well as at the time at which they are incurred. The effectiveness of product disclosures may vary with the type of product, the context and the median with which the information is presented. Disclosures should therefore be tested for effectiveness in the context in which they will be used in order to ensure that the targeted consumers do indeed understand the essential information provided.

Given the increasing complexity of annuity products, the role of financial advice in helping consumers to understand the different types of products and select the product which is most suitable is increasing in importance. Ensuring that the financial advisor reliably and effectively communicates product features and risks to the consumer and can match these with the consumers' needs is therefore necessary.[6] Policy makers can address this issue from several angles. First is to ensure that the advisors themselves understand the products available, secondly is to ensure that their advice is suitable for the consumer and finally is to provide the consumers with tools to better judge whether they are getting appropriate advice.

Policy makers first need to ensure that financial advisers are also keeping up with the innovation in the annuity product market and not only are aware of the products available but also have the knowledge to understand the underlying mechanisms of the product. Several jurisdictions address this through ongoing education and examination requirements for advisors to ensure that they are sufficiently trained on the products they sell and are able to make appropriate recommendations.

Various approaches can be taken to help ensure that product advice is in the best interest of the consumer and that they end up with a suitable product. The most common approaches focus first on duty of care standards for financial advice and secondly on the way in which advisors are compensated for their services. First, duty of care sets a standard for the advice itself, but the way in which it is defined and enforced can vary. At one end of the spectrum, it can be defined as a strict legal standard such as fiduciary duty, which offers legal recourse to the affected consumer in the event that the product was not in their best interest. Less stringent standards, however, require only a determination of whether the product is reasonably suitable for the consumer. Regulation of compensation structures, on the other hand, aims directly to mitigate any potential conflicts of interest for the advisor which could inadvertently or otherwise result in less suitable advice for the consumer. Measures taken to address this issue can vary from banning commissions completely, banning certain commission structures or imposing a cap on the commission. However, while such measures may help to improve the quality of financial advice by better aligning the interests of the advisor and the consumer, there is a risk that such limits could lead to a reduced take-up of financial advice. The costs and benefits should therefore be carefully weighted when considering limits on compensation, and the appropriate measure to take will depend on the particular problems observed in the market.

Finally, policy makers can try to provide consumers with the tools with which to assess the advice received. This is most often done through the required disclosure of commissions paid to the advisor. Nevertheless consumers do not necessarily use and act on this information to assess any potential incentives to recommend one course of action over another, nor do they call into question the advice they receive, so this measure alone is not likely to be effective at improving consumers' decisions. Another tool is the cooling-off period implemented in some jurisdictions, which allows the consumer time to digest the advice and product information and change their mind regarding their purchase. Nevertheless the effectiveness of this measure also relies on the quality and clarity of the product disclosure and information provided.

4.4. Encouraging appropriate risk management

Ensuring the sustainability and suitability of products in the evolving annuities landscape also involves ensuring that the risks resulting from these products are able to be managed appropriately by the annuity providers. Risk exposures are determined by product design and the features and flexibility the products offer as well as how the market or longevity experience evolves going forward. Annuity providers need to ensure that they will be able to make the payments promised to annuitants, even in the event where experience deviates from expectations, for example lower than expected investment returns. The framework that policy makers put in place must encourage annuity providers to have a clear view of their risk exposures and mitigate the risk where needed. This framework should encourage the appropriate risk management of annuity products through the accounting framework, investment limits and the capital requirements which are in place.

Policy makers need to be aware of the potential impact that accounting standards can have on the risk exposures from the different types of annuity products in order to identify any potential misalignment of risk management incentives or areas which may need additional monitoring. For example, the accounting framework will directly affect the risk exposures from participating annuity products in particular, as the calculation of the surplus to be shared with the annuitants will depend on the accounting measure used. Historical valuation methods will result in more balance sheet stability, as unrealised gains and losses are not recognised and therefore would not be shared with the annuitant. On the other hand, fair value methods which better reflect the financial position of the entity will result in higher levels of volatility both for the annuity provider's balance sheet as well as for the payments to the annuitant. To manage this potential volatility and reduce its risk exposure from an economic point of view, the annuity provider may establish a buffer reserve to smooth payments to the annuitant by retaining some of the profits during good periods to be paid out during less profitable periods. However, supervisors need to closely monitor and understand the calculations underlying such smoothing mechanisms in order to ensure fairness and transparency of the profit participation. Furthermore, any minimum participation rate imposed by regulation must take into account the interaction between the participation rate, the accounting measure and any smoothing mechanism imposed to ensure that the annuity provider is able to manage the resulting volatility exposure and solvency risk.

The accounting framework can also have an impact on the risk management strategy implemented for annuity products where dynamic hedging strategies for market risks are used, such as with variable annuities. Such strategies rely on the measurement of the annuity liability value at a given point in time, which is determined by the accounting measure used. Dynamic hedging strategies based on Generally Accepted Accounting Principles (GAAP) or statutory measures of the liability can result in an under-hedging of certain risks compared to hedging on an economic basis. Supervisors may therefore want to also monitor economic measures of the balance sheet so as to not provide a disincentive for annuity providers to more fully hedge their risk exposures on an economic basis.

Policy makers should also ensure that annuity providers are able to effectively use and implement appropriate strategies to mitigate their risk exposure. For example, investment in financial derivatives should be allowed where these instruments can be used to hedge risk exposures. However, supervisors should also ensure the effectiveness of such strategies. Some jurisdictions address this by requiring that annuity providers submit a plan for their use of derivatives as well as their resulting investments. This allows supervisors to ensure that these instruments are being used as part of an effective hedging strategy and not for speculative purposes, as well as to monitor annuity providers' overall exposure to derivatives.

In addition to ensuring the effectiveness of any risk mitigation strategy, policy makers should also be aware of any potential increase in risk as a result of the strategy. For example, the use of over-the-counter (OTC) derivative instruments to hedge market risks can also increase the counterparty risk exposure of the annuity provider. Such exposures are generally addressed through concentration limits to counterparty exposure. However recent regulation implemented such as the Dodd-Frank Act in the United States and the European Market Infrastructure Regulation (EMIR) in Europe have sought to reduce this risk through centralised clearing and collateral requirements. While such measures can be effective in reducing counterparty exposure, they may also increase liquidity risk or duration mismatching as a result of the collateral requirements. Therefore policy makers must find a balance so as to ensure that the overall reduction of risk results from risk mitigating measures so as to not reduce the incentives for annuity providers to mitigate their risk exposures.

Capital requirements, including both reserve and solvency capital requirements, should recognise the risk reduction from any risk mitigation strategies in order to serve as an incentive for annuity providers to hedge their risk exposures. This includes, for example, the recognition of reinsurance coverage as well as investment strategies which minimise the asset-liability duration gap or otherwise reduce the investment risk exposure of the annuity provider. Partial risk reduction may also be recognised, such as for dynamic hedging strategies where the hedge is approximate by nature. For example, both Canada and the United States only partially recognise the risk reduction from dynamic hedging strategies in reserve and solvency capital requirements for variable annuity products, as the effectiveness of these strategies is not expected to be perfect.

4.5. Policy considerations

Annuity products and the guarantees that they offer may provide part of the solution to address the increasing investment and longevity risks that individuals are facing. Product innovations enhancing the attractiveness of these products for consumers through increased flexibility or lower cost through risk-sharing mechanisms which reduce the level of guarantees broaden the menu of options available and the ability for these products to meet the varied needs of consumers.

Nevertheless, in order for these products to provide an effective solution, policy makers must consider the challenges that these products present with respect to their underlying risks and their increasing complexity in order to ensure the sustainability of these products for annuity providers and their suitability for consumers.

The first barrier for policy makers to overcome is the lack of consistency with respect to what is meant by an annuity product and the terminology used to describe the different types of products. The definitions and classifications presented in this chapter could serve as a starting point to arrive at a common language for discussing the role of annuity products and the related policy considerations. The proposed classification could also serve as a basis for comparable data collection on the size and composition of annuity markets.

Policy makers also need to design a coherent pension framework which facilitates the expected role of annuity products to provide income in retirement. The rules around the accumulation and drawdown of pension assets need to accommodate the annuity products which can meet individuals' needs at the various stages of their retirement planning. Limits on annuity product design or features, including limits on factors used for pricing, should not be imposed without considering the impact on the cost and risk exposure of the annuity product.

Moreover, the use of annuity products needs to be encouraged. Given the heterogeneous needs of society, particularly between high and low socioeconomic groups, a one-size-fits-all prescription is not likely to be appropriate. Default options can increase take-up, but need to be carefully designed so as to maintain competitive pressure among annuity providers. The effective provision of information on the options available and engaging individuals in the decision of whether to purchase an annuity is another option. Fiscal incentives can also be a useful tool to encourage demand for annuity products.

Approaches based on principles are better suited than approaches based on static formulas to ensure that capital requirements are able to adapt to changing product features. The continued innovation in annuity product design requires the regulatory framework to be more flexible and adaptive to changing risk exposures and risk drivers in order for capital requirements to remain sufficient to back the annuity liabilities and guarantee the sustainability of these products.

Policy makers also need to make sure that consumers are purchasing products which are suitable for their needs, particularly given the increased complexity of products that has accompanied innovation. Product disclosures should not only provide a minimum level of information regarding the product features, risks and costs, but also ensure that this information is easy for the consumer to understand. Policy makers can help to make sure that financial advice for these products is suitable through qualification and education requirements for advisors, duty of care standards or potentially limits on compensation structures. Commission disclosure requirements and cooling-off periods can also provide the consumer with tools to better assess the quality of the advice they receive.

Finally, the regulatory framework should ensure that the tools to manage risk and the incentives to do so are in place in order to encourage appropriate risk management by annuity providers. Supervisors should ensure that the relevant accounting measures are monitored to ensure a realistic view of risk exposures and to provide an incentive to manage risks effectively. Hedging should be facilitated, but the strategies should be monitored to ensure their effectiveness in reducing overall risk exposures. Any requirements to control the risks from the strategies themselves should also ensure that overall risk reduction still results, so as to avoid reducing incentives to hedge. Finally, capital requirements should reflect the reduction of risk from any effective risk mitigation measures in order to align with the incentives of annuity providers to manage their risk exposures.

Implementing effective policy to support the annuity products to finance retirement requires that the mechanisms and risks these products present be understood by all stakeholders. Annuity providers must recognise and understand the dynamics of risk to ensure that their products are sustainable, consumers must understand how the products function in order to select the most suitable, and policy makers need to be able to monitor the risks to ensure the continued relevancy of the regulatory framework in place. As such, the framework put in place should be designed to keep up with innovation and adapt to the changing retirement landscape.

Notes

1. The OECD Roadmap for the Good Design of DC Pension Plans, *www.oecd.org/finance/private-pensions/50582753.pdf*.
2. For a more thorough discussion of the issues relating to annuity products and their guarantees, see OECD (2016).
3. The discussion throughout focuses on life annuity products. Providing protection from outliving one's resources (i.e. longevity risk) is one of the most important goals of pension arrangements (see the The OECD Roadmap for the Good Design of DC Pension Plans)
4. 401(a), a 403(b) plan, a governmental 457(b) plan or a traditional IRA
5. Based on the estimation that 60% of annuitants get an annuity from their existing provider, and 27% of these have pension pots under 5 000 GBP. The FCA indicates that for premiums less than 5 000 the rates are around 4.25%, and the rates are around 5.1% for premiums between 5 000 and 10 000.
6. Chapter 3 discusses these issues in more detail and provides examples of the types of measures which have been taken in various jurisdictions.

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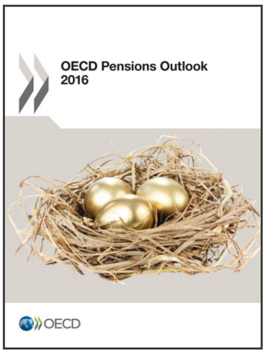

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