Global

Pension Watch

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Economics Analysis

Pensions
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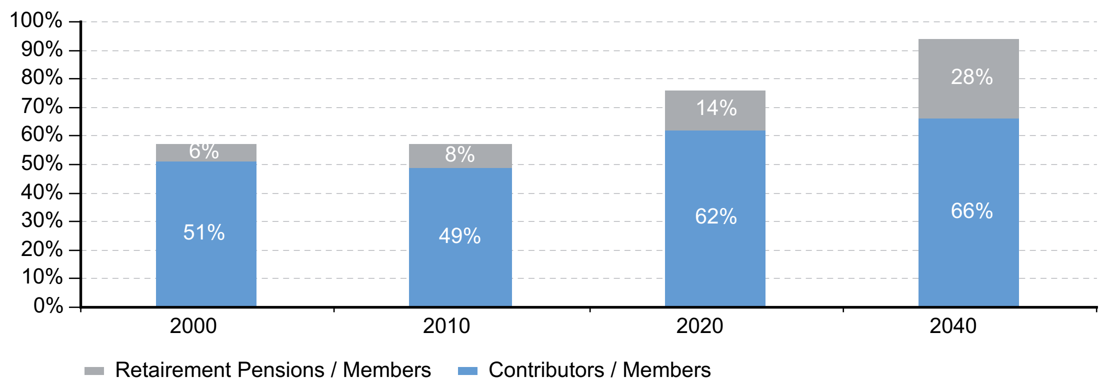
Risk in the Payout Phase

- Individually Capitalized Pension Systems have not yet reached full maturity. In these systems, the payout phase will only increase in importance.
- There are certain risks related to the payout phase, such as longevity, solvency, and market risk, among others. The exposure to these risks depends on contributors' characteristics such as income level, the existence of a solidarity pillar, and the type of pension selected or available.
- Longevity risk is one of the main risks. Depending on the type of pension selected, contributors' exposure to this risk will be either direct or indirect (by assuming the risk of solvency of the insurance company that is facing the aggregate longevity risk).

Chart 1
Chilean Pension System: Mandatory Pillar



Source: BBVA Research and Pension Superintendency of Chile

- **Individual capitalized pension systems are a relatively new development around the world**

  The oldest of these is the Chilean system, which was launched in 1981. Whilst this was a long time ago, 30% of all old age pensions are still paid under the old system and among pensioners under the new system "recognition bonds" for contributions made under the old system still have considerable weight in the pension received. It will take a further 15 to 20 years before the transition to the new system is complete in Chile. In summary, there are no fully mature individual capitalization systems anywhere in the world.

- **For the future, the payout phase can only increase in importance**

  In other words, the proportion of social security contributors receiving pensions and the amounts administered during the period of payment of benefits will increase. As a result, it is appropriate to analyze retirement schemes in even relatively young systems in order to identify difficulties that might arise.

- **There are a number of risks related to the payout phase that need to be correctly handled by countries with reformed pension systems**

  The risks which need to be offset are: outliving the funds saved (longevity risk), the commercial risk of the company which provides the pension and uncertainty about the value of the pension. The degree of exposure to such risks will depend on socio-economic conditions, the existence of social support systems and the form of pension chosen (or available).

- **The main forms of pensions are programmed withdrawal and fixed annuities, and combinations thereof**

  With programmed withdrawal, longevity risk falls on the pension contributor; however, if the pension system has a social support system, and the individual is eligible to benefit from it, the risk falls on the State. As a result, if there is a social support system, only medium-high income pension contributors are exposed to longevity risk under a programmed withdrawal system. Under a life annuity system, the Insurance Company that provides the pension is exposed to the longevity risk.

- **The commercial or solvency risk of the company, which provides the pension, also depends on the form of the pension**

  Under programmed withdrawal, the Pension Fund Administrator (PFA) provides the pension, and this is subject to regulation to avoid risk for the pension contributor. For example, in Chile, the regulatory system establishes a clear separation between the capital of the PFA and its pension funds, under which if the PFA goes bankrupt, the pension funds are not affected and are simply transferred to another PFA. However, in the case of Life Annuities, if the Insurance Company goes bankrupt, individuals with medium-high income (who do not have rights to the social support system) lose their pension. Life Insurance Companies can go bankrupt as a result of poor management, poor investment decisions or poor risk management. In the annuities market the Insurance Company exposure to aggregate longevity risk is particularly important, meaning a systematic and generalized subestimation of life expectation of the insured population. It is therefore enormously important that insurance industry regulations guarantee solvency, and the IAIS has produced a series of recommendations aimed at achieving adequate standards. The trend towards self-regulation in the industry represents a greater challenge for supervisors, as the OECD has highlighted. Furthermore, the recent global financial crisis has led to questioning the effectiveness of supervisory and regulatory mechanisms, at least in terms of the way such systems have worked in the past.

- **It should be noted that the insurance companies exposure to aggregate longevity risk,** implies that contributors with medium-high incomes are indirectly exposed to systemic longevity risk when they take out a life annuity. In this regard, this leads back to the need to promote a market for longevity bonds.

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