Payout phase in DC pension funds – policy option - Theoretical considerations and Albanian available options

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Abstract

The aim of this paper is to provide a brief overview of the third pillar of pensions in Albania and what are the different alternatives related to the payout.
Referring to the actual development of this market in Albania, experience of the actors involved, I find it indispensable and necessary to provide some theoretical background and considerations, and then build up a simple model of projection of a pension scheme cost and a model for payout alternatives for the Albanian pension funds. A great deal of importance is shown towards posing the assumptions.
Also, the paper gives an explanation about the differences among different payout options and suggests the best option for the existing pension funds in Albania. The best option represents my conclusion and recommendation for the actual third pillar of pensions and the others that might join latter.
To sum up, the first conclusion of the paper is that the annuity option is the best alternative for the payout phase of the pensions. It has the advantage of providing the highest protection against the risk of longevity. The second conclusion is that based on other countries experiences, the annuity market have to be developed hand in hand with the pension system development. Therefore Albania should rely on and follow this experience.

Keywords: Voluntary Pension Funds, Life annuities, Longevity risk.

Introduction - Albanian pension scheme in brief

The pension scheme in Albania consists of two pillars. The first pillar is PAYG funded system, publicly managed by the Social Insurance Institute, and "defined benefits" (DB) calculated according to a specific formula based on the number of working-years, wages earned, and contributions paid. The second pillar, as per international definition of it, does not exist. Instead, there is third pillar, privately managed, voluntary contributed and defined contributions (DC). During the past decade, the first pillar has demonstrated certain problems, like low net replacement rate, high dependency rate and considerable high level of evasion of contributions payment. The international financial organizations like the World Bank and International Monetary Fund have been closely supporting and assisting the Albanian Administration to measure those problems, and provide studies and financial support to undertake several reforms. Concerning the third pillar, under the assistance of the World Bank experts, the new law on Voluntary Pension Funds was drafted, and approved in 2010, including new concepts of corporate governance, fit and proper criteria for management level, risk-based supervision, custodianship of assets, etc. Albanian Financial Supervisory Authority has licensed three Asset Management

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Companies, which are the main stakeholders in this process. The Financial Supervisory Authority (AFSA) was established pursuant to the Law No. 9572 of 3 July 2006 "On the Financial Supervisory Authority", changed, as a consolidated independent regulatory body, which reports to the Parliament, and supervises non-banking financial markets in Albania such as insurance, securities and private pension market. The law on *Voluntary Pension Funds* lays down standards for the regulation and supervision of the voluntary private pension funds in accordance with the EU directives and OECD-IOPS provisions, generating a suitable legal basis for the development of the third pillar system in Albania. The scheme below shows the mechanism and logic of the law *On Voluntary Pension Funds (10197)*, the roles and what each actor represents.

Voluntary Pension Scheme
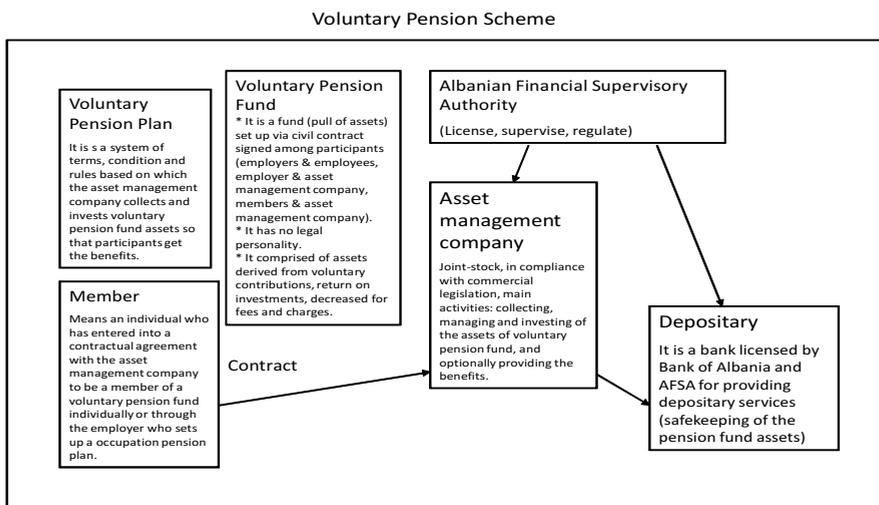
From the box defining the asset management company roles, it can be drawn that one possible role of it is to provide the benefits during the payout phase. This is the reason why in this paper I am addressing the asset management company as a possible provider of pensions in the appropriate time.

In order to have an overview of the private pension market in Albania, it is necessary to refer to some statistics. In 2014 the number of contributors was 8,491, with an increase of 7.66% compared to 2013, and the net assets under management reached a value of 629,145,606 lekë, with an increase of 44.69% compared to 2013. For the period of 30.06.2015, the number of contributors reached 10,791 and the assets under management 754,826,347 lekë, which marked an increase of 27.09% and 19.98% respectively. Despite high growth rates, the size and the development of private pension market in the country are very modest, as at the end of 2014, this market accounted for 0.05% of the Gross Domestic Product. The current situation emphasises the need for fast development of this pillar and the significant role of the asset management companies in establishing funds attractive to the individuals. Those

funds should be set up in accordance with investment strategy requirements by the legislation, and also tailored as per requirements and interests of different groups taking in account the low education level of the population.

Theoretical explanation of possible option for the payout phase
## Albanian case - available options

The participation of individuals in a pension scheme is divided in two periods, the accumulation period, and the payout period. The pension is calculated based on the accumulated amounts in his account and can be provided by different providers based on the choice of the individual. The assets accumulated during the accumulation phase can be allocated to the beneficiaries in various ways which have different characteristics and protection related to risks. Such ways include Lump-sum, Programmed withdrawal, Life annuities, and a combination of all these together (OECD, 2008, pg. 5). The main risks involved are liquidity risk, longevity risk, and legacy risk. The first option/alternative (lump-sum) protects the individual very well against the liquidity risk. This risk is less protected under the second option (the programmed withdrawal), but it is not at all under the third option (life annuity), which contrary to the others addresses better protections of the individual towards longevity risk. Another risk involved is if the dependants (children, spouse, etc) can inherit the accumulated assets, and it is addressed in all the alternatives/options, except the third alternative.

Each of the above mentioned options of paying out benefits has its characteristics and risks involved, therefore it might be more preferable to have a combination of the three options to achieve a better protection. The choice of individuals and the way they behave depends on various of factors such as: availability of different alternatives/options; the role-model of existing pension scheme/system; and the alternatives and protection provided by other pension schemes. In addition, other factors might include the financial education of the population, individual personal needs and history, financial marked development, life insurance companies in the market and their financial position, as well as the reinsurance availability. Individuals that have significant and good protection from the state schemes (as PAYG for example) which expect to receive adequate pension, can allow themselves for more risky choices in the private pension payout options. Different studies show that there is a slight positive correlation between replacement rate provided by PAYG financed pensions and flexibility of retirement payout option allowed for DC plans (OECD, 2008, pg.7). In order to protect individuals from draining the finances during the first years of retirement, the government can restrict by legislation the choices in the payout phase. Therefore, the alternative of lump-sum is considered one risky option and is to be applied with cautions. Another important factor is the market availability of certain products/ options, such as annuity. In countries where the annuity market is not developed, or is in its embryonic stages, lump-sum and programmed withdrawal will apply as the only choices. Studies show that there is a low correlation between the insurance market penetration and the degree of flexibility in choosing payout option (OECD, 2008, pg. 11). Experience shows that there are some constrains in the annuity market related to demand

and supply concerns[1].

Two important ways to make people annuitize is to make annuitization mandatory and work on improving population's financial education. The adverse selection, which is the main reason for high annuity prices, will be reduced and disappear with mandatory annuitization. Other alternatives include higher flexibility in early stages, making the annuitization mandatory in certain ages, and introducing tax incentives. Concerning longevity risk, as mention before, there are no financial instruments to hedge against it.

There are many studies undertaken by the working party of private pensions of the OECD. Below there is a graph showing the findings of such studies related to incomes from different payout options (OECD, 2008, pg.8). There are four alternatives towards payout: life annuity, 1/LE (one over life expectancy), term annuity and regular payments until 100 years of age. From the graph in Figure 1 below one can see that life annuity is the best choice to protect the individual from longevity risk and the risk of remaining without means at older ages.

Figure 1
Income from Alternative Payout Strategies
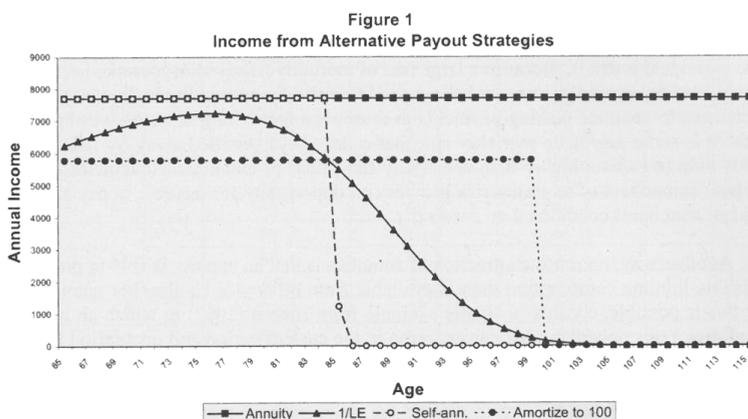
Providers of annuities and products' types

Annuities can be provided by various institutions such as pension funds, financial institutions and state annuity funds, but the main provider remains life insurance companies. Each of them has advantages and disadvantages relating to risks involved, regulatory requirement, and management and expertise. The annuity product[2] can be classified in different ways, depending on the topic one wants to use while splitting.

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[1] From demand side we can mention:- Perception of unfair pricing, Crowding out by social security provisions, Tax disadvantages, Mistrust of institutions providing annuities; and from supply side we have: Adverse selection because of high prices, Incomplete market (lack of inflation protection), Exposure to longevity risk, Regulatory capital requirements.

[2] Based on (OECD, 2008, pg. 18), the annuity product can be classified related to the - way the annuity is financed (single or flexible premium), - primary purpose(immediate pay out or deferred), - type of provide(qualified non-qualified), duration of the pay-out(fixed term, life annuity) and people covered (single, joint and survivor).

Which are the main risks when buying an annuity?

There are various risks related with the buying of an annuity, such as the time of purchase, the choices made, as well as the individual financial situations. To reduce the timing risk, governments enforce by legislation individuals to annuitize gradually, or participate in less risky investment strategies near the retirement age, called life savings strategies, and adhere in other protection schemes like social security. Relating to the choices made and individual situation, financial education is a crucial element, together with brokers, who can advise the appropriate product. In the table below, there is a matrix showing the different risk protection of annuity products (OECD, 2008, pg. 19).

	Investment risk	Longevity risk	Inflation risk	Interest rate risk	Partner's protection	Provision of bequest	Facilities accumulation
1. Programmed withdrawals, term annuity	No	No	No	No	Yes	Yes	No
2. Life annuity (single, fixed)	Yes	Yes	No	No	No	No	No
3. Joint and survivor life annuity	Yes	Yes	No	No	Yes	No	No
4. Guarantee life annuity	Yes	Yes	No	No	No	Maybe	No
5. Life joint annuities with bequest	Yes	Yes	No	No	Yes	Yes	No
6. Variable annuity	No	Yes	No	No	No	No	No
7. Fixed indexed life annuity	Yes	Yes	Yes	No	No	No	No
8. Deferred life annuity	Yes	Yes	No	No	No	No	Yes
9. Deferred joint indexed life annuity with bequest	Yes	Yes	Yes	No	Yes	Yes	Yes

Table 1. Annuity products/ risk protection

From the above table, it is clear that the alternative number nine is the best alternative which protects the individuals from almost all risks except the interest rate risk, followed by alternative number five which covers four different risks, and alternative number six, which covers only one risk. The price of the product directly depends on the degree of protection provided and is affected by the option and guarantees offered, and the flexibility allowed. The attractiveness of the annuity products does not go in line with the attitude of individuals towards buying them. If we refer to statistics, they show little voluntary annuitization from individuals in many countries. This is because of high prices of annuity products and also from weak demand from the side of individuals. The main reason for the latter is the level of financial education of the general population. In the demand side, there are also some more concerns, as for example some annuity products are not protected from the effect of inflation, or are not expressed in real terms. Other reasons are the adverse selection for some of the annuity products, and forced annuitization applied in other pillars of the pension system.

Albanian case - available options

Let's consider the possibilities and challenges in the Albanian situation. Based on the theoretical analysis made so far, Albania can be considered a very special and different case, as the annuity market is new and almost undeveloped. There are only few very simple life insurance products, that can be considered as hybrid products between life and non-life insurance such as personal accidents, group accidents, critical illness, and health insurance during travel or other, that are in fact short term (one year) contracts. There are some elements of health insurance included as well. The long term contracts are renewed each year, premium and other costs involved recalculated. No any no-claim-discount policy applied, and there are very few contracts that can be considered term life insurance (the debtor's life contracts) or collective funds or pension plans from the employer (like savings contracts). There are three Life Insurance Companies in Albania (one is composite life and non-life), the gross written premium in 2014 amounted 1,026.[3] thousand lekë or equivalent in Euro 7,332,771 (1 Euro = 140 lekë). The volume and variety of products are modest as a result of mentality, financial education, degree of confidence, financial position, and inexistence of employees' associations.

Based on the current legislation the main provider of the annuity products in Albania are the insurance companies. However, there is a clause in the voluntary pension legislation (Article 19 of the law no. 10197, date 10.12.2009 "On voluntary pension funds") that allows the asset management companies to provide pensions, if they have the necessary expertise and capacity to carry out this activity. The investment strategy is based on principle of spreading out the investment risk through diversification, but at the end there is the investor (member) that bares the investment risk. According to the Albanian legislation (Article 16 of the law no. 10197, date 10.12.2009 "On voluntary pension funds" and by laws associated), the payout of voluntary pensions can be in the form of lump-sum (or only a part of it), periodical/ regular payments (or only a part of accumulated sum), annuity or combination of the above. The annuity can be in the form of annuity (immediate), term annuity, or joint life annuity.

Concerning the Albanian situation, as mentioned above, the annuity market is almost undeveloped. However, the experience of other countries, Chile for example, can be used in this stage. It is known that the annuity market in Chile did not exist in the year 1981 when the pension reform was first introduced. The prudent regulatory requirements and basis served the development of the annuity products and the pension system in general. The Chilean model is a guide to be followed if we plan to develop private pension schemes in Albania. The success of the application of the international experience and theory in the third pillar model can serve and make the adequate preparation for the second pillar introduction in the country.

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[3] Where gross writen premium for Debtor 'life contracts is 596 Lekë.(58% of total GWP). Source AFSA, http://amf.gov.al/pdf /publikime2/raport/amf/10417_Raporti%20Vjetor%202014.pdf.

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Deterministic Model – Example

In this section a simple deterministic model of projection pension scheme cost is build up. The purpose of the model is to project the cost of the voluntary pension scheme from the perspective of asset management company, the projection of average individual accounts, the returns earned and their effect and implication on the individual accounts developments. The investment strategy applied is based on the AFSA Regulation. The portfolio of investment alternatives proposed is within the allowed asset classes. The return on investment is projected for each asset class and for the portfolio as whole. Another simple model for the pension benefits is set up as well. The data used in the models are taken from the current and past data from three pension management companies in Albania. Others are referred to the data of first pillar in Albania. As concern the life tables, the UK life tables from the yellow book are used in absence of appropriate tables for the country. There are three groups of assumptions used: economic, demographic and scheme rules assumptions. The logic behind the assumption is based on the first pillar development and the experience possessed by the author in this field. More specifically, the projection model which covers a 16 year period, covers the projection of ten blocks of indicators which can be seen below. The model can be run using different set of assumptions based on recent data coming into light or specific expected developments in the future. It is very important to emphasize that the models set up are not necessarily representing the reality. The main objective is to show the relationship among parameters and to stress the importance of the assumptions in the model.

Assumptions:

Economic (earning inflation, price inflation, state benefits, investment return, etc.)

a) **Earning inflation** (wage increase or indexation) 6% per annum over all projecting period. This assumption is taken from the projection done for the first pillar.

b) **Price inflation** is assumed to be 4% per annum. This assumption is taken from the projection done for the first pillar. (The rate 6% + 4% = 10% is used for pension indexation.)[4]

c) See also assumptions (h), (j), (x), (z) in pension scheme rules.

Demographic (mortality rate, withdraw rate, early retirement rate, morbidity rate, etc.)

a) **Mortality rate** *(net total figure)*: 5.6% new survivor pension every year. The percentage is applied on the number of survivor pension in the previous year. The rate of increase in the number on survivor pension is the same as in the first pillar.

b) **Morbidity rate** *(net total figure)*: 8.8% new disability pension every year. The percentage is applied on the number of disability pension in the previous year. The rate of increase in the number on disability pension is the same as in the first pillar.

c) **Withdrawal rate** *(net total figure):* 1% of the total number of members up to the

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[4] Earning and price inflations reflect an optimistic scenario.

Y8 and after on the percentage will be 0.8% and ending up with 0.6%.

d)   **Transfer rate** *(net total figure)*: 1% of the total number of members up to the Y8 and after on the percentage will be 0.8% and ending up with 0.6%.

e)   **Pensioners' breakdown**: 77% (retirement); 8% (disability); 15% (survivor). This assumption is derived from the first pillar distribution of number of pensioners.

f)   **New pensioners**: 3.2% (retirement); 8.8% (disability); 5.6% (survivor). The rate of increase is derived from the trend in the first pillar.

g)   **Male/female ratio**: female proportion: 43% (in retirement pensions); 30% (in disability pensions); 15% (in survivor pensions). Apply the same gender distribution as in the first pillar.

Pension scheme rules and developments

a)   **Participation** consists of five groups: three wage interval groups, those who withdraw from the scheme, and those who transfer. As concern wage intervals the indicator used in breakdown is the wage amount, high wages interval (100,000-200,000 lekë); medium wages interval (70,000-99,999 lekë); and small wages interval (<69,999 lekë). It is supposed that in the first year (Y1) there will be no withdrawal and no transfer from the pension scheme. In the first year (Y1) the breakdown of participants according to monthly wage intervals is supposed to be like 40%, 40% and 20%. From the second year on, it's supposed that some participants will withdraw or transfer to other funds with a percentage 2% up to the Y8, continuing with 1.6% and ending up with 1.2%. The wages are supposed to increase during the years, as result of inflation-indexation applied, average wage increase applied is 6% (higher rate applied for small wages). The weight of small wages interval is supposed to be the highest weight, about 45%, by the end of the projection period Y16.

b)   **Change in number of membership**. This projection is based on not very optimistic assumption of increase in the number of fund members. It is supposed to start with 5,000 members, and by Y16 to end up with 31,000 members, with an average increase about 10-12% per year.

c)   **Contribution amount** can be wage related or not, but it is supposed to be not related to the wage. There are three levels of contributions applied, 5,000 lekë/month, 2,000 lekë/month and 1,000 lekë/month, depending in which wage group they are. So, it is supposed to start with an average contribution amount 3,000 lekë/month. Further on, it is supposed to increase for each group by 500 lekë/month every year until Y16. By the end of projecting period, in Y16, the average monthly contribution will be roughly 10,082 lekë/month.

d)   **Penalty for delay in contribution payment.** Assume there is no penalty applied for the first three years. Thereafter is assumed to apply 0.5% - 1% of the amount in delay payment.

Number of pensioners and pension amount

e)   **Pensioners' breakdown** (see paragraph (e) at demographic assumptions).

f)   **Number of early withdrawals** (see paragraph (c) at demographic assumptions).

g)   **Number of those transferred** to other funds (see paragraph (d) at demographic assumptions).

h)   **The number of new pensioners** (see paragraph (f) at demographic assumptions).
i)   **Male/female ratio** (see paragraph (g) at demographic assumptions).
j)   **Vesting period and pension age:** Assume vesting period is 5 years. Retirement age according to the law is 60-65 for men and 55-60 for women.
k)   **Rate of those receiving lump-sum:** 20% receives the pension in the form of lump-sum.
l)   **Disability pension:** Assume disability pension amount equal to 82% of old age pension amount.
m)   **Survivor pension:** Assume survivor pension amount equal to 50% of old age pension amount.
n)   Early withdrawal
In case of early withdrawal the pension amount is reduced by:
i.   17.5% when withdraw within Y0-Y5 (since the first contribution paid)
ii. 12.5% when withdraw within Y6-Y10 (since the first contribution paid)
iii. 7.5% when withdraw within Y11-Y20 (since the first contribution paid)
iv. 3.5% when withdraw beyond Y20 (since the first contribution paid)
 Assume the percentages of pensioners which withdraw in each of the above groups are:
v.   Within Y0-Y5, in average 1% of the pensioners withdraw.
vi. Within Y6-Y8, in average 1% of the pensioners withdraw.
vii. Within Y9-Y10, in average 0.8% of the pensioners withdraw.
viii. Within Y11+, in average 0.6% of the pensioners withdraw.
o)   **Transfer to other fund:** Apply the fee 0.5% of the transferred assets, as per the Article 69 of the law no. 10197 date 10.12.2009 "On voluntary pension funds".
Assume the percentages of pensioners which transfer in each of the above groups are:
i.   Within Y0-Y5, in average 1% of the pensioners transfer.
ii. Within Y6-Y8, in average 1% of the pensioners transfer.
iii. Within Y9-Y10, in average 0.8% of the pensioners transfer.
iv. Within Y11+, in average 0.6% of the pensioners transfer.
p)   **Tax in case of early withdrawal:** Tax is applied after early withdrawal reduction at a rate of 10%.
q)   **Allowable investments:** The assets of a voluntary pension fund can only be invested in the instruments allowed. (See Article 3 of Regulation no. 1 date 28.01.2010, changed, of the Board of the Authority in the Appendix D.) Assume (based on the actual statistics of the existing pension funds), the average investment return is 6.8% per annum during Y1-Y5; 7% per annum during Y6-10 and 7.25% in Y11-Y16. Assume that during Y1-Y5 investment classes are government bonds (80%) and bank deposits (20%); during Y6-Y10 besides the government bonds (70%) and bank deposits (20%) assets are invested in corporate bonds (10%); during Y11-Y16 the breakdown supposed is government bond (60%), bank deposits (20%), corporate bonds (10%) and in shares (10%).
r)   **Expenses:** According to the legislation the administration fee cannot exceed 3% of annual assets. Also, the fee to the regulator is equal to 1.5% of annual assets, and the fee to depositary is 0.05% of annual assets.

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s) **Pension amount:** Assume pension amount is indexed by 10% per annum.

Methodology and data used
The model established is simple, developed under Excel program, and containing straightforward relationships among parameters and variables, which are expressed in formulas. Changing the values of parameters can serve seeing the influence of that parameter in the outputs/results of the project. Thus, everyone can do sensitivity tests, on individual parameters (assumptions) or groups of them. The calculation can be easily done for other values of parameters, or different set of assumptions. The approach was to take very simple and stable assumptions, as voluntary pension scheme in Albania is new and lacks the past data or industry data. The only source of data is the first pillar and the 2-3 years data of the third pillar. Once the model is set up it can be improved and updated with fresh and more realistic data in the future. Therefore, the request to change the assumptions can be easily applied.

Findings of the Model

According to the findings the scheme provides an increase on individual average accounts about 28% p.a. as result of payment of contribution and return on investment. The pensions amount (in the form of regular payment) starts (Y1) with 10,000 lekë/month and ends up 26,000 lekë/month in the year Y16. This shows an increase of 160% in the amount of pension in 11 year period. Also, an individual calculation of accumulation and payout phases is provided as well. If we consider an individual which pays contribution of 5,000 lekë/month with an increase of 500 lekë/month every year, then the accumulated amounts in his account applying an average annual rate of return of 6% will be 2,658,061 lekë after 16 years; 4,118,836 lekë after 20 years; and 10,228,268 lekë after 30 years, in case the benefit is received as lump-sum. If the remaining balance is invested at 6% and the pension indexation is 10% p.a., the individual can receive regular payment pension for 16 years. The individual starts with a monthly pension in Y1 of 10,000 lekë and ends up in Y16 with a monthly pension of 41,772 lekë. The same interest rate is applied in the accumulation and payout phase, about 6% annual rate of return. This is the case that asset Management Company is investing in fix rate of return securities (i.e. government bond).
The same application/calculations can be done if we consider more years of payment of contribution and different pension amounts, different investment returns during accumulation and payout phase. Thus the model can be extended and applied for other individuals with different contributing history and different pension amount agreed and different duration history. In case that the accumulated sum will be used to buy annuity, then, base on calculation, the annual/monthly annuity for a life annuity contract will be:
Assume a 60 year male which has contributed in a pension fund for 16 years, wants to buy a life annuity. Sum assured (what is in his account) is SA = 2,658,060.78 lekë. Initial expenses are E_1 = 2,500 lekë, other expenses are 1% of the sum assured (E_2). The assumption on E_2 is very simplistic aiming not to complicate the calculations. In

practice and real life, usually this percentage is applied on premium paid (in our case contribution paid) during the accumulation period.

Using UK, AM92 table, at 4%, the Equation of value is:
PV (contributions) = PV (benefits) + PV (expenditures)
$SA = P*a_{60} + E_1 + E_2$
Where P is the pension received.
$2,658,060.78 = P \times (ä_{60} – 1) + 2,500 + 0.01 \times 2,658,060.78$
$2,658,060.78 – 2,500 – 26,580.61 = P \times (14.134 -1)$
$P = 2,628,980 / 13.134$ $P = 200,166$ annual pension amount
For the monthly amount we receive: $P/12 = 16,680.5$
⇨   The pension received during the life is 16,680.5 lekë/month.
The calculations show that the monthly pension amount in case of buying annuity is less than in case of regular payment (where the individual receives indexed periodical payment for 16 years). But as explained before annuity pension protects the individual from the risk of longevity.
The above calculation has the drawback of using the UK table in the absence of one for Albania.

Conclusions and recommendations

Finally, based on the theoretical explanation and experience of developed countries and outputs and finding of deterministic models constructed and explained above, my conclusions and recommendation are:
· *The annuity option is the best alternative for the payout phase of the pensions. It has the advantage of providing the highest protection against the risk of longevity.*
· *The annuity market has to be developed hand in hand with the pension system development. It is considered waste of time waiting for annuity market to be developed and after setting up pension schemes based on annuity option as payout. Both processes should happen in parallel.*
· *Albania should follow the best practice and experience in the field of annuity payment as the best alternative for the payout of pensions.*

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Organization for Economic Co-operation and Development (OECD), www.ocde.org.

Appendix A: *Recent data on voluntary pension market in Albania (source AFSA)*

Company	Net assets in ALL/ Members			
	2013		2014	
Raiffeisen Pensions	174,493,520	2,548	232,854,678	2,540
Sigal Uniqa	202,189,769	3,503	310,558,256	4,027
SiCRED Pensions	58,137,870	1,836	85,732,672	1,924
Total	434,821,159	7,887	629,145,606	8,491

Table 2. The Voluntary Private Pensions' Market in Albania (Net assets and Members).
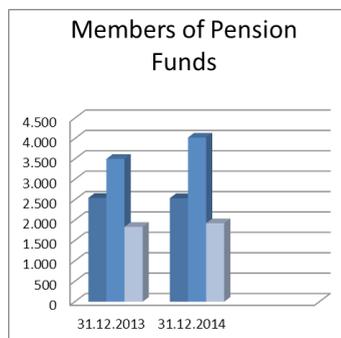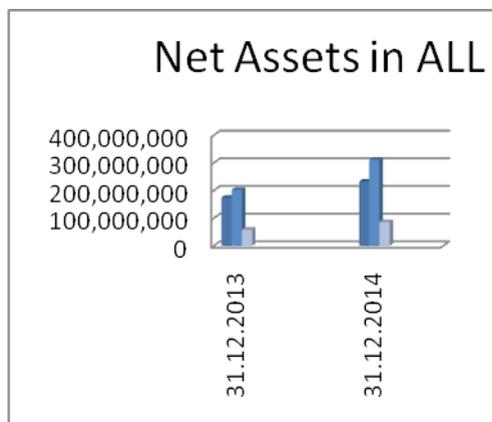

Figure 2. (Net Assets in ALL)   **Figure 3** (Members of Pension Funds)