The market for annuities in Italy: reality or chimera?

♦

Preliminary results of research by a study group including **Elsa Fornero (University of Turin and CeRP) and Margherita Borella, Carolina Fugazza and Giacomo Ponzetto (CeRP)**

♦

Turin, 21-22 June, 2002

CeRP, Centre for Research on Pensions and Welfare Policies
Via Real Collegio 30 – 10024 Moncalieri (TO) – Italy - Tel. +39 011 6402402 – Fax: +39 011 6403680
E-mail: cerp@cerp.unito.it - http://cerp.unito.it

Plan of the work

1. After 10 years of intensive legislative action, the Italian annuity market:

- is still very small, although with considerable growth potential

  - Why is it very small?

  - Will its potential be realized?

2. Pre-requisites from the demand side

- Partial inadequacy of public pensions
- Economic advantages in terms of:
  - fiscal incentives
  - net returns
- Confidence in the market
  - full information and transparency
  - professional competence
  - good supervision and governance

2.1 An analysis of households' attitude toward annuities

- Analysis based on Italian micro-data (Survey on Households' Income and Wealth, SHIW)

- The use of repeated cross-sectional data (from 1989 to 2000) allows to identify, among other things, the effects of changes in public pension wealth and in fiscal incentives on participation in annuity market.

- Preliminary analysis shows that households' participation in the market as well as amount invested have been growing in the decade. Younger and wealthier households are more likely to invest in annuities.

- Preliminary results show that a reduction in social security wealth induces an increase in participation in the market (results not shown).

2.2 Percentage of households participating in the market and average contribution by year

	1989	1991	1993	1995	1998	2000
Deferred annuities						
% Participants	18.71	23.86	28.40	27.71	30.96	30.28
Average contribution	160.34	232.25	322.73	355.97	456.04	390.77
Contrib. conditional on participation	857.18	973.48	1136.39	1288.40	1482.93	1299.19
Pension Funds						
% Participants	6.88	7.68	9.94	8.16	9.33	15.52
Average contribution	91.56	109.12	142.20	153.68	165.49	282.86
Contrib. conditional on participation	1330.82	1421.21	1430.82	1787.40	1697.91	1822.95
Number of families	5,378	4,858	4,236	4,140	3,753	3,738

Note: monetary values are expressed in euro at constant prices (year 2000)

Sample selection: households headed by person active in the labour market and non-unemployed

2.3 Households’ characteristics by participation in the market

	Deferred Annuities	Pension Funds	DA+PF	Total
Head Age	43.99	43.08	43.81	44.19
Head Married	0.88	0.83	0.86	0.84
Head Male	0.89	0.87	0.88	0.87
Head Higher Edu	0.57	0.62	0.58	0.46
Head Self-Employed	0.35	0.38	0.35	0.27
# Income Recipients	1.86	1.86	1.86	1.75
# HH Components	3.50	3.21	3.43	3.41
Resident in the South	0.30	0.12	0.26	0.36
Disposable Income	37386.50	40468.51	37492.65	30765.62
Net Wealth	208631.00	221453.20	206256.60	145940.50
N. of Obs.	6809	2432	8431	26103

Note: monetary values are expressed in euro at constant prices (year 2000)

Sample selection: households headed by person active in the labour market and non-unemployed

Source: SHIW, various years

3. Pension policy since 1992

– Reforms have reduced public pension benefits for younger and future generations, but have not cut payroll tax rates

– As for private pensions, in the trade off between paternalism-guarantees and risks-returns, the second option has been chosen

– The severance pay - TFR - flows have been erroneously regarded as a "free" source of private pension financing

3.1 -The diminishing Money's worth for younger and future generations

Money's worth measures (per cent)				
Regime	***Cohorts***	*IRR*	*RR*	*NPVR*
EB	*1943*	3.25	68.3	143
	1948	3.06	70.4	136
	1953	2.83	71.1	127
Pro rata	*1958*	2.31	64.7	109
	1963	2.07	62.9	102
	1968	1.85	60.1	95
	1973	1.58	57.6	88
CB	*1978*	1.57	57.5	87
	1983	1.57	57.5	87

EB: earnings based; CB: contribution based; the first reflects pension formula before 1995 reform; the third reflects the new notional defined contribution method introduced in 1995 and the second reflects the slow phasing in of the new method.

Source: E.Fornero-O.Castellino (eds.), La riforma del sistema previdenziale italiano, Il Mulino, 2001.

3.2 - The relative ineffectiveness of legislation on pension funds

- **Many different laws directed at**
  - **granting fiscal advantages (only nominal? hampered by TFR diversion?)**
  - **"Securitization" (too complex)**
  - **compulsory diversion of TFR flows (payroll tax rates already too high?)**
- **With the aim of:**
  - **maintaining for the diverted TFR funds the same liquidity of present TFR (precautionary savings vs. retirement savings)**
  - **encouraging annuitization**

3.3 Fiscal treatment

a) Contributions

Type of income	Contributions deductible up to the lowest among:
Labour income of employees with TFR provision	- twice the amount of the diverted TFR flow - 12% of income - € 5165
All other incomes	- 12% of income - € 5165
For dependent members: Income of supporting head of household regardless of its source	- 12% of income - € 5165

b) Accumulation phase

- Reduced tax rate on investment income: 11% instead of 12.5%
- Capital losses deductible from future taxable capital gains with no time limitation

c) Payment phase

i. Life annuity upon retirement

- All investment income (already taxed at 11% during the accumulation phase) is tax exempt
- All investment income earned during the payment phase is taxed at 12.5%
- Progressive general income tax is due only on the annuity resulting from the sum of original contributions without considering any returns

ii. Tax-advantaged capital withdrawal options:

- complete redemption upon unintentional job termination
- complete redemption by the heirs of a deceased participant
- partial redemption or advances during working life and partial lump-sum withdrawal at retirement, totalling no more than 1/3 of accumulated fund
- complete withdrawal as a lump-sum at retirement if the annuity is lower than 50% of the "social allowance" (currently ∈4438 yearly)

✓All investment income (already taxed at 11% during the accumulation phase) is tax exempt

✓ The sum of original contributions is taxed at the average income tax rate of the previous 5 years

iii. Other capital withdrawal options:

- complete redemption upon intentional job termination

  ✓ The net-of-returns redeemed amount is taxed at the marginal income-tax rate

- partial redemption or advances during working life and lump-sum withdrawal at retirement, totalling <u>more</u> than 1/3 of accumulated fund

  ✓ The <u>whole</u> redeemed amount is taxed at the average income tax rate of the previous 5 years

Remarks:

• Complex system, not free from ambiguities, but allowing differential treatment of advantaged and disadvantaged pay-out options

• (Disregarding the condition on TFR diversion), great generosity to annuitants: investment returns are ***never*** taxed as ordinary income if an annuity is eventually taken out, making the effective tax rate lower than in a pure E-E-T pension scheme

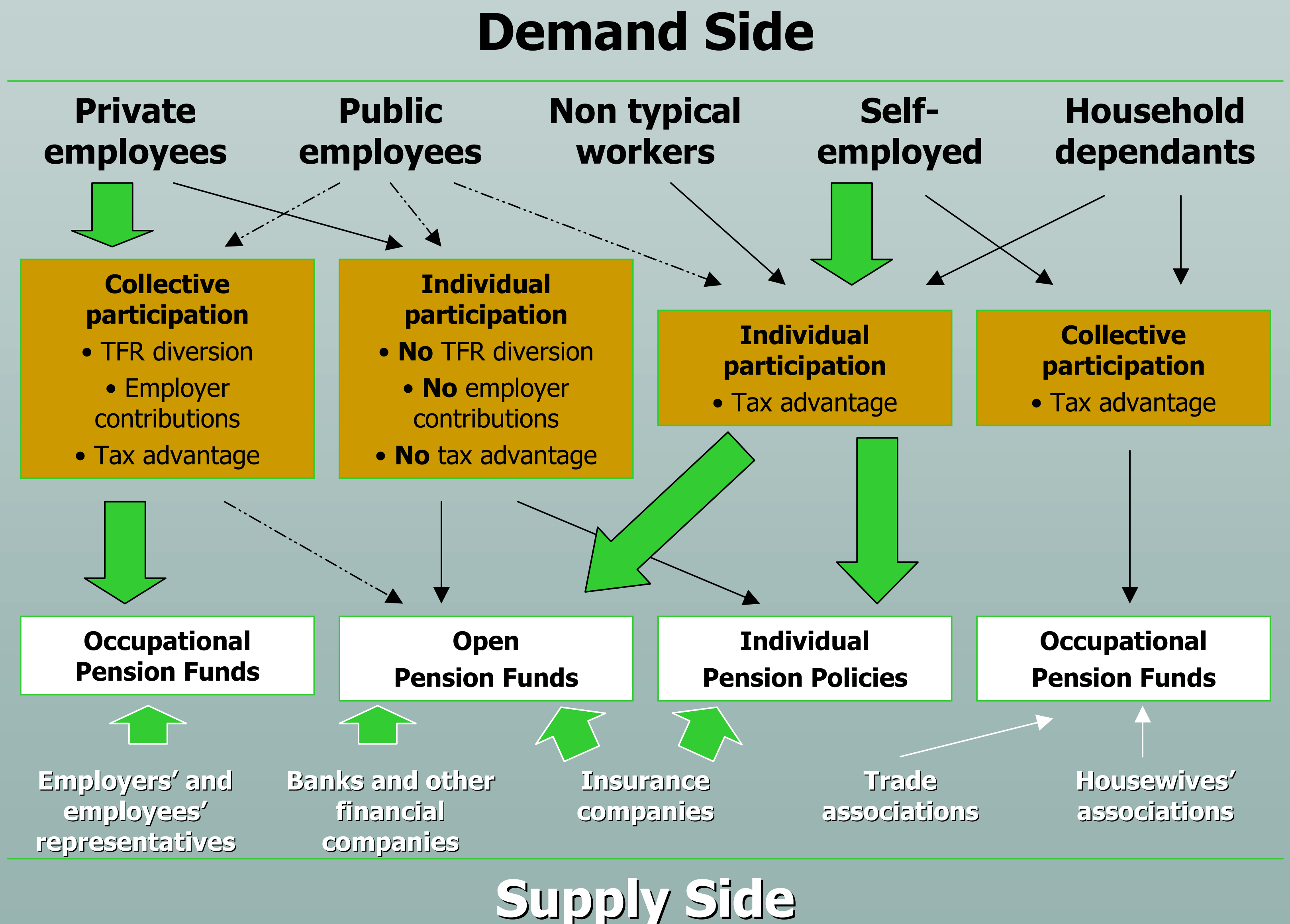
• The higher the investment returns, the lower the effective tax rate: an incentive to risk-taking?

• A regressive tax regime, that reduces the overall progressivity of income tax

4. The annuity industry's supply side

- Insurance companies have largely disregarded annuities so far:
  - assuming demand to be insignificant
  - finding other policies (purely financial instruments) far more popular and profitable
- Renewed interest after reforms have given scope for funded pensions

5. Features of the market: 5.1. Segmentation



5.2. Liquidity

a) Capital withdrawal options

- complete redemption by the heirs of a deceased participant
- complete redemption upon job termination

→ more favourable tax treatment if termination is involuntary

- advance (for participants to collective pension plans) or partial redemption (for participants to individual pension plans) when a TFR advance would have been possible

→ favourable tax treatment only if withdrawn amount is no more than 1/3 of the total

- lump-sum withdrawal upon retirement, up to 50% of the total

→ favourable tax treatment only if withdrawn amount is no more than 1/3 of the total

- lump-sum withdrawal upon retirement, when the resulting annuity would be lower than the "social allowance" (currently € 4438 yearly)

→ favourable tax treatment only if the resulting annuity would be lower than 75% of the "social allowance"

b) Mobility between pension plans

- Participants in any pension plan may transfer to an occupational Pension Fund whenever they become eligible for participation after changing employment
- Participants can switch from an occupational Pension Fund to any individual pension plan (open Pension Fund or FIP) subject to minimum-stay requirements: but if they do they can no longer enjoy employer contribution nor divert their TFR flows, and thus lose all tax advantages
- Participants may freely switch from an individual pension plan to another, subject to minimum-stay requirements: but the pricing structure of FIP (though not of open Pension Funds) usually discourages switching

5.3. Different players with different rules

	Occupational Pension Funds	Open Pension Funds	Individual Pension Policies (FIP)
Assets owned by	the Pension Fund, whose board of directors is appointed by employers and employees in equal shares	the Pension Fund, whose director is appointed by the incorporating financial firm or insurance company	the Insurance Company, <u>separately</u> from its other assets
Assets managed by	asset management companies selected by the Pension Fund directors	the incorporating financial firm or insurance company, acting in the sole interest of the Pension Fund	the Insurance Company, acting in the sole interest of the insured

5.4. Investment options

Occupational Pension Funds	Open Pension Funds	Individual Pension Policies (FIP)	
		Unit-linked annuities	With-profits annuities
• Currently: single investment line in all Pension Funds (except the Dentists' Pension Fund already operating in multiple lines) • In preparation for most Pension Funds: multiple investment lines as in open Pension Funds	• Multiple investment lines: typically 3-5 • Individual participation allowed for one line at a time • Possibility to switch once a year	• Individual participation in more than one investment fund at a time • Possibility to switch whenever desired (at a cost) • Funds of funds and age-specific portfolio allocation sometimes offered	• Investment in safe bonds (mainly BTP) through a separately managed account which is not marked to market and carries a year-on-year return guarantee • A with-profits annuity may be offered as one of the investment options in a unit-linked annuity

5.5. Financial risks and guarantees

a) Accumulation Phase

Occupational Pension Funds	Open Pension Funds	Individual Pension Policies (FIP): Unit-linked annuities	Individual Pension Policies (FIP): With-profits annuities
• Financial risks are shouldered by participants • Defined-benefit Pension Funds are allowed for the self-employed only (none exists) • No financial guarantee is offered • The legal rate of return on TFR contributions is often chosen as a benchmark	• Defined-benefit Open Pension Funds are allowed (albeit only for the self-employed) but none exists • Financial guarantees are offered on some very conservative investment lines, but these have not been very popular, accounting for about 5% of the market	• Financial guarantees are very rare, with the exception of with-profits annuities offered within a unit-linked policy	• The policy guarantees a minimum return each year, without averaging favourable past returns with present losses • The maximum rate which can be guaranteed is 4%, or 60% of the average return on BTP (current ceiling is 3%, but actual guaranteed returns are lower)

b) Annuity pay-out phase

- all pension plans offer only a with-profits annuity with minimum yearly returns during the pay-out phase
- it is envisaged that different products could be created and offered to clients before private pensions actually begin to be paid

5.6. Demographic Risks

	Occupational Pension Funds	Open Pension Funds	Individual Pension Plans
accumulation phase	On participants	On participants	On participants, except for contracts adopting a fixed mortality table
decumulation phase	On the insurance company	On the insurance company	On the insurance company

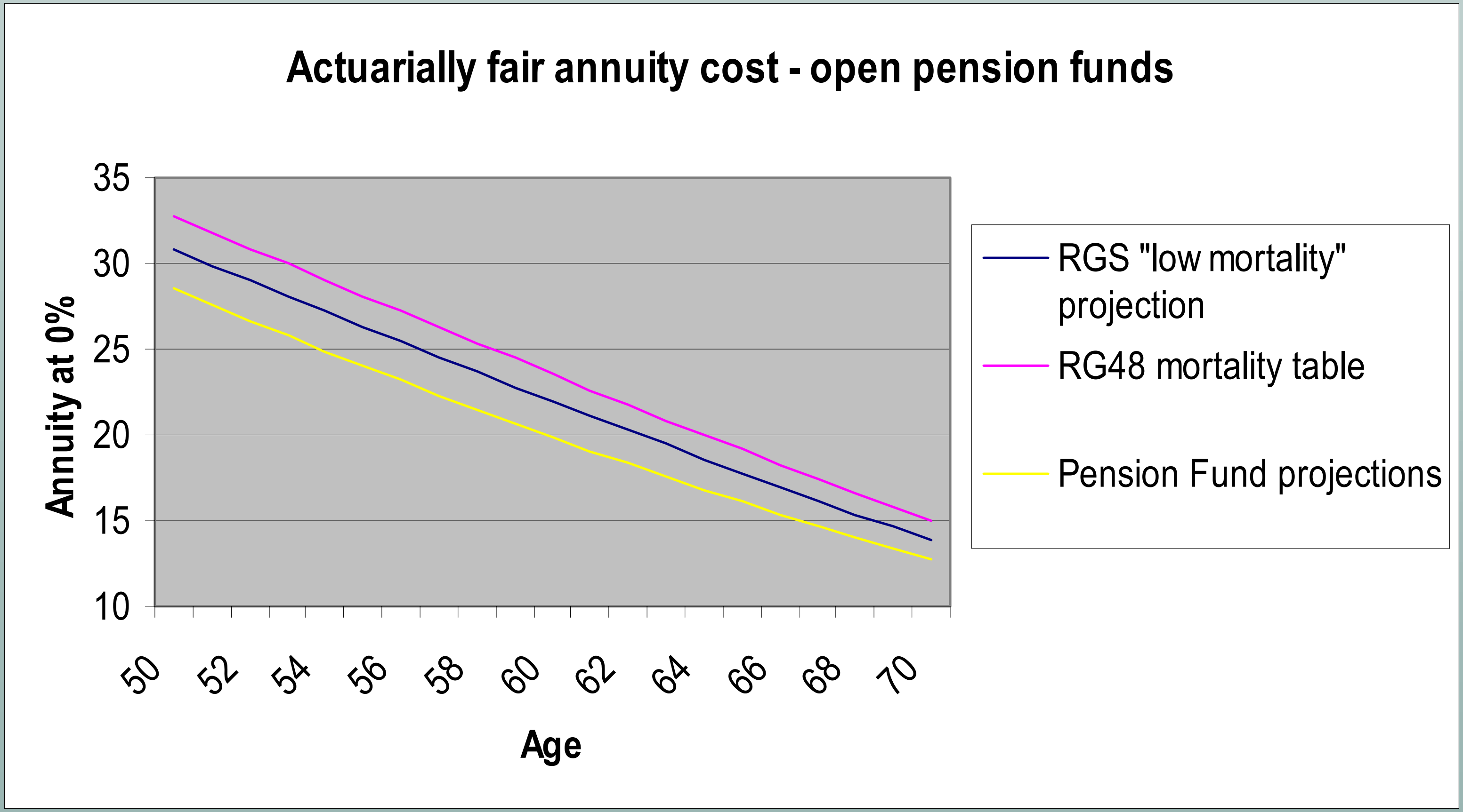
5.7. PRICING

	Occupational Pension Funds	Open Pension Funds	Individual Pension Plans
mortality tables	Yet to be decided No gender differentiation?	Mortality table declared in advance, but changes are possible any time in the accumulation phase RG48 Generali 98ps ISTAT SIM (SIF) 91 projections gender differentiation	RG48 gender differentiation
technical interest rates	Varying between zero and the maximum allowed by the supervisory authority		

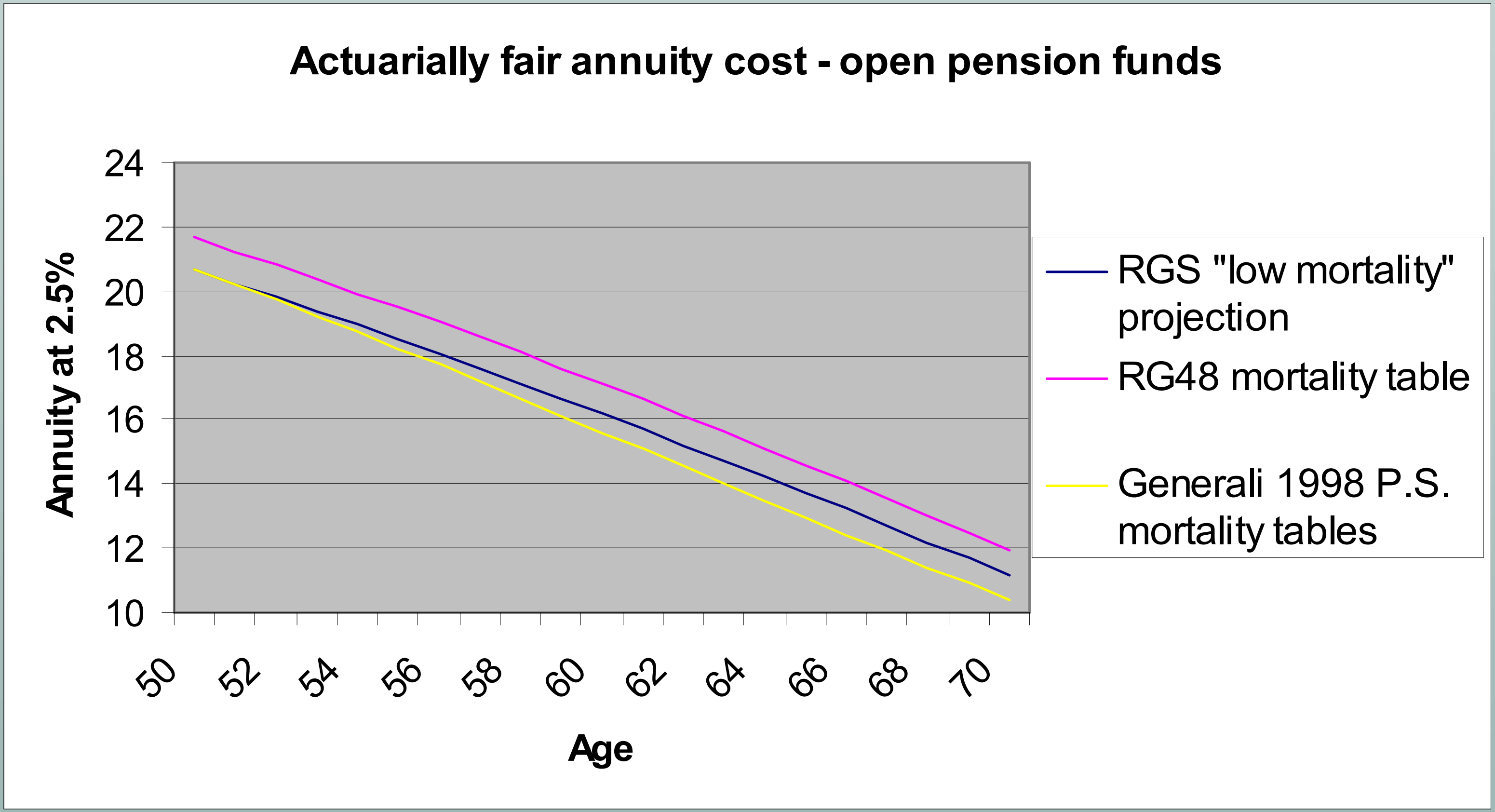
5.8. Costs

Occupational Pension Funds	Open Pension Funds	Individual Pension Policies (FIP) -based on market leaders-
Simple structure, low costs: • Entry fee: Small lump sum (€ 10) • Annual administrative and management fees: On average 0.70% of assets	Simple structure, moderate costs: • Entry fee: Modest lump sum (€ 10 - 60), waived for group participation • Possible fixed annual fee: Usually € 15 - 20 • Possible fixed fee for switching investment line or leaving the Fund: Variable but modest • Annual management fee: 0.6%-1.5% of assets Comparable to that of mutual funds and possibly lower.	Often complex structure with poor transparency and very strong front-loading. Generally higher costs: • Loading on premia during the accumulation phase: 1,5%-8.5% but up to 80% on the first premium • Often double management fees (direct and indirect), even totalling more than 4%, though in some cases in line with open pension funds

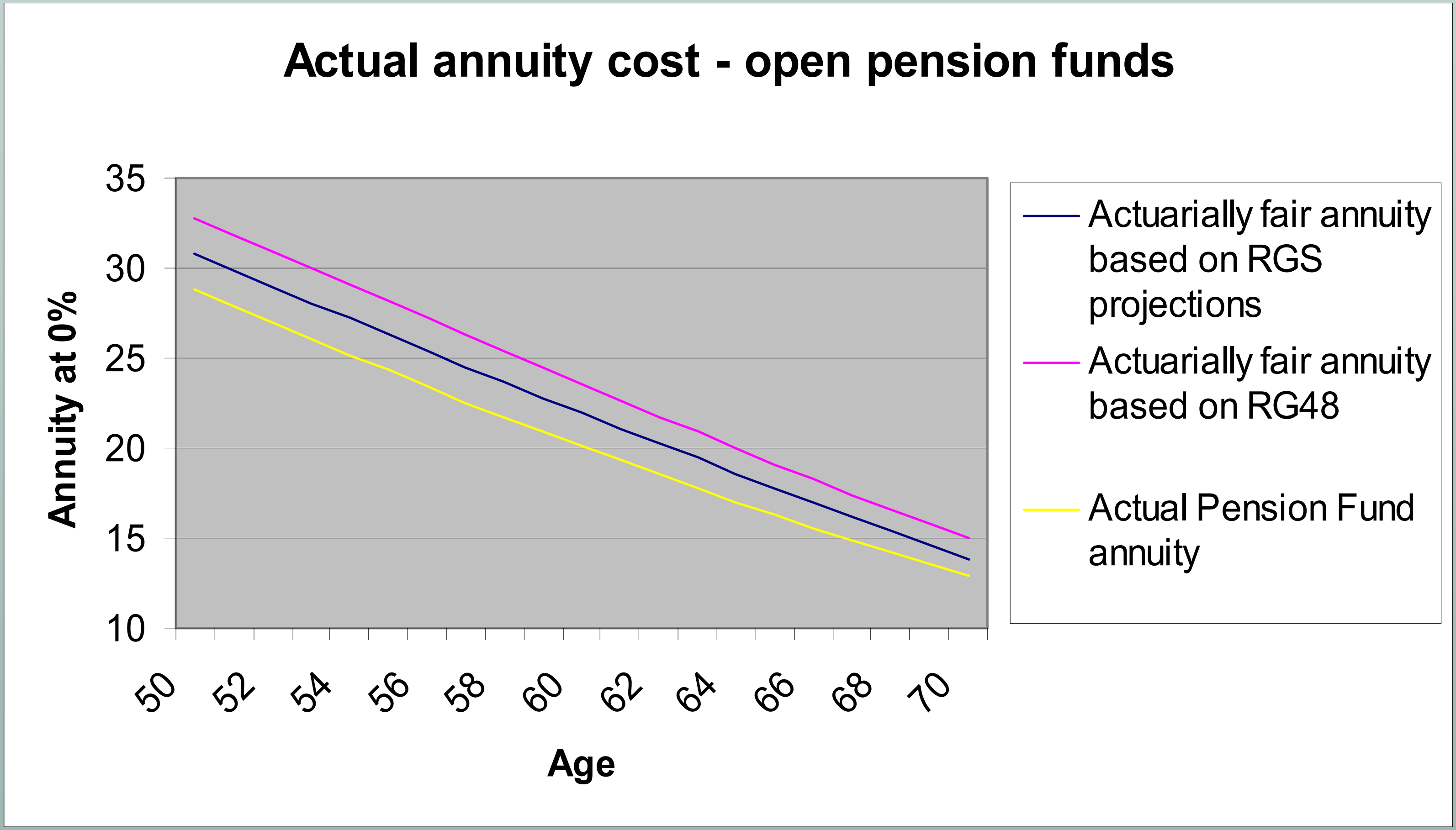
6. Comparisons between different mortality tables



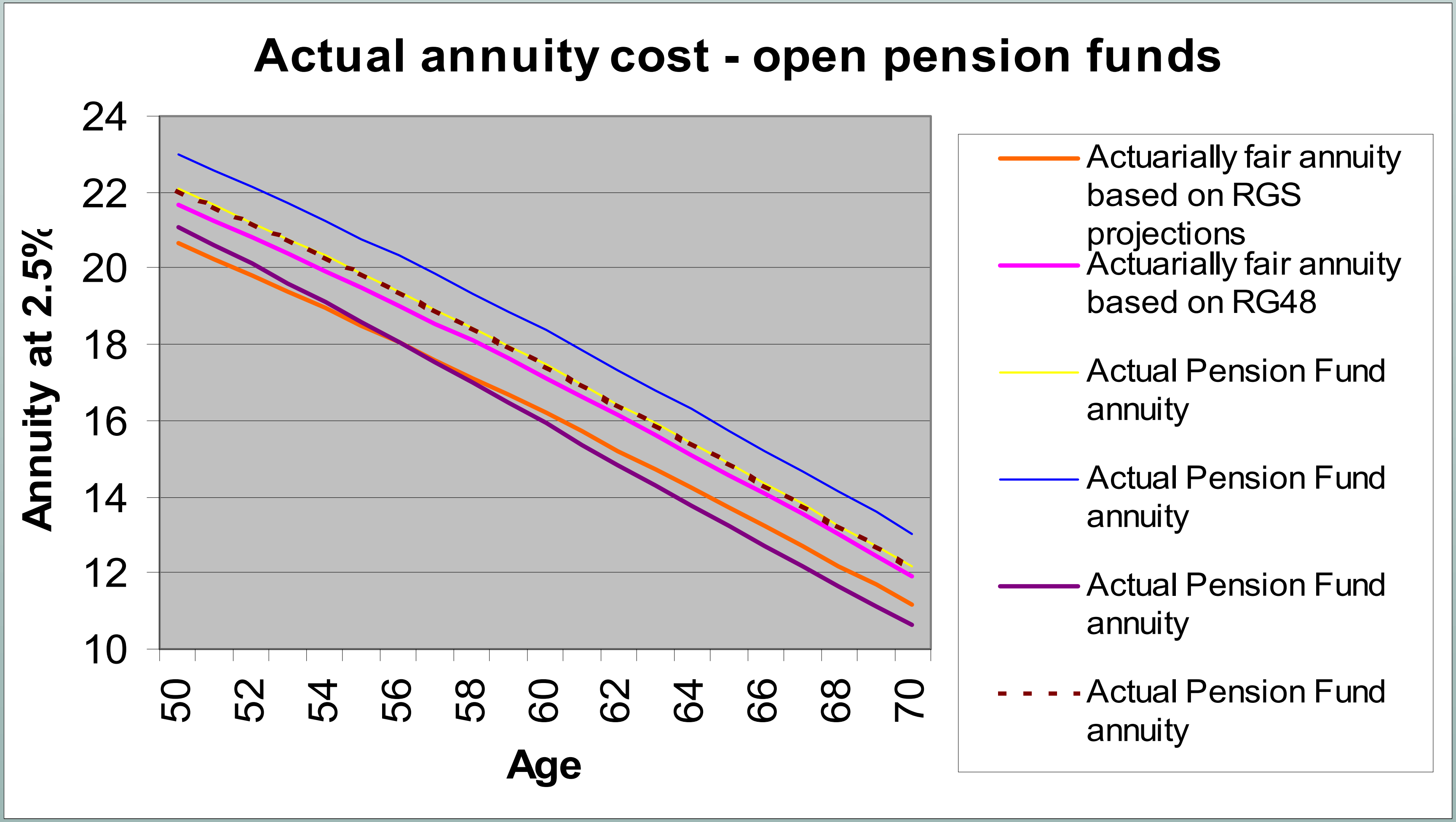
Source: authors' calculations from insurance companies' data



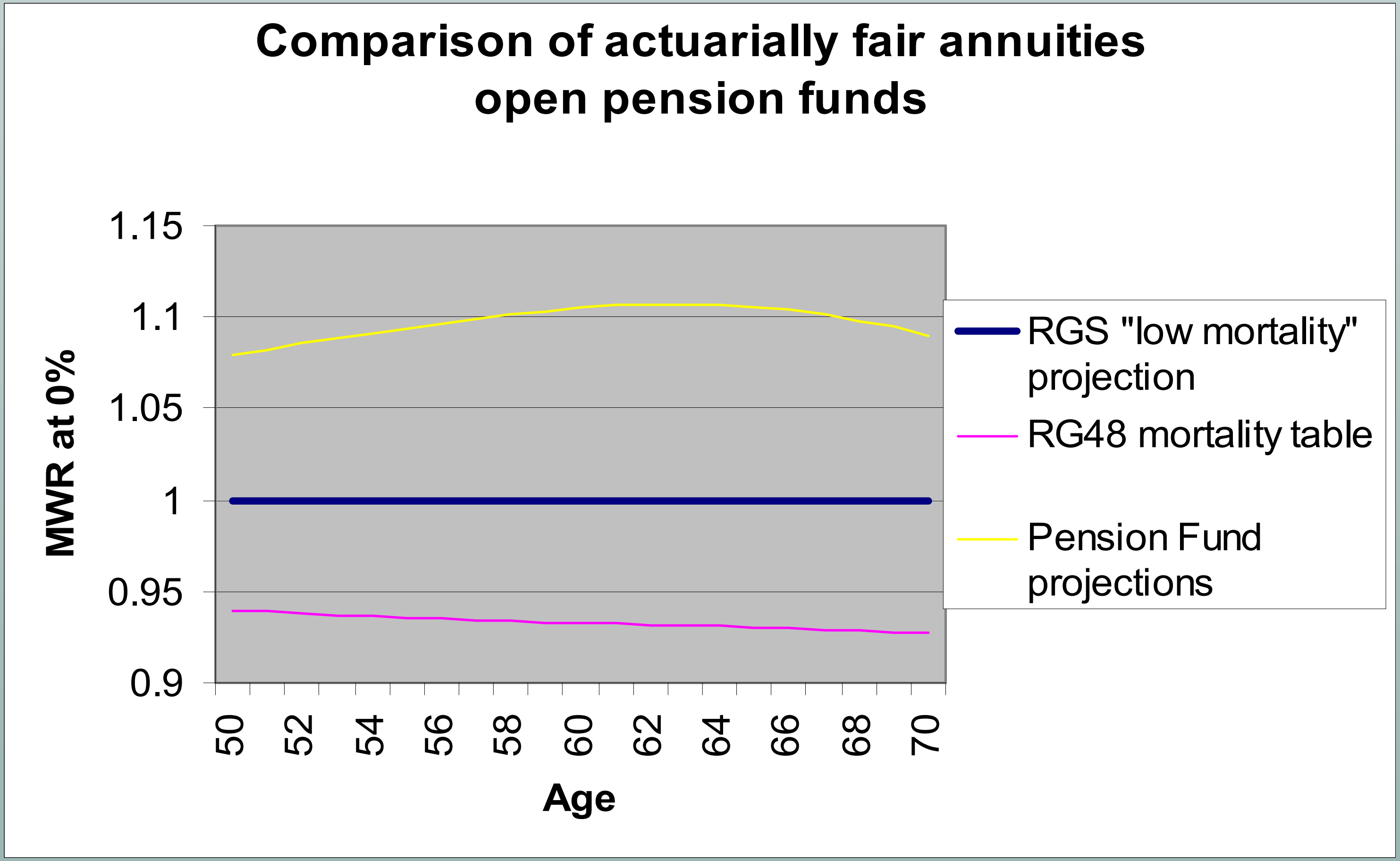
Source: authors' calculations from insurance companies' data



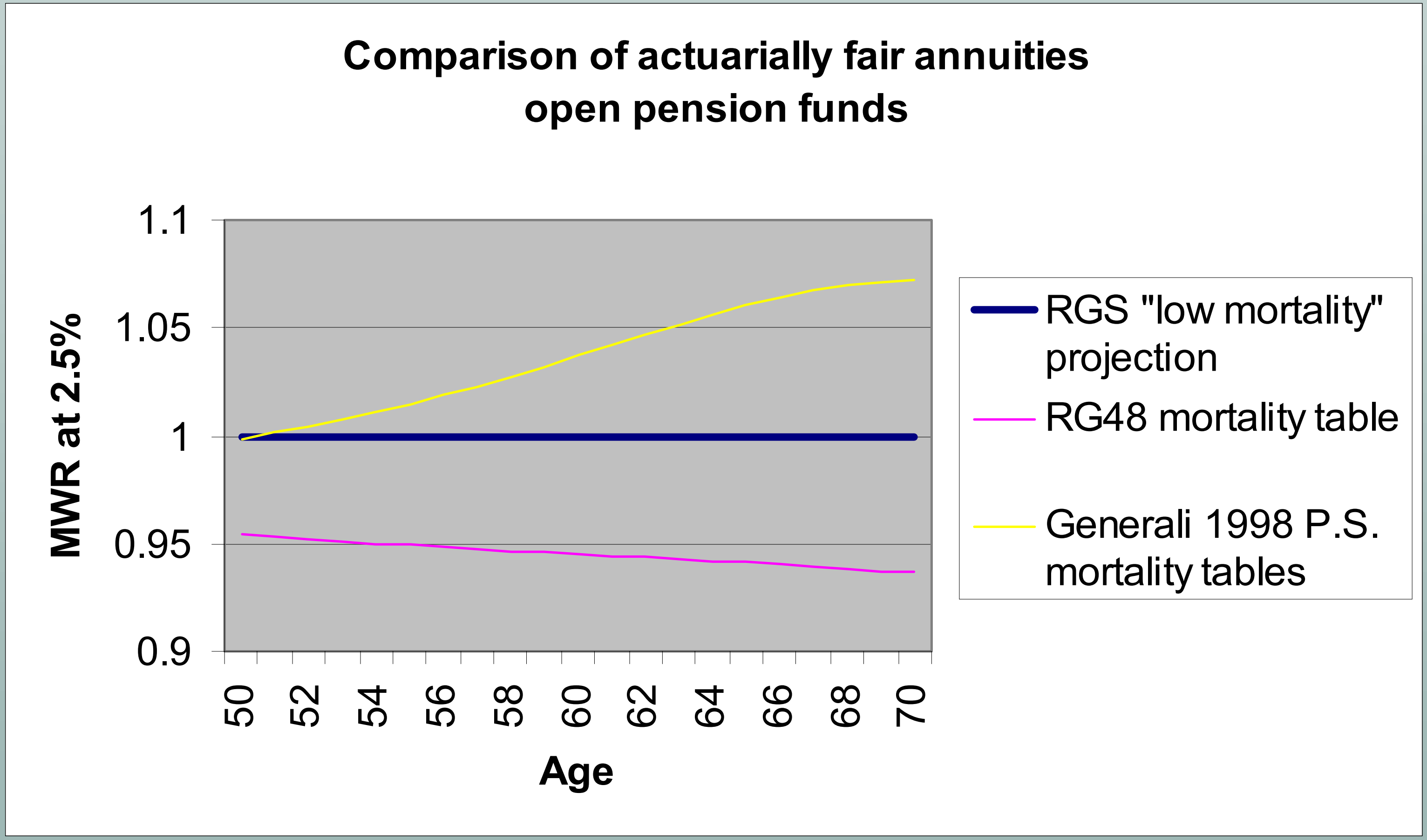
Source: authors' calculations from insurance companies' data



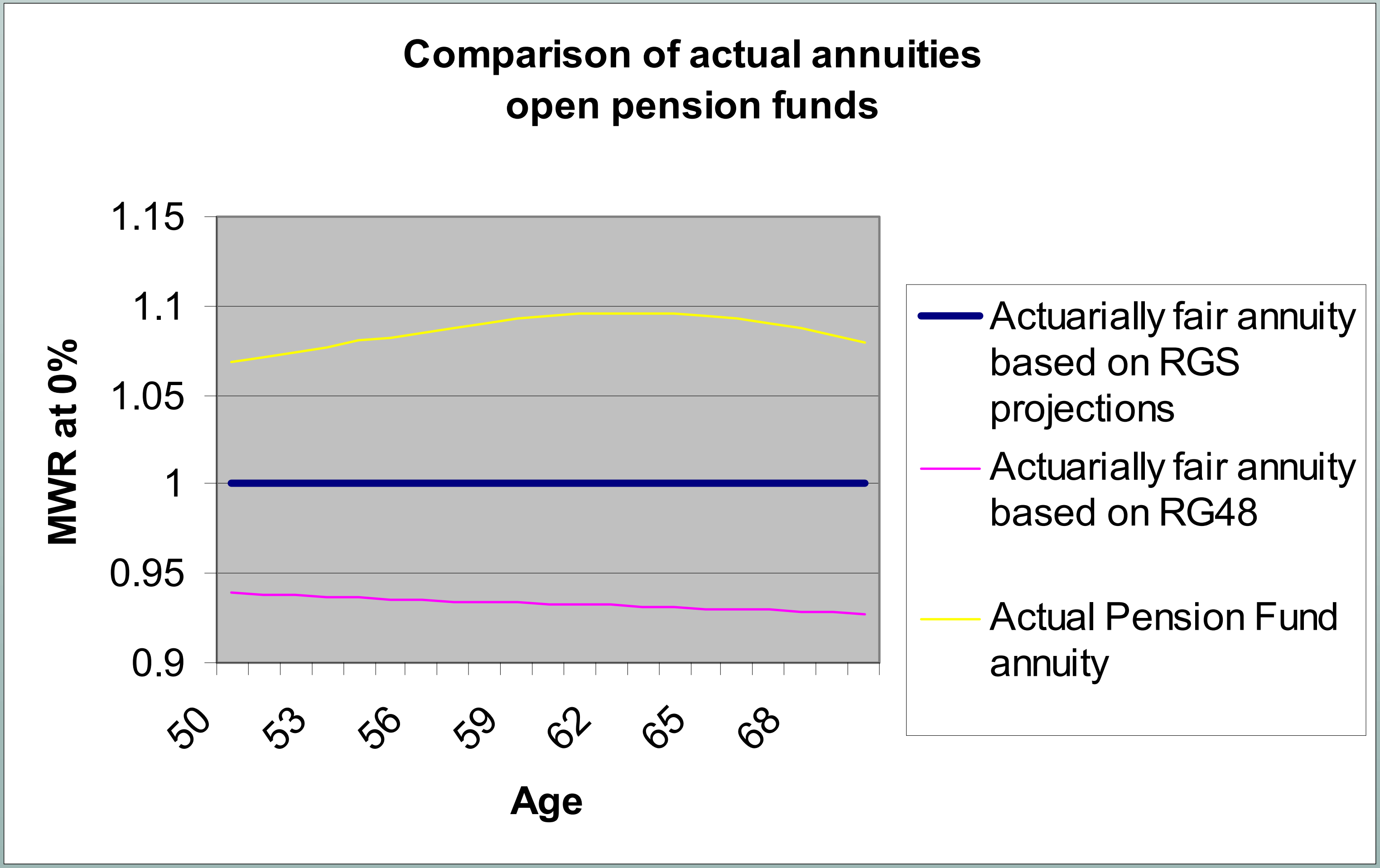
Source: authors' calculations from insurance companies' data



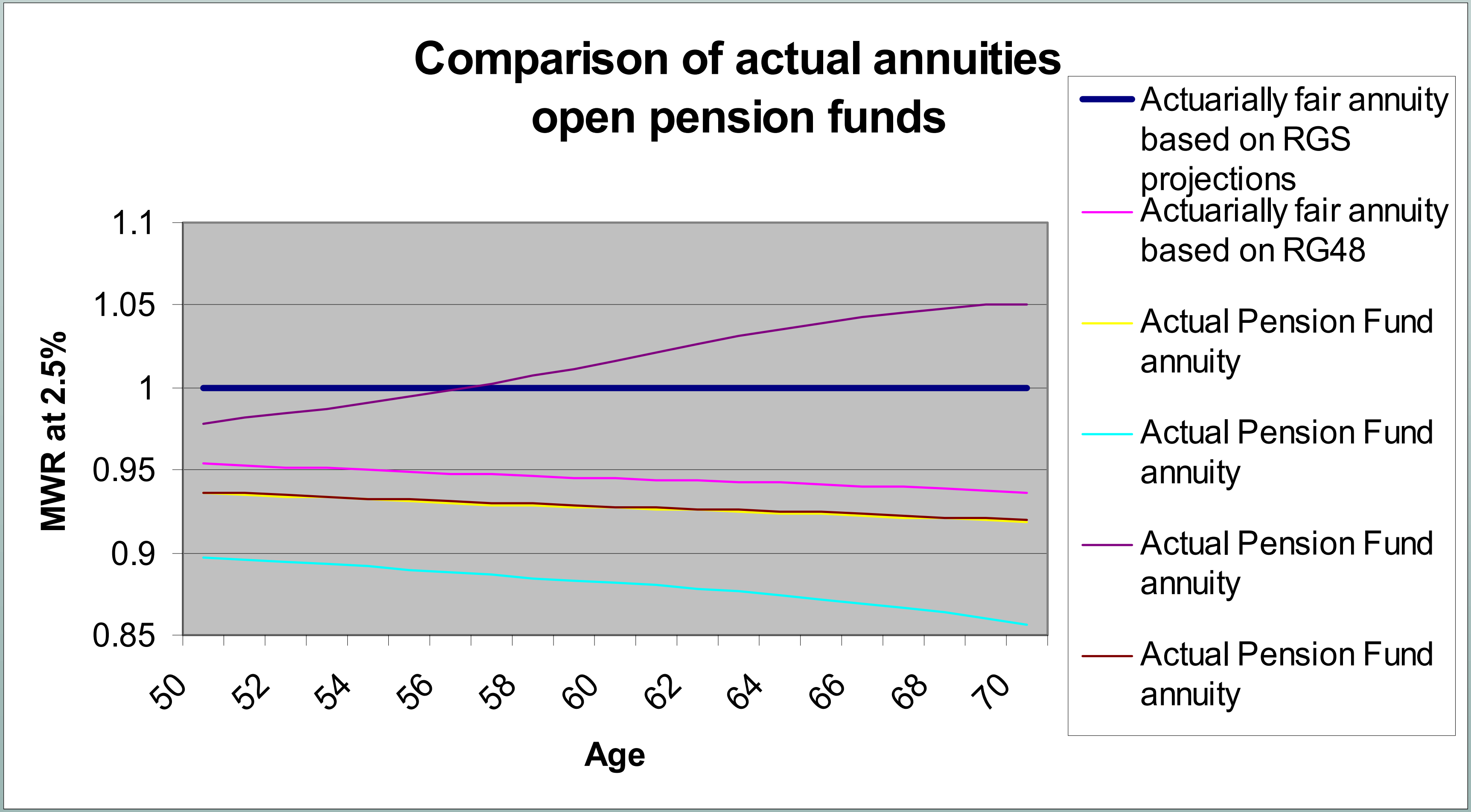
Source: authors’ calculations from insurance companies’ data



Source: authors' calculations from insurance companies' data



Source: authors' calculations from insurance companies' data



Source: authors' calculations from insurance companies' data

Comments

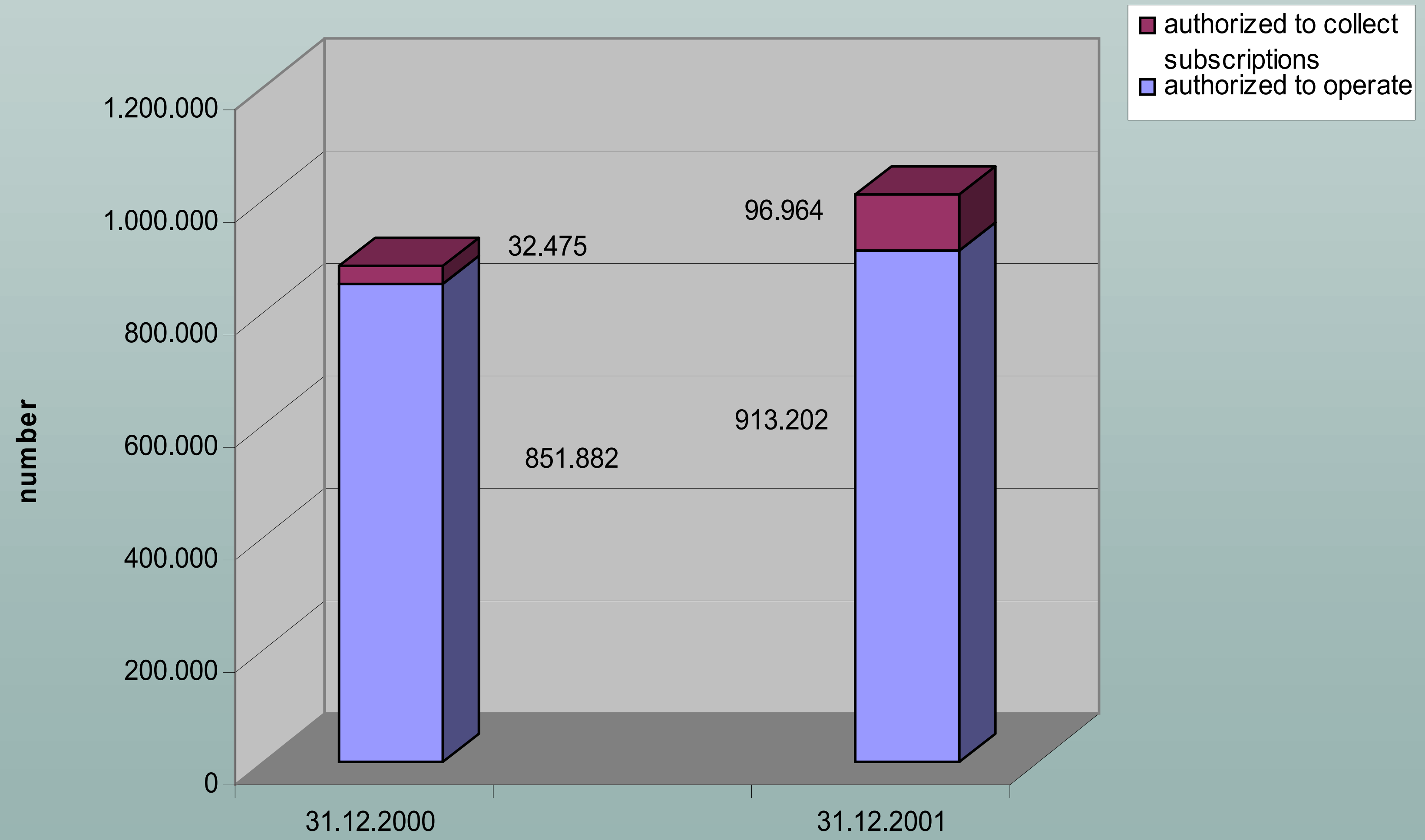
- A few open Pension Funds adopt mortality tables different from the RG48:
  - ➢ Are some companies taking undue risks in order to attract customers?
  - ➢ Are the "low mortality" projections calculated by the *Ragioneria Generale dello Stato*, which form the basis for the RG48 table, overly precautionary?
  - ➢ Is the price differentiation on annuities illusory?
    - ✓ Companies may change their annuity price at any time
    - ✓ Participants may switch to a plan offering a better annuity price at little or no cost up to the end of the accumulation phase

Conclusions

- Despite all efforts, the Italian annuity market remains an "infant industry"
- On the demand side, little is known of households' true attitudes towards annuities
- On the supply side, normative differentiation among schemes are not backed by either efficiency or by explicit redistributive goals
- Financial and demographic risks are substantial and unfamiliar to Italian households
- Guarantees – if possible at low costs – should be reinforced and transparency in the individual schemes enhanced
- In the next few years, occupational pension funds will "naturally" grow, while the first private pensions will be paid out
- However, the main obstacle to the development remains the high coverage of the public pillar for employees
- Hence, CeRP proposal of introducing a small and gradual *opting out* from social security

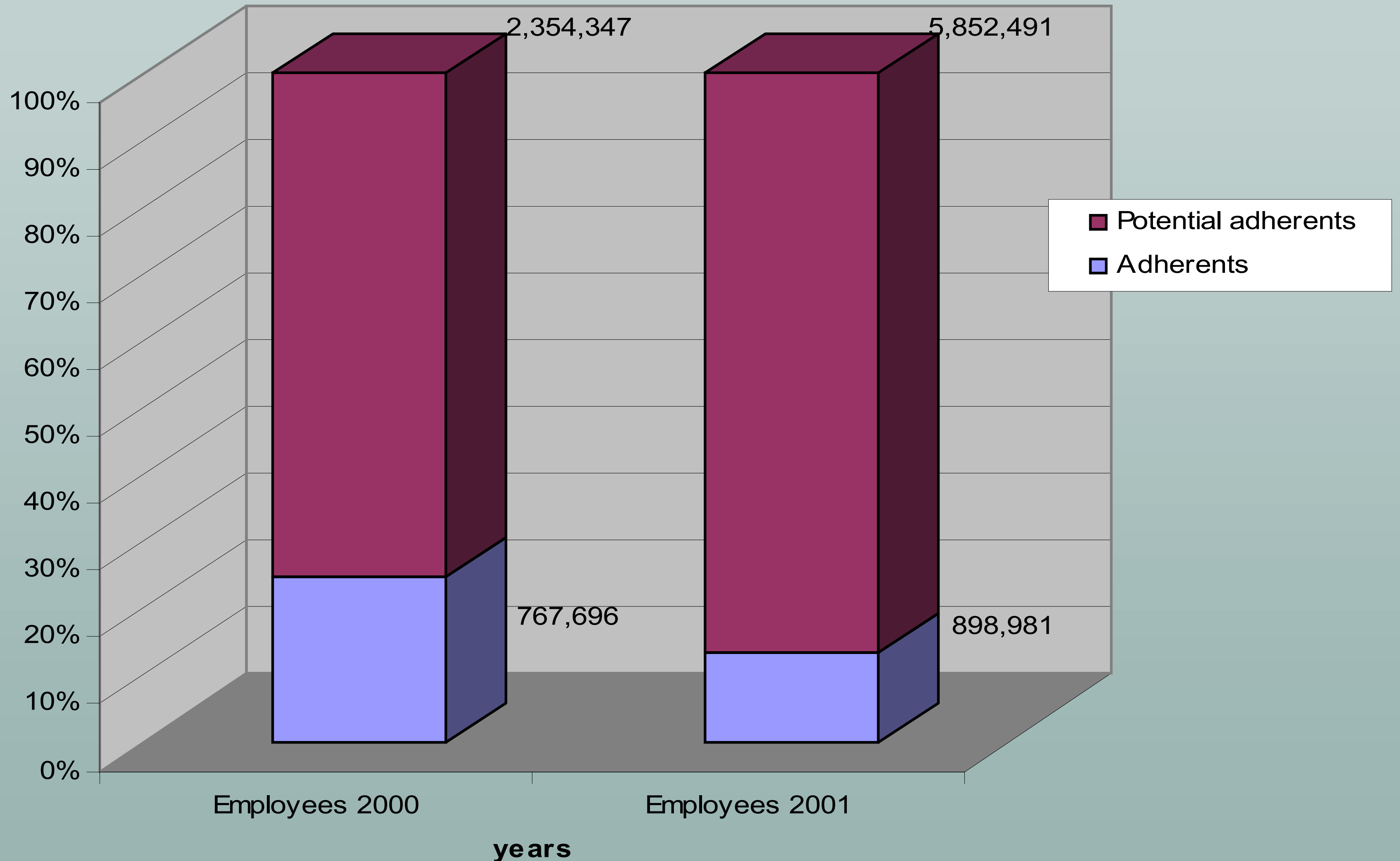
Appendix: Data on pension funds in Italy

Occupational funds: adherents



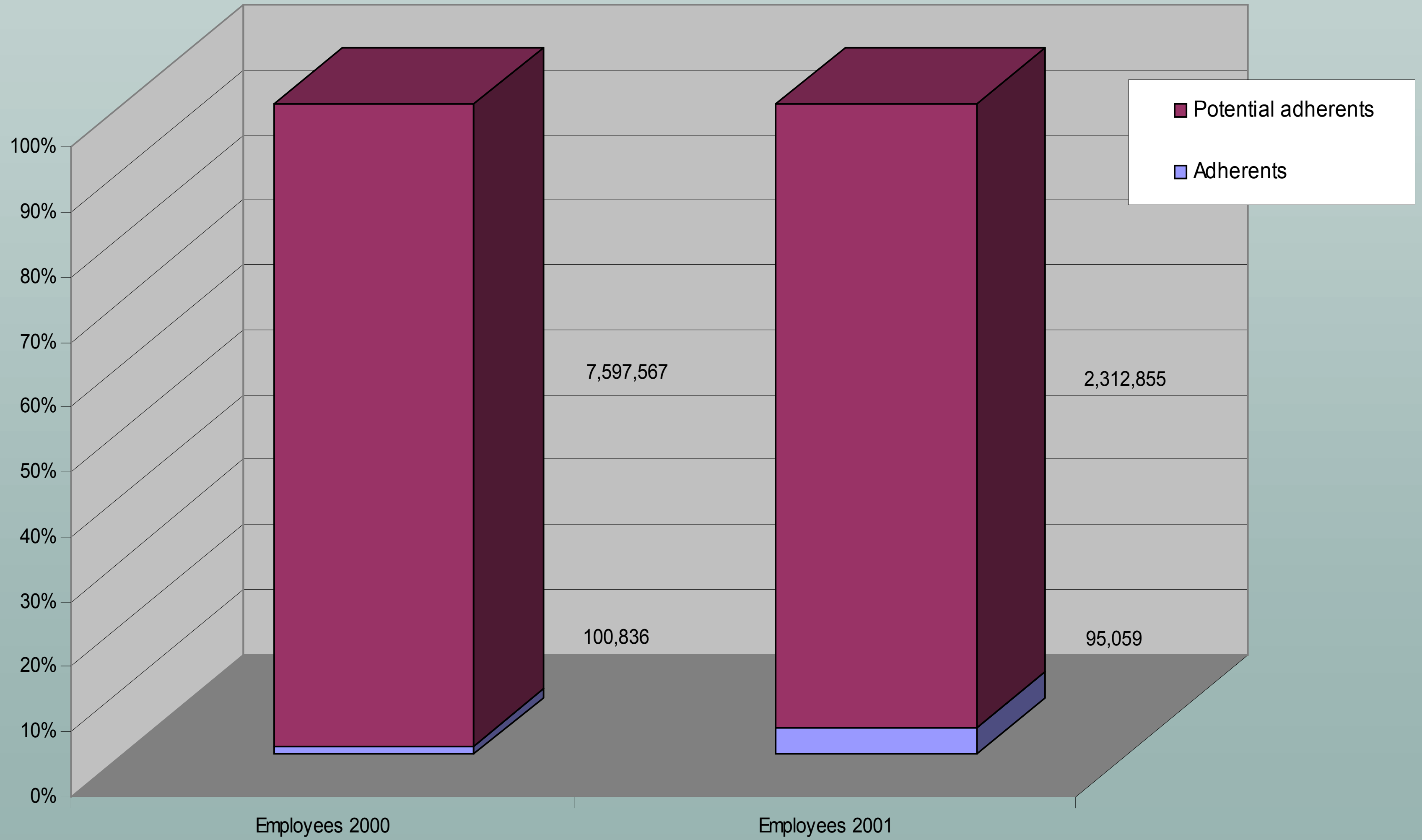
Source: COVIP – Annual Report 2001

Occupational Funds authorized to operate: adherents (employees)



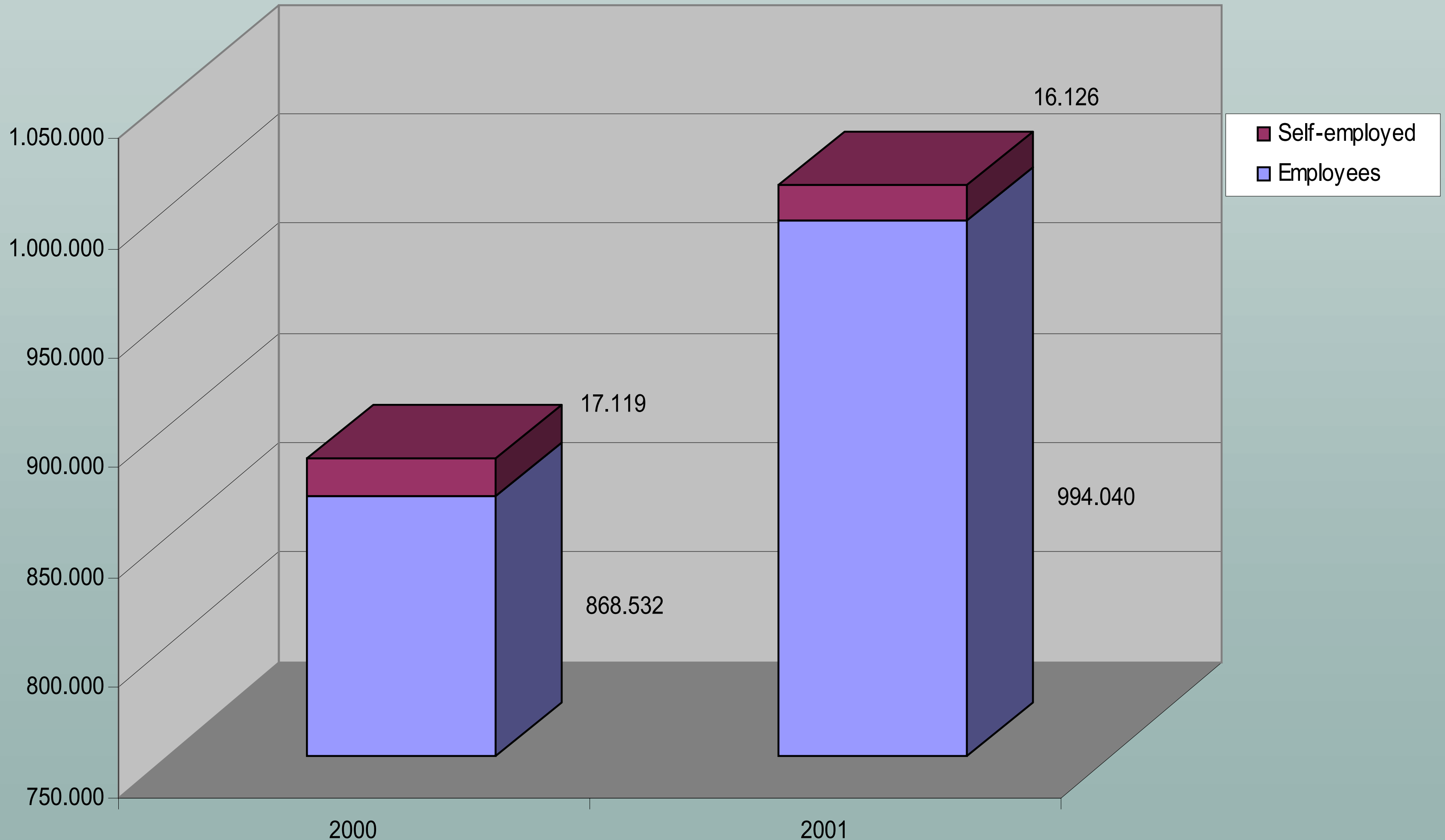
Source: COVIP – Annual Report 2001

Occupational Funds authorized to collect subscriptions: adherents (employees)



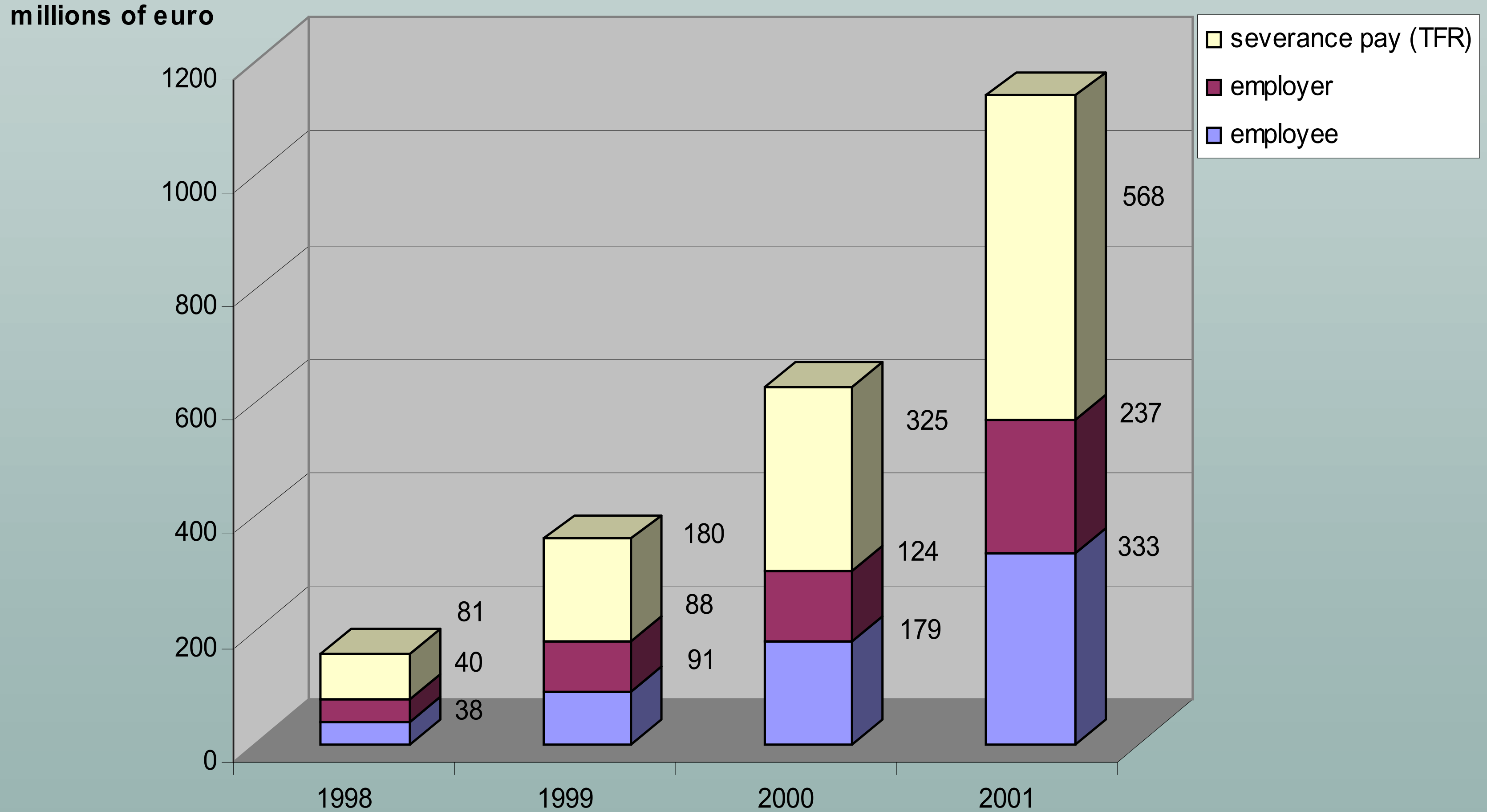
Source: COVIP – Annual Report 2001

Participants in occupational funds: employees and self-employed



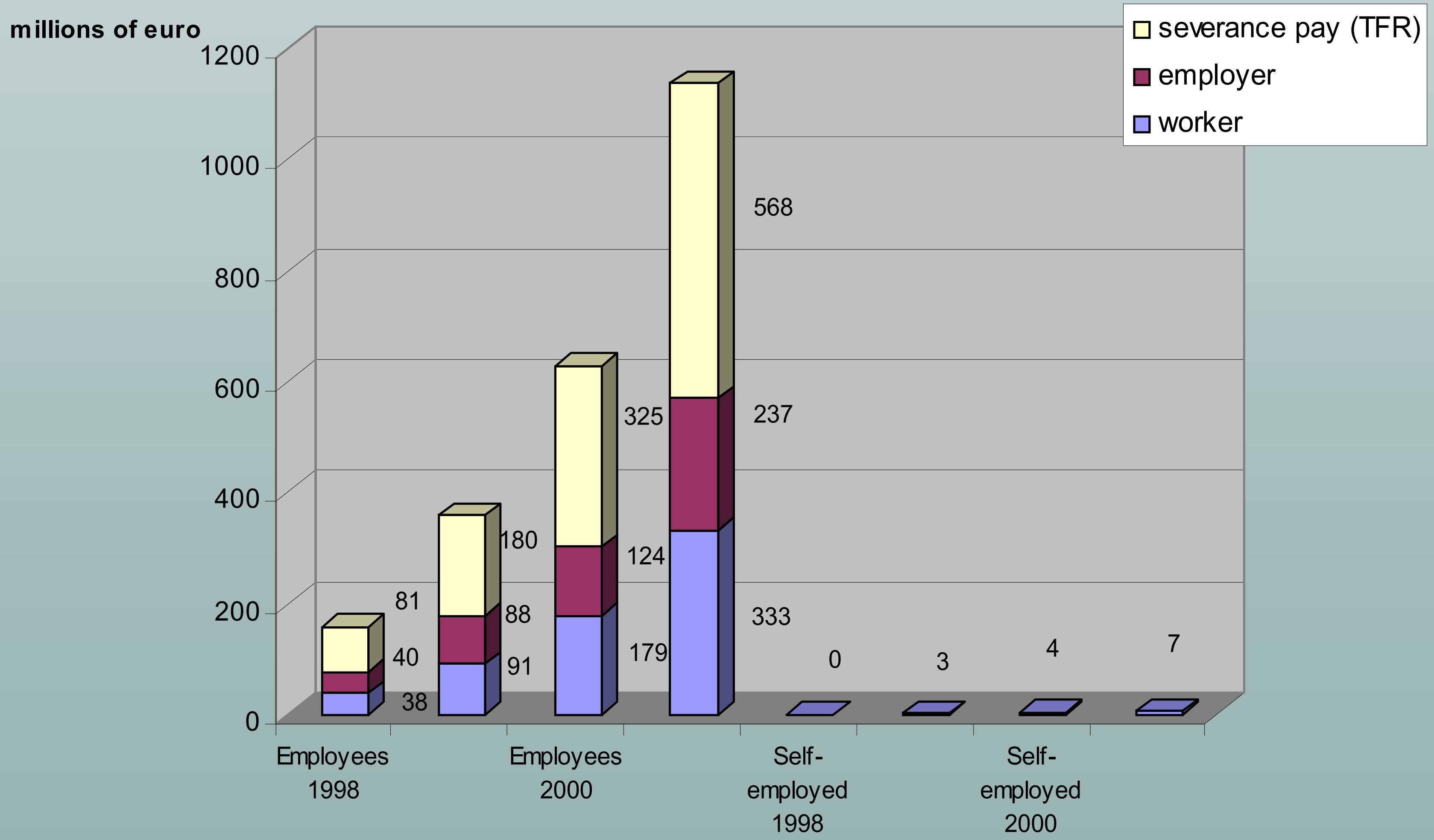
Source: COVIP – Annual Report 2001

Occupational funds: annual flows of contribution



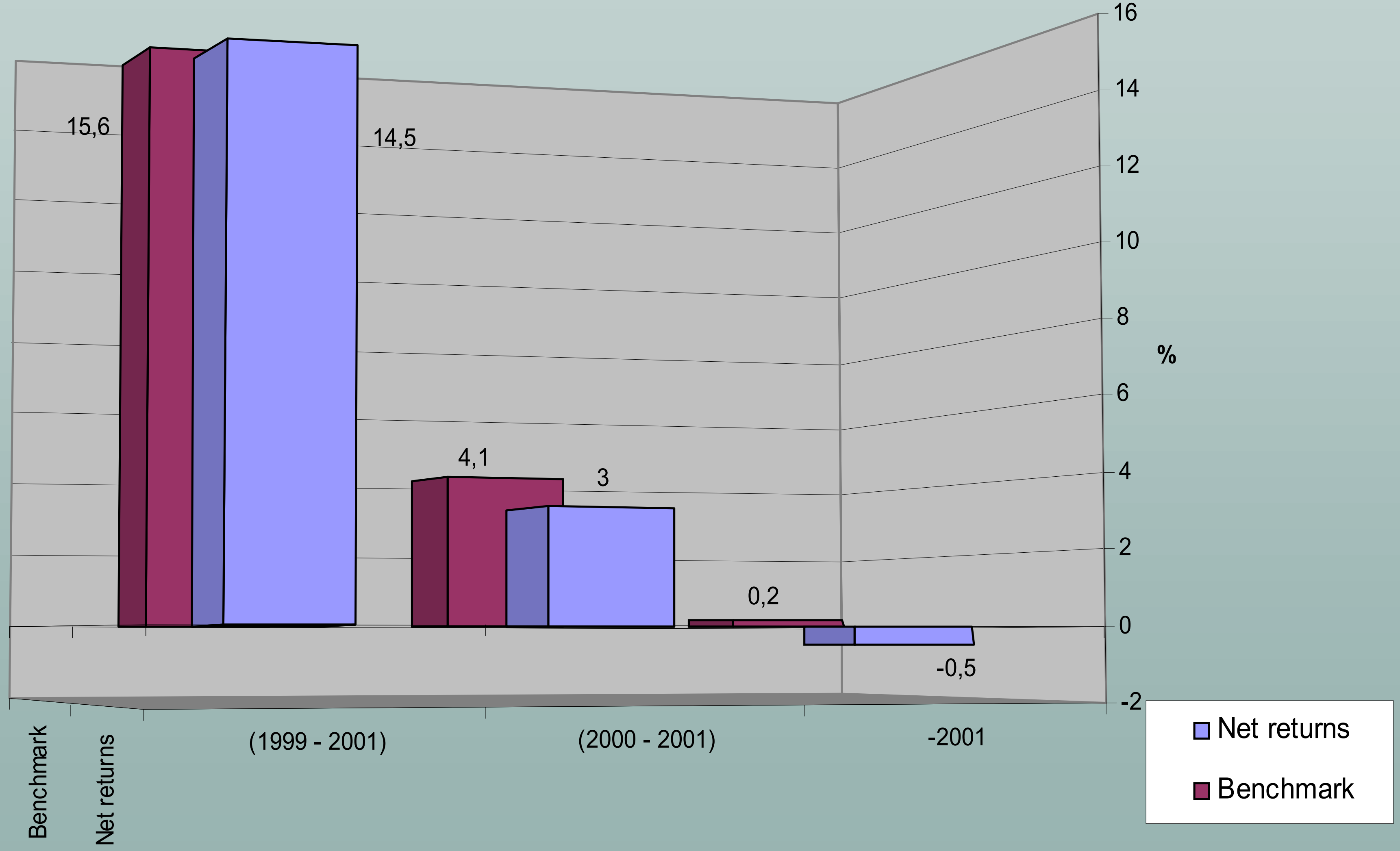
Source: COVIP – Annual Report 2001

Occupational funds: annual flows of contribution (employees and self-employed)



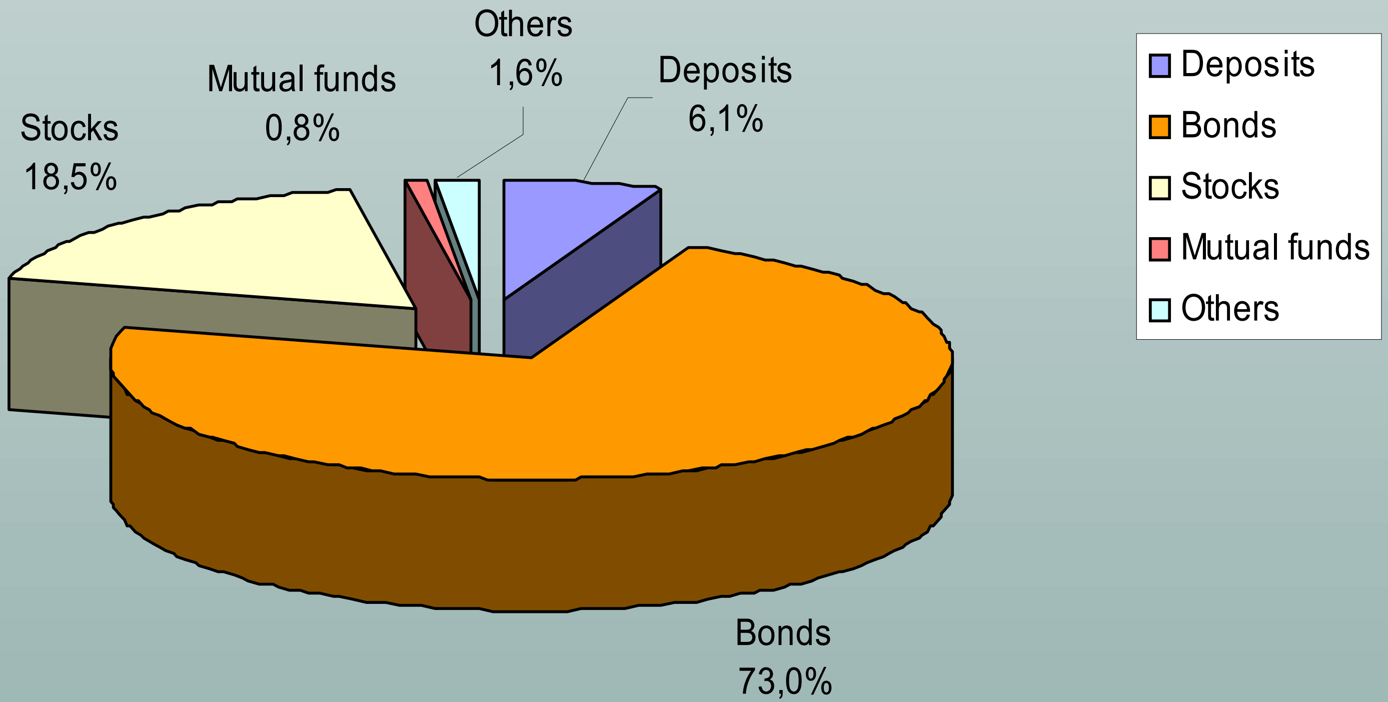
Source: COVIP – Annual Report 2001

Occupational funds: multi-period returns



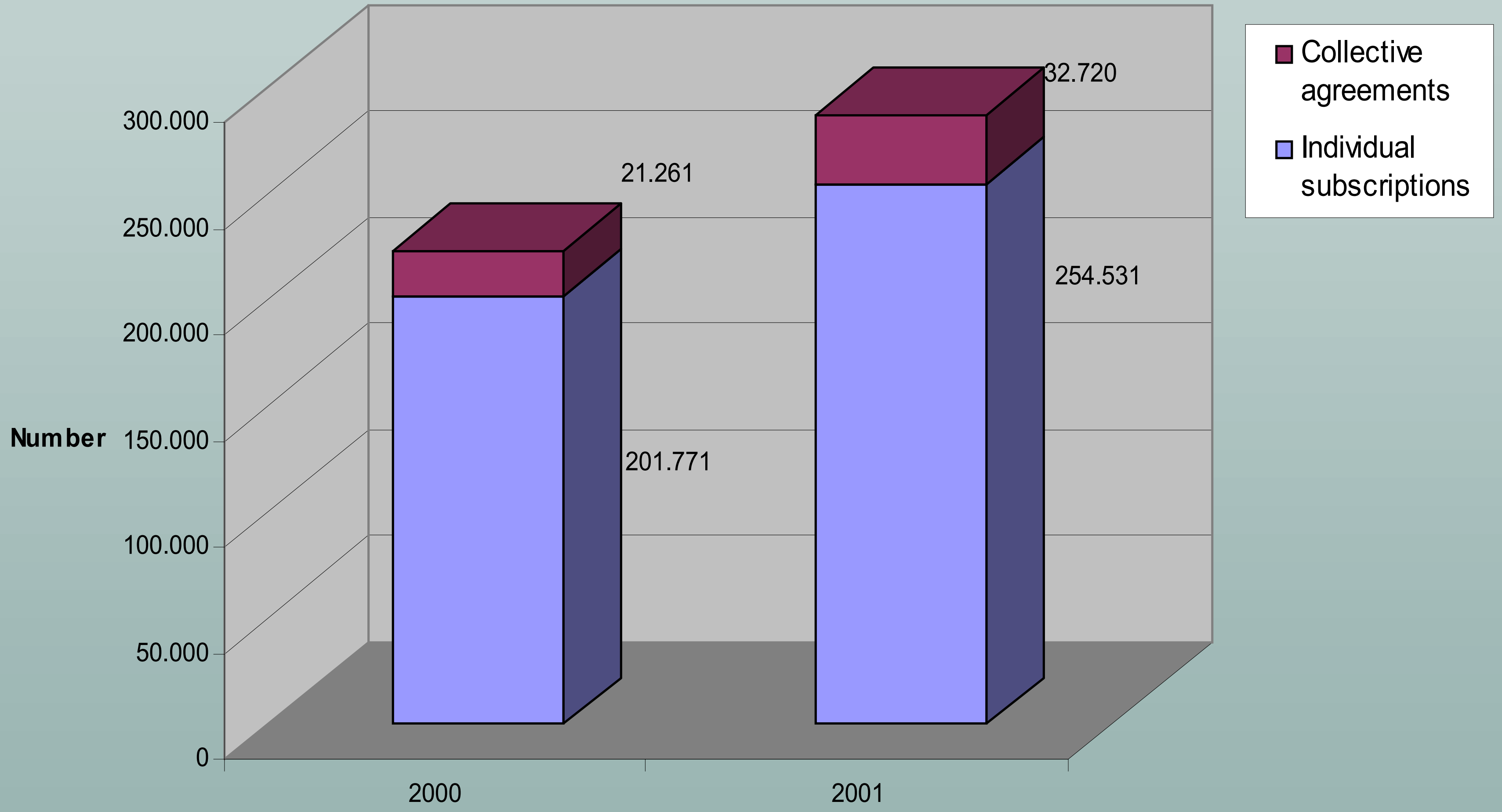
Source: COVIP – Annual Report 2001

Occupational funds: portfolio allocation



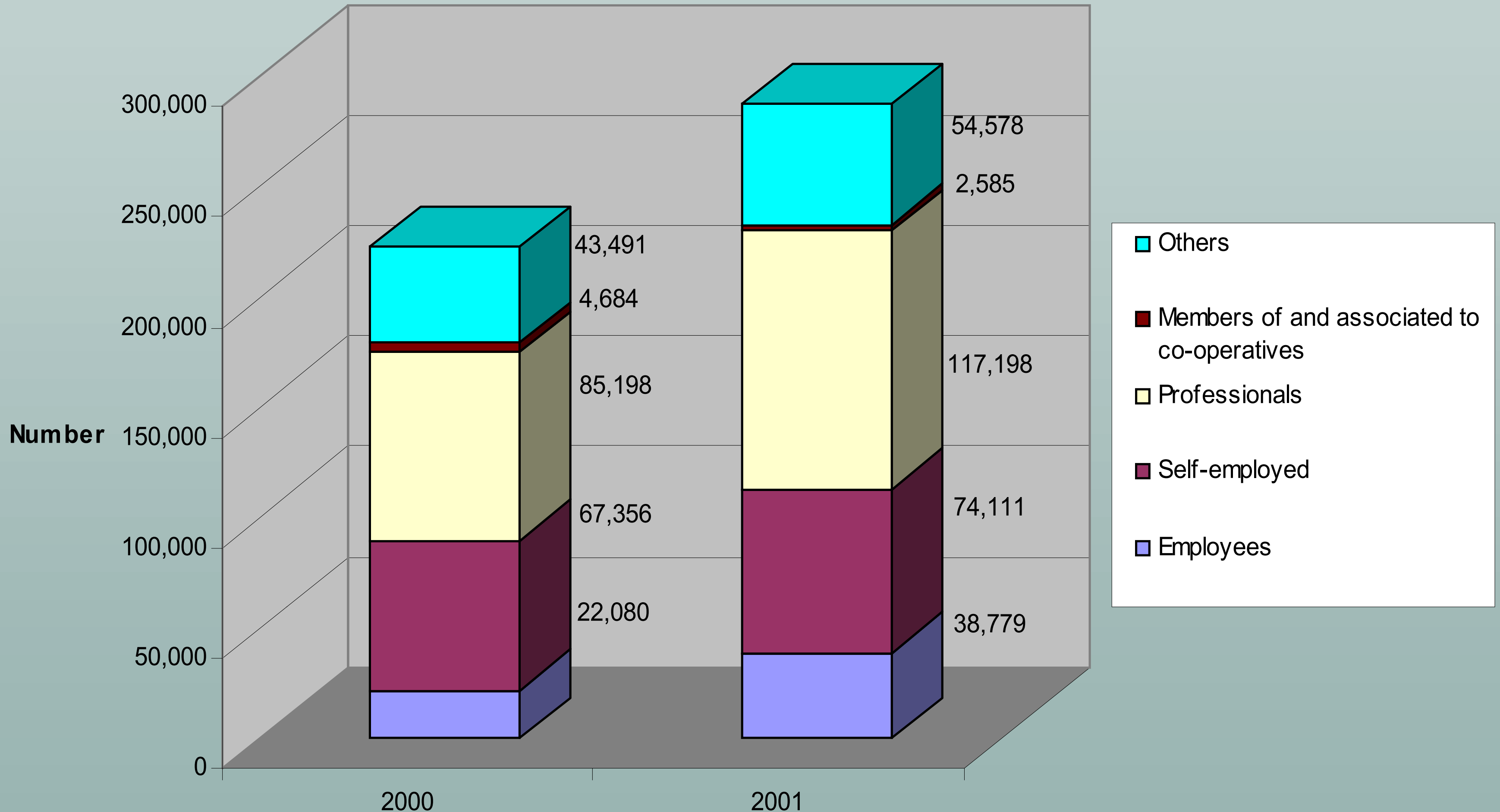
Source: COVIP – Annual Report 2001

Open funds: adherents



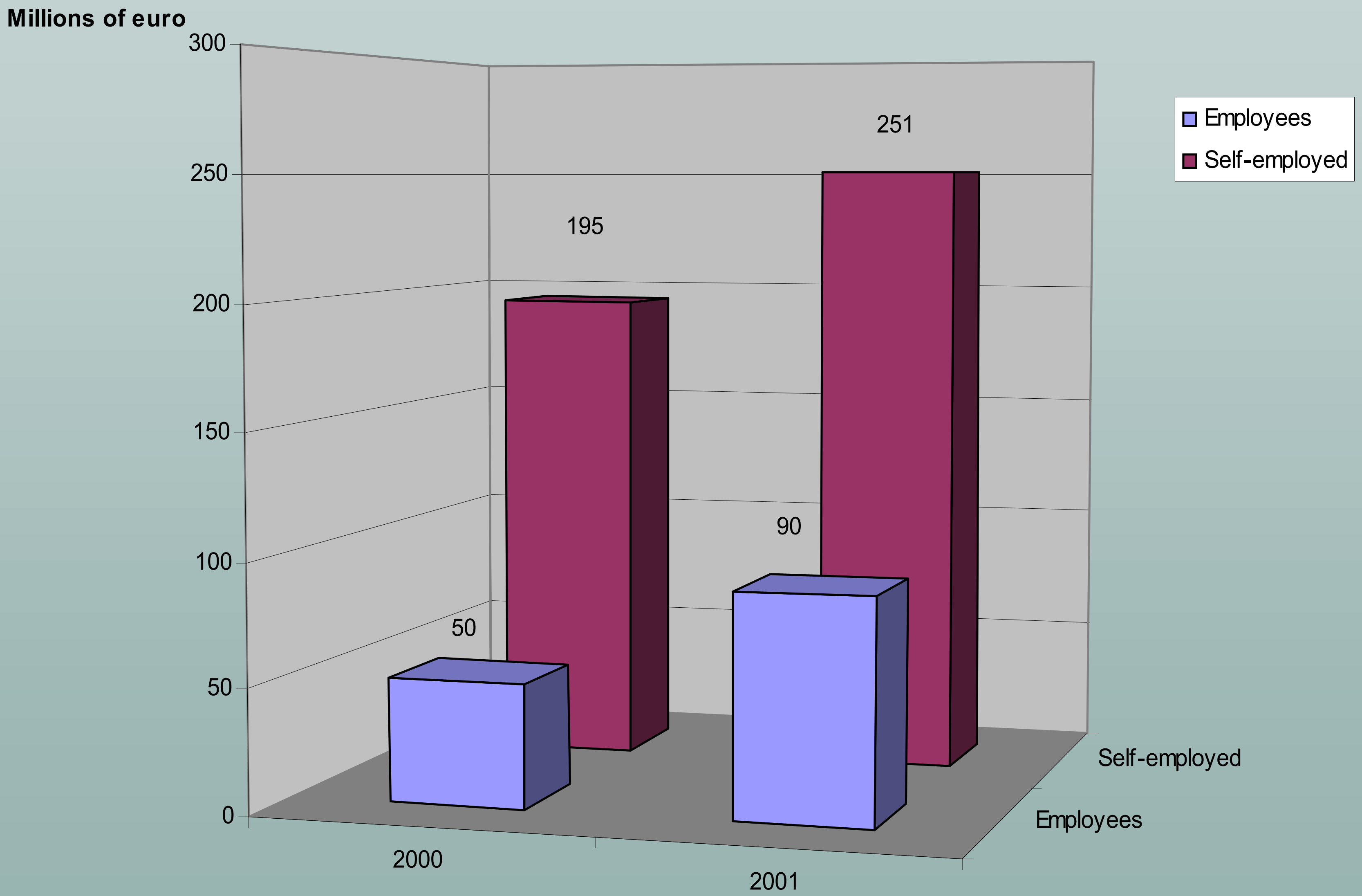
Source: COVIP – Annual Report 2001

Open funds: adherents' distribution by category



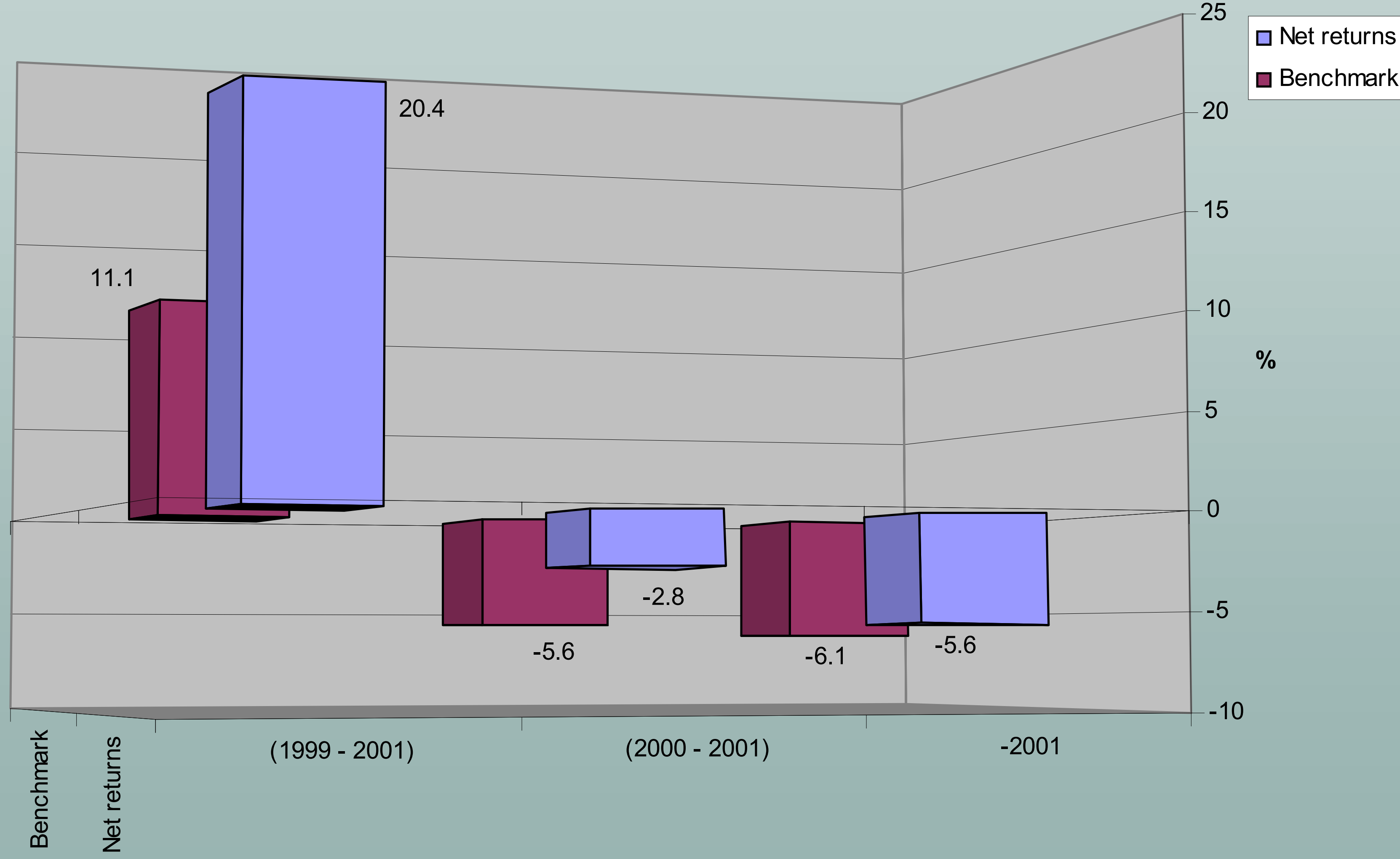
Source: COVIP – Annual Report 2001

Open funds: flows of contribution



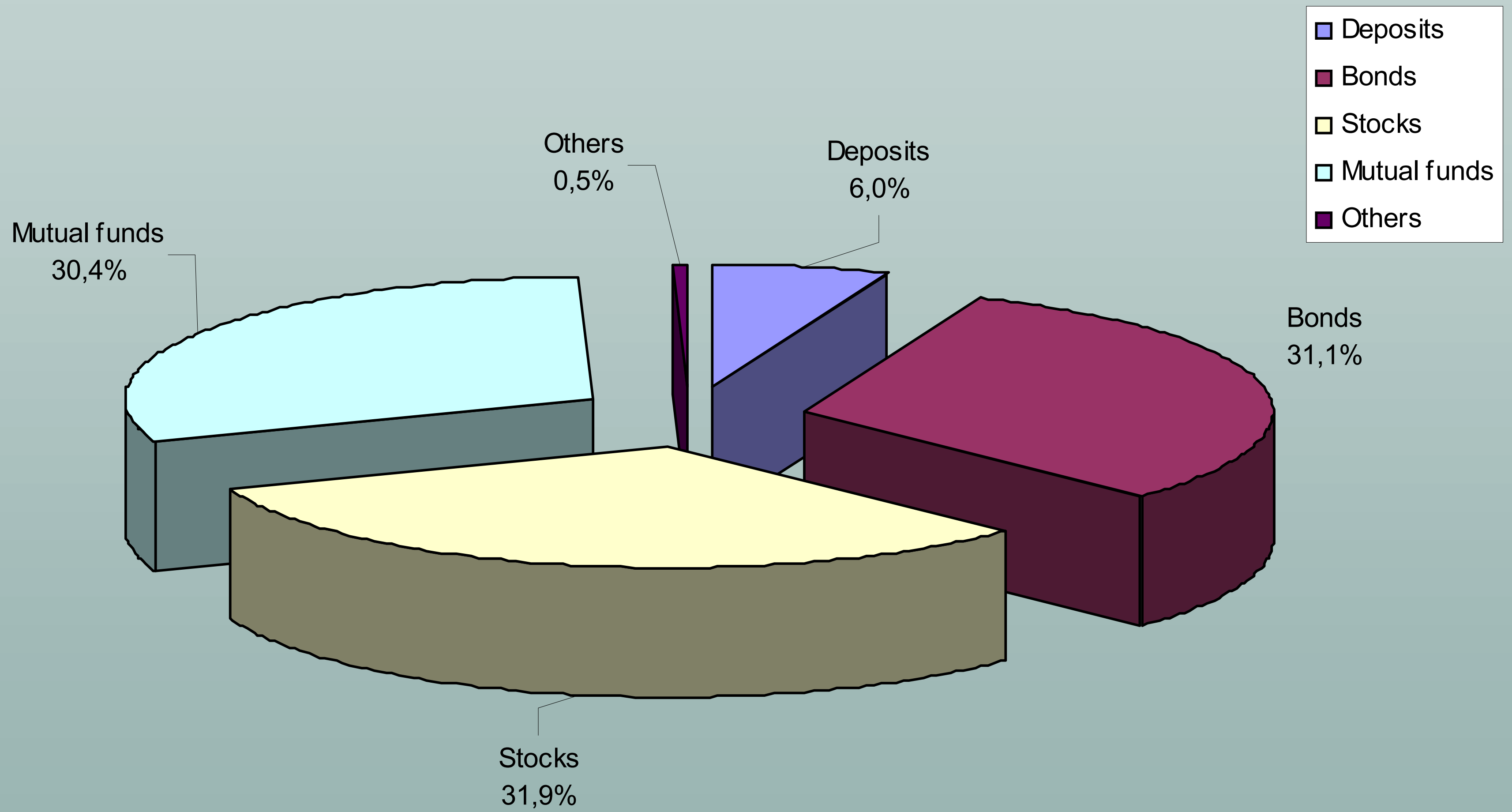
Source: COVIP – Annual Report 2001

Open funds: multi-period returns



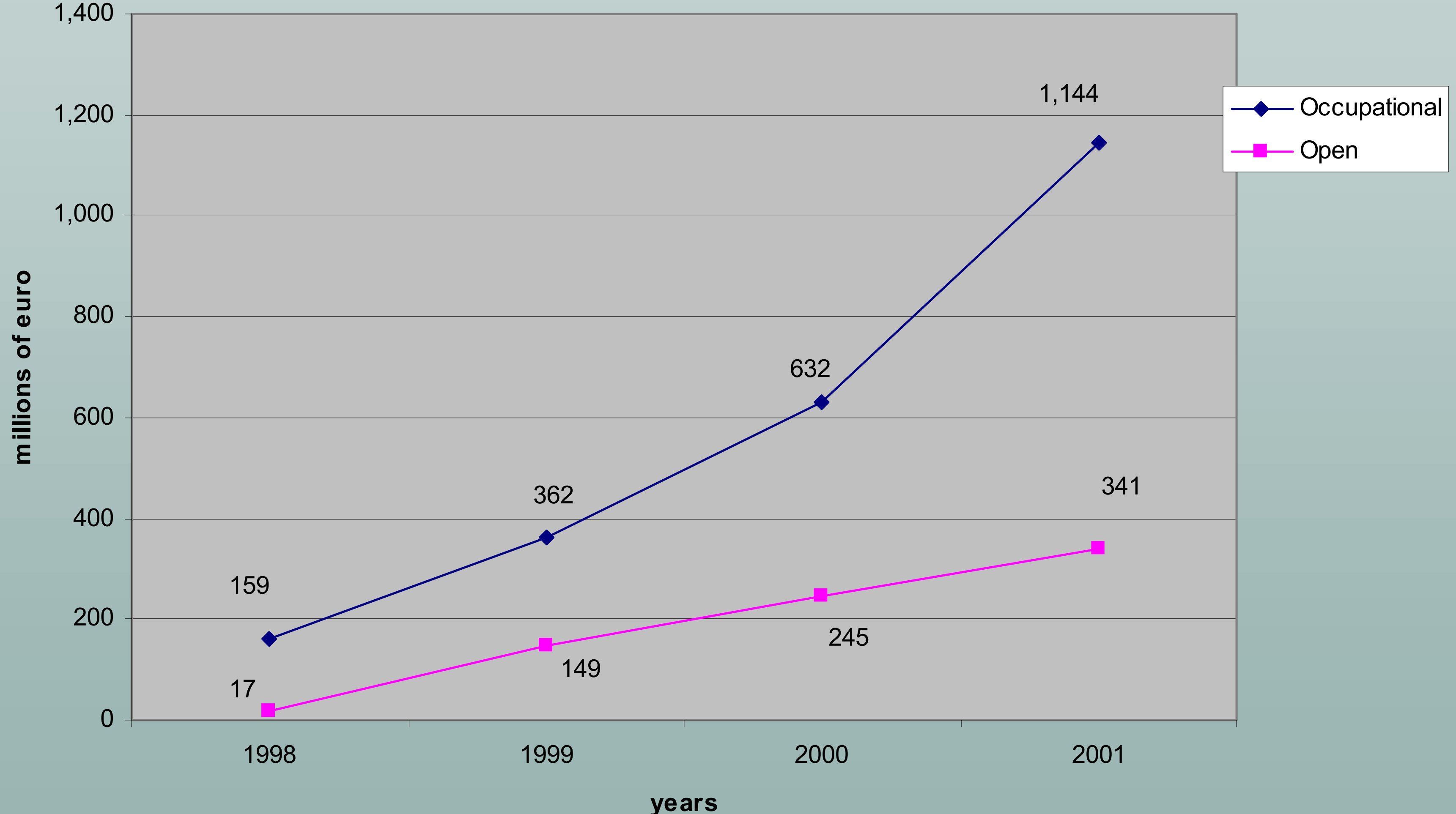
Source: COVIP – Annual Report 2001

Open funds: portfolio allocation



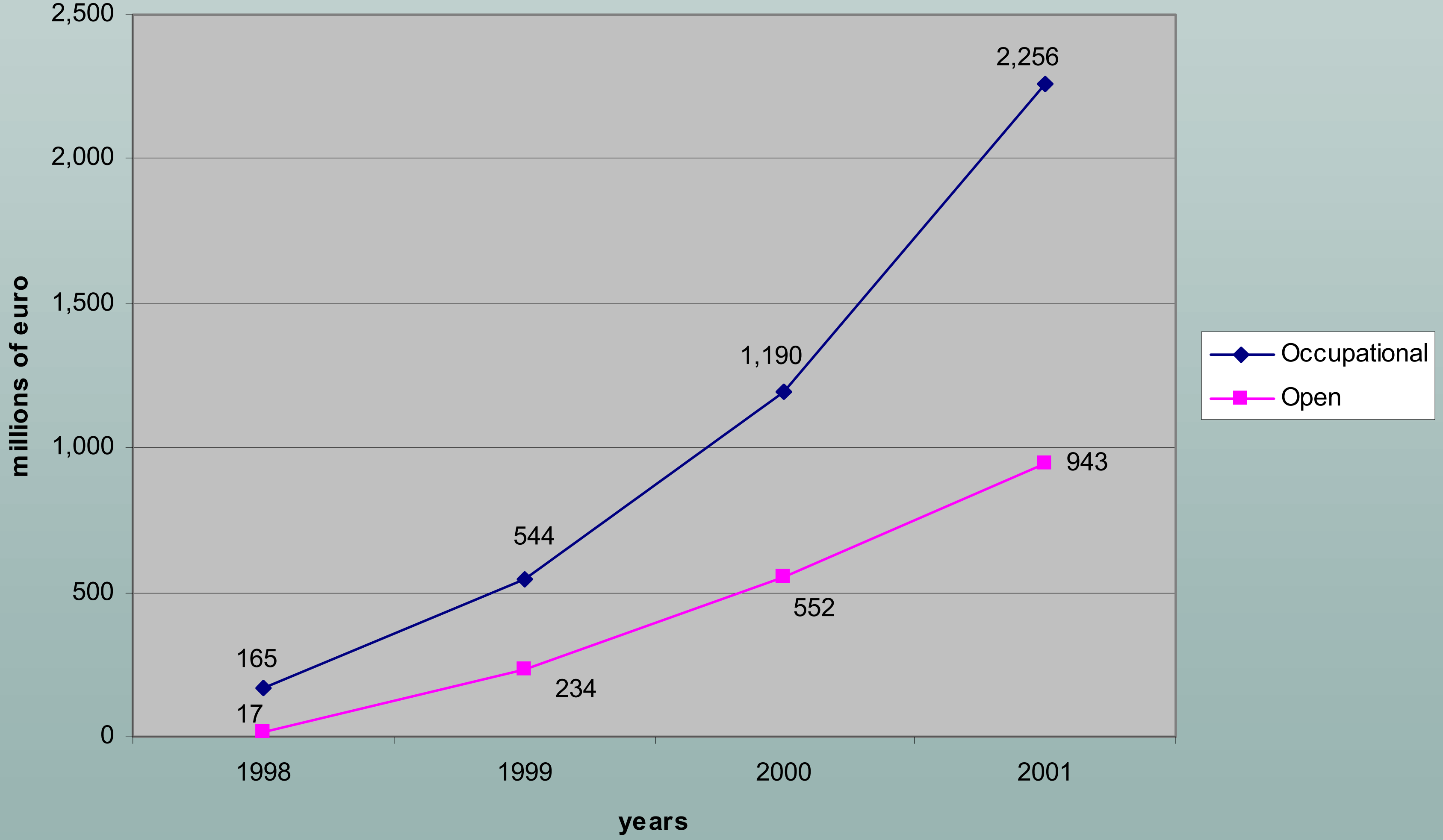
Source: COVIP – Annual Report 2001

Occupational and open funds: annual flows of contribution



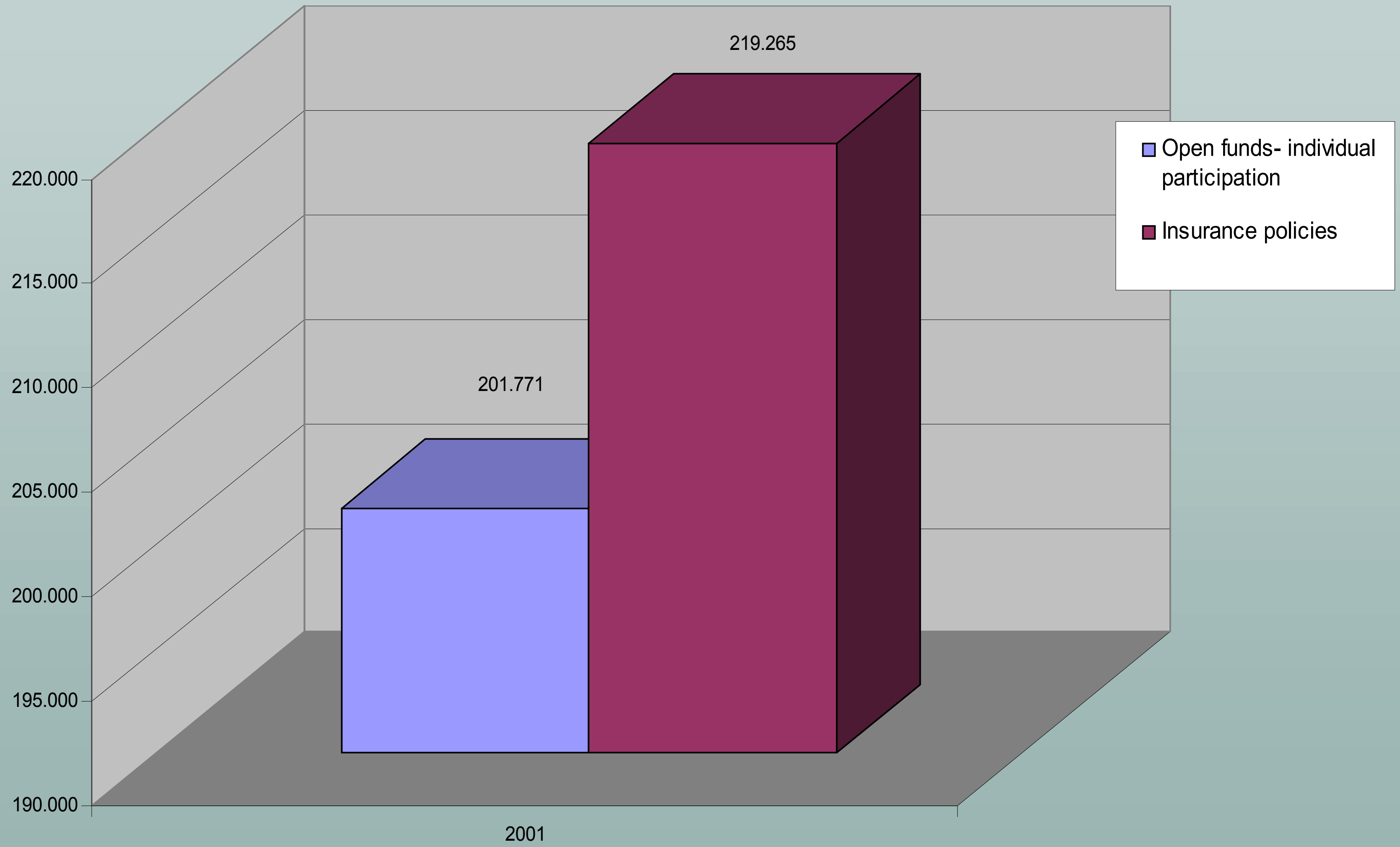
Source: COVIP – Annual Report 2001

Occupational and open funds : net assets



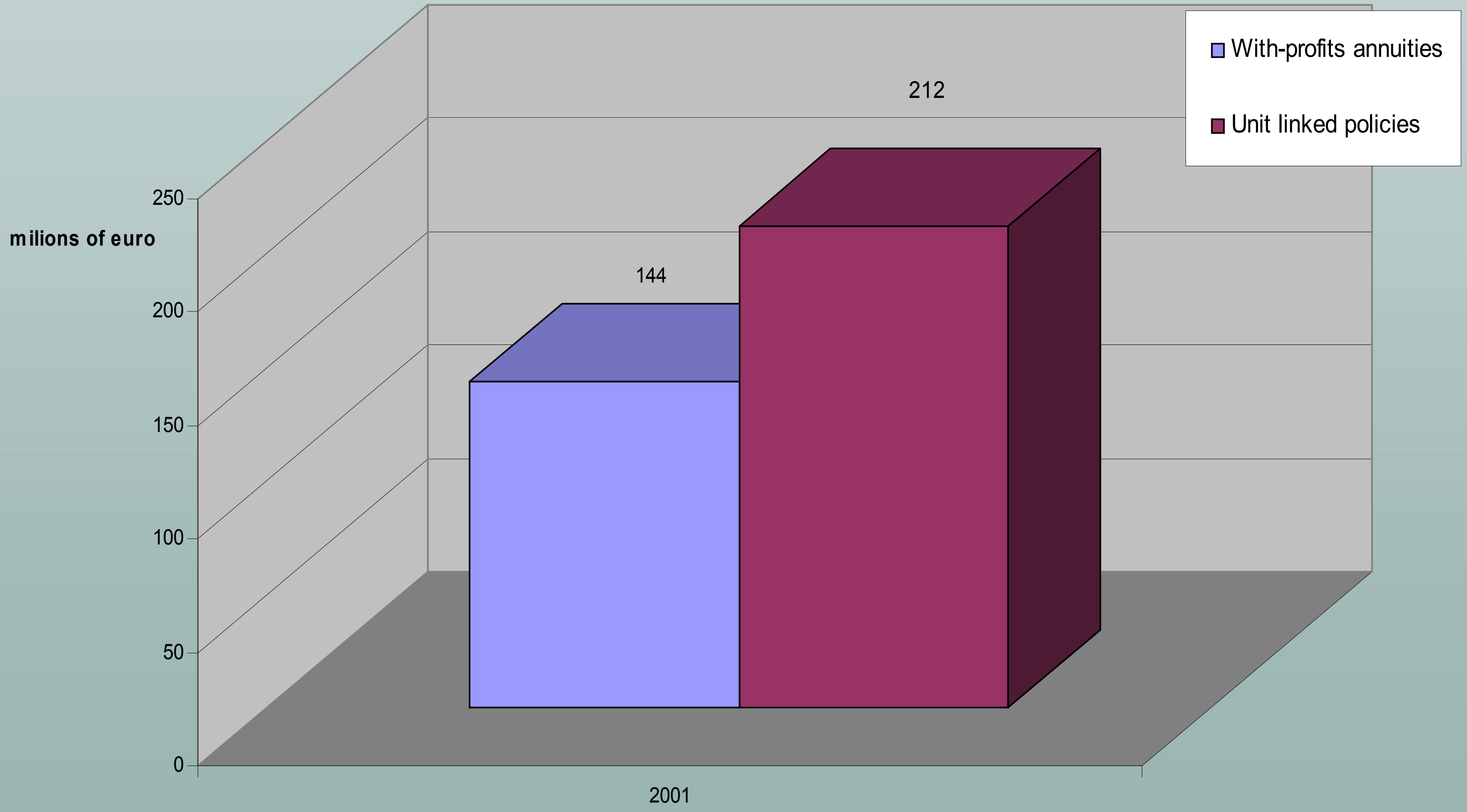
Source: COVIP – Annual Report 2001

Individual pension schemes: adherents



Source: COVIP – Annual Report 2001

Insurance policies: collected premiums



Source: COVIP – Annual Report 2001