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DISCUSSION PAPER:

Pension Pay-Out Products

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1.0 BACKGROUND

For some time now, the debate pertaining to the development of the private pension market in many countries has been increasingly shifting from the design and regulation of the capital accumulation phase to the development and supervision of the decumulation or pay-out phase with considerable interest in the retirement payment options. In Jamaica, this discussion gained greater prominence when a Technical Committee chaired by the Ministry of Finance and Planning and consisting of a wide cross section of public and private stakeholders, including the Jamaica Employers' Federation, the Jamaica Conference of Trade Unions, financial industry representatives and the Financial Services Commission (FSC) recommended that:

> "the Act should be amended to permit the industry to offer new pension products…"

1.1 Since the definition of pension in the Pension Act is "a periodic payment payable to a member on retirement, at least annually for the lifetime of that member", any new pension products must facilitate the members of an approved pension plan to receive an income for their life span in retirement.

1.2 This paper presents the FSC's proposal for a pension product that meets the objectives of the recommendation made by the Technical Committee and that will add to and improve the quality of the payment options available to pensioners.

2.0 MAIN OPTIONS FOR THE PAY-OUT PHASE

There are two main forms of periodic benefit payments at retirement; namely Programmed Withdrawals[1] (PW) and Annuities.

2.1 Programme Withdrawal

A Programmed Withdrawal product is a series of fixed or variable payments whereby the retiree draws down a part of the retirement capital (and continued investment earning thereon). International literature shows that for countries that allow Programme Withdrawal as a pay-out option, pensioners are permitted to transfer their pension assets to a PW product. PWs are governed by rules covering the pace of withdrawals. One example of these rules is that the withdrawal fraction, which governs the maximum payment that can be made, is set each year equal to the inverse of a factor relating to the age of the account holder (e.g. life

[1] Other names for PW are phased withdrawal and allocated annuities.

annuity or remaining life expectancy). The account balance of PWs may increase initially if the rate of investment returns exceeds the withdrawal fraction. However, as pensioners grow old and their remaining life expectancy decreases, the withdrawal fraction is more likely to surpass the rate of return and thus both the account balance and the annual benefit will fall and will eventually become too small for long-lived individuals. See Figure 1.

Figure 1: Flow of Retirement Income from a Programmed Withdrawal

The graph shows the general flow of retirement income; however the actual amount and shape for an individual will depend on a number of factors including, but are not limited to, (i) amount of assets, (ii) withdrawal factor, (iii) personal choices, and (iv) market conditions.

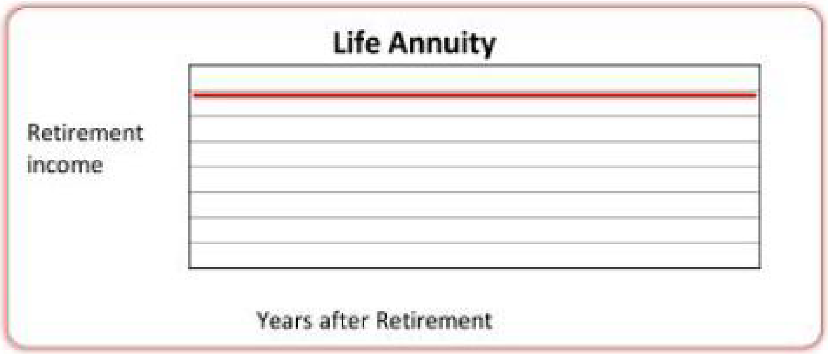
2.2 Therefore PWs do not provide protection against longevity risk. Along with the lack of protection against longevity risk, the other drawbacks of PWs are that they are exposed to inflation and investment risks. The advantages of PWs are that they allow bequests and can be transferred to another institution if the individual so desires.

2.3 Countries permitting PWs have prescribed specific rules and restrictions aimed at stretching or preserving the payments to the pensioner over a longer period. Additionally, these countries tend to have adequate social safety networks.

2.4 **Life Annuity**

The benefit of life annuities is that they fully protect individuals from longevity risk, since they provide a stream of payment as long as the pensioner lives. See Figure 2. However, the shortcoming is that at least in their “plain vanilla” form do not allow for bequests. They are also inflexible and illiquid since it is not possible to change an annuity once it has been established. Guaranteed periods, indexation and cash benefit option are some features incorporated in the design of an annuity to satisfy the need for flexibility and, in particular, the bequest motive.

Figure 2: Flow of Retirement Income from a Life Annuity

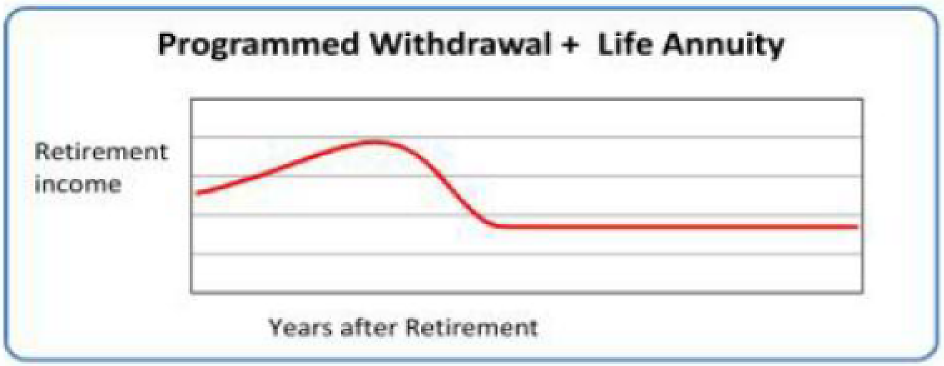


The graph shows the general flow of retirement income; however the actual amount and shape for an individual will depend on a number of factors including, but are not limited to, (i) amount of assets, (ii) personal choices, and (iii) market conditions.

2.5 Combination of Life Annuities and Programmed Withdrawals

As stated above, the two different payment options transfer significant upside and downside risks to the pensioner. However, policy makers have found that by combining the options, products can be designed that can provide flexibility, satisfy the bequest motive and allow participation in the higher returns of market investments while reducing longevity risk. Figure 3 displays the flow of retirement income from such a combination.

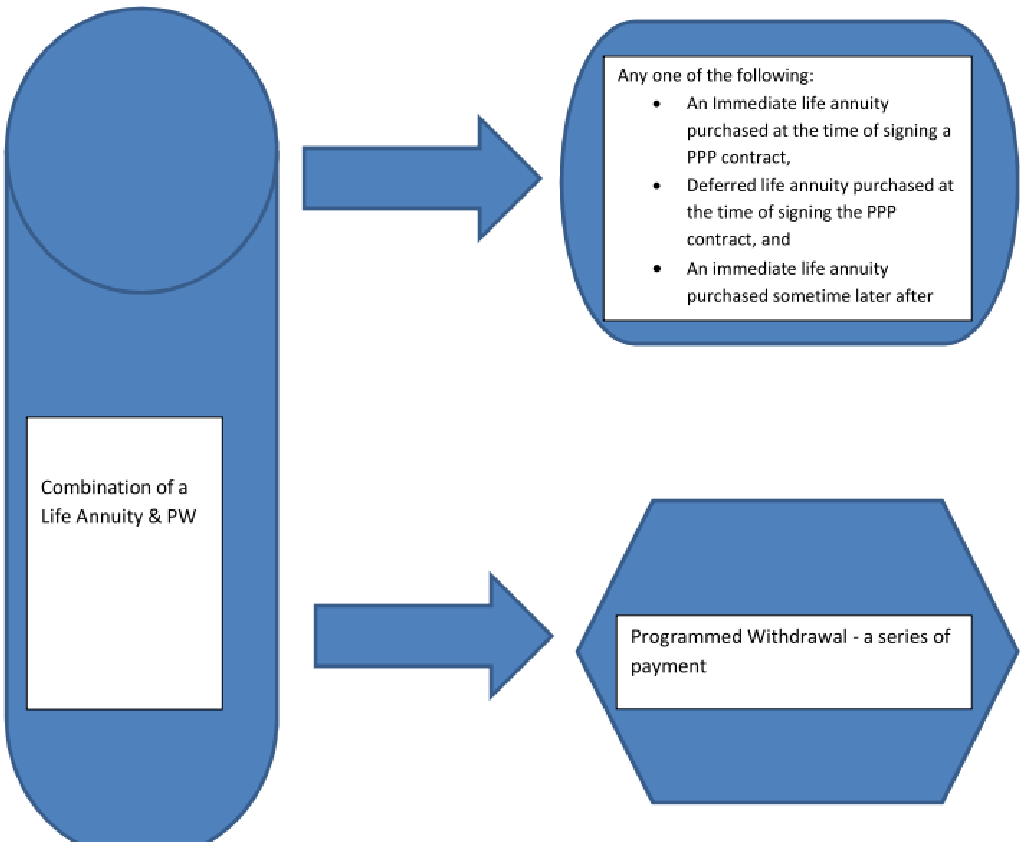
Figure 3: Flow of Retirement Income from a Combination of a Programmed Withdrawal & Life Annuity



The graph shows the general flow of retirement income; however the actual amount and shape for an individual will depend on a number of factors including, but are not limited to, (i) amount of assets, (ii) withdrawal factor, (iii) personal choices, and (iv) market conditions.

2.6 International literature demonstrates that there are several ways to combine a programme withdrawal and life annuity. Figure 4 shows three types of combination. Depending on the option chosen, the pensioner could obtain payment from one or both components initially.

Figure 4: Combination of a PW and Life Annuity



3.0 PROPOSAL FOR JAMAICA: PENSION PAY-OUT PRODUCTS

In response to the need for additional pension products in Jamaica, the recommendation made by the Technical Committee, and interest shown by various members within the financial industry, the FSC has examined international experience and has considered a number of country-specific factors, which include, but are not limited to the following:

i. The desire to have assets accumulated in approved pension plans protected and not depleted at an old-age,

ii. The development of the financial market such as the regulatory framework, availability of products, cost, disclosure and the level of the public's understanding of annuities and other financial products;

iii. The level of assistance and protection offered by social safety networks;

iv. Pensioners' desire for flexibility, liquidity and the ability to leave an inheritance while managing longevity risk, and

v. The configuration of pension plans such as whether they are defined benefit or defined contribution.

3.1 As a result, the FSC is exploring the granting of approval to products that will have the generic name "Pension Pay-out Product" (PPP). A pension pay-out product is defined as a form of structured pension payment arrangement which guarantees for the life of the pensioner a series of fixed or variable payments. The transfer of the money from the pension plan into a PPP does not change the fact that the pension plan was established to provide the pensioner with income for the remainder of his life after retirement.

4.0 REGULATORY FRAMEWORK FOR PPPs

The proposed regulations that will govern the regulatory framework for PPPs entail the following elements:

4.1 Definition and Requirements for Approval

i. A pension pay-out product is defined as a form of structured pension payment arrangement which guarantees for the life of the pensioner a series of fixed or variable payments.

ii All PPPs must be approved by the FSC before it is marketed to the public.

iii Requirements for approval are as follows

a) The PPP must be offered by an approved Investment Manager, as licensed under the Pension Act, with a Securities Dealer's License;

b) The PPP must be purchased from the value of the member's accrued benefits or accumulated contribution in an approved superannuation fund (ASF) or approved retirement scheme (ARS);

c) The FSC must be satisfied that the product will be able to provide the pensioner with a retirement income for the remainder of his life; and

d) The minimum life-long retirement income shall be equal to the annualized national minimum wage at the time of retirement. [2]

4.2 Members' Freedom of Choice to Purchase

i. Each member of ASF or ARS upon his retirement shall have the option to transfer his funds from an ASF or ARS to any approved PPP. In executing the option to purchase a PPP, each member must not be restricted in selecting from among the various PPP providers. That is, the retiring members must be able to "shop around" in the market for the best rate available if they so desire.

4.3 Who can sell and distribute PPPs

i. Only licensed investment managers will be authorized to distribute PPPs. The investment manager will manage and invest the pension assets used to purchase the PPP.

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[2] An annualized national minimum wage will be equal to the product of the number of weeks in year and the weekly national minimum wage

ii. Where the use of life annuity is conceptualised in the PPP, the investment manager must outsource the life annuity. Only registered life insurance companies will be allowed to provide life annuities.

4.4 Administration and Operation

i. An ASF or ARS shall permit the transfer of funds to an approved PPP on retirement if the member makes such a request in writing.

ii. The funds transferred from the ASF or ARS to a PPP shall be

a) held by an investment manager for a client pursuant to a written safekeeping agreement,

b) segregated and identified as being held in trust for the client, and

c) described as being held in segregation on the investment manager's security position record, client's ledger and statement of account,[3]

iii. Pursuant to the Securities (Conduct of Business) Regulations 1999, the provider of a PPP shall have a request for proposal completed and signed by each client.

iv. All assets contained in the PPP that is held by the investment manager shall be invested.

v. The maximum payment from the PPP in any one year must not exceed the sum of (i) the amount of pensions assets held by the investment manager at the start or subsequent anniversary, divided by the factor for the PPP at the then attained age, and (ii) life annuity payments, if any. The factors for the PPP to be applied will be specified by the FSC.

vi. On the death of the member, without any additional charge or penalty:

a) The balance in the assets managed by the investment manager shall be payable to the member's designated beneficiary (ies).

b) The designated or principal beneficiary shall determine whether such payment of (a) should be a lump sum or to continue the arrangement of payment. Where the election is to continue the PPP, the factor for PPP that should apply will be determined by the age of the principal beneficiary.

vii. On the diagnosis of a terminal illness, a lump sum representing the remaining value of the PPP, without additional charge or penalty, would be payable to the member.

viii. The member shall at all times be able to purchase a life annuity from a registered insurance company using all or part of the remaining assets held by the investment manager without charge or penalty.

4.5 Duties of PPP Providers

ii. Subject to the guidelines issued by the FSC from time to time, it is a requirement that each provider of PPPs disclose all relevant product information in a clear and timely manner that promote product

[3] Adapted from Regulation 11, the Securities(Conduct of Business) Regulations, 1999

understanding and promote product comparison; including terms and fees in a way that is readily accessible to the market.

iii. Furthermore, investment managers who sell and distribute PPPs must provide the necessary information and advice that will aid each pensioner to understand the risks involved and to assess that the product is appropriate and suitable for him.

iv. Each investment manager selling PPPs will also be required to provide after each anniversary date of purchasing the PPP statements of the pensioner's account to each pensioner in keeping with the guidelines to be issued by the FSC from time to time.

v. All providers of PPPs are expected to comply with the relevant provisions of the Securities Act and the attendant Regulations.

5.0 Trustees

Subject to the guidelines issued by the FSC from time to time, it is a requirement that trustees provides relevant and timely information to their members to assist in their decision-making process regarding choice of pay-out options.

Questions regarding this Discussion Paper may be directed to the Senior Director, Pensions at the contact details specified below:

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