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What is it that makes the Swiss annuitize? A description of the Swiss retirement system

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Why is it that makes the Swiss annuitise? A description of the Swiss retirement system

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Introduction: the 'annuity puzzle'

The 'annuity puzzle' stems from

- economic theory (Yaari, 1965; Davidoff et al., 2005, to cite a few) suggests that annuitisation is the optimal choice of consumption flow in terms of utility
  but
- there surprisingly small demand for voluntary lifetime annuities troughout the world (Purcal and Piggott, 2008):
  - U.K.: a big annuities market, but they are compulsory
  - U.S.: most of tax-sheltered deferred annuities are withdrawn as lump sums
  - Australia: only 61 annuities sold (for some AUD 11.9 mio) in 2008! (Plan for Life Research, 2008)

For that matter, Switzerland is a (puzzling!) exception.

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The Swiss 3 pillars

The Swiss old age security system is based on 3 pillars:

1. social security
   - universal benefits
   - run by the government
2. professional forethought (occupational plans / pension funds)
   - aims at complementing the 1st pillar for active population
   - independent but highly regulated
   - comprises mandated (2a) and non mandated (2b) benefits and savings
3. individual initiative
   - regulated (3a) or not (3b)

The Swiss annuitise

- More than half of the Swiss choose to annuitise
  - $\approx \frac{3}{4}$ annuitise all or part of their capital (Bütler, 2003)
- In 2003 (OFS, 2007, 2009)
  - 78% of retirees' income came from annuities, about 1/2 from the second pillar
  - only 14.9% from investments
  - system achieved a replacement rate of 61.2% of income flows
- In 2007 (OFAS, 2009; OFS, 2009)
  - 900,000 annuities from the second pillar
  - 1,250,000 Swiss residents were 64 years old or more

Other particularities

- Substantial savings
  - amount to > annual GDP—more than CHF 600 bio in 2007 (Gerber and Weber, 2007; OFAS, 2009)
  - tax exonerated
  - investment income (interest) is also tax exonerated
  - market risk not transferred to individuals: the retirement savings accounts are strictly nondecreasing
- The first 2 pillars offer benefits at retirement, but also in case of death and disability, throughout the insureds' life
- Main area of practice for actuaries in Switzerland

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Brief description and plan of the paper

Contents:

- main focus on retirement benefits
- *overview of 3 pillars*
- description of rules, benefits, regulation and organisation of the second pillar
- some insight on why the Swiss choose to annuitise
- some current issues

Available on SSRN:
`http://ssrn.com/abstract=1407370`

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Good value for money

- annuitants get good value for money, especially if married and/or with children (Bütler and Teppa, 2007)
- private insurers struggle to match level of benefits—private annuities sector relatively thin
- possible future "free" adaptations to prices

Trust and simplicity

- the pension fund is the annuity provider: insureds don't give their capital to a new person, it just stays where it is
- annuitisation is the default choice
- no underwriting process or medical tests
- highly regulated, good level of confidence in the system
- safe: if bankrupt, Security Fund
- the Swiss generally don't know what to do with such an amount of money (financial planning not in the culture)

Rules for and size of the retirement savings

- additional voluntary contributions are tax exonerated
- capital growth (interest) also exonerated
- capital blocked until retirement, but it can be used for
  - own home (min 50%, depending on the age)
  - own business (100%)
  - 'permanent' departure from Switzerland
  - anticipated payment is taxed at a reduced rate (max 10-15%)
- put savings there is thus a rational choice for many

Housing

Housing is not a usual savings vector: few Swiss own their home.

In addition, whether

- you own your home, $\Longrightarrow$ it is fiscally optimal to keep a mortgage for life
- or rent your home (vast majority of the Swiss),

there will be a flow of negative cash flows to match during retirement.

Others

Bequest motive

- annuity is a package with survivor and children annuities
- some pension funds pay a complementary capital in case of death

Decision making process

- Some authors suggest that psychological biases, as well as default and framing (Brown, 2007; Agnew et al., 2008) can have an impact on the decision to annuitise
- yearly statement
- annuity as a default
- annuity is more likely to be chosen if presented in terms of consumption (vs investment) (Brown et al., 2008)

The Swiss and punctuality

Are the Swiss always on time?

- not always..!

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