

Death of an Annuity Market Foretold

Ana Veronica Perez Villasana and Tapen Sinha
ITAM, Mexico

Abstract: In the past decade, most research on the structure, performance, and regulation of publicly mandated but privately pension funds. Most research has been focused on the accumulation phase of private pension. There has been less effort to examine the problems of the payout phase. Many countries that have enhanced the role of the private sector in pension provision will start facing the problem of converting the individual balances accumulated in defined contribution schemes into streams of retirement income, such as contingent annuities.

How does a country design and develop an efficient market for such products from a low initial base? Can the insurance sector can effectively deliver relatively complex products such as annuities, and honor contracts that span decades? Given the lack of reliable mortality data in countries where there is no history such data in developing countries, there is very little institutional and regulatory framework.

Mexico substituted its defined benefit system (IMSS) of the formal sector by a defined contribution system in 1997. The initial plan called for buying single premium annuities for the widows and disabled workers under the new system. In the first three years, this market came to occupy a significant part of the insurance sector. Then, the number of workers getting benefits started to fall dramatically.

We show that such a fall has been a direct result of how the IMSS authorizes the issuance of single premium annuities. We analyze the rationale behind such a dramatic change in policy. It stems from a cash-flow problem that IMSS is trying to stem. We analyze various possible scenarios of IMSS strategies. We examine the problem to see if it brings in any long-term benefits to IMSS.