

Pensions, Social Security and Private Insurance Solutions: Opportunities Squandered¹

By Patrick M. Liedtke²

Modern societies are trying to develop concepts that allow them to protect their citizens and at the same time stay competitive in the globalized markets. The approach of the new welfare state is no longer to arrange for full coverage of (ideally) all risks but to replace the existing extraordinarily expensive systems with more targeted and efficient approaches. They achieve this through requiring people to assume more risks individually and to organise adequate protection themselves. This is the so-called “risk shift from public to private”, a concept we have been developing for a number of years at The Geneva Association.³

Unfortunately, usually as a consequence of half-hearted or partial reforms, this has often led to an erosion of the protective systems rather than their real modernization. Genuine protection mechanisms, like insurance, provide cover for those risks that somebody cannot (or does not want to) bear. Today’s social security systems do anything but that, often protecting people against risks that they need no (or different) protection for, while excluding others.⁴ It is then up to each person to compensate for the inefficiencies and short-comings of the existing state systems and to find individual solutions that adequately cover their risks. The need to augment the ordinary provisions, as commonly set up by the social security systems, is particularly substantial in the area of old-age pensions. It is here where private insurance solutions can and have to play a significant role.

Few things in life are as costly as a bad pension arrangement. Nevertheless, few people fully realize this. There are scores of papers that analyse this phenomenon and try to explain why people behave in a non-economical and myopic way.⁵

¹ This paper is a background text for the Aurelio Peccei Lecture of the author on 1 March 2007 in Brussels. It has been submitted for publication to the New European Welfare Papers, published by the Risk Institute and might be reworked before official publication.

² The author is Secretary General and Managing Director of The Geneva Association (www.genevaassociation.org), leading international insurance research centre.

³ See especially issue no. 281 of the Etudes et Dossiers Working Papers “The Risk Shift from Public to Private: Which Role for Insurance and Financial Groups?” published by The Geneva Association in March 2004.

⁴ An obvious example is the ubiquitous state employment “insurance”, a particularly strange protection arrangement where the groups with the highest risks usually pay the lowest premia, where moral hazard and asymmetric information are almost expressly built into it, and where the enormous redistributive effects seem to be the prime reason for its existence. Many of the key elements of this scheme have little to do with proper risk analysis of the insured risks and the efficient risk management of the portfolios.

⁵ Among others see: Hu, S. (1996) “Myopia and Social Security Financing” Public Finance Quarterly, Vol. 24 pp.319-48. Feldstein, M. (1987) “The Optimal Level of Social Security Benefits” The Quarterly Journal of Economics, Vol. 100 pp. 303-320.

- Insurance can play a key role in providing solutions for old-age income but the key question to our industry is: does it so efficiently, fulfilling customer needs?
- The risk shift „public to private“ opens opportunities, but does insurance want to take the risks and can it take the risks?
- The future economic environment needs good pension solutions, but does society provide the best rules for the private industries to operate?

It is important to remember that pension provision is chiefly future business with the current and next generations. Hence long-term economic and legal aspects play a key role.

There are risk transfer mechanisms between individuals on the one side and insurance companies, the capital markets or government and society on the other. While insurance contracts and pension funds provide direct legal relations between the original risk owner, that is individuals, and/or the companies, there are also a set of informal relationships that dominate the social security world. Ultimately, the role of government in our modern society is key in defining the risk transfer mechanisms and in also ensuring that they operate efficiently over time providing enough accessible and sustainable solutions for people to cope with the individual risks that they are facing. This is at the very heart of the modern welfare state.

As we all know, we are living in a time of unprecedented increases in life expectancy. The population explosion of the elderly above the age of 60 years is something that is projected into the future – and this is not only true for Europe where the current focus of most research lies. It is especially true for countries in Asia. If we were to draw a conclusion from an analysis from past and future population developments, then we can only conclude that Asia will be in the year 2040 where Europe is in the year 2005 (*see attached slide – Asia versus Europe: Population Development*). However, a key difference between Asia in 2040 and Europe in 2005 is that the next 3 decades in Asia will see a much accelerated phenomenon as the old population will increase much faster than it did in Europe and the younger population will shrink much faster than it has done in Europe. Consequently, we are dealing with a global problem, that affects different parts of the world in different decades, but it will be a persistent challenge of the 21st century.

Certainty versus uncertainty of projections and future developments

Before developing the theme of this paper further, I want to briefly highlight what is certain against what is uncertain about our future in this domain:

1. It is certain that the population development effects are unavoidable. Few projections into the future are as reliable as population developments.
2. It is also certain that fertility levels and changes in fertility only impact these developments and their effects in the very long run. Influencing fertility will not solve immediate problems.
3. The first big uncertainty, future mortality: There are currently two schools of thought on mortality trends.
 - a) Positive: Past demographic projections have underestimated mortality improvements – this leads some specialists to predict that life expectancies will go on increasing at a sustained rate.
 - b) Negative: Some factors point in the opposite direction: decreasing returns on medical progress, new pathologies, quicker/more widespread transmission of viruses, delayed impact of decreasing selection at birth, increasing obesity and health risk factors associated with it, etc. These either decrease gains in life expectancy or even lead to the opposite, that is, a shortening of life expectancy in the future. We do not know at present which of those two scenarios is the more likely one.⁶
4. The impact of technological breakthroughs in medicine and related fields on mortality and morbidity is notoriously difficult to predict. It is uncertain what the effects will be on population development but not only on population development but also on the possible activity level that can be expected of the population from the age cohorts above the age of 60 years.

Summarizing this, we can deduce that while there is no apparent inflexion for Western developed countries, things generally remain open. This is especially true in the emerging countries where the longer time-lines add more room for special developments.

Specific challenges facing individuals and managing longevity risks

I now want to directly address the specific challenges facing individuals and the managing of their longevity risks:

⁶ A recent session at The Geneva Association's Chief Risk Officer Assembly, which was hosted by Munich Re in November 2006, lead to inconclusive results with the experts present at the meeting. The "middle position" in the analysis expected longevity to improve in the future but at a somewhat slower pace than in recent decades. Much improved trends were seen as less likely as was a collapse of the positive future increase of life expectancies (regional special situations excluded). Conference papers have been assembled by The Geneva Association and will be made available in early 2007.

The first group of risks concern the health and long-term care of individuals. There is a possibility that the resources allocated to cover these risks provide insufficient to cover all related expenses. The next risk facing individuals is the investment risk. That is the possibility that the actual investment returns deviate from the expected, with the possibility of a shortfall due to smaller returns than foreseen. The third and final risk is the so-called “pure” longevity risk. It is the real possibility of outliving resources or, alternatively, of dying with resources remaining. It is the task and the chance for life insurance companies to help their customers cope with these risks.

The individual longevity risk management is likely to become more important. More responsibility is being shifted to individuals:

- a) Employers continue substituting defined contributions for defined benefits pensions, shifting decisions about securing retirement income to individuals;
- b) Public pension benefit levels are declining relatively, shifting more of the retirement income burden to individuals;
- c) The partial “privatization” of public pension systems is a further likely shift of retirement income decisions to individuals. So, individuals are not just having more extended responsibilities to deal with, they are also facing increasing uncertainties surrounding longer life expectancies. Medical breakthroughs and complex tax and old-age security systems complicate the management of an individual’s longevity risk. It is here where insurance companies can be of special service.

What to do? Economic theory makes it clear that the rationale response by individuals is the purchase of actuarially fair life annuities. Yet, comparatively few individuals annuitize their wealth in any market worldwide. Why? In some cases certainly because public pensions, defined benefit plans and family security preclude the need for substantial annuitization for some. However, this is not the case for most persons.⁷ There might be a desire to retain assets because of concerns of other retirement risks and/or possible bequests. However, one of the key questions is whether there is so little annuitization because of the lack of information and/or inefficient markets coupled with incompetence on both sides, the customer and the provider.

Let us consider one of the key components: The imperfections in the private annuity market.

⁷ There is a wide body of literature available for most countries in the world indicating a shortfall of existing and expected assets of citizens to finance their retirement at an appropriate level (usually set at 80% of the last net income). Consult the OECD and World Bank websites for extensive lists of references of these studies.

1. There is a lack of inflation indexed annuities in most markets. This could be addressed, particularly with increasing prevalence of inflation indexed government securities which would help us hedging risks.
2. The irreversibility of annuitization: This problem is difficult to address because of adverse selection problems. However, it is not totally impossible.
3. Consumer problems: Low consumer knowledge about annuities can be rectified, however, consumers' difficulty in assessing distant future states is much more challenging. Overcoming the myopic behaviour of consumers in this regard, is a key challenge.
4. The lack of actuarially fair pricing because of loadings and the failure to price the risk (correctly): Loadings seem to be less of a problem than the lack of risk-based pricing. Products could be easily changed to avoid front-loading and to provide customers with a more equilibrated spread of administration and sales costs over the life of the product.

The consequences for life insurers of imperfections in the annuities market are dire. They forgo potentially enormous sales in a major market segment, particularly for those in less than perfect health where offers for covering their future needs are especially sparse. Insurers also fail to retain assets under management. In most of the cases, at liquidation, substantial proportions of annuity funds are withdrawn. Comparatively modest proportions of benefit payments under life insurance policies are retained by insurers under payout options including annuitization. It is one of the key challenges to a life insurance company, to make sure that any life insurance policy that comes due allows them to retain the asset under management for a longer period of time, rather than encouraging their customers to look for solutions elsewhere.

There are four important questions to tackle concerning the competitive issues that were just discussed:

1. Why have life insurers failed to respond more positively and creatively to annuity market imperfections?
2. How much profits are foregone and how much value-added for consumers was never created?
3. Are obstacles to comprehensive risk-based pricing really insurmountable?
4. How can the capital market be used to address this issue?

The challenges for the life insurance industry lie in various areas. It has to reconsider the value propositions of life, health and long-term care insurance solutions, especially under

the scenario of a very rapidly increasing older population with continuing improvements in remaining life expectancy. Life insurers have to live up to the opportunities that the gradual exit of state systems provides for private old age provision. Insurance is not only a protection but also a savings vehicle of great importance to individuals. It acts as a distribution mechanism not only between groups of individuals, but also, and most importantly, over time. There are very little other financial solutions that distribute risks over groups and over time. Life insurance contracts are also private contracts that, in contrast to public solutions, usually enjoy a better legal protection and are more difficult to change through unilateral action by a government. Another key challenge to the life insurance industry is to speed up the development of new products, especially in retirement planning and for health and long-term solutions.

In a demographic environment that is changing so rapidly and in directions that are completely new to mankind, it is surprising to find how little true innovation we have seen in the past few years, especially for the key risks that individuals face in their lives. Beyond this, the life insurance industry has to help develop financial markets for instruments that can be used to lay off some of the insured risks. Only if life insurance companies are able to organize efficient distribution systems on the one side and then decide which risks to keep on their balance sheet and which risks to lay off to the capital markets in an efficient way, will they be able to accelerate the scope and depth of available solutions in the marketplace.

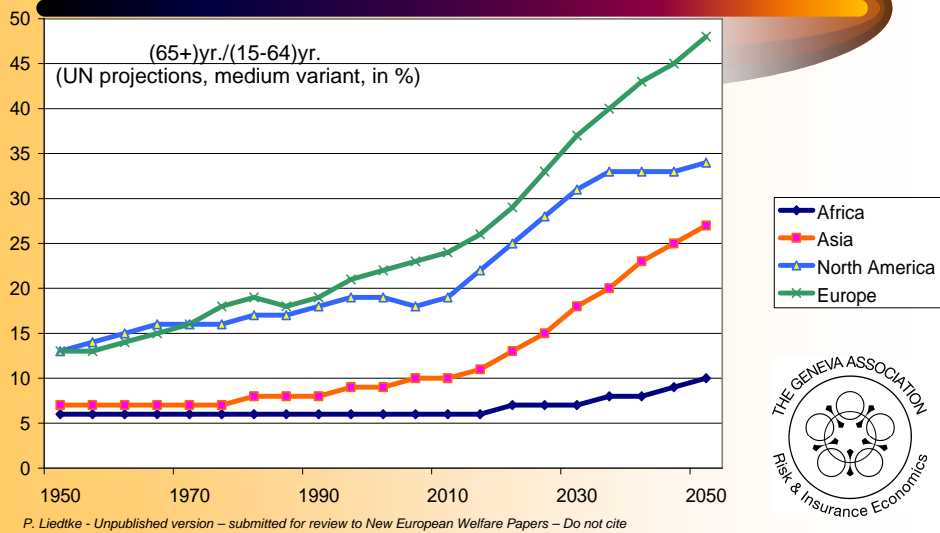
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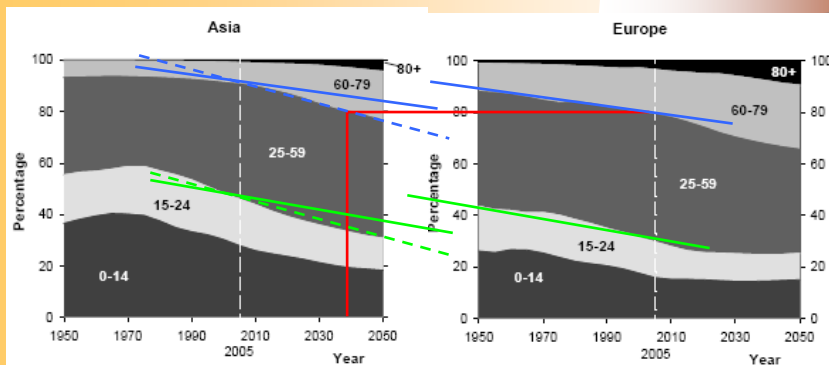
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Increase of Old-age Dependency



Asia versus Europe: Population Development



- *Asia will be in 2040 where Europe is in 2005...*
- *...but the old population will increase faster...*
- *...and the younger will shrink faster*

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