Aging populations: How governments and the insurance industry can work together

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Demographers can predict the future. Unfortunately, we seem to have ignored the facts.

Our societies are aging. Dependency ratios will increase in a highly predictable fashion. We face a challenge—not an insurmountable one but a difficult one—and we are running out of time. Solutions will require collaboration of governments and the private sector. They will require insurance industry vision and leadership.

This situation should not come as a surprise. It is a challenge we have known about for many years. There has been much discussion but little effective action. If we continue on this course, the golden years will be meager for many.

As Samsung Life so eloquently observes, we are not facing problems that have discrete solutions. We are facing:

> *A long-term adaptive challenge, one where our fundamental expectations and thinking about current methods of resource allocation have to change.*

This paper summarizes the issues and ideas developed in six papers prepared by insurance company representatives from six large insurers / reinsurers for discussion at the International Insurance Society's 49th annual seminar in Seoul, Korea, in June, 2013.

ECONOMIC GROWTH

Our success will hinge ultimately on the health of our economies. We must invest in infrastructure; we must invest in public health; we must educate not just our young but ourselves. We must innovate and change our ways of thinking.

As we reflect on these challenges, we must ultimately ask ourselves:

- Will our society have adequate resources to provide for the aged?
- Will we come to a consensus on how to allocate these resources?

Surely we can answer each question in the affirmative. The insurance sector will play a vital role.

THREE PILLARS

The papers submitted to this conference draw lessons from societies at diverse junctures in their development; the lessons emerge from countries with very different cultural heritages and varying political philosophies. Yet in facing these challenges, we have much in common.

Every country discussed in the six papers—Canada, China, Germany, Italy, Japan, Korea, and the United States—conceptualizes retirement funding in terms of three pillars:

- Government programs
- Employment-based programs
- Individual savings

There is a universal recognition that the retirement challenge requires both the exercise of individual initiative and a sense of collective responsibility.

Each pillar is weak and has undoubtedly become weaker following the financial crisis.

Budget pressures wrought by diminishing tax revenues in OECD countries have put social welfare spending under the microscope. There is a growing recognition that at least modest change—increasing retirement ages, less generous inflation indexing, introduction of means testing, and possible tax increases—will be required to shore up public pension programs.

In the private sector, reductions in coverage and conversions from defined benefit to defined contribution plans have for many years been shifting risk from employer to employee.

The result in almost all jurisdictions has been a dramatic weakening in pillars one and two. There has been a shift of responsibility to the individual. But the shift has been stealthy. Whether it is Italy or Korea or the United States, there is little public awareness of the problem, and individuals are woefully underprepared.

THREE CHALLENGES

As the paper from Prudential points out, we can reflect on government-industry collaboration in terms of three challenges:

- The savings challenge
- The coverage challenge
- The retirement income challenge

THE SAVINGS CHALLENGE

The savings challenge can be stated simply. Can we encourage increased levels of savings and provide reasonable vehicles to facilitate a productive use of this savings? Our track record is not impressive. Even though the developed nations have offered incentives to promote savings for many years, savings in most OECD countries fall woefully short of what will be required to fund retirement. As Manulife points out, even in Canada, long a leader in the promotion of retirement savings, savings rates have declined over the past decade and levels of indebtedness have increased. As the Generali paper discusses, in Germany, and particularly in Italy, a severe savings gap has emerged following the financial crisis. The vast majority of the population appears either unable or unwilling to reduce current consumption.

Education is essential to addressing the savings challenge; individuals need to understand the resources that will be required to maintain a standard of living in retirement. They need to understand that much of the burden will fall to them. They need to be shown credible retirement planning options. Yet education alone will not solve the problem.

Tax incentives have been tried and may help, but will need to be revamped. Because moderate tax incentives have been shown to be ineffective, governments may need to pursue more aggressive ideas. These could include government matching contributions to defined contribution plans, or tax deferral coupled with fully or partially tax free withdrawals after a certain age. The viability of such solutions, of course, must be balanced against the associated loss of tax revenues. If incentives do not work, mandatory savings may be needed, following examples from Hong Kong and Singapore.

THE COVERAGE CHALLENGE

In the developed countries, the coverage challenge relates mainly to the second pillar: How can we bring more people into employer-based programs? Due to the complexity of establishing and maintaining an employer-sponsored program, the coverage challenge is particularly acute for workers in smaller enterprises. Governments can alleviate this burden by allowing multiple employer plans. Insurers can add value through expertise in administration and asset management and by providing vehicles for the annuitization of benefits.

In China and other developing countries, where coverage may be regional or limited to specific industries, the coverage challenge also requires expansion of public programs.

THE RETIREMENT INCOME CHALLENGE

Even with adequate savings and coverage, we must address the retirement income challenge. How can we assure that accumulated savings can be converted into a lifelong stream of income to support the needs of a retiree? Though intertwined, it is useful to reflect separately on longevity and investment risks.

Longevity risk

We need to assure that we are not impoverished by the good fortune of a long life. Product design needs to accommodate 21st century demographics and finance. Our clients may work part time in retirement. Many will have savings and other resources. Many will have obligations beyond providing for themselves and a spouse in retirement. Annuities must be customized to reflect the resources and demands of each situation.

Financial planning must take a comprehensive look at retirement needs and available resources. Long-term needs should consider post retirement work plans, available public benefits or private pension payouts, and the drawdown of defined contribution or other private savings.

The financial plan should include an analysis of inflation risk and a comprehensive view of resources that might be available in a stress scenario, such as net equity in one's home.

By fully reflecting resources available to support income needs in the early years after retirement, retirees can benefit more from the enhancement in benefits that arises through survival. Regulators, companies, and customers must overcome reluctance toward "tontine" designs–plans that offer enhanced benefits due to survivorship. A relatively modest outlay at age 60 can fund a significant potential income stream if benefits are deferred to 75 or even 80; an increasing pattern of benefits thereafter will facilitate a lower initial outlay and inflation protection.

Investment risk

Individuals can expect to live for 20 years or more after they begin to scale back their workforce activities.

Given the long time horizon associated with retirement, retirees might be advised to adopt riskier investment strategies in order to capture associated higher returns. In practice, however, the risk of capital depreciation tends to lead retirees into conservative strategies; undue caution will increase the likelihood of depletion of resources. Insurers have begun to address this risk by coupling minimum withdrawal benefits with variable annuities; this allows participation in equity gains, while limiting downside risk. We anticipate ongoing development of protection strategies that facilitate balanced investment strategies in the payout annuity phase. Because the strategies protect against withdrawals during market declines, even after reflecting the costs associated with the hedge, average lifetime income exceeds that of an un-hedged portfolio. Insurers are uniquely positioned to develop products that mitigate investment risk, provide longevity protection, and enhance lifetime income over simple savings and payout scenarios.

We must allow individuals to tap all sources of wealth, especially wealth that is locked up in home ownership. By developing mechanisms to tap less liquid forms of wealth, individuals will be able to enhance yields by avoiding unduly conservative investment approaches.

Governments can further facilitate inflation protection by offering inflation-indexed bonds and designing tax regimes that do not impose a tax on illusory gains associated with inflation.

CONSUMER EDUCATION

Over the past several decades, consumers in many countries have had the means but not the motivation to save. Even in the developed countries, there is little awareness of the inadequacy of government schemes. Financial literacy is low; those aware of the need have little knowledge of the steps they might take.

In Italy, only one in five workers takes advantage of a supplementary pension savings scheme. In Germany, Riester pension plans were introduced in 2001 to bolster the individual savings pillar. To date, enrollment represents only about 40 percent of eligible savers. Samsung Life's description of the situation in Korea seems applicable to almost all jurisdictions:

> *Most Baby Boomers are ill-informed, unmotivated to invest, and unsure of whom to trust when it comes to managing money over the long term.*

Yet research by Prudential suggests that consumer education can make a difference. Users of one retirement income illustration tool increased savings plan contribution rates by five percentage points.

As RGA points out, the problem is not so much a lack of content but a lack of effectiveness. Materials exist, but "navigating the mountain of educational resources may be as daunting as the financial decisions themselves." This is not hyperbole. The insurance industry has the requisite expertise in financial planning and risk management. Insurers can play a leading role in crafting the message and delivering it locally, but only a partnership with government will assure adequately broad dissemination.

THE BROADER CONTEXT OF DEMOGRAPHIC CHANGE

Nippon Life points out that it is important that government and insurers reflect on the broader context of demographic change. We are seeing a growing number of single households. Very low birth rates will continue to change the composition of the workforce.

The role of women will increase; historically closed societies like Japan and Korea may allow an increasing number of immigrants. These factors, along with increasing societal mobility and urbanization, are weakening traditional family structures. Even in traditionally Confucian societies, a majority of people view government rather than family as the primary provider of social services.

What will an aged society look like? Due to the paucity of individual savings and scarcity of government resources, we will see many individuals working as long as they are able. Risk management needs will become more complex. Individuals will face overlapping and rapidly evolving needs—from life insurance, to disability income, through savings, annuities, long-term care, and medical.

GOVERNMENT AND INDUSTRY COLLABORATION

Yes, we are facing a complex problem. It is one of adaption; it will not be solved by a single player or a single idea.

Governments and industry must work together to recognize the nature of the challenge and the universe of potential solutions.

Our working lifespans will increase, the nature of retirement will change, and we will phase into retirement with part-time work over an extended period. The nature of retirement savings and the nature of post-retirement risk management will need to reflect this change.

In the past, we conceptualized the move from work to retirement as a discrete step. During our working years, we saved; during retirement, we drew down these savings. With a more flexible view of retirement, we need to accumulate funds for a period; gradually we will increase our dependence on these funds as we disengage from work and pursue other activities. Annuities must be integrated with this evolving view. By integrating innovative product offerings with evolving needs, we can mitigate risk and optimize retirement security. In particular, through a realistic evaluation of immediate resources, we can defer and tailor our demand for retirement income, and incomes will be enhanced through the benefit of survivorship.

In order to assure that we can adapt, we must think expansively and assure that all options are on the table.

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