

Think Tank – The Geneva Association : New risks for old-age security

Much has been said of the recovery from the global financial crisis. But very little attention has been given to the old-age security system. Mr Patrick M Liedtke, Secretary General and Managing Director of The Geneva Association calls for special efforts to find solutions for the new risks presented for old-age security. He also recommends considering the larger consequences of all solutions being proposed.

The past three years have seen a very rough ride for the world's financial markets. Not only did the credit crisis (which The Geneva Association has studied intensively) directly impact the value of many real world assets (especially US real estate) and stock markets, with particular bearing on bank stocks, many derivatives and structured financial products, it has also led to a deeper rethinking of how we deal with financial risks and what role financial stability plays for the proper functioning of modern economies.

Much has been written about this in terms of overcoming the crisis and (re)positioning those parts of our economic and financial system that suffered most to generate future growth. Unfortunately, less prominent in these discussions are the long-term consequences for securing an efficient and resilient environment for persons to cover their old-age risks.

What if resources allocated for the future are insufficient?

There are specific challenges facing individuals when they are confronted with the managing of their longevity risks. The first concerns are usually linked to their health situation and possible long-term care.

As long as individuals are healthy enough to pursue remunerated activities, they have a fall-back option to deal with any shortcomings in their savings (including sudden devastation of their portfolios through financial crises). But at some point that might no longer be the case. There is always a possibility that the resources allocated to cover a future phase where remunerated work is no longer possible, where health costs might rise and where long-term care solutions become expensive outlays prove insufficient. The basic idea of any (individual-based or socialised) old-age security system is to provide mechanisms for the population to cover their future needs based on their current and past activities, which are transferred either as capital stock or entitlements into the future.

Questions to ask

The problem now arises that nobody knows for certain ex-ante what these entitlements are worth nor what kind of products and services might be available in exchange for future capital as it is used up and at which prices¹.

It is here that the really interesting long-term questions following the credit crisis find a crucial focal point. One needs to ask a series of questions in this respect:

- How far will the recent destruction of wealth affect the prospects of guaranteeing old-age security to populations?

- What will be the impact of a new perception of financial volatility and a new appreciation of risk on the organisation of pension systems and wealth creation mechanisms for savers?
- How will states and central banks deal with the long-term consequences of their recent rescue actions?
- How will current and imminent reforms of our financial systems shape old-age security in the long run?

The answers to these questions are anything but straightforward. They are complex, demanding and won't present themselves without specific work.

Special efforts will be needed to find suitable solutions for the key problems: How to reduce government debts without overly impacting economic development and without creating runaway inflation; how to rebalance central bank activity and cheap liquidity; how to find more efficient ways to allocate capital commensurate with the risks of the activities undertaken; how to channel long-term savings, particularly those for old-age, into vehicles that are apt for the purpose; how to distribute the clean-up costs of the recent crisis between current and future generations; how to... it is a long list indeed.

Some proposed solutions may result in unintended consequences

Some of the more recent financial discussions about financial stability or future accounting norms, solvency capital requirements or restrictions in the range of financial activities open to some institutions are very relevant to old-age security. Unfortunately, the full impact on the greater societal plane of what amounts to many important technical reform projects is too often neglected.

When the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) proposes new capital requirements for life insurers, it not only sets mechanisms to safeguard against a possible future failure of a specific carrier, it also de facto fixes the price for saving for old-age. When governments discuss policyholder protection mechanisms beyond those that already exist, they also have to balance the benefits of an added (hopefully efficient) layer of protection with the costs associated with it. When cash-strapped and highly indebted countries resort to taxing the transactions of, or the capital held by, financial institutions that are relevant for old-age security, they also change the incentives for individuals to save.

Even when governments resort to providing guarantees for bank accounts at risky (domestic or foreign) financial institutions, they have an impact on long-term savings decisions and the allocation of capital as they send signals as to what they consider worth protecting and salvaging in times of great stress. When accounting reforms (possibly) introduce spurious volatility in reported results, it shapes investor behaviour also in the long-term. And so on.

Getting it right

Over the past twelve months, we have arguably witnessed the start of the most comprehensive and far-reaching effort to reform our financial systems in our life-time. It is of great importance that besides the technical solutions in each area, we consider the larger consequences of the proposed solutions. Since small changes in a course, projected over a long time result in great final deviations, we must strive to get it right, especially for old-age security which has a particularly long risk

horizon.

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