



The Four Pillars Newsletter

Research on Insurance, Retirement and Social Security

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Editorial

The Four Pillars: Looking at the Last 25 Years and the Next 25 Years

by Krzysztof Ostaszewski

It is my honour and pleasure to introduce myself to you as the new Director for Life Insurance and Pensions at The Geneva Association, and the Editor of this Four Pillars Newsletter. This year, 2012, marks the 25th anniversary of the Four Pillars Programme. The Programme was set up in 1987, with the aim of studying the key importance in the new service economy of Social Security, Insurance, Savings and Employment, the four key components of retirement systems. The Programme focuses on the future of pensions, welfare, insurance and employment.

The main key drivers for this work are changing demography and its financing impact; complementarity between social security and insurance; and the changing perspective of the welfare state, employment and life cycles.

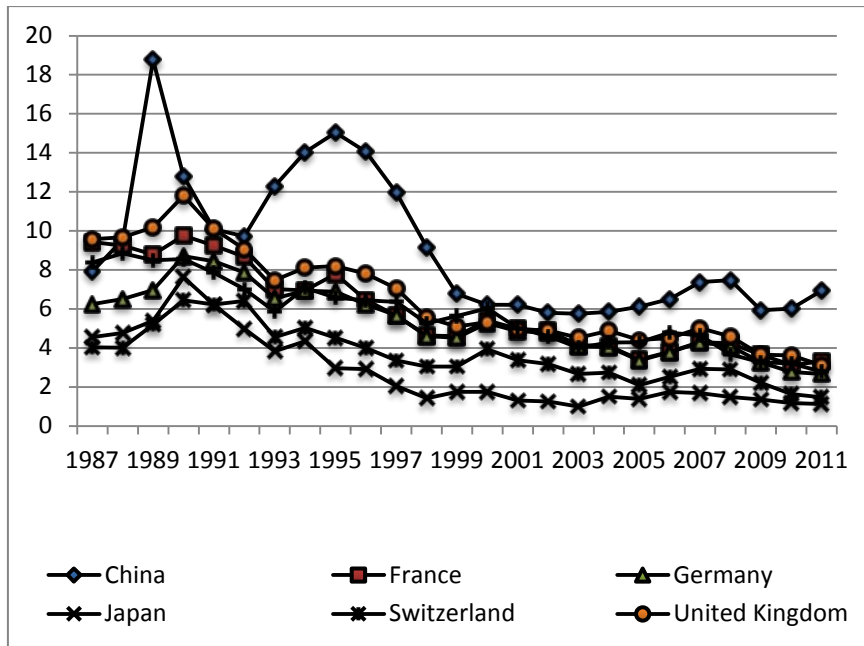
The related research activities have had four main objectives: 1) analysis of the key elements in organising old-age security systems; 2) research of conditions for multi-pillar systems of pension financing; 3) encouragement of multiple and complementary solutions to the challenges of ageing; and 4) understanding of the role of insurance in the provision of old-age security systems.

As we enter the second quarter century of this Programme, the world looks dramatically different than at its onset. In 1987, world politics was still viewed through the prism of the Cold War, while world economics experienced the shock of the largest one-day global stock markets crash in the recorded history on 19 October 1987. But the stock market debacle did not prompt any significant action from governments and no significant real economy effects appeared subsequently. In the world we see today, the stock markets debacle of 2008 was followed by very painful real economy dislocations. As of early 2012, the United States economy is showing signs of mild growth but its levels of unemployment remain at levels not seen since 1983. The European economies are struggling with the sovereign debt crisis, and the future of the common European currency, the euro, is uncertain.

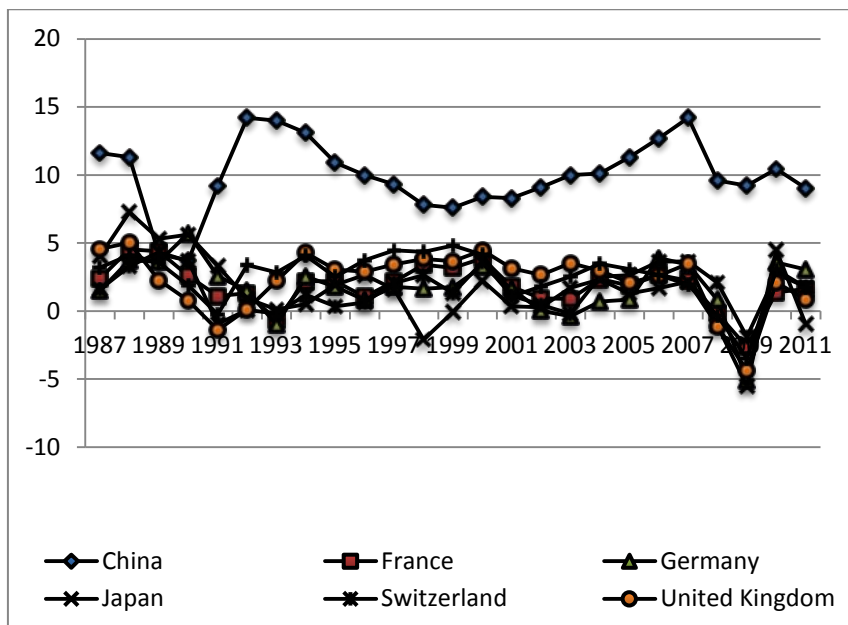
The world has also changed in ways that affect retirement systems in profound ways.

The costs of retirement systems are affected by a variety of factors, but the most important ones are: 1) levels of interest rates and rates of return available from investment portfolios, for private systems, or the growth rate of the underlying economy for public systems; 2) length of retirement period, affected by the timing of retirement, as well as longevity of retirees; and 3) level of benefits and whether they are affected by increasing cost of living in retirement.

In the graph below we show the history of yields on long-term (10-year) government bonds in China, Switzerland, France, United Kingdom, Germany, United States and Japan.



We see a pronounced downward trend in interest rates in all of these countries over the last quarter century. In fact, after the 2008 crisis, interest rates in the United States and Japan collapsed to levels not seen even during the bottom of rates in the late 19th century. Lower interest rates mean higher costs of private retirement systems. But there is more. In the chart below, we show the levels of real economic growth (real Growth Domestic Product, or GDP, percentage change year-to-year) in the same countries over the same period.



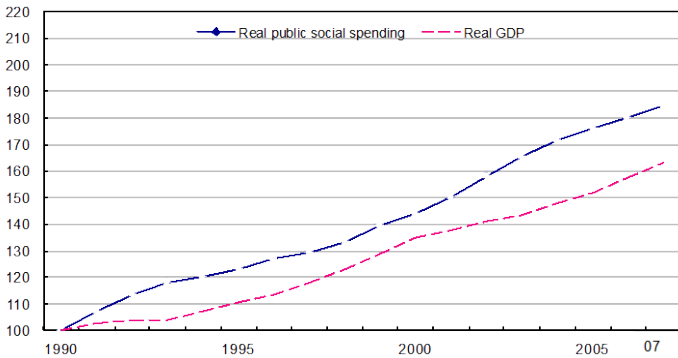
With the exception of China, we see the same downward trends in rates of economic growth and an outright collapse in 2009. Low interest rates and low economic growth mean that rates of return in private retirement systems and revenues collected in private retirement systems go down significantly. Low interest rates also mean higher present value of future benefits.

But the trouble did not end here. The last 25 years have also been marked by two more phenomena significantly impacting retirement systems:

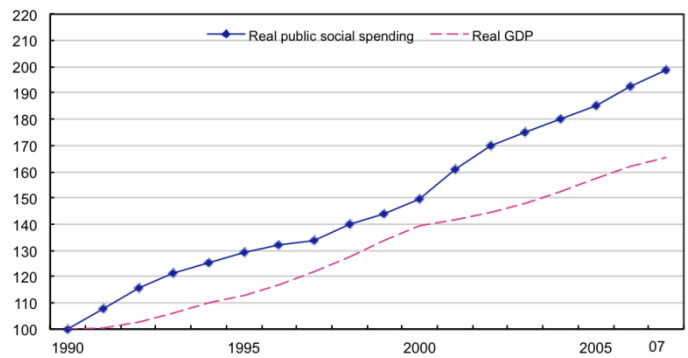
- increased social spending even before the crisis of 2008, resulting most likely from the sense of economic security created by increased standards of living and relatively stable economic growth (in other words, developed countries felt they could afford those additional expenditures and considered them socially desirable); and
- increased longevity.

According to the data available from OECD Social Expenditure Database¹ growth in real social spending has largely outpaced real economic growth, as illustrated in the graphs showing the two since 1990 in selected economies (the graphs compare growth of those two quantities, assuming hypothetically they both start at the same level of 100):

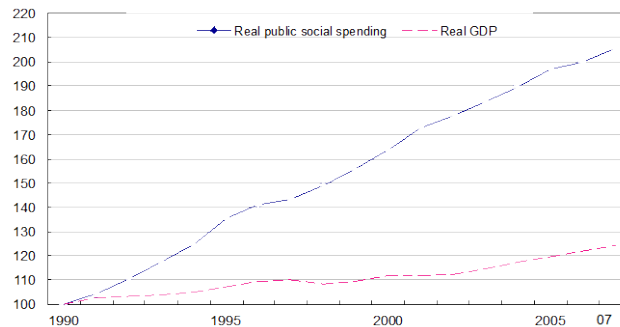
European Union 15



United States

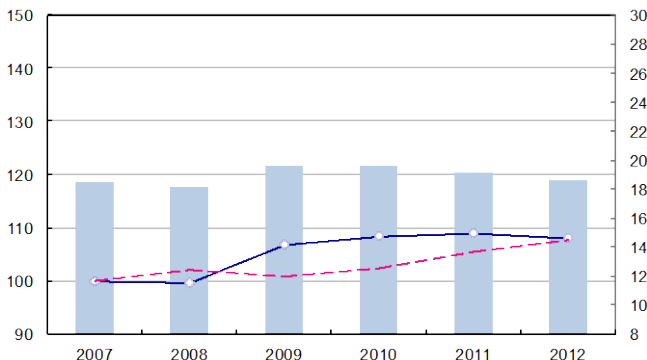


Japan



This phenomenon is especially pronounced in Japan and we should think about this with care, because Japan since 1989 could be in many ways a laboratory for what is awaiting the developed economies over the next quarter of a century. Why? Because what has distinguished Japan was low economic growth and automatic need for greater social spending. This may be the future for the developed world now. Let us look at the change in public social spending in some economies since the crisis of 2008, also from the same OECD database.

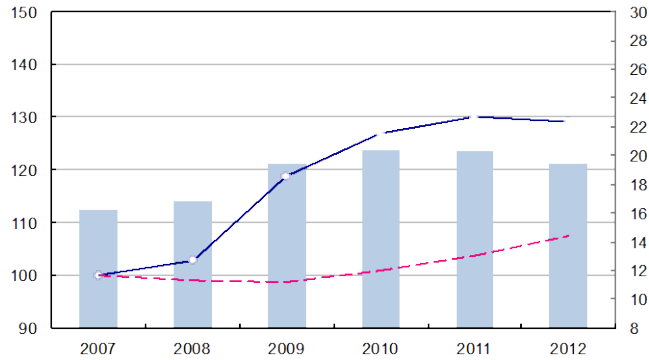
Switzerland



In this graph for Switzerland the columns show public social spending as a percentage of GDP (right scale), while the continuous graph shows real public social spending with the 2007 level treated as 100, indicated in reference to the left scale, and the dotted line shows the same type of information for real GDP, also indicated in reference to the left scale. The data for Switzerland does not show any drastic developments, but the data for the United States looks quite dramatic:

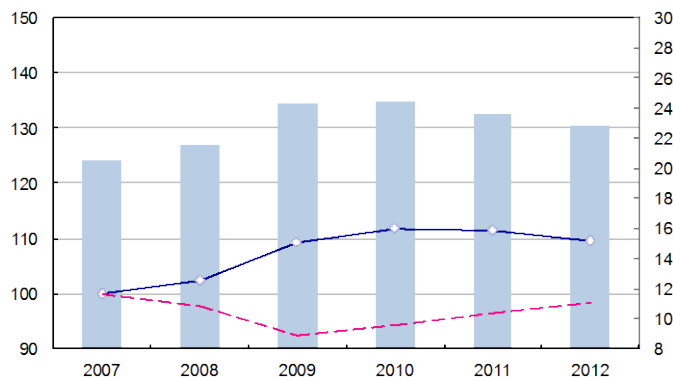
¹ SOCX, www.oecd.org/els/social/expenditure.

United States



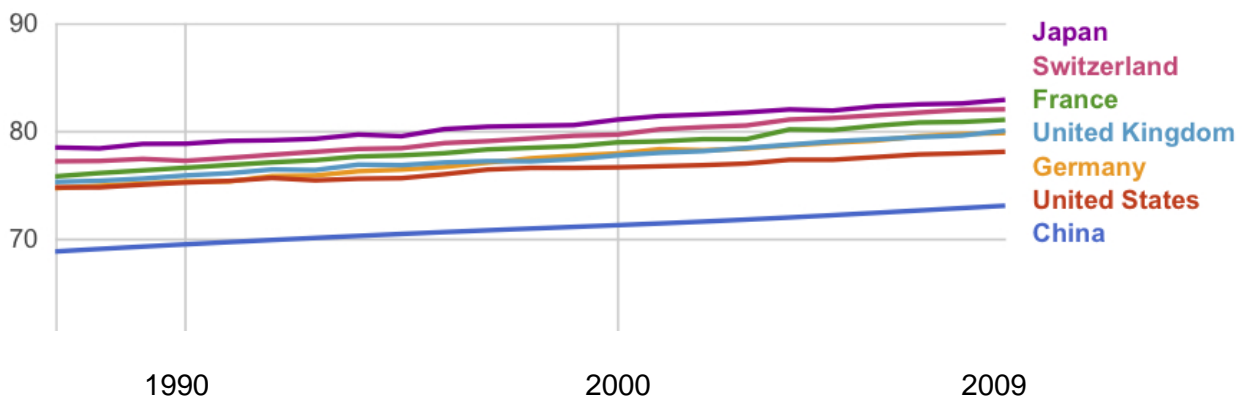
Following the crisis, public social spending in the United States increased from about 17 per cent of GDP to close to 23 per cent, and growth of public social spending outpaced economic growth very strongly. We see a similar pattern in the data from the United Kingdom, below.

United Kingdom



This means that the trend of increased social spending from the period when its objective was greater social welfare, before the crisis, was forcefully redirected to new social needs resulting from the crisis. But we also know that as a result of this new increased spending, numerous European Union members are struggling with financing their public debt and many countries worldwide have increased their public debts to levels that have not existed before in developed economies. In fact, developed economies known previously as the most sound borrowers globally have recently been downgraded.

During this period of declining rates of return and increasing risks, the cost of retirement has also increased due to increased longevity. According to the World Bank's, World Development Indicators,² life expectancy at birth since 1987 in the countries we had looked at before has changed as illustrated in the manner illustrated in the graph below:



² http://data.worldbank.org/data-catalog/world-development-indicators?cid=GPD_WDI.

Longevity is marching forward relentlessly, increasing the cost of retirement.

All of the developments indicated above illustrate how significant the challenges ahead are. The next 25 years will be very difficult for the Four Pillars that hold up retirement systems:

- Public social security systems are under significant pressure due to lower revenue and increased current social spending for needs such as unemployment benefits, or retraining of workers displaced by rapid dislocations occurring in the global economy.
- Employers are competing in the global economy and seek ways to cut their costs and are less willing to provide pension benefits or pension guarantees. Private insurance firms find themselves in a world where they cannot earn any significant returns nor provide them to their customers.
- Higher unemployment rates, reduction in wages from cost cutting by employers and increased cost of living put a squeeze on workers who find themselves less and less able to save for retirement.
- High unemployment rates and challenging labour markets mean that Silver Workers cannot automatically assume that they will supplement their retirement benefits with continued employment. In these challenging times, every job is a prize and Silver Workers will find themselves competing intensely for those prizes. And Silver Workers are very likely to live longer than they ever expected.

We must ask ourselves seriously how did it happen that developed economies arrived at this crisis in such a vulnerable state that all four pillars of our retirement systems were painfully sabotaged by the crisis? We need to prevent such vulnerability from happening again. As we celebrate the 25th anniversary of the Four Pillars Programme, we find ourselves looking at the future with concerns. In this issue of the newsletter you will find a call for papers for a special issue of *The Geneva Papers on Risk and Insurance: Issues and Practice* on the challenges for retirement systems in the next quarter century. We are also planning a conference addressing these issues.

In this newsletter, you will also find some perspectives on this new situation we find ourselves in:

- Orio Giarini, the first leader of The Geneva Association, looks back at history of the Four Pillars Programme and its significance for our world. The beauty and enthusiasm of this piece alone will make the reading of the newsletter worthwhile. Enjoy!
- Professor Milton Nektarios looks at the country most affected by the current crisis, Greece, and how this country is dealing with its retirement system in this difficult time.
- Anna Rappaport and Joe Tomlinson present the work that the Society of Actuaries is doing in the United States, through its Committee on Post-Retirement Needs and Risks, to advance understanding and to study post-retirement risks.
- Moshe Milevsky presents research from The Fields Institute for Research in Mathematical Sciences in Toronto, Canada, on life annuities and optimal patterns of retirement income payments.
- Cande Olsen presents new product development idea from the United States: contingent annuities.



Author: Krzysztof Ostaszewski is Research Director, Life and Pension, The Geneva Association.

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