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**Editorial**

# THE NEW NORMAL AND THE ACTUARIAL BUBBLE

**BY JAMES RAMENDA**

**THE NEW NORMAL ONLY FEELS NEW** if you don't remember the "old normal." For example, it's not really a new concept among banks that "you need good credit to get a loan." It's not new for consumers to spend less than 100 percent of their income. In fact, there was even a time when "consumers" was not our collective name; we were called, well, just people.

For sure, most of the new normal doesn't seem nearly as fun as the bubble that preceded it. Yet there is some satisfaction that comes to an actuary in recognizing how much of the economic bubble was really an actuarial bubble—not that actuaries were responsible for the bubble, but that the underlying causes were actuarial in nature.

Conventional wisdom regarding the bubble says that 30 years of declining interest rates and easing credit led to highly leveraged consumption and highly leveraged economic growth. All of which, in turn, led to the realization of bad credit, reduced spending, deleveraging and low growth. Throw in a little fraud, a good measure of self-delusion, and a lot of bad risk management, and a credit cycle turned into a systemic crisis.

But how much of the bubble was really actuarial in nature? For starters, there are

the demographics. There is no better read on demographic changes affecting growth cycles than Nino Boezio's February 2011 article in *Risks & Rewards*, "Taking Stock: What is the Real Problem with Economic Growth." To grossly oversummarize one of the article's key points, when a population bulge hits its high earnings and high consuming years, growth will be good, but as the bulge moves into retirement, growth will suffer. The 20 to 30 years prior to the crisis were the baby boomers' high earning and high consuming years. It was a long stretch of generally increasing corporate earnings, increasing leverage, higher returns on equity, and generally inflating asset values. During that time, much of the economy's success was attributed to technology, financial innovation, and assorted business superstars—but how much of the boom years' apparent success was simply being on the right side of demographics?

More pointedly for the U.S. corporate segment, how much of the earnings growth was due to shedding defined benefit pension plans and other post-retirement benefits (remember those?) in favor of 401(k) plans? It has been estimated that the once-traditional package of post-retirement benefits for average workers could account for up to 30 percent of total compensation costs. It's

a big drop from there to today's 401(k) plans. The difference—a pay cut really, and largely uncontested at that—fell directly to the corporate bottom line over the past three decades. There was no great product innovation associated with this earnings boost, no technological breakthrough, just a big transfer of expense and investment risk from the corporate sector to individuals.

Of course, some of the gains that corporations realized through pension savings were offset by rapidly rising health care costs. This increasing expense was itself partly offset by employers shifting costs to employees in the form of increased contributions. How were employers able to shift costs back on to employees? This goes right back to demographics. The opening up of global labor markets, including developing countries with relatively younger populations, helped shift the bargaining power to the employers' favor. Who knew the math of non-stationary populations would be so relevant to global economics back when we were studying it?

Actuarial realities unfold very gradually over many years and decades, a much longer time frame than the typical company or employee considers in their planning. Investment returns earned during years of

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rapid population growth, with leveraged balance sheets and inflating asset values may seem normal at the time. So it's understandable that behavioral adjustment can lag ongoing long-term shifts.

For example, even with the pressure on real wages, the evaporation of pension plans, and the widespread awareness of increasing longevity, individuals kept increasing their borrowing and their consumption (actually bringing the overall savings rate below zero), fueling the bubble. This spending boosted corporate earnings and overall economic growth statistics, but from an actuarial perspective what was happening was that individuals were de-funding the third leg of their retirement—private savings. Many remaining pension plans, both private and public, have since had to question whether their assumptions reflect the future, or a historical averages that may not be relevant.

Private savings rates are now trending solidly positive, but the generally inadequate funds

committed to this third leg of retirement, together with the weakening of employee retirement plans and ever-increasing longevity, seem to make it likely that the “new normal” of constrained consumer spending will be a long-term reality. How different might the economic contours of the past 30 years look if individuals had saved something on the order of their “normal cost” of retirement annually, rather than take savings rates down to zero?

It is hard to measure the shortfall in private retirement savings because there are no unfunded liabilities to amortize, no trust funds to run down. The impact will be gradual—an increasing number of older people without enough money to sustain the spending that our economy has been built upon. But they will not be completely out of luck. What they lack in economic power they will make up for in political power. If you think that Social Security and Medicare, so central to the spending side of the fiscal cliff, are tough political issues to touch now, remember that the baby boomers are just getting into their retirement years. It is a discomfoting fact that the financial crisis

began to break not long after the first baby boomers went on Social Security.



It's probably human nature to see the issues of the day through the lens of one's own profession. Still, it's hard to avoid the conclusion that many of our economic challenges have at their roots—a lack of policymakers' understanding (or perhaps willful ignoring) of intergenerational transfers, and long-term demographic shifts. While many of the aftereffects of the bubble are unpleasant, actuaries can take pride that our training is so relevant to the current economic situation and perhaps afford ourselves some optimism that we will be critical to developing future solutions. **A**

**James Ramenda, FSA, CERA**, is senior vice president, Enterprise Risk, with SS&C Technologies, Inc. He can be contacted at [JRamenda@sscinc.com](mailto:JRamenda@sscinc.com).

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