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Actuaries: Long-sighted or blinkered?

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Peter Drucker, the famous marketing guru, first said that the life insurance industry needed to adapt as people no longer worried about dying too soon; they worried about living too long.

Actuaries are in the business of assessing long-term risks and trends; we do not get swayed by short-term blips. There have been several structural changes in the economic environment in the last forty years; to what extent have actuaries led the way in anticipating them? Let us consider a few examples.

In the late seventies, swingeing inflation was playing havoc on defined benefit pension schemes in the United Kingdom with contribution rates going up alarmingly, sometimes to over 30 percent. JK Scholey, the senior partner of Watsons, asked whether it was reasonable to project the then high rates into the future. Something was bound to give. Indeed he was right. Over the next ten years there was massive restructuring of the U.K.'s manufacturing industry: jobs were shed, prices brought under control and by the late eighties pension funds were showing surpluses. Bless you, Ken Scholey, but what happened next?

The taxman decided to tax the surpluses so actuaries suggested ways of overcoming that. To the employer, they suggested contribution holidays and, to the trustees, using some of the surplus to enhance member benefits. No real attempt was made to explain the long-term consequences of either. The latter, in particular, ratcheted up the cost of the scheme. Not long afterwards, the rights of early leavers were inflation-proofed, substantially increasing scheme costs. Although it took another two decades for it to die, that marked the death-knell of defined benefit schemes. Actuaries sat on the sidelines and did nothing.

In 1988 Gordon Pepper, an actuary specialising in bonds predicted a collapse of the housing market. He said the rise in house prices over the past two years (1987–88) was comparable to that in the early seventies, with one key exception: inflation was lower. House prices were bound to fall as borrowers would be unable to service their debt. This turned out to be prescient and had dire consequences. Unfortunately, no one took any notice of Pepper.

In the early nineties, I read an article in a publication by Society of Actuaries, discussing ageing baby boomers. They had boosted the equity market by saving for retirement, but soon they would be retiring, disinvesting, and going into bonds. So equity prices may fall and bond prices rise. It took some years to happen (as there were all sorts of local diversions) but this was again prescient.

Following the recent banking crisis, the U.K. government pursued Quantitative Easing, pumping in money to keep interest rates low. This has had a disastrous effect on annuity rates as government bond yields have plummeted. No one in their right mind would voluntarily buy an annuity today.

So what did the government do? It removed the requirement to buy an annuity, which has been very well received. But is it a step too far? Drucker says longevity protection is what people want. Should the government simply have said that the annuity need not be a guaranteed annuity; it could be an equity-linked one? In the past, equity-linked annuities have been unattractive as the initial starting amount was low compared to guaranteed annuity rates. But that was when bond yields were 8 to 9 percent and dividend running yield 4 percent. Today, bond yields are around 2.75 percent but dividend yields around 3.75 percent.

This presented a golden opportunity for actuaries to design longevity protection on an income generating vehicle. Instead of a guaranteed annuity of, say, 5.5 percent pa, the insurer could offer a similar starting level of annuity but rely on the running yield and use capital appreciation to increase the income. Of course you get no capital guarantee but you can't have everything.

A friend of mine was on holiday in the United States when she suspected she suffered a mild heart attack. She was taken to the hospital and asked if she had funds. She said she didn't but she had travel insurance.

They put her through various tests and declared that there was nothing wrong with her. She was given a $122,000 bill and a demand for immediate payment. She said she couldn't believe the bill, didn't have that kind of money and they'd better deal with her insurer. They then reduced it $100,000 to $22,000 but still demanded immediate payment; she gave the same answer. Finally they reduced it to another $21,000 to $1,000 but she still didn't pay.

The medical care was quality, but was all of it necessary? And why couldn't they bill the insurance company? She asked for an itemised bill and crossed out many of the items they charged her for.

There are plenty of people out there looking to make money out of the elderly: medical professionals, the drug industry, care home providers. The baby boomer himself might wish to avail himself to the latest remedy available. How much money should they set aside?

Retirement used to be a major milestone: you ceased to earn income and had to make do thereafter with what you had set aside, be it pension or savings. The presumption was that your income requirements would reduce greatly: mortgage paid, children out of the house, no more commuting to work. But baby boomers are finding that their expenditures are not necessarily lower; they need to consider provision for long-term care and all those luxurious cruises. And they may live for another 40 years.

Can society afford to offer forty years of retirement after 40 years of work?

Let's attach labels to the three stages of our life: Learner, Earner and Burner.

Learners are children or, to use an alternative phrase, "trainee adults." **Earners** are adults that contribute to the economy. **Burners** are people who society no longer continue economically beneficial activities, and society says it is okay.

Learners are unable to enter into a contractual relationship but receive food, shelter, role-modelling, love, guidance and entertainment from their parents. The country, through a democratic process, determines the minimum level of support a Learner should receive in terms of education, health care, food, and shelter. Health care and primary/secondary education are free. Taxation and social security policy redresses the balance.

Earners contribute to the society by growing GDP and paying taxes.

Burners, under my definition, consume resources without replacing them. Sometimes they consume all of their allocated resources, sometimes they accumulate surplus assets, which they pass to the next generation, and sometimes they run out of resources.

I can see social unrest developing as young adults resist bearing the cost of long term care of their elderly parents. They should have set sufficient assets aside instead of blowing it all on cruises. Basically it is a problem of resource allocation, across the population and across time.

There are two approaches we could take to address these problems:

We could adopt the principle that each cohort should be value-neutral over time—i.e., they should take out no more than they've put in; or, as a variation, we could say that each cohort should leave the country x percent better off than they found it. This is a **longitudinal** approach.

Alternatively, we could say that the total allocable resources in a given year is X (however defined) and should be allocated "in the following manner" (however defined). This is the **latitudinal** approach we usually see taken by governments and local authorities.

Both approaches can work on a cohort basis, where the cohort is homogeneous and sufficiently large to absorb random fluctuations but not so large as to conceal distinctive differences.

But the two approaches are fundamentally different:

- The longitudinal approach is of a capital nature. It determines the Burners' "moral right" and will have to be converted into income that may be drawn each year.
- The latitudinal approach is of an income nature. It determines the amount the nation can afford to give a Burner in a particular year.

There's potential to use the approaches together. For example, the latter approach may be used to scale back the former in times of hardship, carrying the balance forward.

Nevertheless, this is another challenge for long-term thinking actuaries.

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