Risk Transfer to Households and Long-Term Savings Challenges

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Nicolas Blancher

International Monetary Fund

nblancher@imf.org

The IMF’s Perspective

- Macroeconomic and financial stability
- Surveillance: multilateral and bilateral; policy recommendations
- Monetary and Capital Markets Department’s *Global Financial Stability Report* (risk transfer series)

Households’ Changing Risk Profile

- Reduced public pension benefits
- Flow of risk in the financial system
  - Banks (CRT)
  - Insurance companies (repricing, unit-linked products)
  - Pension funds (DB to DC & hybrid)
  - Households
- Future reductions in healthcare benefits

Households’ Changing Risk Profile

- More *direct* risk exposures of households
  - Households have always been the shareholders of the system
  - Increasingly must take responsibility to *manage* risks
- Retirement savings challenges
  - Uncertainty over returns and costs of systematic errors
  - Uncertainty & risks affecting aging-related liabilities
  - Complexity/variety of products available
- Bottom line
  - Household sector more of a “shock absorber of last resort”?
  - Household risk management capacity part of financial stability

Households' Capacity to Manage New Risks

- Households need to manage larger and more complex risks, but they:
  - Often do not take a comprehensive approach to their long-term savings strategy
  - Are slow to adjust their asset allocation as needed
  - Underestimate required level of savings and risks
    - In several countries, long-term investment underperformance a key risk?
- Experience of previous generations not a good guide
  (changing benefit structures, financial instruments available)

Some Survey Results…

… showing a substantial lack of knowledge of households' own arrangements for retirement savings

- Netherlands: 65% of households are unable to provide an estimate of their pension income upon retirement
- U.K.: 44% of the population reported a basic knowledge of pensions in 2004, down from 53% in 2000
- U.S.: 47% of workers who have not saved at all are confident that they will have enough for retirement. Many count on employer-provided benefits that are increasingly unavailable

Government Communication on Priorities and Challenges

- Important for public awareness and success of pension (and health care) reforms
- Public debate and awareness often still nascent—need for further initiatives
- Develop broad and forward-looking measures of the impact of changes in pension and welfare systems on households' wealth (including distribution of risks across subgroups)

Raising Awareness—Examples

- U. K.: Pensions Commission Report
  - "*Pensioners will become poorer relative to the rest of society*" unless taxes or social security contributions devoted to pensions rise, individuals save more, or employees accept longer working lives
- Sweden—new public pension system
  - Following a broad information campaign, surveys have shown that the share of participants who say they do not understand the system has fallen from about 30% in 1998 to 13% in 2003

US National Retirement Risk Index

A good example of how complex risks associated with retirement saving can be presented relatively simply

- Measures share of working age households who are “at risk” of being unable to maintain their pre-retirement standard of living in retirement
- Assuming individuals retire at age 65 and annuitize all their wealth, 43% will be “at risk”
- Good news: changing retirement and savings behavior can substantially improve the outlook (e.g., retiring at 67 reduces share to 32%)

Percent of Households "At Risk"

TABLE 1. PERCENT OF HOUSEHOLDS 'AT RISK' BY BIRTH COHORT AND INCOME GROUP, 2004

Income group	All	Early Boomers 1946-1954	Late Boomers 1955-1964	Generation Xers 1965-1972
All	43%	35 %	44 %	49 %
Top third	36	33	35	42
Middle third	40	28	44	46
Bottom third	53	45	54	60

Source: Center for Retirement Research at Boston College (2006).

Household “Financial Margin”

- The Sveriges Riksbank has sought to assess households’ financial margin relative to anticipated future obligation (e.g., after interest expenditure and regular living costs)
- Distribution across income categories
- Takes into account potential benefit adjustments or economic shocks (e.g., a rise in interest costs and/or a decline in income)

(Sveriges Riksbank, Financial Stability Report, 2004:2)

Information vs. Education

Information cannot substitute for greater household financial literacy

- Financial information may be accessible, but households often make limited use of it
- U.S.: increased financial information for consumers may not result in improved financial management in areas such as mortgages and investment (behavioral economics and finance)
- Disclosure vs transparency

Financial Education and Long-Term Saving Challenges

- Saving for retirement: uncertainty over returns and costs of systematic errors
- Uncertainty/risks affecting ageing-related liabilities (e.g., longevity risk)
- Complexity/variety of products available (greater for savings/investment products)
- Purpose of financial education
  - Equip individuals to ask informed questions and understand potential outcomes

Governments and Financial Education

- Governments may come under growing public pressure to intervene in support of the household sector, for example:
  - in the form of added public expenditure pressures
  - in the form of re-regulation of certain products or services
  - in order to deal with waves of litigation
- A key objective for governments may be to strengthen basic financial education programs at school and at the workplace—indeed, such efforts are underway in some countries
- Some population segments most at risk? (data/identification issue)

Financial Education Program Design

- Focus
  - Home ownership, savings vs. debt reduction, etc
- Target audiences
  - Basic financial education in schools;
  - Long-term planning for the middle aged;
  - Consideration of payout strategies during later working life
- Delivery channels
  - Public/private, new media, etc
- Coordinate and evaluate effectiveness of efforts
- Government and private sector have comparative advantages
  - E.g., banks in Japan; employer-supported seminars in the U.S.

Governments and market solutions

- Focus on building necessary framework and incentives
- Encourage long-term household savings
  - Simple and stable tax and regulatory regime
  - Opt-in/out schemes; mandatory savings (?)
- Support market solutions and risk management by pension funds and insurance companies
  - Long-dated/inflation-linked bonds
  - Sharing the “toxic tail” risks?
- Strengthen incentives for financial advisers
  - Availability/appropriateness of advice may be an issue
  - More transparent commission/fee structures

The need for investment products

- Life-cycle products
- Structured products
  - E.g., long-term capital and performance guarantees
- Mutual funds
  - Lower cost funds allowing diversification benefits
- Annuities
  - Under-utilized products although longevity risk may be greatest retirement risk
- Home equity withdrawal
  - Housing as a major share of household assets
  - Reverse mortgages can offer a variety of cash flow profiles and an annuity-like income stream

Wrap up

- Risk transfer through the financial system—increasingly shifted to households
- Surveys show lack of household knowledge of even basic financial issues
- Governments have a key role in:
  - Raising awareness and financial literacy of individuals
  - Facilitating market solutions to improve the management of long-term savings risks
- The private sector has a key role in providing targeted, quality advice and products