Danny Quant
Singapore

Milliman

Institute of Actuaries of India

C2.5 Experience, assumptions and planning for retirement

Danny Quant

F.I.A., Milliman Employee Benefits, Asia

Waves of Reforms…Oceans of Opportunities

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Agenda

- Background
- The equation that defines retirement financial security
- Major driving factors
- Confidence in the drivers
- The defined benefit v defined contribution discussion

Why security matters in old age

"Older people provide care for children, sick people and other family members in the household; they look after orphans and vulnerable children and those living with HIV." *Ethiopia*

"I have lost three of my children to HIV and I am now caring for my grandchildren." *Nigeria*

"I have a niece who died and I have to take care of one of her children." *Jamaica*

"While my children are working, I take care of my grandchildren." *Ukraine*

"When the parents have to go out they leave their children and it's the grandparents who take care of them." *Germany*

"Look at all the grannies who are babysitting and minding the kids." *Ireland*

"We all help watch our grandchildren. Every single one of us has a child in Thailand right now, so most of us have to watch their children." *Cambodia*

Source: Ageing in the Twenty-First Century – UN Population Fund

Employment or catastrophes lead to greater demands on elderly generations

Opportunities for the children to generate their financial security

Financial security feeds into retirement security which perpetuates the support system

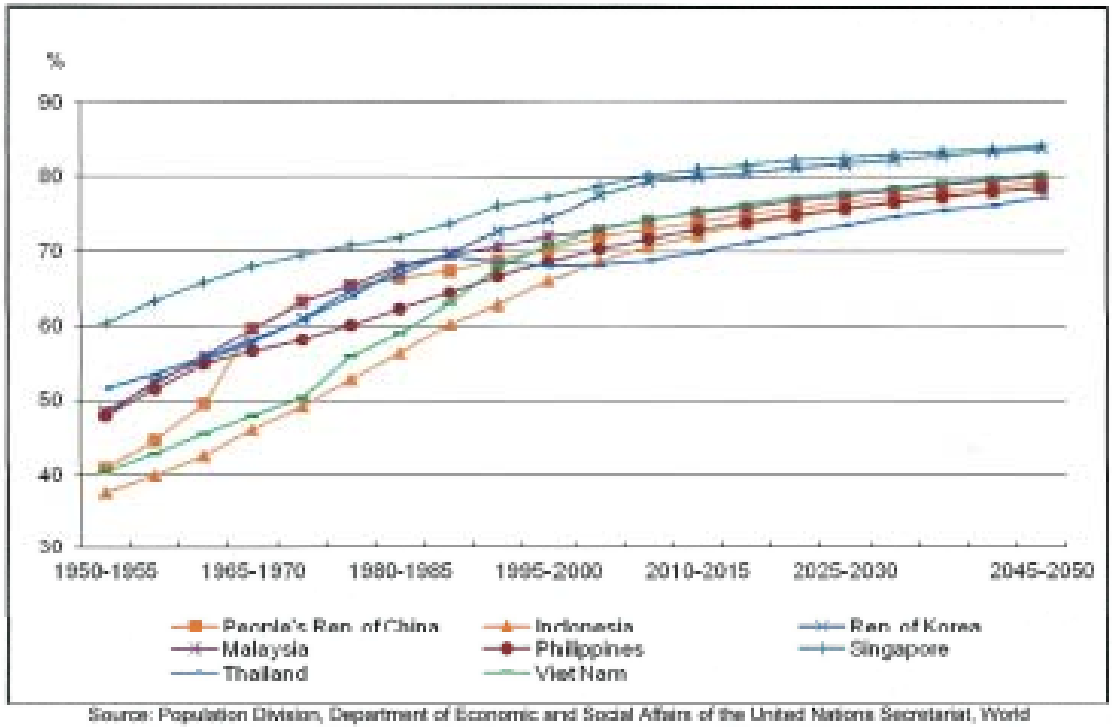
- 58 million people celebrated their 60th birthday last year.
- In 1950 205m people were over age 60. In 2012 810m, one in nine people are over age 60. This will be 2b, one in five, by 2050.
- In 2007 life expectancy was beyond 80 in 19 countries. Now it occurs in 33 countries.
- In Japan more than 30% of the population is over age 60. By 2050 63 more countries will join Japan.
- For births in 2010-15, life expectancy is 78/68 (developed/developing).
- By 2045-50 it will be 83/74
- Life expectancy in India has increased to 64 years (males) and 65 years (females) from 62 years in 1997 and 32-33 years in 1947

Proportion of population age 60 or over 2012

- We can see Japan and some Central European countries are already trying to cope with aged populations
- North America and Australia also

- In less than 40 years only Africa will be OK

Life expectancy at birth

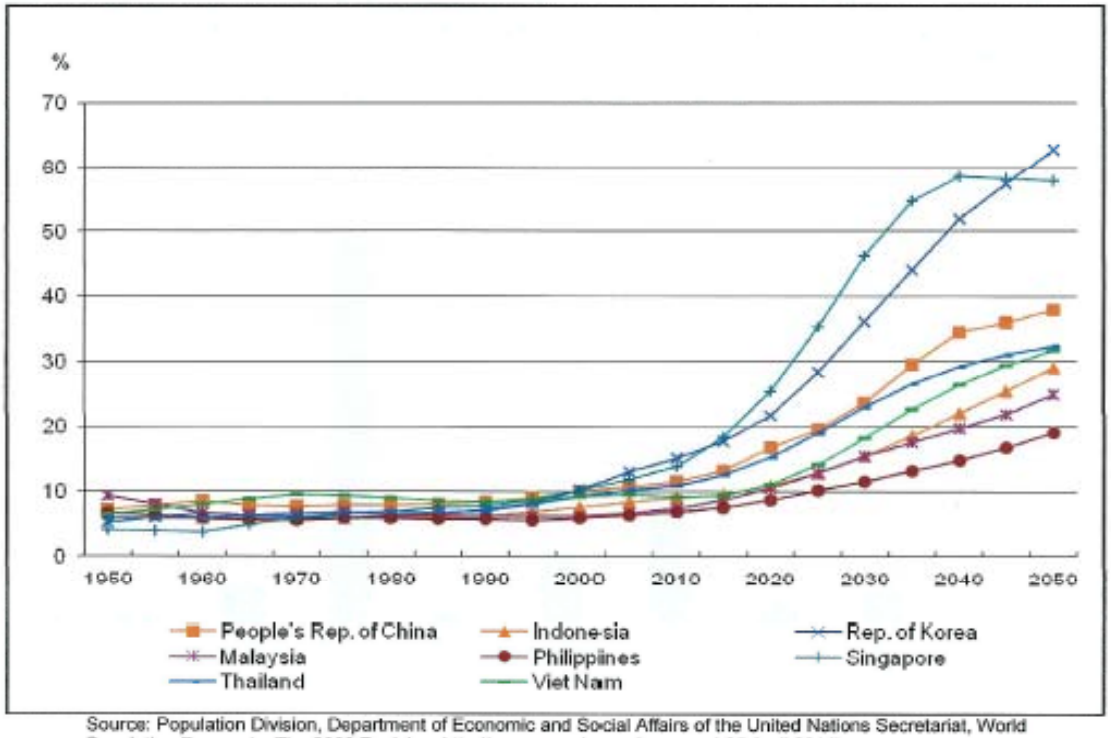


Source: Population Division, Department of Economic and Social Affairs of the United Nations Secretariat, World Population Prospects: The 2008 Revision. http://esa.un.org/unpp (accessed 25 April 2011).

Life expectancy is expected to continue to improve

While much of the improvement has already occurred, it is still expected that life expectancy can improve by another 5 years in the next 40 years

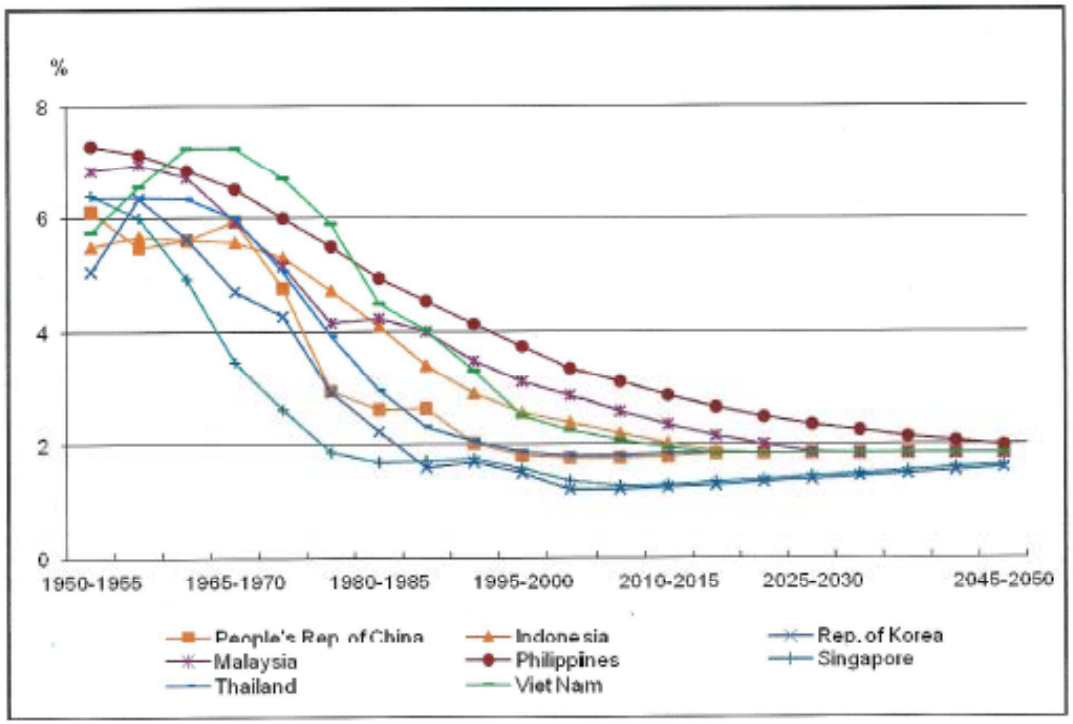
(Aged over 65)/(Aged 15-64) - Asia



Source: Population Division, Department of Economic and Social Affairs of the United Nations Secretariat, World Population Prospects: The 2006 Revision. http://esa.un.org/unpp (accessed 25 April 2011).

Everywhere there will be many more over aged 60 relying on the working population placing enormous strains on PAYG systems

Fertility rates



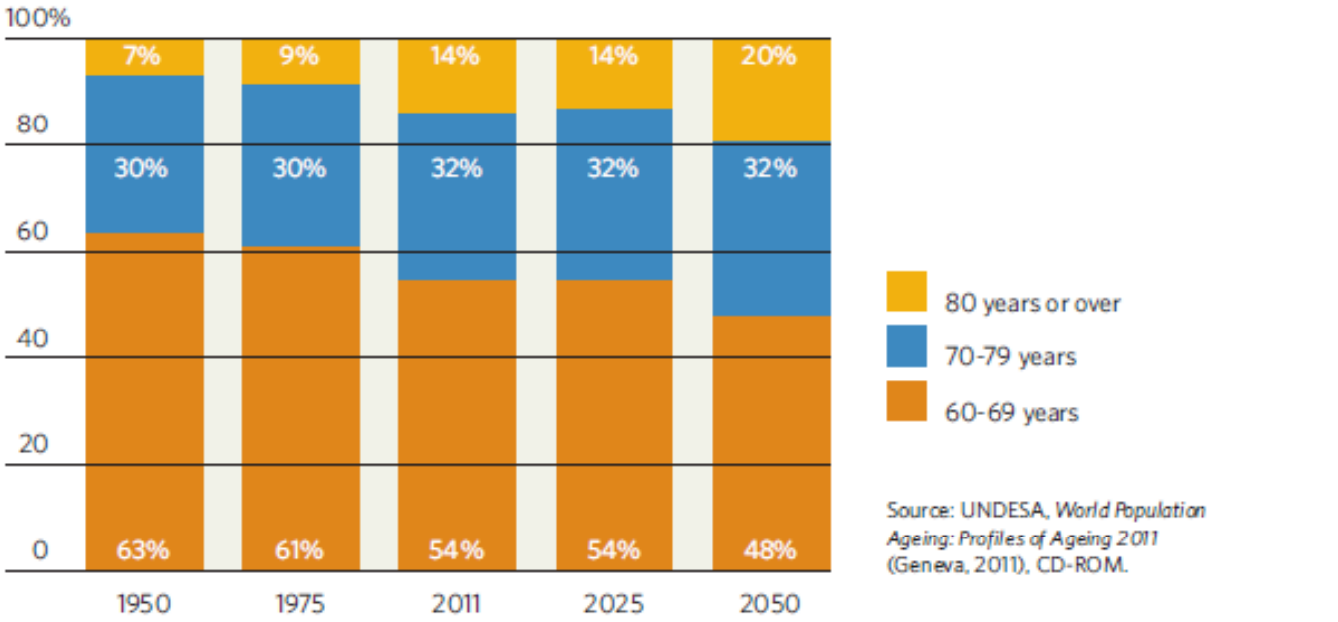
Source: Population Division, Department of Economic and Social Affairs of the United Nations Secretariat, World Population Prospects: The 2008 Revision. http://esa.un.org/unpp (accessed 25 April 2011).

Medical improvements and safer working conditions help lengthen life

Alongside is a reduction in births per mother.

Often less than the ideal 2.1 replacement level

Distribution of population over age 60



- **The number of over 60's versus the working population will become a secondary issue**
- **The proportion of over 80's will be a huge toll**

The fundamental equation

Contributions *plus* **Investment Income**

equals

Benefits *plus* **Expenses**

March 7, 2013

Perspectives

- Defined benefit (final salary structures)

Contributions

equals

$\text{Benefits} + \text{Expenses}_{DB} - \text{Income}_{DB} + \text{Risk}(\sigma)$

- Defined contribution (accumulation structures)

Benefits

equals

$\text{Contributions} + \text{Income}_{DC} - \text{Expenses}_{DC} - \text{Risk}(\delta)$

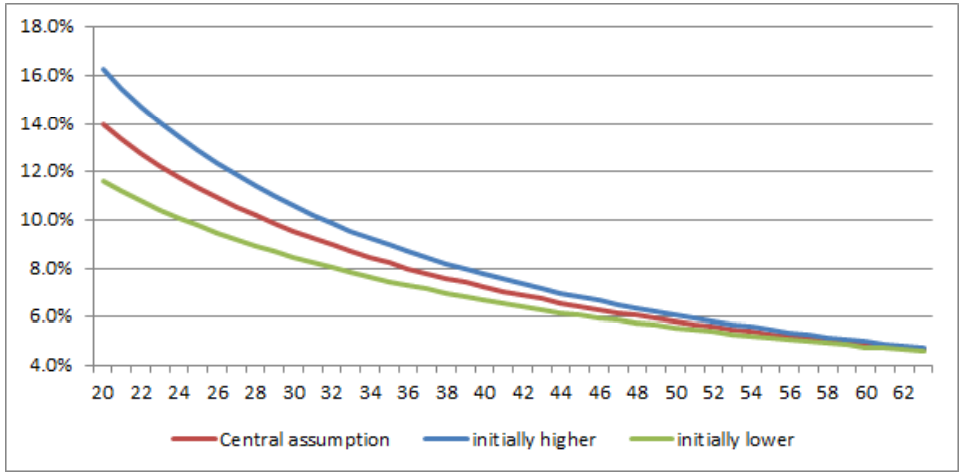
Major factors for the σ and the δ

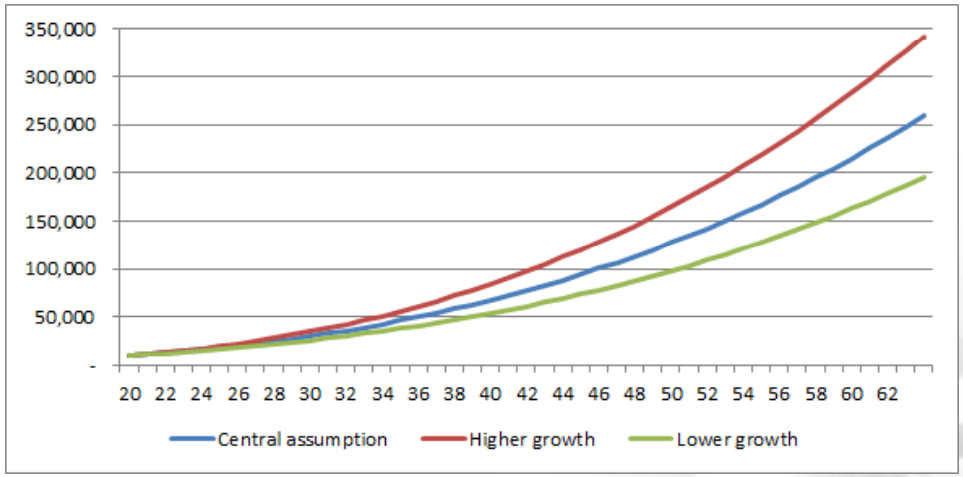
- Income
  - Attitude to risk
  - Regulations
  - Strategic asset allocation (market return: β)
  - Tactical asset allocation (manager returns over benchmarks: α)
  - Total expense ratio
- Expenses
  - Retail
  - Institutional
  - Economies of scale
  - Influence (related to other services within asset managers's group)

Major factors for the σ and the δ

- Salary inflation
  - Young v old
  - Juniors v seniors
  - Inflation + Promotional scales
- Mortality
  - Young v old
  - Gender
  - Occupation/industry

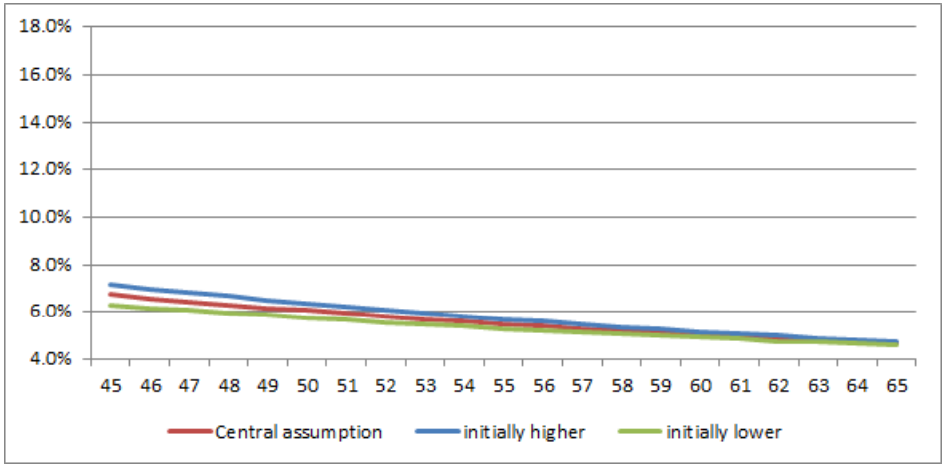
Salary growth hard to predict over long periods

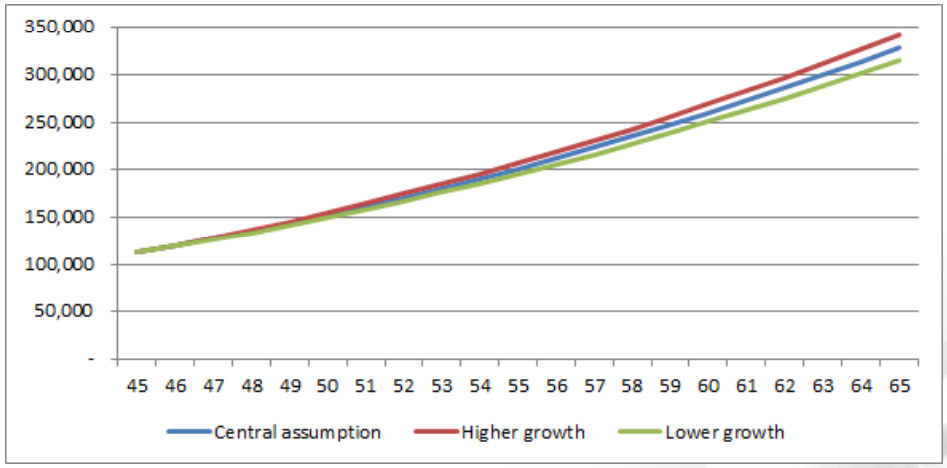




- Upper chart shows classic salary scales
- Starting with large increases during the accelerating promotion period.
- Initial growth depends on personal success. Perhaps +/- 2% p.a. each year at the start.
- Towards the end of the career increases are generally around inflation whatever grade you have reached.
- Lower chart shows range of salaries that would be achieved at retirement based on these salary scales.
- The final salary in this example could be 32% higher or 25% lower depending on the rate of acceleration early in the career.

From mid career until retirement salary growth is a little easier to predict





- **Same vertical scales.**
- **The ranges of results are much narrower.**
- **The initial acceleration due to promotions and other advancements are already in the salary by mid career.**
- **From this point much of the growth is inflation driven and is constant at many levels for base salaries**
- **The difference in the level of salaries for the lower growth and upper growth ranges are both around 4% of the central assumption.**
- **This is convenient for planning the funding of final salary related benefits.**

The impact of an error in mortality experience

Mortality experience - versus central assumptions*					
	Adjustment to central mortality assumptions	Expected age at death for female age:		Expected duration of annuity:	
		65	85	65	85
Central assumption	100%	84.4	91.0	19.4	6.0
Lighter mortality	90%	85.3	91.5	20.3	6.5
Heavier mortality	110%	83.7	90.6	18.7	5.6
Very light mortality	75%	86.7	92.5	21.7	7.5
Much heavier mortality	125%	82.8	90.1	17.8	5.1
Delta heavy/light		3.9	2.4	3.9	2.4
Delta relative to expected at age 65		4.6%	2.8%	20.2%	12.3%

* Based on 2000-2006 experience collected by 30 June 2007 from UK self-administered pension schemes, published in CMI Working papers 34 and 35, 2008.

- **Notice that the confidence in the cost of providing an annuity to an 85 year old is much higher than the cost of providing an annuity to a 65 year old**

Income and Expense

- There are also risk elements in the income and expense components
- The expense component is controllable to some extent and should be small compared to the other components
- The investment risk remains and is for another session:
  - Note that it will be different for DB and DC plans
  - There are techniques to control the downside risk (although it may be at the cost of some of the upside)

Suggestion for the future

- Consider
  - A core DC benefit for all employees throughout their careers
    - Provides universal coverage and a predictable outlay for the employer
    - Driven by affordability, tax incentives and desired replacement ratios
  - A supplementary DB arrangement that is funded during the latter period of employment and is paid later in retirement
    - Higher confidence in the funding and payment phases
    - Driven by affordability and assumptions around the utilisation of DC pot
  - Retirees have a basic pension in their early retirement years without the worry of whether the defined benefit pot will last until they die
  - The defined benefit entitlement is security for those retirees who survive beyond their average life expectancy age.

Implementation

- Carry out demographic analysis to see
  - what is the sensible accumulation phase: from age 45?
  - what is the sensible late payment pension start age: at age 85?
- Convert existing defined benefit plans to DC plus Late Payment Pension Plans
- Establish DC plans in the knowledge that they are there for retirement but that the Late Payment Pension will become available at age 85

Caveats

- The samples in this presentation are for illustration only and depend critically on the underlying assumptions
- The figures in this presentation are neither guarantees nor forecasts
- Milliman does not accept responsibility for investment decisions made based on the figures in this presentation
- No warranty is given for the accuracy or suitability of the figures in this presentation for any particular fund without appropriate due diligence carried out on the fund's circumstances