

Lombard Odier Darier Hentsch

The Sustainability Forum

**“Demographic Change and Financial Services:
a Short List of Threats – a Long List of Opportunities?”**

**Capital markets in transition – How will Capital Flow and Accumulate
in Future?**

Stefan T. Bichsel
Partner of the Group Holding Company
Lombard Odier Darier Hentsch & Cie
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Demographic Change: Food for Thoughts

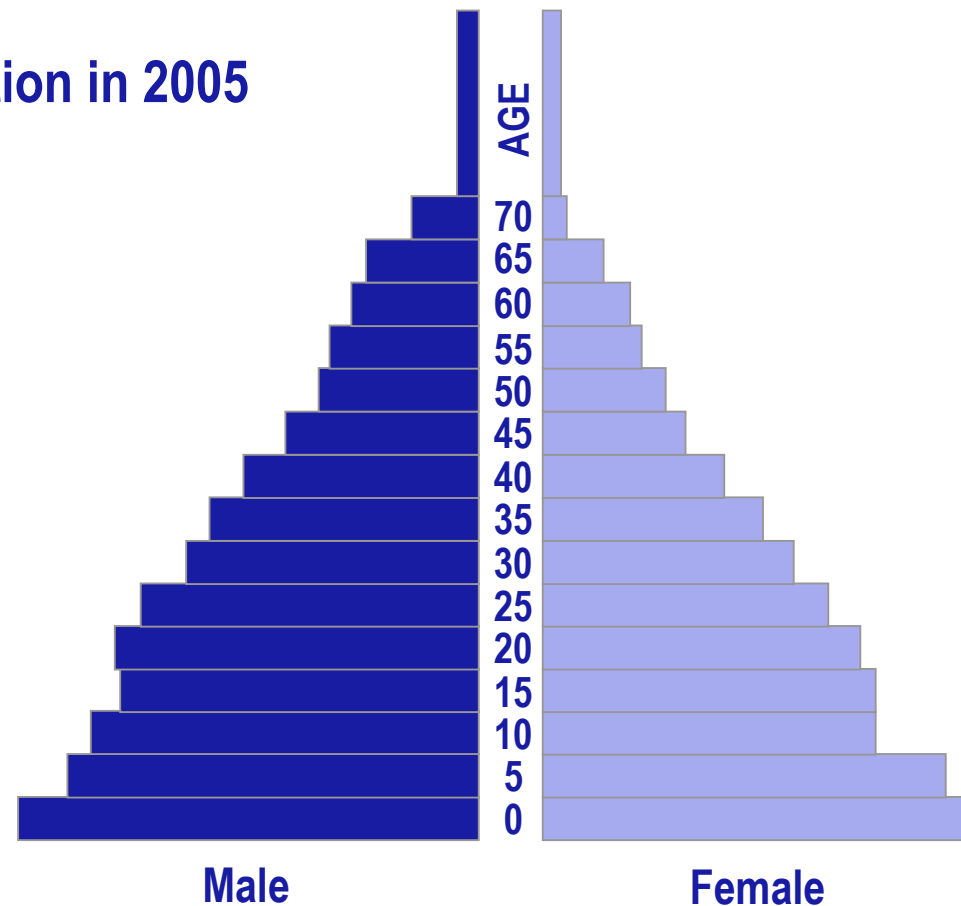




Macroeconomics' View

Aging of the population: not all countries at the same level

World situation in 2005



Source: United Nations

Male
Female
Still sound, but...

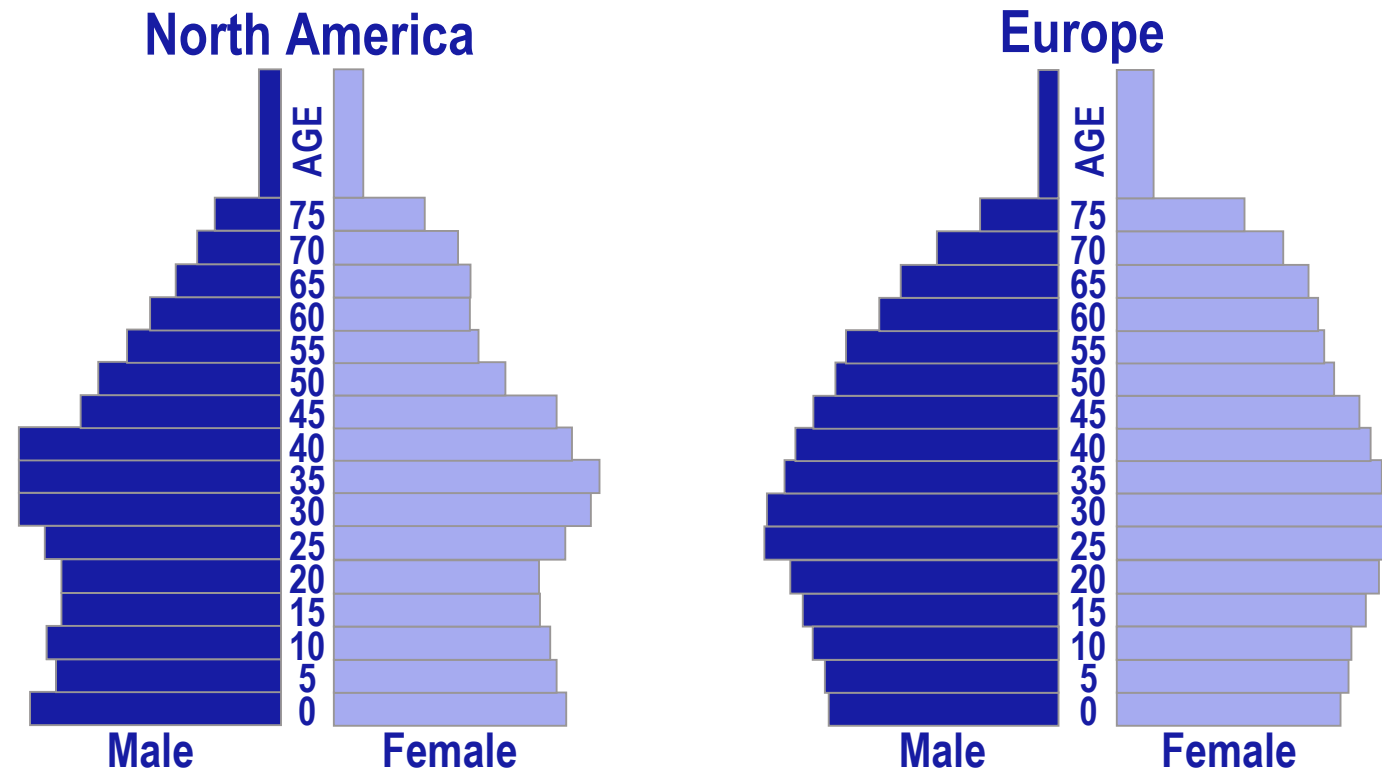




Macroeconomics' View

Aging of the population: not all countries at the same level

Situation in 2005 in



Situation in some developed countries already deteriorated...

Source: United Nations

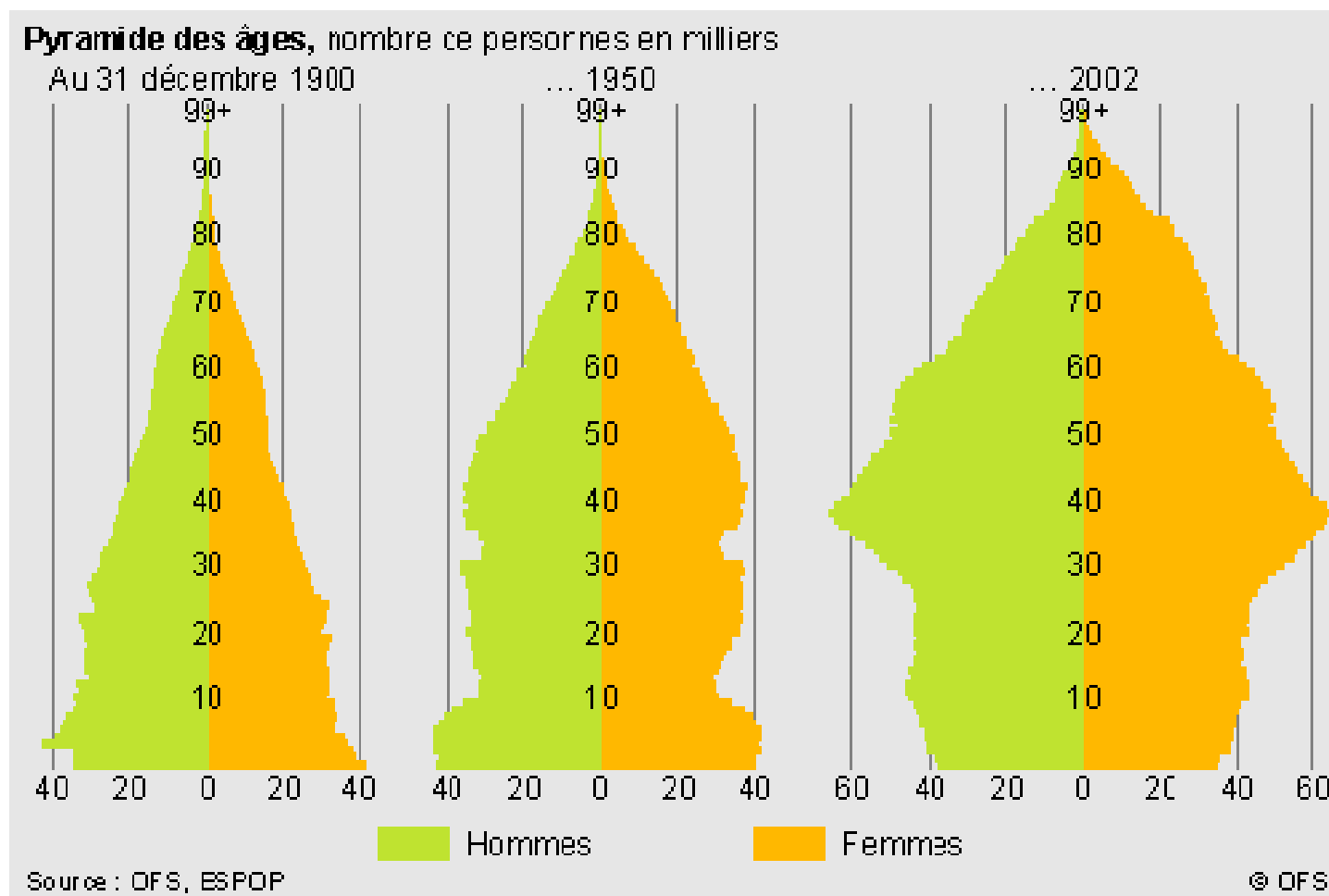


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Macroeconomics' View

Switzerland : a rapid change...





Demographic Change: Impact on financial markets





Demographic Change:

Impact on financial markets

- “By 2010, two-thirds of all investable assets could be controlled by households in the age group of over 55 years!”***

Source: FSC 4164/07

Are we going to face an asset market meltdown, when baby boomers will enter the “de-cumulating phase”?





Demographic Change:

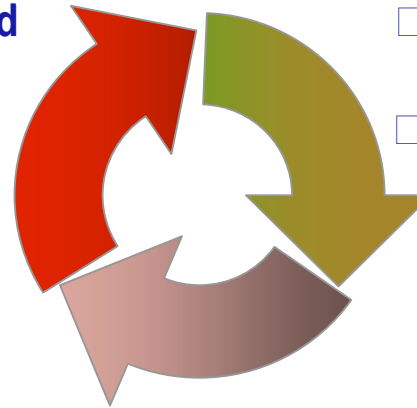
Impact on financial markets: the market meltdown hypothesis (1/2)

Lower expected return on equities +
necessity to finance spending:

- Selling of equities from private and institutions
- Decrease in the equity market prices

Decrease in consumption + shrink
in labor supply:

- Negative impact on economic growth
- Decrease in the equity market prices



Lower tax entries + increase in social spending:

- Increasing tax pressure
- Negative impact on economic growth
- Decrease in the equity market prices





Demographic Change:

Impact on financial markets : the market meltdown hypothesis (2/2)

An apocalyptic vision...

Necessary conditions:

1. **Sudden sale from new retirees**

2. **Assets unattractive to others**

... fortunately not supported by empirical evidence

- **Withdrawals will happen gradually over time**
- **The wealthy aren't likely to sell much in retirement**

- **The Markets participants go beyond US and European baby boomers**

We do not believe in the “market meltdown hypothesis”!

- > **Equity market is mainly driven by the state of the economy**
- > **+~2bn more people on Earth in 2030**
- > **Strong economic growth in rapidly emerging countries creates new wealth accumulation that needs to be invested (globally)**





Demographic Change: Impact on Pension Plans





Demographic Change:

Impact on pension plans



**Development of the old age dependency ratio,
as forecasted by the European Union:**

24% in 2003, or 1 aged over 65 for ~4 people of working age!

35% in 2025, or 1 aged over 65 for ~3 people of working age!

51% in 2050, or 1 aged over 65 for ~1 people of working age!

Source: FSC 4164/07





Demographic Change:

Impact on pension plans : key challenges






- > **Necessity to reinvent/rebalance solidarity and to introduce more individual responsibility**
- > **Necessity to speed up the reforms' process started in Europe**
 - Reducing the state pension generosity
 - Increasing retirement age
 - Increasing the funded element of the system
 - Strengthening the 2nd pillar (occupational plans) and 3rd pillar (private plans)
- > **These reforms have to lead to a general shift from too much collectivism towards individuals taking more responsibility for the provision of adequate retirement income**
- > **Schemes sponsored by employers, traditionally Defined-Benefits (DB), should be increasingly replaced by Defined-Contribution (DC) schemes**





Demographic Change:

Impact on pension plans : risk linked with DB and DC plans

	Defined Benefits (DB)		Defined Contribution (DC)
Investment risk	Borne by sponsor; indirectly, risk may be borne by different cohorts of plan members		Borne by member, <u>but risk can be managed</u>
Longevity risk	Borne by sponsor; indirectly, risk may be borne by different cohorts of plan members		Borne by member (including annuity conversion risk)
Wage path risk 	Borne by the member		Risk reduced because contributions based on life-time earnings
Job tenure risk 	Borne by the member		Risk reduced due to greater portability of DC pensions
Employer default risk 	Borne by the member (unless pension insurance system where the risk and costs are shifted to a third party)		No risk to member (except where pension plan assets are invested in employer stock)





Demographic Change:

Impact on pension plans : new risks for the households...

New risks for the households...

> **Within DC plans, households have an active role to play in order to overcome following risks**

- Insufficient level of contribution
- Wrong strategic asset allocation
- Wrong individual product selection

> **This risk is more relevant when households**

- Have a lack of understanding of (increasingly complex) financial products,
- Have unrealistic expectations and
- Receive substandard advice quality

...create new opportunities and a useful role for the financial industry!





Demographic Change: Opportunities for the Financial Industry





Demographic Change:

Opportunities for the financial industry

- > Households often do not have the ability to properly assess the right investment horizon, which leads them to look for protection/insurance to deal with these risks**
- > Thus, new products/strategies are becoming increasingly popular, such as**
 - Guaranteed products**
 - Unit linked insurance products with a minimum guaranteed return**
 - Liability driven investments**
- > But capital protection/minimum return guarantee strongly impacts final performances due to**
 - Packaging fees and limitation of the upward participation**
 - Suboptimal in term of asset allocation (regions, asset classes, etc.)**
 - Low risk assets do not provide sufficient returns to finance the whole retirement period**





Demographic Change:

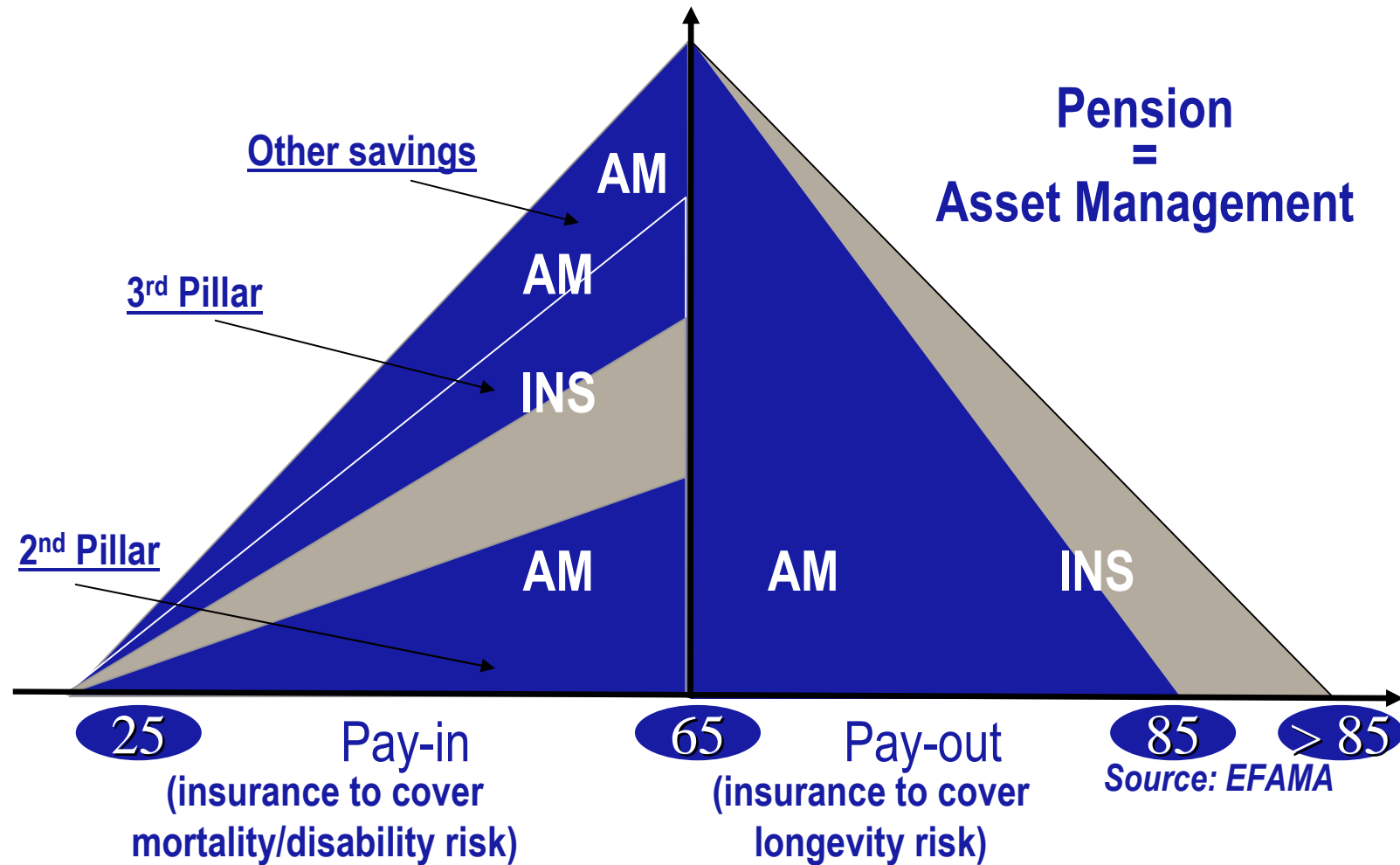
Opportunities for the financial industry

- > **Looking for short term guarantees is often the worst policy, when taking into account the real investment horizon (misallocation)!**
- > **Unfortunately, current legislation continue to heavily favor the insurance industry and insurance thinking**





Demographic Change: Opportunities for the financial industry





Demographic Change: Proposal for new policies





Demographic Change:

Proposal for new policies

> Increase households' participation and contribution levels in pillar 2 and 3 by

- Switching from “opt-in” to “opt-out” approach and propose an intelligent standard solution
- Adapting the tax treatment/incentives

> Increase the supply of pension savings products in a competitive and prudential environment by

- Changing the “insurance/protection” approach to a broader diversification in order to have optimal portfolios (allowing all modern asset classes and global diversification)
- Allowing all relevant financial service providers to compete (insurers, bankers, asset managers)
- Proposing attractive, transparent and thereby comparable products





Demographic Change:

Proposal for new policies

- > Increase households preparation (awareness and financial education), by**
 - Simplifying information for customers**
 - Improving financial advice provided by intermediaries**
 - Starting financial education for proper investment behavior and raising pension's issues awareness at school**





Demographic Change:

Conclusion

- > Necessity to raise public awareness of the situation : face the facts!**
- > Politics must undertake unpopular but vital reforms to adapt the frame work to present and future needs**
- > Financial industry must assume its responsibilities by providing adequate solutions and good advices**





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