

# Behavioural effects

## Impact of the Crisis on long term retirement security

Elias Masilela and Viresh Maharaj

### Introduction

This article looks at some effects of the economic crises on economic players, in particular the consumer.

In light of the dismal saving record in South Africa, and growing need for long term savings to finance both a social and economic backlog, this subject needs to be elevated in policy debate going forward. There is a growing fear that the savings trend has been affected - structurally.

### Impact of crisis on trust

A number of risks were identified at the outset of the crisis and more as it unfolded. Some of these have already been realised and constitute a wide range of effects, namely:

- Economic slowdown;
- A vicious cycle, originating from a financial crisis to a multi-faceted crisis; as well as
- Collapsing asset prices.

These developments resulted in governments experiencing widening deficits as tax bases collapsed and social interventions were necessitated as well as company performance swinging from profits to losses leading to closures across the globe.

Ultimately, households experienced income collapses and rising dependency as unemployment grew.

These developments resulted in the crisis briskly transforming itself from a financial one to a social crisis. In turn, it is this transformation that is a deep concern for the retirement industry with a particular focus on the negative impact that has been felt by households and individuals.

A number of long term developments have taken place following the crisis, where:

- The structural gap between developing and developed economies has narrowed meaning that it is no longer the case that developed economies are the benchmark for global best practice;
- Unemployment is as much a concern to developing countries as it is to developed economies;
- The same applies to fiscal imbalances. The concern of growing fiscal imbalances amongst OECD economies, in particular amongst the PIGS<sup>1</sup> group of economies in Europe, is becoming a real concern;
- The developed world is increasingly looking to the emerging world for insights into sustainable implementation of policies as well as regulation.

These experiences have led to the evolution of a very interesting new world order - thanks to the economic crisis.

However, what has not been determined, thus far, are the underlying behavioural impacts of the crisis. How deep and how long-term these will be and whether or not they will result in structural changes to the financial sector as well as the economy at large. What is clear though is that every economic player, ranging from government to regulators to service providers as well as consumers, has been affected in one way or another. It has already been established that subsets amongst the latter two groups have been affected significantly differently depending on their preparedness to deal with the crisis. The differential preparedness is defined by the level of savings ahead of the crisis, which had an important differentiating effect amongst players in this category.

<sup>1</sup> Portugal, Ireland, Greece and Spain

Those with higher savings had the fortunate ability to dip into reserves, which significantly mitigated the negative impact of the crisis. Whereas, those experiencing high levels of indebtedness, suffered most. This has been observed at the level of individuals, institutions as well as countries.

We have seen key policies being elevated, not only in South Africa, but globally due to the systemic effects of the crisis. These include, amongst others;

- The role of the economy and in particular the relationship between savings, investment and growth;
- The importance of labour markets in business cycles; as well as
- The impact of waning trust towards the financial sector.

The impact of declining trust can easily be seen as the deepest behavioural impact on financial societies. Trust is the basis for every contract and business relationship therefore if the issues of diminishing trust are not resolved then it may spell a long term structural impairment of the financial sector. However, it has been common belief that trust has not been a major concern in the South African context. This, nonetheless, does not mean the economy is immune to the negative global impact of this phenomenon.

A recent study undertaken for the FSA found that consumer confidence towards the financial sector in the UK has historically been lower than towards other sectors. In a 2005 report by the Chartered Insurance Institute (CII) in the United Kingdom, it is revealed that 43% of consumers were found not to be confident that financial products will provide for their long-term future. This compares to 90% of people being satisfied or very satisfied with the way doctors do their jobs. That means only 10% are not confident of their medical providers.

What tilts the scale against the financial sector has been found to be two critically unique factors, namely the long term nature of the future promises made in this sector, as well as the professional, transparent and honest manner with which products are sold at the outset of a contract.

They argue that resolution of this debate will be a critical part of "... shap[ing] the future of trust in insurance and financial services in the UK."

According to the CII, trust is defined as a willingness to take on a certain level of risk because of a positive belief in the intentions and behaviour of another person or institution.

Their proposed response to the problem is an acknowledgement that "there is no silver bullet, and it will take time to build trust. Any revival is likely to depend as much on the detailed day-to-day actions of participants as on any single policy or institutional measure."

In that regard, they identify five key responses that are found essential to success, namely:

- Professionalism
- Transparency
- Regulation
- Corporate responsibility
- Outcomes

The last response is the most critical out of these five because it provides the most practical and tangible means for the consumer to be able to gauge delivery. In the same CII report, an important statement is made to the effect that, "For citizens, what counts the most is the bottom line. Many say they won't begin to trust the sector until their own personal finances recover – debt, homes, and jobs. How do we encourage a savings culture and a proper understanding of risk?"

## UK's public commentary

- We have lost trust in the entire financial system, from the regulator to the bankers, for taking too many risks, failing to foresee or prevent the crisis, and continuing to dole out handsome bonuses throughout.
- We have lost trust in politicians, for their role in backing the economic model that failed, and for the cushy expense claims which were brought to light in the midst of it all.
- We have lost trust in the police, after high profile incidents of incompetence and gratuitous violence, from de Menezes to the G20 protests in the City
- And we've lost trust in the media, as we saw scandals rock not only commercial networks but also the publicly-owned BBC, from phone in scandals to prank calls.

Source: CII, 2010

The sentiments displayed by the UK consumer are not unique, or isolated within that economy. They are reflective of a much deeper problem that is observed across the globe.

If we contrast this with recent findings in the South African context, the picture is slightly more positive. There are a few more bright lights with the Ernst & Young financial confidence index recording an increase in the first quarter of 2010.

This is supported by the Merchantec CEO Confidence Index released in June 2010, which points to a continuing recovery in the economy. The index recorded its third consecutive quarterly gain from a 2009 second quarter low of 48.13. The report notes that, "The South African financial services sector did not have an impact on the economic crisis as was the case with the rest of the world." This is reflective of the generally more positive sentiment in the South African financial sector, which is a direct function of a strong banking sector and sound regulation.

In the recent BENCHMARK members and pensioner survey by Sanlam, we find that about 50% of active contributors to retirement funds feel confident that they will meet their retirement goals. As a result, the majority of the employed plan to retire at about the prescribed age, averaging 60. On the other hand, about 40% of the retired people consider themselves

financially independent. These results say a lot about their incomes in retirement, as well as how their investments are performing.

This is in contrast with other dispensations. More than half (55%) of Europeans believe they will have to delay their retirement because of the current economic climate, according to Aon Consulting. French and German workers are the most pessimistic, with 74% and 73% thinking about extending their working careers respectively, followed by the Irish (65%), the Swiss (67%) and the British (60%).

Of those who believe the economic situation will force them to delay retirement, the Irish and the British have the most gloomy outlook with nearly 90% and more than 80% of workers respectively saying they think they will have to delay retirement by over two years.

Coming back to South Africa, we find that 52% of the active members believe financial advisors have their best interest at heart. However, a staggering 61% of active members are not willing to pay for the advice. This may be explained by costs, rather than value of the service.

The optimism of pensioners in South Africa is not dissimilar to that of active members. South African pensioners seem to have not suffered from the crisis, as much as their counterparts elsewhere. More than

40% consider themselves financially independent. Despite living on retirement income, over 56% still manage to save. Many, over 84%, own and stay in their own houses. However, over 70% of pensioners fear outliving their retirement assets. Longevity risk is significant across the world.

Amongst pensioners who feel their incomes are not sufficient, only 16 % work to supplement their incomes.

The picture painted by the working and pensioned populations, in South Africa, is challenged by rising dependencies. This phenomenon is explained by a combination of rising unemployment and rising mortality amongst the working-age population.

The average worker has an average of 2,38 direct dependants. But we know that in the South African context, many workers are faced with indirect dependants as a result of extended families and the impact of AIDS. Even worse, the survey finds that 30% of pensioners find themselves having to look after dependants apart from their spouses. On average, pensioners have 1,97 dependants.

## Behavioural effects by grouping

This section attempts to identify a list of actions of the most likely effects left by the crisis and those which any policy response considered should endogenise. Whilst these are attributable by economic agent, there is one that seems to cut across all agents and that is short-termism.

### Governments:

- Accommodative fiscal and monetary policy stances, to help mitigate the vulnerability of societies. Together these have deepened budget deficits and raised the burden of structural debt;
- Stepped up social interventions aligning these to long term structural goals;
- Some governments have renegotiated promises, forcing individuals into DC arrangements as well

as limiting benefits growth to inflation or walked away from these completely;

- Liberalised the labour market;
- Reform reversal and a shift towards DC rather DB arrangements;
- Wide ranging attempts to restore trust and confidence;
- Stepped up education and financial literacy;
- Started signalling the need to withdraw economic stimulants to ensure long term structural balance. However, inertia is a big risk here;
- Scramble to restore fiscal sustainability; and
- Some governments have become quite short-termist in their planning.

### Regulators:

- Confidence on self-regulation was dealt a further blow;
- Reformed financial regulation and instruments; and
- Applied some focused interventions such as the provision of guarantees, removal of toxic assets, recapitalising institutions and transitioning out of institutions.

### Consumers:

- On the back of collapsing asset prices, increased their consciousness about returns and performance on their assets;
- Collapsing incomes have caused consumers to increase their attention towards take home pay. This has had a tendency of increasing early withdrawals from funds and reducing voluntary contributions, where these existed;
- Feeling of increased vulnerability as a result of growing unemployment;
- Have grown increasingly insecure owing to growing vulnerabilities and realisation that they have to work longer, as accumulated savings are inadequate; and
- Scaling back on debt.

**Service providers:**

- Tightening of benefit structures;
- Herd behaviour amongst asset managers in particular;
- Stepped up liquidity management, as well as risk/collateral management.

**Sectoral challenges**

The treatment of the financial sector has also emerged as a crucial source of debate on the global arena. Industrialists have started arguing that the financial sector is being treated with kid gloves (soft-touch regulation). It is argued that many bankers should have been put behind bars for the extent of their mis-behaviour, the toxicity of their products and their sabotage of the world economy. The industrialists make the point that had this toxicity originated from the industrial sector, no support would have been provided by the state. Instead, many companies would have been shut down and the heads of these establishments arraigned in court.

However, the primary defence advanced for the manner in which the crisis was handled is that the financial sector is the engine of an economy and any imbalances recorded in this sector will quickly reverberate across all sectors of the economy defining its underlying systemic nature.

Incidentally, the biggest structural consideration for the South African economy will be the labour market as it is this sector that bears the biggest scars after the retirement savings sector. With respect to the latter, whilst we recorded the worst asset price collapse in history, the sector recorded firm recovery in 2009. The question that still remains is whether this recovery will be sustainable? The labour market will take many quarters before we can see a convincing recovery as it is a lagging economic variable. This situation is worse for economies typically characterised by a low level of flexibility in the labour market. According to the OECD, it is estimated that the average lag is 5 years in the whole of the OECD group whereas it is recorded at less than 5 years in the US. Whilst in Finland it can be as long as 18 years. The difference amongst these countries,

predominantly, is a function of flexibility.

An observation that has been made in South Africa, is that for the first time, the unemployed are now increasingly peppered with high income earners as evidenced in the latest UIF data. The structure and sensitivity of the labour market is critical for designing the right policy responses.

Learning from the OECD experience, we can easily see that the most vulnerable sub-categories in the labour market are the youth, low skilled workers and those under temporary contracts. This is observed from the magnitude of employment declines for these categories, between 2008 and 2009. This behaviour is observed to be also structural, where over a period of just below 50 years, the sensitivity to business cycles is highest amongst these categories.

At the aggregate level, over the period 2008/09, whilst the OECD experienced an employment decline of 1.8%, South Africa recorded 4.2%. This difference can also be attributable to flexibility differences.

<b>Worker type</b>	<b>% Change in workforce (2008-09)</b>	<b>Business cycle sensitivity (1960-2007)</b>
Total	-1.8	
Men	-2.9	99.2
Women	-0.3	101.4
Youth	-6.8	179.8
Prime workers	-1.7	87.2
Older workers	2.9	99.3
Low skilled	-2.5	110.7
Medium skilled	-5.4	97.4
High skilled	3.5	87.0
Self employed	-2.1	97.0
Permanent	-0.5	88.0
Temporary	-7.0	207.2
<b>South Africa</b>	<b>= -4.2</b>	

Source: OECD 2010

Across Europe and the OECD group of countries, systematic responses have been recorded to deal with labour market responses. These responses have been embarked upon, with the explicit understanding that any form of economic recovery will be hindered by a poor or non-responsiveness of the labour market. It cannot be forgotten that, retirement management is underpinned by the employment dynamics of an economy.

The OECD responses are wide ranging, to include:

- Temporary wage freezes
- Short-time working arrangements
- Flexibility with respect to work hours
- Training to increase the mobility and employability of labour
- Job subsidies
- Reduction in non-wage labour costs
- Public sector job creation
- Short-time week
- Job search assistance
- Training programmes
- Work experience
- Business start-up assistance
- Support for apprentices
- Unemployment benefits
- Social assistance
- In-work benefits
- Other support for job losses

## Conclusion

Whilst South Africa's economy has emerged little scathed by the financial and economic malaise, it still remains exposed to secondary real economy effects, which will have had negative implications for job creation and thus savings ability. In order to mitigate this secondary impact as well as to capitalise on an economic turnaround, it is essential that

restructuring of and flexibility of markets be realised. This is particularly so for the labour market, as it is at the heart of the economy's ability to providing a base for higher savings potential and greater entry into the long term savings space.

That our active members and pensioners feel less affected by the slowdown, is particularly comforting. The above interventions are critical to ensure that this decoupling is sustained.

## Selected references

World Bank, various publications

IMF, various publications

OECD, various publications

US consumer behaviour survey

Employee Benefit Research Institute (EBRI)

Eves Brian J, Consumers – Choice or Control, LIMRA, USA, 2010

Fundamentals of Private Pensions, 9th edition, by Dan McGill, Kyle N. Brown, John J. Haley, Sylvester Schieber, and Mark J. Warshawsky, 2010,

Mitchell Olivia S, Implications of the Financial Crisis for Long Run Retirement Security; Pension Research Council Working Paper, Philadelphia, January 2010

Knowledge@Wharton, So You Want to Live to 100? More of us Will and Here Is What Life Might Look Like; Pension Research Council Working Paper, Philadelphia, December 2010