



**Remarks by Jean-Claude Ménard, Chief Actuary
Office of the Chief Actuary
Office of the Superintendent of Financial Institutions Canada (OSFI)
to the
ISSA World Social Security Forum**

**Adapting Social Security to Demographic Changes to Make it
Sustainable**

**Cape Town, South Africa
Wednesday, December 1st, 2010**

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Good morning Honourable delegates:

I am delighted to participate in this plenary session dedicated to the ISSA Technical Commissions' achievements during the last triennium with respect to the extremely important topic of adapting social security to demographic changes.

As a Chairman of the Technical Commission on Statistical, Actuarial and Financial Studies, I am very pleased to provide you with the highlights of our Technical Commission's activities.

In January 2008 the Technical Commission identified two main projects to be addressed for the triennium. The first project was "Longevity improvements and its impacts on the sustainability of social security schemes". The second project was "Optimal financing of social security schemes in a changing demographic environment". Within the framework of these two projects, the Commission organized three international events that took place in Cyprus, Canada, and Uruguay, and has supported a number of initiatives including two international surveys. I would like to use this opportunity to thank all the people who made this triennium successful: the National Organizing Committees of all three events, more than 40 brilliant speakers from more than 30 countries, and, last but not least, about 250 delegates who participated in these events.

Global Aging

Changing population structures, deteriorating dependency ratios, and increases in life expectancy are major causes of expected increases in pension expenditure. According to the United Nations, from now until 2050, virtually all population growth is projected to occur in less developed countries. For example, Africa's population is projected to almost double. This is in contrast to Europe's population, which is expected to decline during the same period.

The growth of populations that is occurring is mainly due to a fall in mortality levels which have in turn led to increased life expectancies. Such increases in combination with falling fertility rates are accelerating the aging of the world. Although populations are aging at different rates, we will nonetheless in time see

a dramatic increase in dependency ratios all around the world, even in those regions currently with low ratios.

Aging is an important cause of economic insecurity due to loss of earned income and deterioration of health. Evolving family structure and the changing nature of the workforce are shifting the responsibility of providing an adequate standard of living for older individuals to individuals themselves as well as to society. A social security system is the principal way by which a society can build a protection net for its elderly citizens to help them plan for the future and to safeguard them from poverty.

Longevity improvements and its impacts on the sustainability of social security schemes

Increasing longevity is positive for individuals and for society as a whole, but it also entails risks. It is clear that in order for social security systems to remain sustainable, the risk of living longer should be assumed by both contributors and beneficiaries. The question of how to allocate this risk between contributors and beneficiaries remains difficult to answer and the answer will vary from country to country. To share the risks associated with living longer, it is necessary to resolve sometimes conflicting objectives: protecting seniors from poverty, preserving the sustainability of social security systems and avoiding substantial intergenerational transfers.

In general, countries deal with increases in life expectancy by introducing defined contribution or notional defined contribution components to their social security systems, by increasing retirement age and/or by adding adjustments related to life expectancy to traditional defined benefit systems.

Defined contribution systems shift many risks to beneficiaries, including longevity risk. Such a shift of longevity risk, especially if the system does not mandate annuitization at retirement, could result in the erosion of social protection of the elderly.

A popular way for defined benefits systems to address changes in life expectancy is to increase the retirement age. As seen from the recent events in France, this could be difficult to implement. However, if the pensionable age rises at or below the pace of life expectancy increases, people can retire later and still have a retirement that lasts the same as or longer than it did for their parents.

Another way to increase the effective retirement age is to offer options to the insured: to retire at the same age as earlier cohorts with a pension that is reduced to reflect a longer payment period, to receive an unreduced pension by continuing to work longer to maintain the same payment period as for previous cohorts, or to work even longer and receive an increased pension that reflects a shorter payment period.

It should be noted that it is impossible to assess the impact of increasing lifespans on the sustainability of social security schemes and to determine proper adjustments for longevity without reliable mortality tables. Attention should be paid to the uncertainty of future mortality improvements and to the importance of

proper techniques to project them such as the use of cohort mortality, stochastic projections, as well as the use of appropriate mortality tables for different segments of society.

Optimal financing of social security schemes in a changing demographic environment

The evolving demographic environment necessarily raises the question of how to optimally design and finance social security systems.

There are many ways to define the concept of “optimal” with respect to social security design and financing. Is it by ensuring fairness to tax payers, current workers, retirees, and future generations? Is it by minimizing risks of mismanagement and market losses? Is it by stimulating labour and financial markets? Is it by ensuring the well-being of society as a whole? There is no single best pension system, and what is optimal will differ across countries and over time. However, what is clear is that social security systems are primarily social instruments, and as such, social security financing should be viewed as a tool to fulfill its “social” mandate.

The main characteristics to choose from in designing a social security system are: funded versus pay-as-you-go; voluntary versus mandatory; individual accounts versus commingling of risk; public versus private sourcing; and the presence of automatic balancing mechanisms.

An ideal social security system should be designed such that it could self-adjust to changes in demographic and economic conditions, thereby mitigating the political risk to which all social security systems are exposed. As it was emphasized in the international survey on self-adjustment mechanisms sponsored by the Commission, there exists a variety of such mechanisms, some of which are very sophisticated. Several mechanisms have never been applied in practice, like in Canada, while some have been subjected to stress testing as a result of the recent global crisis, like in Sweden. It remains to be seen how efficient and robust these mechanisms will be over the long term. This is an area where we will undoubtedly see more developments in the future.

When debating between fully or partially funded systems and pay-as-you-go, it is important to realise that the funding of social security systems (either fully or partially) presumes the existence of appropriate financial instruments in which to invest as well as a strong governance structure. According to the annually published Corruption Perception Index by Transparency International, only 26% of surveyed countries are perceived as not having serious corruption problems.

Individual accounts systems pass the majority of risks, such as investment risk and longevity risk, to insured people. High management fees, poor market performance, and turbulence in national labour markets have all eroded both the level of benefits and the level of labour force coverage. The recent financial and economic crisis has deepened these problems. In my opinion, pure defined contributions do not share risks fairly and are not a good solution for sustainable and socially responsible systems.

This crisis has particularly emphasized the many layers and complexity that exist with respect to the question of optimal financing by subjecting social security systems to stress testing. Not surprisingly, no pension system was immune to the crisis. Not only were schemes' assets, if any, affected by negative market returns, but the rise in unemployment also eroded contribution revenue.

In summary, the crisis has reminded us that the objective of social security is the insurance protection of participants. As such, systems should properly incorporate risk sharing in their design and financing in order to be both sustainable in the long term as well as during extreme events like the 2008 financial crisis.

Yesterday, we talked about good governance for social security systems. I would like to emphasize that we could spend days talking about systems' designs and the choice of the financing method, but no system and no financing method will work if they are not properly evaluated and monitored. To promote systems that are actuarially sound, well-defined and well-documented actuarial measures are required. Furthermore, these same measures should be used to assess the financial sustainability of social security programs.

Professional Duties

The rapidly changing demographic and economic conditions around the world demand that we apply the best of our professional abilities with integrity and a social conscience. I would like to quote from the Rules of Professional Conduct of the Canadian Institute of Actuaries:

"A member shall act honestly, with integrity and competence, and in a manner to fulfill the profession's responsibility to the public and to uphold the reputation of the actuarial profession."

I stress here the words "**profession's responsibility to the public**", since it is not only actuaries, but all social security professionals who must be **objective and devoted** to their duty to serving the public interest. All actuarial organizations that are full members of the International Actuarial Association have professional standards of conducts that contain a similar requirement. Accordingly, we are required to continue to fulfill our responsibility toward society both as professionals and citizens.

Thank you for your attention.