The impact of ageing on financial markets

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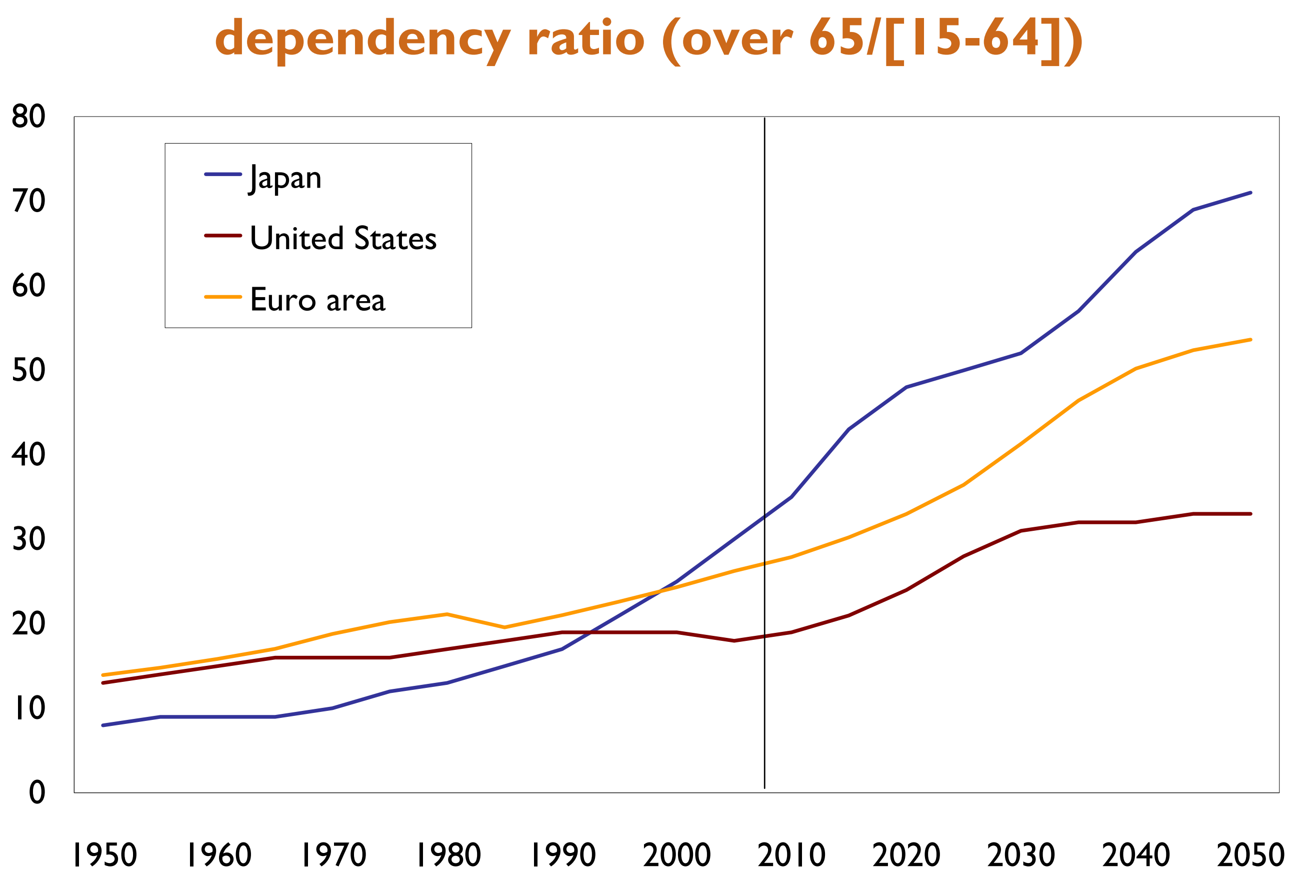
Population ageing

Population ageing is a widespread phenomenon, more pronounced in industrialised countries



Source: United Nations

Challenges and reforms

- **Several consequences of population ageing for economic growth, financial markets and public finances**

- **Pension reforms moved in the direction of:**
  - **increasing contribution rates**
  - **reducing replacement rates**
  - **deferring retirement**

- **Workers are required to save more and contribute to funded pension arrangements**

Outline of my presentation

- Impact of demographic changes on financial markets
- Changes in the retirement savings industry
- Financial instruments helping individuals to cope with “longevity risks”

Impact on asset prices

Will there be an *asset meltdown*? Probably <u>not</u>, but there could be an impact on prices:

- **people may change their saving and investment behaviour (and invest more in financial assets) especially if the benefits of public pension schemes are significantly reduced**
- **international capital flows could help to smooth imbalances in domestic capital markets (for all kind of assets?)**

International capital flows

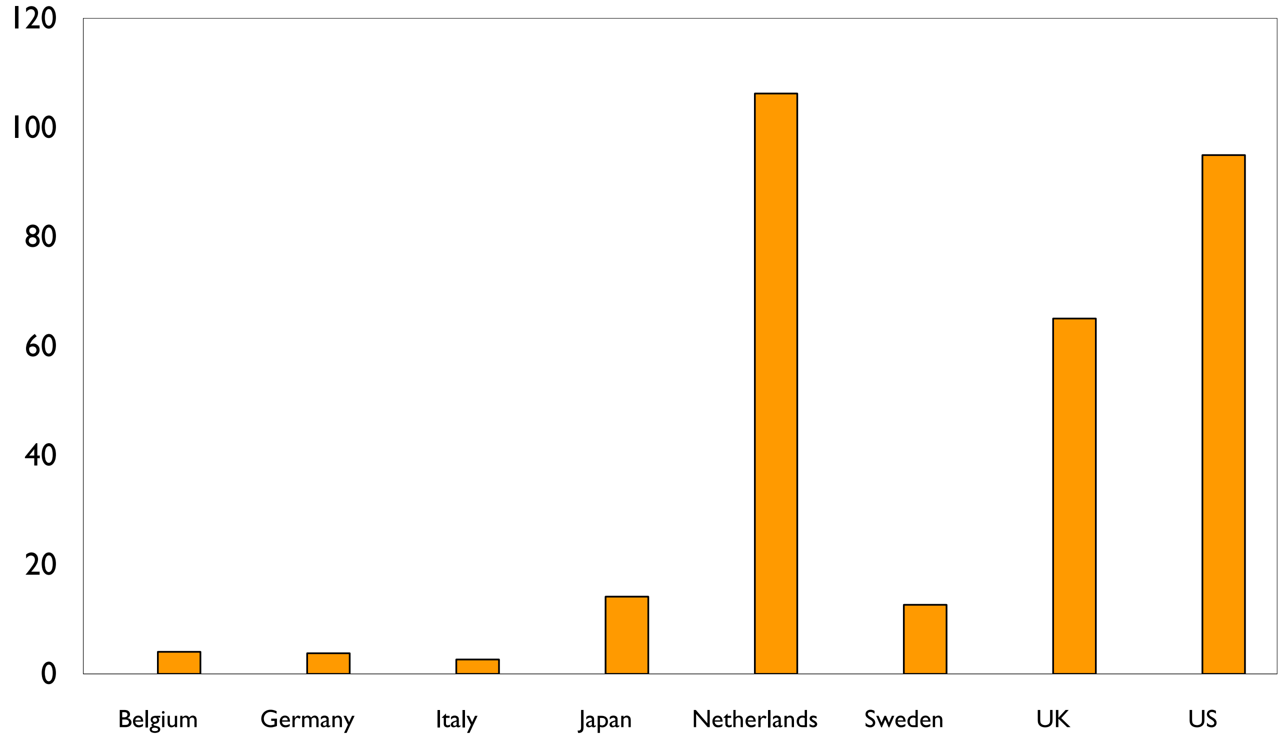
Current **demographic patterns would imply capital flowing from developed to developing economies, <u>but</u>:**

- **demographic changes in some emerging economies (e.g. China) might have worked in the opposite direction**
- **domestic financial markets in emerging economies are relatively underdeveloped and this may deter capital mobility**

The retirement savings industry

- **The role played by institutional investors will grow (at least in some countries)**
  - **this may have a number of market implications and possibly an impact on corporate governance**

Pension funds assets, as % of GDP, 2004



Source: OECD

Structural changes in the industry

- shift from *defined benefits* to *defined contributions* plans
  - portfolio choices will be more aligned with individuals' preferences
- revised *industry regulations* place more emphasis on risk management
  - need to increase the supply of products to hedge against interest rate and inflation risk
    - long-dated bonds
    - inflation-linked products
    - financial innovation
  - instruments to hedge against longevity risks are more problematic to develop

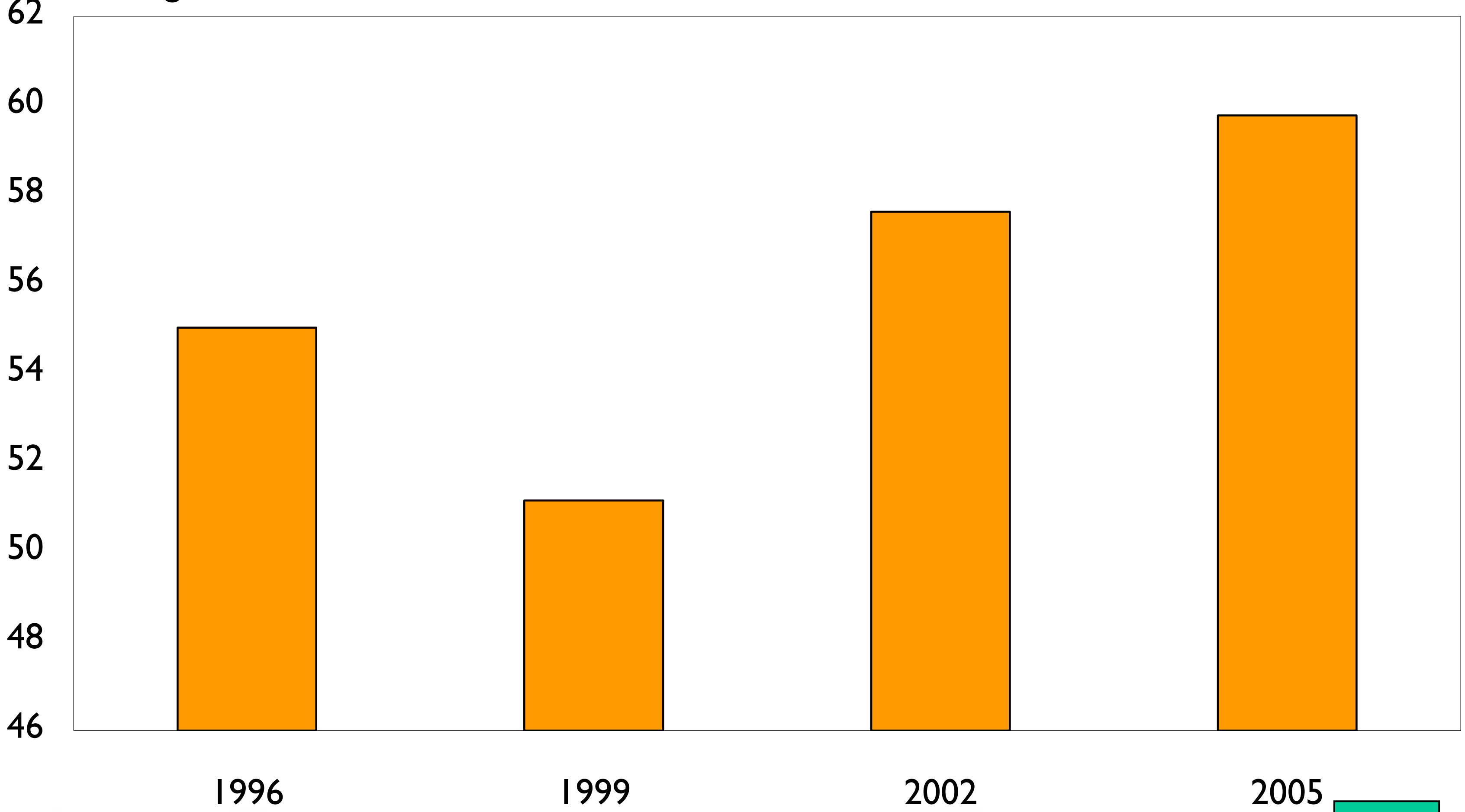
Individual longevity risk (I)

- **The natural product to hedge against longevity risk is an *annuity*, but**
  - **annuity markets are often under-developed (or under utilised)**
  - **taxation, bequest motives, adverse selection problems, and lack of understanding may all contribute to this result**
  - **the market is crowded out by the benefits of public pension schemes**

Individual longevity risk (II)

- **Households' wealth is often accumulated in forms other than cash, and in particular in real estate**

housing wealth as % of total wealth, euro area



Source: ECB

Individual longevity risk (III)

- Reverse mortgages allow to "extract" income from housing wealth

- These arrangements are still rare in most countries

- Policies can be put in place to help develop these markets

Financial literacy and financial education

- **Households need to become more sophisticated investors; they often behave myopically and they lack knowledge of basic financial concepts**
  - **increase financial literacy**
  - **support programs of financial education**
  - **promote mechanism to facilitate households' choices (e.g. default option in pensions arrangements, tax incentives?)**

Conclusions

- **Demographics may alter the existing equilibria in the prices of financial assets**
- **But at the same time…financial markets can also provide instruments to manage these risks**