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Finance, Society and Sustainability

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23 May 2017



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Finance, Society and Sustainability

What is the purpose of the finance system?

23 May 2017



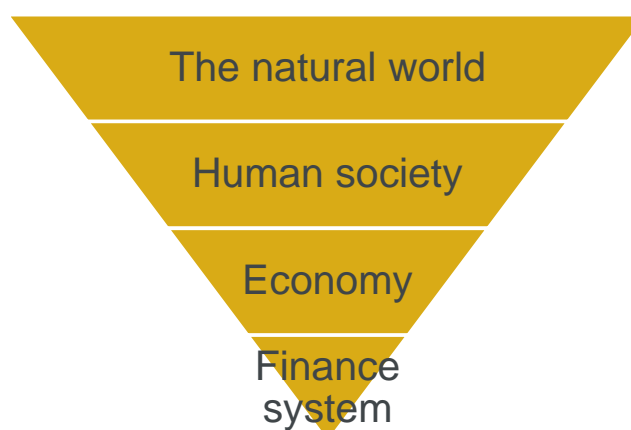


Finance is a social technology which
allocates economic surplus back into the
economy

finance directs where economies' capital is
allocated

What is finance for?

- Payments system
- Smooth lifetime consumption
- Risk management
- Matches savings with useful investment



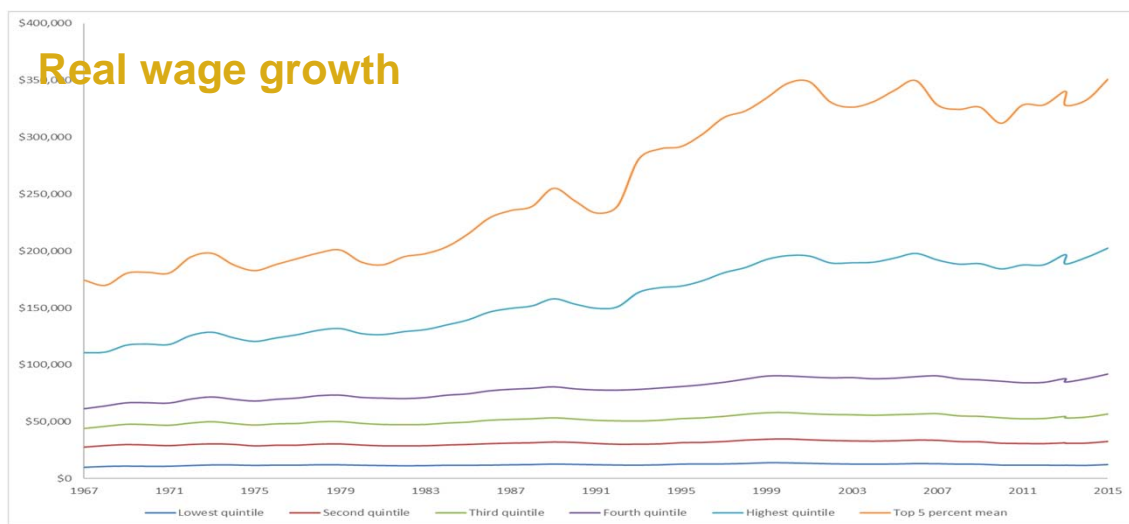
3 Levels of sustainability

- Self-sustainability: Can the financial system keep going indefinitely?
- Economic sustainability: does the finance system contribute to sustainability of the economy?
- Ecological and societal sustainability: Does the system contribute to environmental or social sustainability?

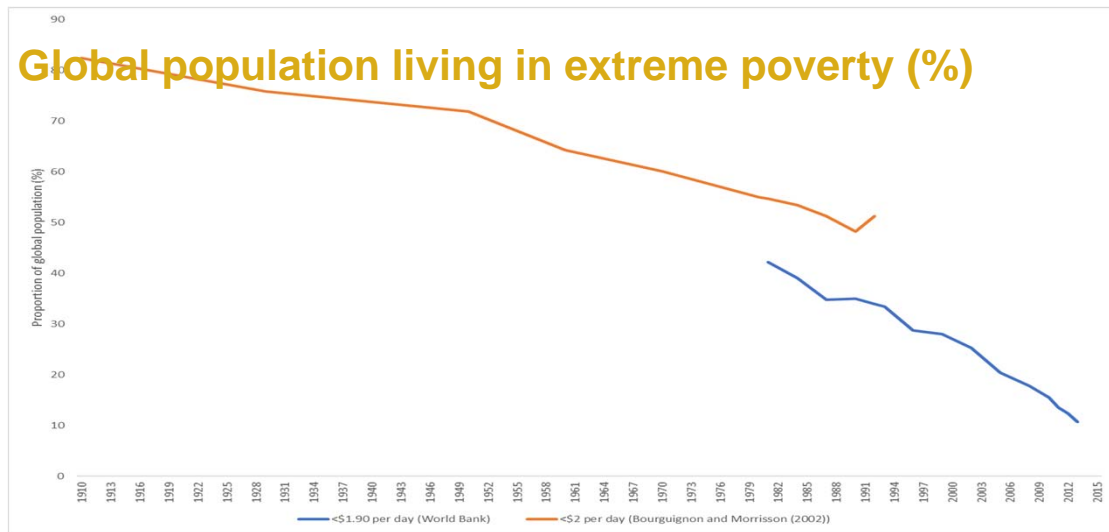


Some pathologies

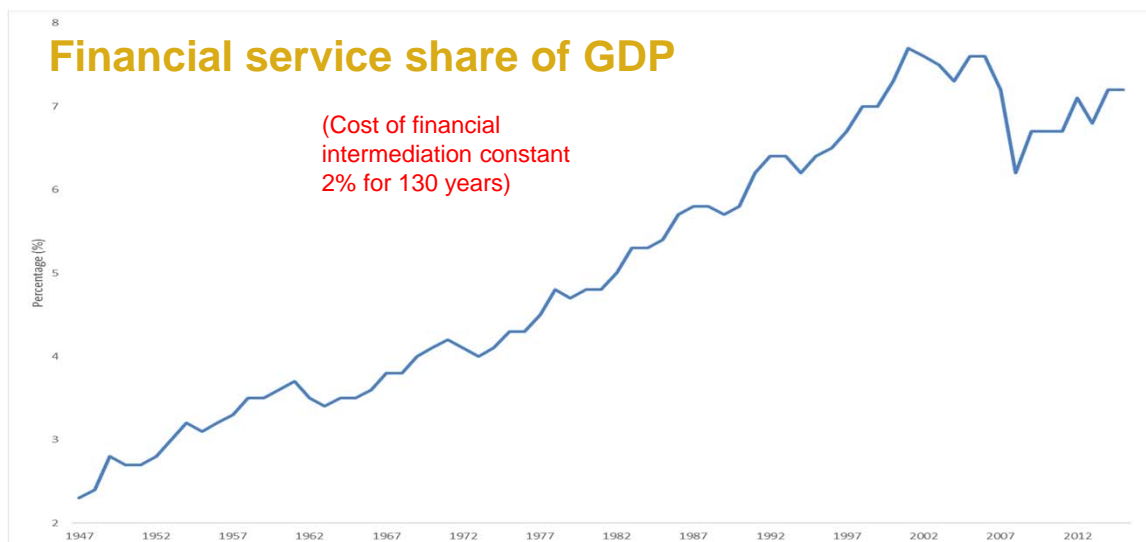




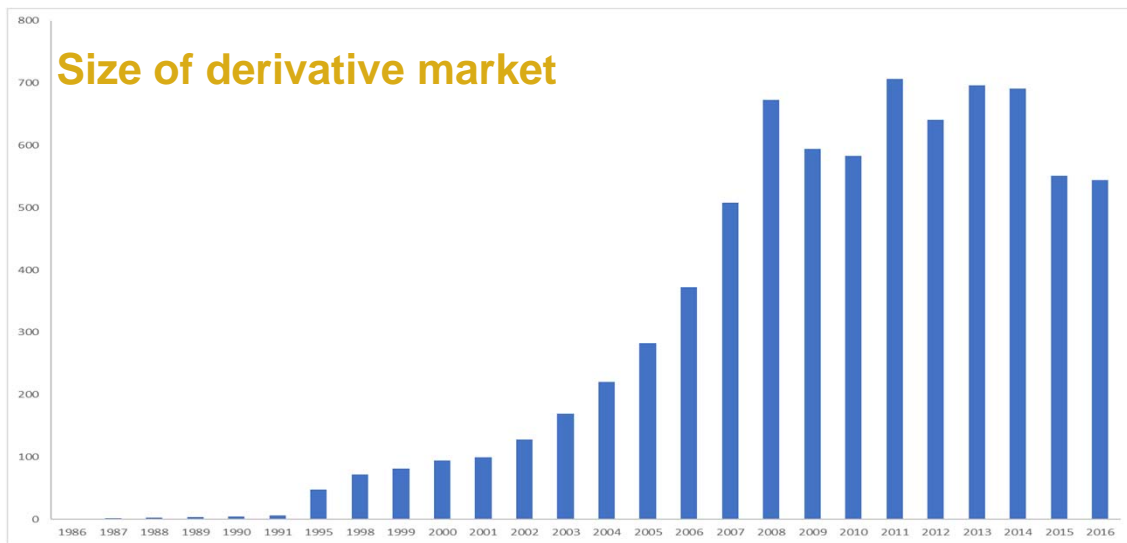
Global population living in extreme poverty (%)



Financial service share of GDP

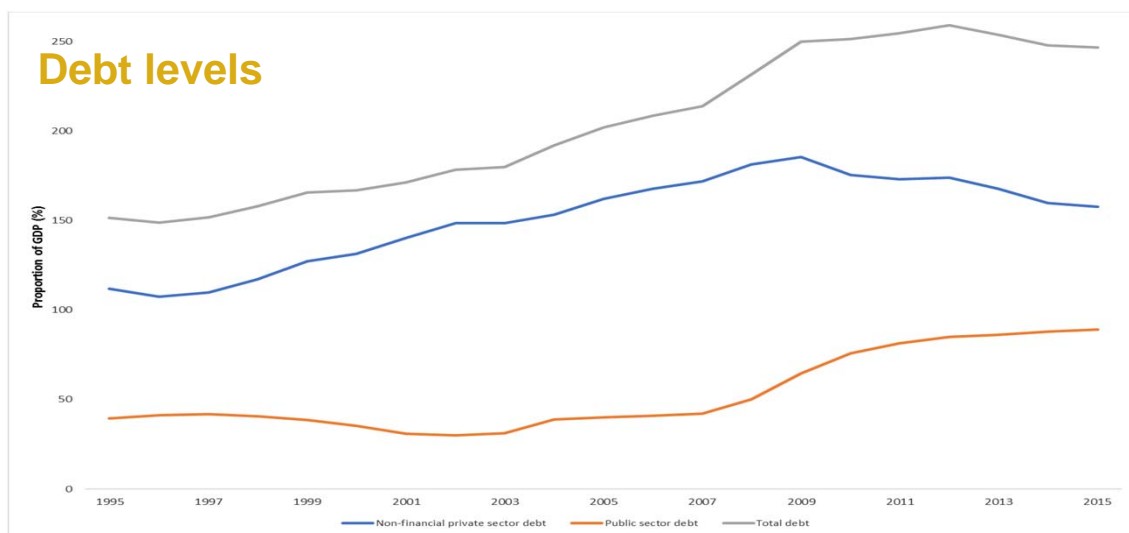


Size of derivative market



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Debt levels

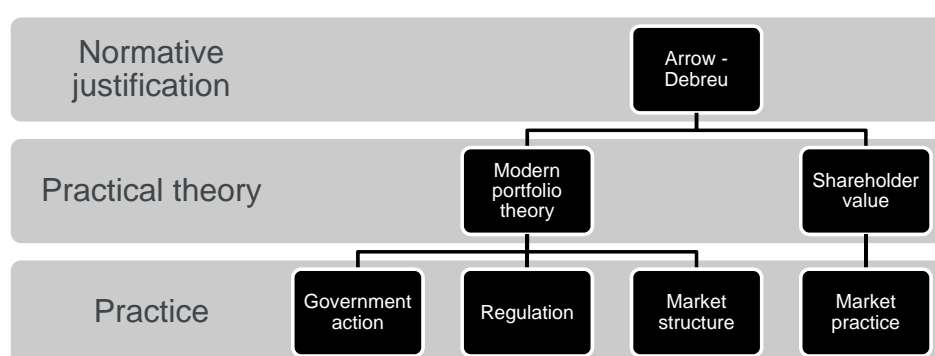


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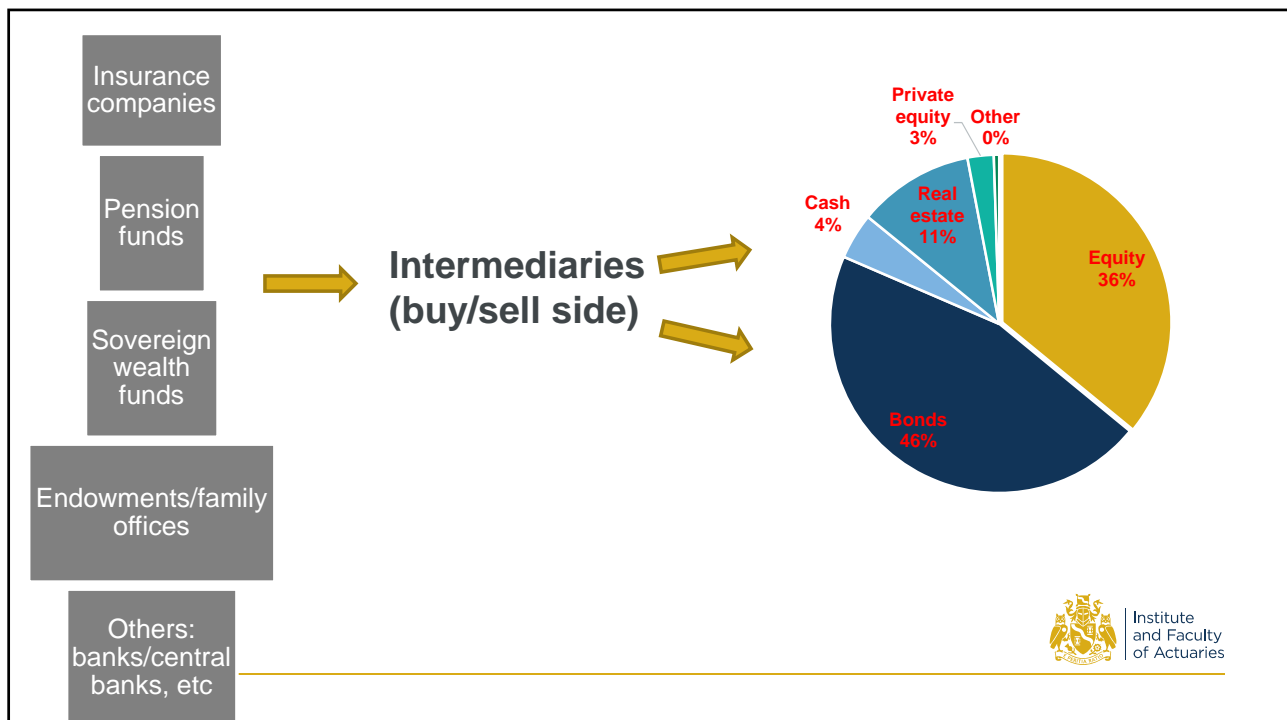
Free market - justification

Allocative efficiency

- Agents seeking best risk/return profile
- Most efficient users can pay highest return/lowest risk
- Resources allocated to most efficient use
- Economic efficiency optimised – maximising growth potential



The savings channel: capital markets



	Pension Fund	Country	Value (US\$ billions)
1	Federal Old-age and Survivors Insurance Trust Fund	United States	\$2645
2	Government Pension Investment Fund	Japan	\$1370
3	Government Pension Fund of Norway	Norway	\$856
4	Civil Service Retirement and Disability Fund	United States	\$850
5	Military Retirement Fund	United States	\$474
6	National Pension Service (NPS)	South Korea	\$422
7	Stichting Pensioenfonds ABP (ABP)	Netherlands	\$388
8	Thrift Savings Plan (TSP)	United States	\$407
9	California Public Employees' Retirement System	United States	\$289.8
10	National Social Security Fund	China	\$247.4



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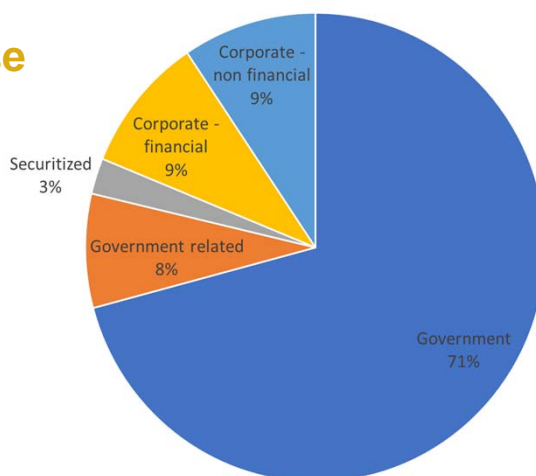
The pensions deal

- Government agencies
- Tax
- Regulatory environment
- Marketing
- Mandatory/auto-enrolment
- Dreaming up new schemes (e.g. stakeholder Pensions, NEST, etc)



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Bond universe



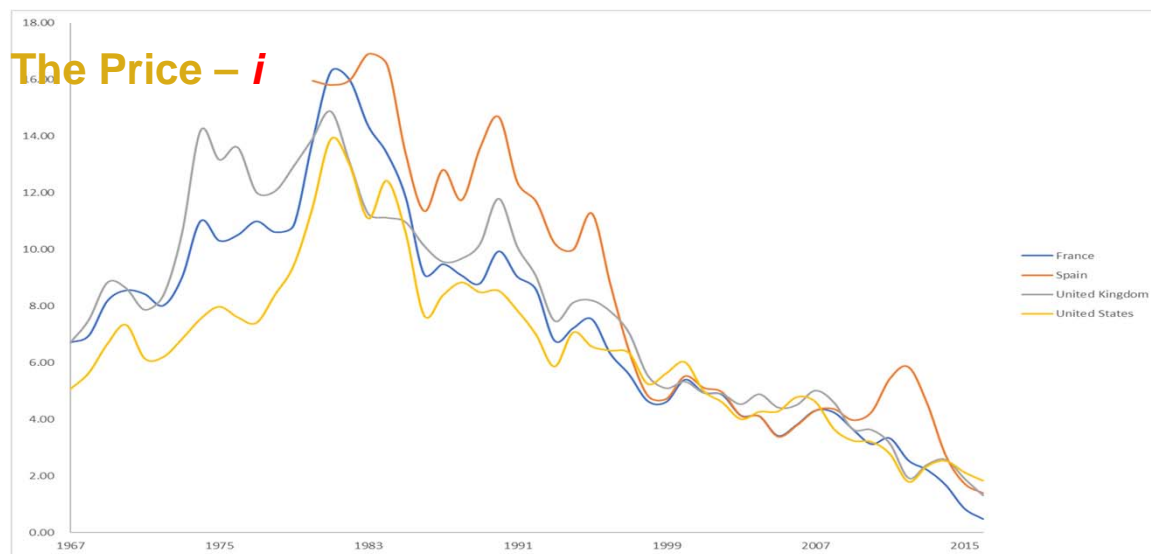
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Equity - examples

- Aerospace
- Food and drink
- Banks
- Utilities
- Healthcare



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What determines *i*?

- Central banks
- Fallout from financial crisis

“natural rate”:

- Low growth
- Savings glut
- Low investment



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The Potemkin Market

Government is buyer, seller and sets the price

- Enacting the will of the government (SWF)
- Perform services for government (pensions)
- Perform a function of government (money supply)
- Behave in a way specified by government (solvency 2, Basel 3, 100,000 pages of pension regulation)



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The pensions deal



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The pensions deal

“Liabilities”

Promote market so that people can save

Reduce fiscal burden

Risk (longevity) management

“Assets”

Capital pool for investment in economy

Capital allocated efficiently

Ensure economy's assets are well managed



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Contributions required to achieve 2/3rds pension

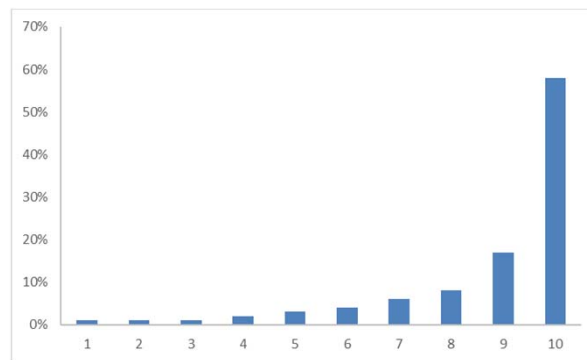
Year	Contribution rate	Contribution £20,000 salary	Contribution £40,000 salary
1991	7%	£1,300	£2,700
2016	39%	£7,800	£15,600

Why? *i*



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Tax relief by income decile



Where do all the savings go?

Some shocking numbers

RSA: Fees of 1.5% translate to 37.5% of fund.

Contributions of £1,000 will buy a pension of:

£16,000 (no fees)

£10,000 (with fees)

But

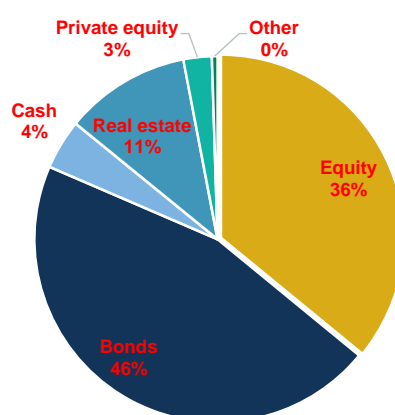
Fees are 3% (transactions, stock lending, performance, sub-managers)

Over half of savings (60%) of savings are eaten up by charges



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The investment universe



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Equity

Provide capital for business?

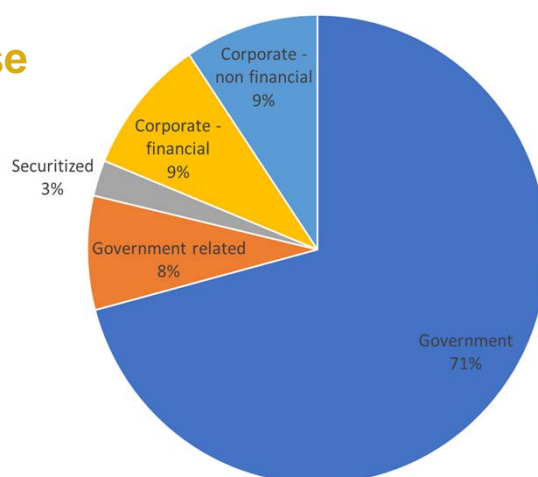
Reward entrepreneurs?

Market cap LSE: £4,000 billion

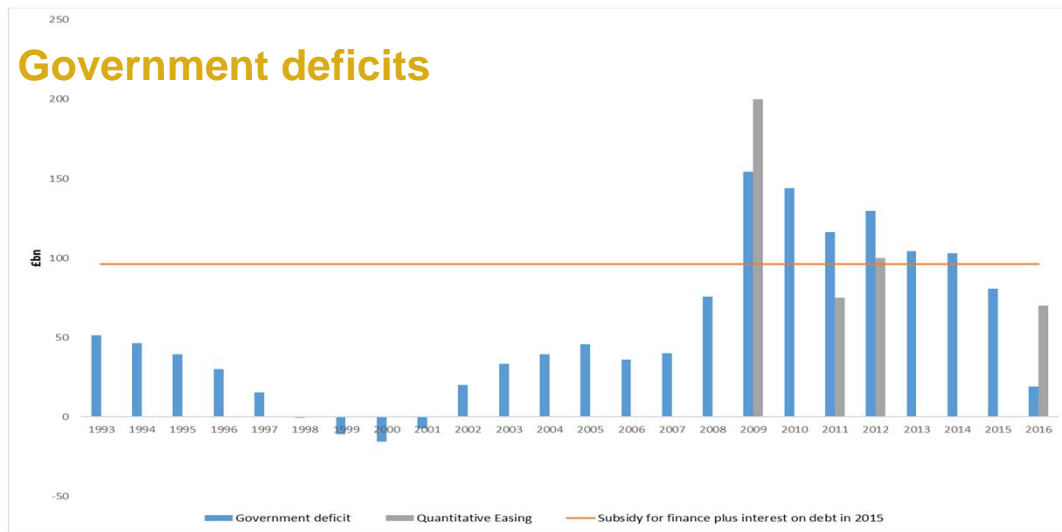
New issuance: £ 24 billion

0.5% of market

Bond universe



Government deficits



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Bonds - productive investment?

~~79% government~~

~~12% financial / securitised~~

9% non-financial ??



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Proportion of pension fund investment that is invested into economy

Proportion invested	
New issuance in the equity market: 0.5% of 52% (invested in equity):	0.25%
Non-financial corporate bonds: 9% of 29% (invested in bonds):	2.6%
Infrastructure investment:	1%
TOTAL	3.85%



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Stewardship

“promoting good governance and stewardship is therefore a central ... function of UK equity markets.”

“The asset management industry can benefit... Savers... only to the extent that its activities improve the performance of investee companies”

Kay review



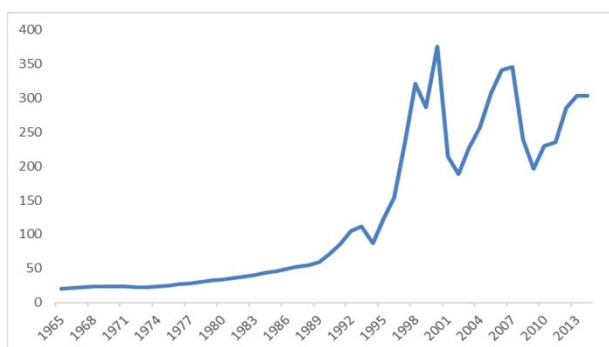
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Fund manager incentives

- Revenue: % of fund under management
- Measurement: Quarterly performance

“engagement with investor companies requires investment of time and resource ...encumbrance... where mandates are being awarded based on fees”

CEO to worker pay ratio

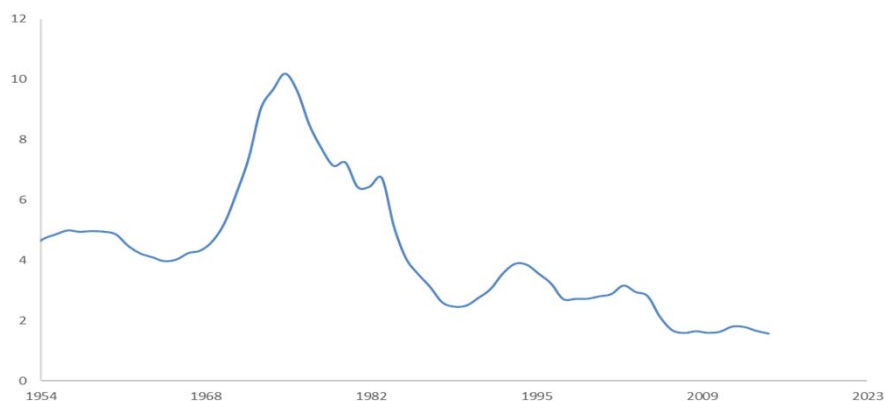


Managers compensated in relation to share price

In fund manager's interest

Low correlation with company performance

Investment compared to funds returned to shareholders



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How to boost corporate profits, short-term

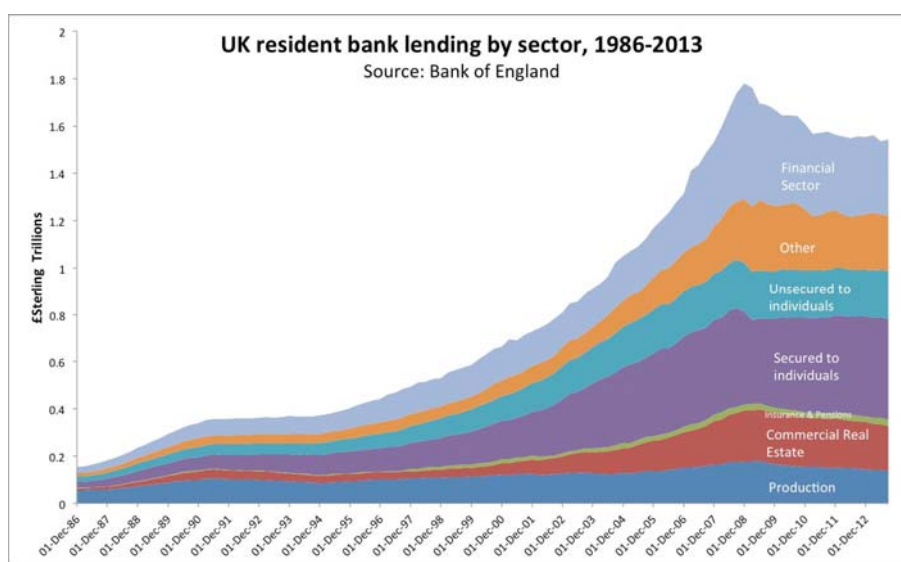
- Reduce long-term investment
- Reduce wage bill
- Lobbying (eg Big Pharma - \$4bn in US)
- Pass externalities to society
- Advertising
- Financialization/Leverage
- Return funds to shareholders
- Tax evasion



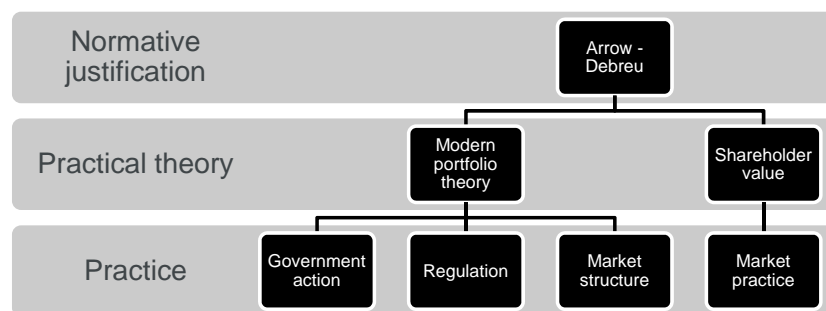
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Summary – a good pensions deal?

- Government fiscal burden not reduced
- System itself makes pensions unaffordable
- Savings are not usefully invested
- Underlying companies managed for short-term
- Over half of return goes to financial intermediaries



Value and Values



Critique

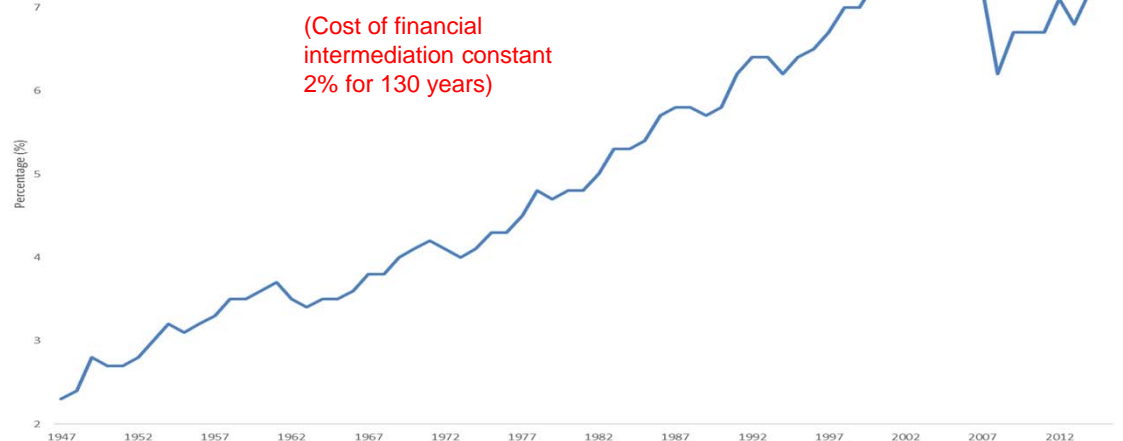
- Potemkin markets not free markets
- Doesn't work in practice (see talk!)
- Doesn't work in theory, either (see book!)
- Values should be decided by democratic debate



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Financial service share of GDP

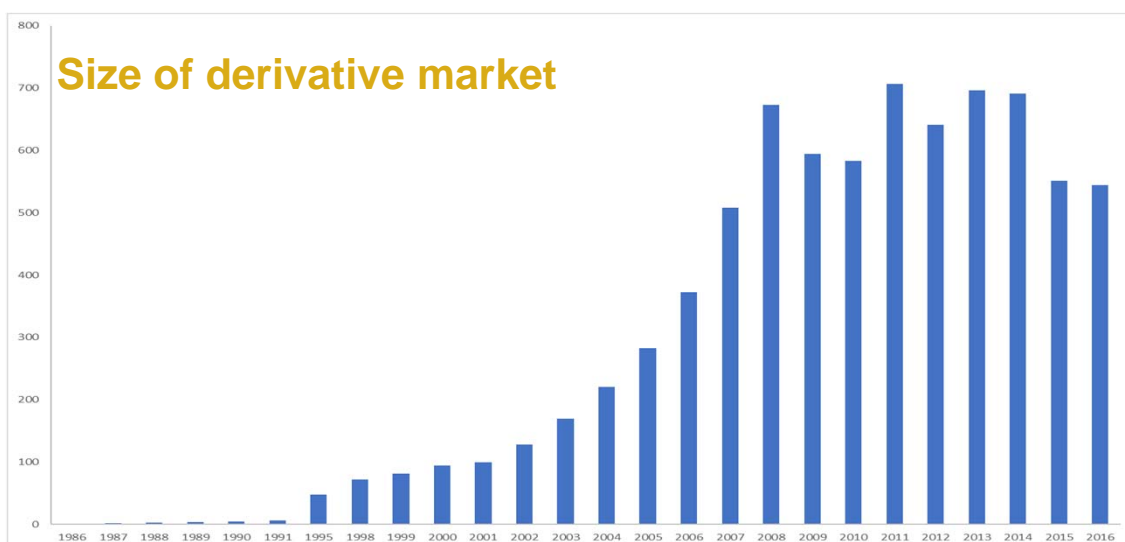


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Tools of finance

- Leverage
- Abstraction/financial innovation
- Colonisation
- Hegemony

Size of derivative market



Finance and the real economy

- Business and governments rely on finance
- If you have access to cheap finance: company/sector of the economy will grow as it can mobilise capital, and attract high quality workers.
- Institutions that arbitrate financial flows, direct future structure of economy

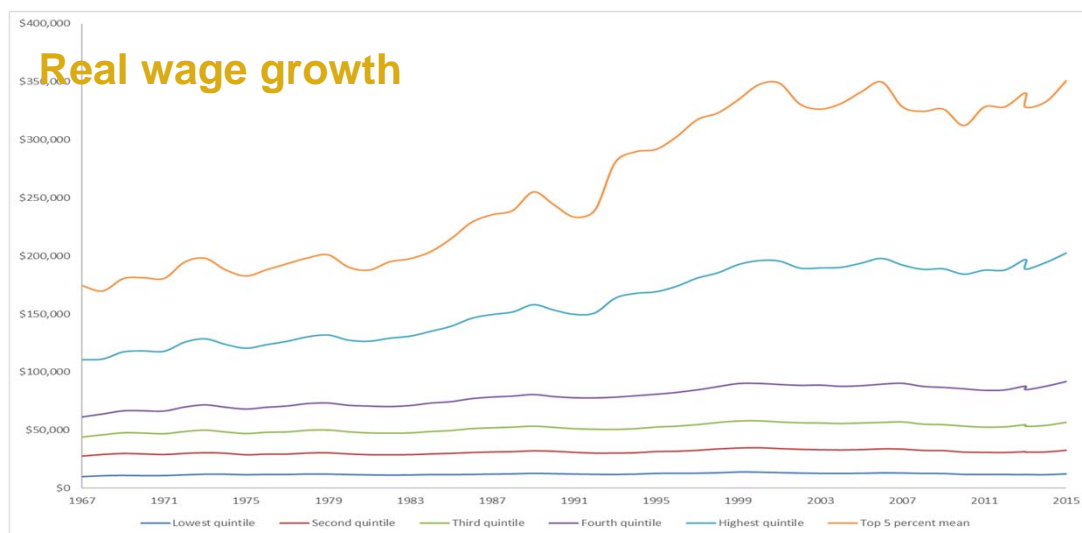
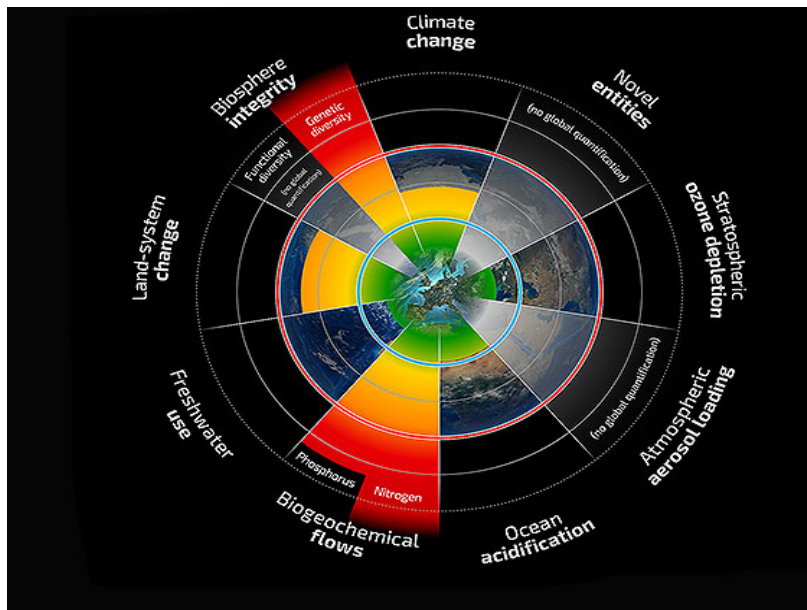


Return on capital

ROC = return / capital

- >1/2 return goes to financial services
- System has driven down returns
- Too much capital
- Lots of problems that need capital
- *Indifference towards crucial issues*





Flourishing finance

Finance used to promote human flourishing:

- Health
- Dignity
- Healthy environment
- Autonomy
- Security
- Fairness



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Some suggestions for pensions



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(1) Swedish System

- Notional DC
- Independent pensions agency
- Break mechanism
- Buffer funds

Unlikely? - NEST: 3-8%



(2) Social Benefit

Pensions are subsidised by tax payer, so tax payer should get something back:

- Sustainable infrastructure funds
- Integrated reporting/triple-bottom line accounting
- VC/crowd-funding



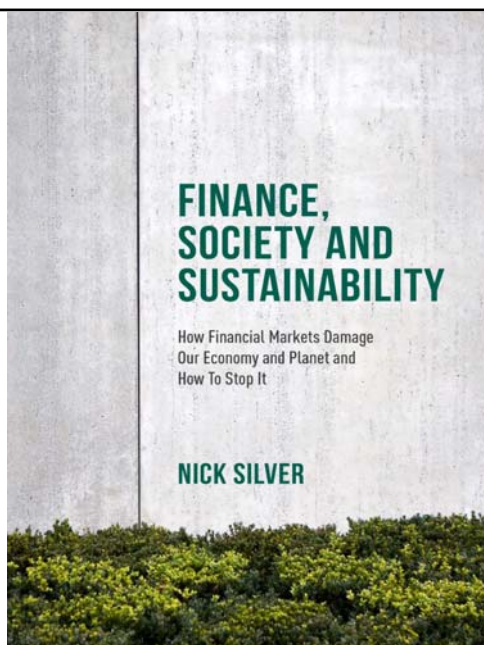
(3) Who needs a pension, anyway?

People are living longer and healthier, machines are replacing jobs, companies don't need capital:

- UBI
- Critical health insurance
- Health/savings/education - personal accounts



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Questions

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