Network for Studies on Pensions, Aging and Retirement

Summary

Shared Interests for Longer: On Solidarity and Accommodating Longevity Risk
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Unlike in many other countries, the Netherlands has life-long pensions. Since we as a population are living increasingly longer, pension's payments are also lasting increasingly longer on average. According to the most recent projections, today's 66-year-old Dutch man has another 19 years to live, on average, and a Dutch woman just over 22 years.

Life expectancy has increased steadily in recent decades due to spectacular medical advances, better nutrition, and healthier lifestyles. Moreover, it is expected to increase even further in the future. In calculating how much money they need now to provide people later with a certain level of pension income for life, pension funds and insurers include estimates of expected future improvements to the best of their ability. Since it is impossible to perfectly predict future trends, however, mortality projections must be adjusted frequently. The uncertainty about future mortality rates is called macro longevity risk.

In the current Dutch pension system, that risk is uniformly distributed among all of a fund's members. If, as expected, the average length of time that benefits need to be paid grows longer than previously envisioned, this will lower the funding ratio. The pension income will then be cut sooner or indexed later. If, according to expectations, payouts are made for shorter periods of time on average, the funding ratio will actually increase. Because this occurs uniformly under the current system, the pension of every member will increase or decrease by more or less the same percentage, regardless of age. When we calculate the percentage adjustment in pension income attributable to changes in mortality rates for each individual age group, however, clear differences emerge between young and old. The percentage adjustment is larger for young people than it is for older people. Under uniform risk sharing, therefore, older people assume some of the risk for younger people. That raises the question as to whether other forms of risk sharing might be possible.

The Dutch Social and Economic Council (SER) is currently discussing the possibility of allowing workers to accrue their pension in so-called personal pension pots. This would enable differentiation between generations in redistributing the macro longevity risk. In this Netspar Brief, we analyze the possibility of having the macro longevity risk of the very old assumed by the active members. The pensions of the very old would then not be adjusted in keeping with changes in the mortality projections.

We provide a quantitative analysis of the impact of this new form of risk sharing and discuss some of the practical aspects of its implementation. Since the assumption of risk by active participants comes without financial compensation, transpiring instead out of solidarity, it is important that the younger generations be able to count on having their risk assumed in turn when the time comes. Meanwhile, a fund's portfolio composition greatly influences the impact of the proposed risk sharing on the various age cohorts. It is therefore important that the providers of pension products or the social partners take this into account as they make decisions about how, exactly, longevity risk is going to be distributed. If this matter is handled properly, possibilities could be created through the solidarity inherent to a collective that outside parties cannot provide.