Title: Pension Schemes with Smoothing Buffers

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One of the alternatives for setting up intergenerational risk sharing within a pension fund system, is to establish an explicit buffer fund to smooth fluctuations in investments returns. This paper investigates the long-term viability of such a system.

The pension debate in The Netherlands and other countries is focussing on alternatives for defined benefit contracts, which used to be the dominant type of pension contract. One alternative under discussion is to establish an explicit buffer fund, which is supplemented through the returns made on the personal pension capital of the participants in the pension scheme. An example where such an approach is already implemented is Denmark, where surpluses are distributed to a buffer fund to smooth fluctuations in investments returns over different calendar years.

A buffer fund is a collective account that is financed by all participants in the pension scheme. All participants will also be able to finance their pension in certain scenarios from this buffer fund. A lower threshold and an upper threshold are set. The returns above the upper threshold finance the buffer fund. In case the returns are below the lower threshold, the buffer fund will supplement the personal pension capital from the individual participant through the reduction of the funds in the buffer fund. Such an set-up combines elements from defined benefit contracts with defined contribution contracts.

However, to maintain a long-term viable pension system, the buffer fund should not be contributed to by outside parties, for example the government. This means that the buffer fund should be self-financing. In this paper we investigate how to set up such buffer funds to be self-financing under a wide range of economic circumstances.