

Summary

As populations age in the decades ahead, the elderly will consume a growing share of resources. It is recognized that this will strain public and private balance sheets, and governments and private pension providers have been preparing for the financial consequences of aging. However, these preparations are based on baseline population forecasts that in the past have consistently underestimated how long people live.

Unexpected longevity beyond those baseline forecasts, while clearly beneficial for individuals and society as a whole, is a financial risk for governments and defined-benefit pension providers, who will have to pay out more in social security benefits and pensions than expected. It may also be a financial risk to individuals, who could run out of retirement resources themselves. These risks build slowly over time, but if not addressed soon could have large negative effects on already weakened private and public sector balance sheets, making them more vulnerable to other shocks and potentially affecting financial stability.

Few governments or pension providers adequately recognize longevity risk. Where they do, they find it is large. This chapter shows that if individuals live three years longer than expected—in line with underestimations in the past—the already large costs of aging could increase by another 50 percent, representing an additional cost of 50 percent of 2010 GDP in advanced economies and 25 percent of 2010 GDP in emerging economies. In an example, the chapter shows that for private pension plans in the United States, such an increase in longevity could add some 9 percent to their pension liabilities. Because the stock of pension liabilities is large, corporate pension sponsors would have to make many multiples of typical annual pension contributions to match these extra liabilities.

Addressing longevity risk requires a three-pronged approach. First, governments should acknowledge the significant longevity risk they face through defined-benefit plans for their employees and through old-age social security schemes. Second, risk should be appropriately shared between individuals, pension plan sponsors, and the government. An essential reform measure would allow retirement ages to increase along with expected longevity. This could be mandated by government, but individuals could also be encouraged to delay retirement voluntarily. Better education about longevity and its financial impact would help make the consequences clearer. Allowing flexibility for pension providers is also important: where it is not feasible to increase contributions or retirement ages, benefits may have to decrease. Risk transfers in capital markets from pension plans to those that are better able to manage the risk are a third approach. The chapter highlights a number of instruments in this growing market, and potential measures to improve its functioning.

Better recognition and mitigation of longevity risk should be undertaken now. Measures will take years to bear fruit and effectively addressing this issue will become more difficult if remedial action is delayed. Attention to population aging and the additional risk of longevity is part of the set of reforms needed to rebuild confidence in the viability of private and public sector balance sheets.