

## Press Points for Chapter 4:

### *THE FINANCIAL IMPACT OF LONGEVITY RISK*

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#### *Key Points*

- That people are now living longer is very desirable and has improved individual welfare. However, there are financial costs of longer life expectancy, for governments through employee retirement plans and social security schemes, for corporate employers with defined-benefit pension plans, for insurers that sell annuities, and for individuals without guaranteed retirement benefits.
- The financial implications of people living longer than expected (so-called longevity risk) are very large. If average life spans by 2050 were to increase 3 years more than now expected, the already vast cost of aging would increase by 50 percent.
- More attention to longevity risk is warranted now, given the size of its financial impact, and because the effective mitigation measures take years to bear fruit.
- Offsetting the financial effects of longevity risk requires some combination of retirement age increases (either statutory or voluntary); higher contributions into retirement plans; and a reduction in the benefits to be paid out.
- Governments need to: (i) acknowledge their exposure to longevity risk; (ii) put in place methods for better risk sharing between governments, private sector pension sponsors, and individuals; (iii) promote the growth of markets for the transfer of longevity risk; and (iv) provide better information on longevity and better education on retirement finance.

**This chapter highlights the potentially very large financial implications of longevity risk—that is, the risk that people may live longer than expected.** The chapter defines the risk, shows its magnitude and provides estimates of its effects on fiscal balance sheets and businesses.

**As populations age in the decades ahead, aging individuals will consume a growing share of resources, straining public and private balance sheets.** 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 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.** While they obviously benefit from living longer lives, individuals face the financial risk that they may run out of retirement resources. These financial 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.** The chapter shows that if average lifespans by 2050 were to increase by three years more than now expected—in line with past rates of underestimation—the already vast costs of aging could increase by 50 percent. 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 typically have to make many multiples of their usual annual pension contributions to match these extra liabilities.

**Addressing longevity risk requires a multi-pronged policy 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. Third, capital markets can be used to transfer longevity risk from pension plans to those that are better able to manage it. The chapter highlights a number of instruments in this growing market, and potential ways to improve its functioning.

**An essential reform is to allow retirement ages to increase along with expected longevity.** This could be mandated by government, but individuals could also be incentivized to delay retirement. Delayed retirement helps in two ways: by increasing the period over which retirement resources accumulate, and by decreasing the period over which it will be used. 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.

**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.