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Industry Voices

Longevity risk and systemic challenges to retirement

Shared burden, market-responsive structures could be fixes

By Karen Mcquiston

Of the myriad assumptions built into a pension plan's funding strategy, longevity doesn't typically keep plan sponsors up at night; market, inflation and interest rate risks are typically top of mind. But longevity risk — both the risk that sponsors might not be fully recognizing today's longevity correctly and the risk of future unexpected increases in human life spans beyond consensus forecasts — poses significant uncertainty for plan sponsors.

In a recent PGIM study, we found if the average life expectancy in a sample plan were to unexpectedly increase by four or five years, then liabilities could increase by as much as 15% to 20% over an extended period of time. As such, longevity risk can be significant. The Society of Actuaries has provided more frequent updates to its mortality improvement factors in recent years, but the challenge for plan sponsors is that timing and magnitude are uncertain: No one knows when the next major change to life expectancy will occur.

We suggest plan sponsors evaluate a multipronged approach to better address longevity risk in their portfolio decisions.

A starting point is to generate accurate, up-to-date mortality measures, including stress-testing the impact on liabilities based on different longevity improvement scenarios. Ideally, this would be applied to the specific demographic profile of each plan and viewed within an integrated framework that specifically accounts for the interactions of interest rate, inflation and longevity risk.

The key risk presented by longevity is that liabilities continue to grow even larger than had been expected. This means assets, in many cases already straining to keep up with liabilities, would need to work harder and over longer time horizons. As such, plans might consider placing a greater focus on investment opportunities that capitalize on these extended time horizons, stepping in as the natural providers of long-term capital. In particular, plans could deploy more capital to growth-oriented investments and sustained allocations to longer-term and less-liquid assets such as real estate, infrastructure and private equity that might be particularly suitable in light of larger, and more extended, obligations.

Yet this is not the tack taken by many plans. Regulatory developments over the past decade, including mark-to-market accounting, procyclical funding requirements and increasing Pension Benefit Guaranty Corp. premiums, have put such stress on corporate pension plans that many have turned to closing and freezing their plans, and dramatically reining in growth assets in an effort to derisk. Some have carved off risk by offering participants lump sums, while others have moved to contain risk via longevity insurance or pension risk transfers.

It is vital for overburdened plans to have these kinds of options to address longevity risk depending on their needs and circumstances. But we should acknowledge this kind of plan-level risk that we strive to contain is reflective of a more fundamental challenge in our retirement systems — we are living significantly longer lives than when these arrangements were established. This raises some bigger questions about retirement sustainability and the need for thoughtful solutions across the industry. Moving forward, we think contribution sharing, risk sharing and market-responsive benefit structures need to be considered more seriously in order for us to make real strides in retirement sustainability.

The Dutch system of industrywide pension plans offers some valuable lessons in sound plan design. First, to promote sustainability, benefits can be designed to be partially contingent on funded status, and with drawdowns also remedied by contributions, market-related risks are effectively shared across stakeholders. Second, benefits are usually structured around career-average, rather than final-average, pay. Further, the industrywide construct means smaller plans can merge to take advantage of economies of scale and governance. Finally, since in many cases the employers bear some, but not all, of the risk, plans may be classified as defined contribution for accounting purposes, thereby alleviating balance sheet concerns and avoiding the conflicts of interest that might arise in serving corporate vs. participant interests.

An encouraging idea that floated closer to home was the USA Retirement Funds, proposed in the Senate in 2014 and reintroduced in the House in 2016. This proposal would allow for privately run retirement plans that would combine the advantages of traditional pension plans, including lifetime income benefits, risk sharing and pooled, professional management. Trustees would manage the plans with an eye toward protecting against both longevity risk and market risks. Importantly, benefits would be based on both a) contributions made by or on behalf of the participant and b) investment performance over time. The American Academy of Actuaries graded the proposal an A-minus based on criteria of alignment, governance, efficiency and sustainability (in contrast to a C and C-plus for the current system's defined contribution and defined benefit plans, respectively). However, the fate of the proposal — which could represent a real step forward — remains to be seen.

Granted, it would be new ground here in the U.S. to define benefits that are contingent on market conditions. But the Dutch system has demonstrated such an approach can be successfully implemented to serve retirement needs across multiple generations. Such reforms have the potential to revive the vestiges of our private employment plan system, and if some of these ideas could be adopted by our embattled public plans as well, they might have a significant positive impact.

Realistic plan design, structured for the long term, is key to addressing the longevity and market risks that might otherwise stand in the way of broad-based retirement security.

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