Abstract

This paper estimates the impact of longevity risk on pension systems by combining the prediction based on a Lee-Carter (1992) mortality model with the projected pension payments for different cohorts of retirees. We measure longevity risk by the difference between the upper bound of the total old-age pension expense and its mean estimate. This difference is as high as 4 percent of annual GDP over the period 2040-2050. The impact of longevity risk is sizeably reduced, but not fully eliminated, by the introduction of indexation of retirement age to expected life at retirement. Our evidence speaks in favour of a market for longevity risk and calls for a closer scrutiny of the potential redistributive effects of longevity risk.

Keywords: stochastic mortality, longevity risk, social security reform

JEL Classification Numbers J11,J14

1 Introduction

This paper estimates the impact of longevity risk on the Italian pension system by combining the predictions based on a Lee-Carter (1992) mortality model with the projected pension payments for different cohorts.
of retirees. Our approach uses the uncertainty generated by a stochastic mortality model to assess the impact of longevity risk on pension expenditure and the effect of social security reforms. The adoption of an explicit mortality model to assess social security policy has two main advantages. First, mortality models generate predictions for the evolution over time of population in each cohorts. This is the requirement needed to assess the impact of sequential social security reforms that, by usually not being retroactive, have an heterogenous impact on different cohorts of the population. Second, the parameters in a mortality model are very unlikely to be affected by the specific social security policy adopted by the government. Therefore, the econometric specification used for policy simulation analysis is robust to the Lucas’ critique (1976). The framework proposed here is of general applicability. In our specific application we concentrate on Italy, as this country represents one of the most interesting cases to ask the question to our interest. The Italian economy is characterized by one of the largest world public debt (both as a ratio of GDP and in an absolute terms) and a traditionally very generous pension system (Sartor, (1999)). Also, the Italian pension system has been subject to a number of reforms, and the most recent one, implemented initially in 2010 and completed in 2012, has introduced an automatic indexation of the retirement age to expected residual life at retirement.

There is a vast literature on equilibrium OLG models that evaluates quantitatively different scenarios for social security reform. The typical question asked is the sustainability of social security systems, given the projected demographic trends. The most recent literature has answered this question through the application of dynamic general equilibrium models in a closed economy framework or, less frequently, in an open economy framework. Starting from the seminal contribution of Auerbach and Kotlikoff (1987) a far from exhaustive list of the closed economy contribution includes Kotlikoff (1993), Kotlikoff and Burns (2004), Gomes et al. (2011), Auerbach et al. (1999) Geanakoplos, Mitchell and Zeldes (1998), De Nardi, Imrohoroglu and Sargent (1999), Huggett and Ventura (1999), Kotlikoff, Smetters and Walliser (1999), Abel (2001, 2003), Bohn (2001), Diamond and Geanakoplos (2003), Krueger and Kubler (2005), Ludwig and Reiter (2011). In an open economy context some authors have argued that the unsynchronized demographic trends across more and less developed countries can shape the dynamics of current accounts. See, among others, Henriksen (2002), Brooks (2003), Domeij and Floden (2004), and Attanasio, Kitao and Violante (2006).

All these models solve for the equilibrium by taking the demographic trends as exogenous. Scenario-based forecasts are then widely used to express the uncertainty of long term forecasts where high and low
trajectories are specified. As correctly pointed out by Lee and Tuljapurkar(1998) no probability is assigned to any of the trajectories or to the range that they cover, and therefore no statistical quantification of the risk associated to demographic trends is feasible in this context. Although the relevance of longevity risk is widely recognized, especially by supranational institutions (see Visco(2006),Visco(2009), IMF(2012)), the abundant literature in demography aimed at estimating statistical models of mortality rates to be able to project them with the associated uncertainty is currently very little used to simulate the impact of longevity risk on pension systems. This literature is potentially important as pension providers face the risk that retirees might on average live longer than expected. The risk of deviation of mortality from its mean can be decomposed in two underlying components: random variation risk and trend risk. Random variation risk is the risk that individual mortality rates differ from the outcome expected as a result of chance – some people will die before their life expectancy, some will die after. Trend risk is the risk that unanticipated changes in life-style behavior or medical advances significantly improve longevity. The term longevity risk is typically used for the trend risk component in the terminology adopted by the International Actuarial Association. A state pension system naturally deals with random variation risk by pooling a large number of different individuals and relying on the law of large numbers to reduce its variability. Longevity risk, similarly to any macroeconomic risk, is on the other hand an "aggregate risk" that cannot be diversified away by pooling and is therefore the relevant one for a state pension system. A first look at the data reveals immediately the possibility of sizeable longevity risk. Mortality rates, survival probabilities, frequencies of death and expected residual life have dramatically changed for individuals aged 65 and over in Italy. Figure 1.1 illustrates the strong downward trend in the time series of mortality at age 65 over the period 1965-2008. Note, however, that the reduction in mortality is not uniform at all ages. Mortality improvements at old ages have been more drastic than the ones for individuals aged between 65 and 70. In 1980 an indi-

\[ q(x,t) \] denotes the mortality for individuals of age \( x \) in year \( t \), where mortality is the probability that a person aged \( x \) and alive at the beginning of the year dies within the end of the year. \( s(x,t) \) is instead the survivor probability for individuals of age \( x \) in year \( t \), which is the probability that an individual will be alive at age \( x \) given that he has survived up to age \( x - 1 \). Survivor probabilities are derived recursively for individuals aged 65 and over: If \( x = 65 \) then \( s(x,t) = 1 - q(x,t) \), if \( x > 65 \) then \( s(x,t) = s(x-1,t)[1 - q(x,t)] \). Frequencies of death for individuals of age \( x \) at time \( t \) are determined as first differences of survival probabilities: \( f_d(x,t) = s(x,t) - s(x+1,t) \). Finally, life expectancy at 65 is defined as follows \( E_x = \sum_{t=1}^{\infty} s(x,t) \)
vidual alive at age 65 had a probability of 90.5% of being alive at 69, a probability of 52.7% of being alive at 79, and a probability of 10.7% of being alive at 89. Such probabilities have shifted respectively to 95.4%, 73.5% and 29% in 2008. Figure 1.2 illustrates this point by reporting survival probabilities for individuals aged 65 and over in 1980 and 2008. Note also that the survivor function tend to shift towards a rectangular shape over time as a consequence of the increasing concentration of death around the mode of the curve of deaths. Figure 1.3 illustrates how this "compression of morbidity" (see, for example, Robine J. Michel J.P. and Institut S. (2008)) has made the profile of frequencies of death for ages above the mode closer and closer to a straight vertical line. Finally, Figure 1.4 shows that life expectancy at 65 has moved from about 13 years to nearly 20 years in 2010.

The aim of this paper is the evaluation of the impact of longevity risk on pension systems by combining a stochastic mortality model with institutional information on the pension payments to each cohort and by conditioning to the macroeconomic scenario for income growth and inflation and to no migration flows. Our strategy to assess the impact of longevity risk on the Italian pension system is based on three steps. First, we derive the numerosity of each cohort of retirees up to 2050 by using the Lee-Carter mortality model to project future mortality and by applying it to the current population pyramid. As future mortality rates are projected with uncertainty, a confidence interval is associated to future population at each age. Second, pension payments to each cohort in the future are projected using institutional information on the Italian pension system. Third, total old-age pension expenditure as a ratio of GDP is projected over the horizon 2012-2050 with its associated confidence intervals. The width of our confidence intervals reflects the impact of longevity risk. In fact, an analogue of the concept of Value at Risk in portfolio management or to Solvency II capital requirements can be applied to future pension expenditure by estimating the upper bound with a given probability (in our application the upper bound of the 95 per cent confidence interval) of pension expenditure as a ratio of GDP in each year. In assessing the impact of longevity risk on the Italian Pension system we consider first a scenario that reflects all the current institutional details with the exception of the indexation of retirement age to expected residual life at retirement. We then devote a section to the simulation of the impact of such an indexation.

2 Methodology

Our proposed methodology is based on the computation of future pension payments based on the last observed population pyramid (2011, in
our sample), projected mortality rates and projected future pension payments to each cohort. In practice, the following specification is adopted:

\[
E(TP_{2011+j} \mid \Omega_{2011}) = \sum_{i=0}^{45} E(POP_{65+i,2011+j} \mid \Omega_{2011}) E(PD_{65+i,2011+j} \mid \Omega_{2011})
\]

\[
E(POP_{65+i,2011+j} \mid \Omega_{2011}) = POP_{65+i,2011} \prod_{k=1}^{j} (1 - \hat{q}_{65+i-j+k,2011+k-1})
\]

where \(E(TP_{2011+j} \mid \Omega_{2011})\) is the expected total old age pension payments in year 2011+j, given the information set available in year 2011. Pension payments for each cohort from retirement age onward are computed by multiplying the projected number of individuals in each cohort \(E(POP_{65+i,2011+j} \mid \Omega_{2011})\) times the average projected pension payment to each individual in that cohort \(E(PD_{65+i,2011+j} \mid \Omega_{2011})\). The number of individuals in each cohort over the horizon 2012-2050 is obtained by applying to the observed population pyramid in 2011 the mortality rates projected for each cohort over the period 2012-2050. A demographic model is used to project future mortality rates, while simple time-series model for annual income growth and inflation, paired with a description of the Italian institutional system, deliver projected \(E(PD_{65+i,2011+j} \mid \Omega_{2011})\), i.e. the expected pension due to all cohorts in all future years. Note that our specification assumes conditional independence between \(E(POP_{65+i,2011+j})\) and \(E(PD_{65+i,2011+j})\) given \(\Omega_{2011}\). In fact \(E(PD_{65+i,2011+j} \mid \Omega_{2011})\) depends on two macroeconomic variables, inflation and income growth that in principle can be affected by demographic trends. We believe that using the ECB target to project future rate of inflation at very long horizon is a fairly safe practice. If the central bank is credible, then the equilibrium inflation of any dynamic stochastic general equilibrium model should coincide with the inflation target of the monetary policy maker. Admittedly having a simple univariate model for income growth independent from the demographic trends is a more controversial assumption. In fact, incentives that determine the labour market equilibrium, and therefore wage growth, might be affected by potential distortions arising from the pension systems (see Ludwig and Reiter (2011)). However, having an endogenous path for income growth generated by an equilibrium model disaggregated by cohorts is a daunting task, we therefore follow the simple approach proposed by Lee and Tuljapurkar (1998) to project income growth via a univariate time-series models. As we concentrate on the demographic risk by conditioning upon a macroeconomic scenario, and on the assumption that the
effect of macroeconomic variables on longevity (which is omitted from our model) is small and slowly evolving, we expect that the practical consequences of our simplifying assumptions are rather limited. Using then the lower bound of the 95 per cent confidence interval on the projected mortality rates we compute the upper bound on future pension payments as follows:

\[
VaR^{95} (TP_{2011+j} | \Omega_{2011}) = VaR^{95} \left[ \sum_{i=0}^{45} (POP_{65+i,2011+j} | \Omega_{2011}) \times E (PD_{65+i,2011+j} | \Omega_{2011}) \right]
\]

\[
(POP_{65+i,2011+j} | \Omega_{2011}) = POP_{65+i-j,2011} \prod_{k=1}^{j} \left(1 - \hat{q}_{65+i-j+k,2011+k-1}\right)
\]

\[j = 1, ..., 39, \quad i = 0, ..., 45\]

\[VaR^{95} (TP_{2011+j} | \Omega_{2011}),\text{calculated by bootstrap and based on the Lee-Carter model, provides an estimate of the impact on pension payments of the realization of the lowest projected mortality rates from 2012 onwards. Note that, as in the computation the only source of uncertainty allowed for is that on demographic trends, the macroeconomic uncertainty affecting } E (PD_{65+i,2011+j} | \Omega_{2011}) \text{ is not considered in the computation of the upper bound for pension expenditure.}\]

3 Projecting Retired Population over the period 2012-2050

To project retired population at each age over the period 2012-2050 we take the Italian population pyramid observed in 2011, available from the Italian National Agency for Statistics (ISTAT) website\(^3\), and adopt a Lee-Carter mortality model to predict future mortality at all ages. Natality is irrelevant to our projections as individual born from 2012 onwards cannot retire before 2050. Our results are also based on the maintained hypothesis of future zero net immigration flows. In 2011 younger generations in the ages between 20 and 34 accounted for slightly more than 16% of the total population, while ages between 35-50 for more than 25%. Individuals above 65 years accounted for approximately 24% of the total. Data on Italian central mortality rates for the years 1872-2008 are available from the Berkeley Human Mortality Database website\(^4\). The mortality model is estimated on the sample annual data 1965-2008. We adopt the Lee-Carter (1992) model to project future mortality rates. The model consists of a system of equations for logarithms

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\(^3\)http://dati.istat.it/

\(^4\)www.mortality.org
of mortality rates for age cohort \( x \) at time \( t \), \( \ln[m_{x,t}] \), and a time-series equation for an unobservable time-varying mortality index \( k_t \):

\[
\ln[m_{x,t}] = a_x + b_x k_t + \epsilon_{x,t} \\
k_t = c_0 + c_1 k_{t-1} + e_t \\
\epsilon_{x,t} \sim NID \left( 0, \sigma^2_{\epsilon} \right) \\
e_t \sim NID \left( 0, \sigma^2_e \right)
\]

where \( a_x \) and \( b_x \) are age-specific constants. The error term \( \epsilon_{x,t} \) captures cross-sectional errors in the model based prediction for mortality of different cohorts, while the error term \( e_t \) captures random fluctuations in the time series of the common factor \( k_t \) driving mortality at all ages. This common factor, usually known as the unobservable mortality index, evolves over time as an autoregressive process and the favorite Carter-Lee specification makes is a unit-root process by setting \( c_1 = 1 \). Identification is achieved by imposing the restrictions \( \sum_t k_t = 0 \) and \( \sum_x b_x = 1 \), so that the unobserved mortality index \( k_t \) is estimated through Singular Value Decomposition\(^5\). Identification and estimation of the system allows to perform stochastic simulations to obtain projections for \( \ln[m_{x,t+i}] \) and associated confidence intervals.

3.1 The performance of the Lee-Carter model on Italian data

Before using the Lee-Carter model to project future mortality rates we have evaluated its ex-post performance by fitting the model to Italian mortality rates for the period 1965-1999 and generating forecasts for the subsequent nine years, up to 2008. Cohorts ranging from 20 to 110 years have been considered. In fact, this is the age-range needed to project pension profiles up to 2050, as the latest cohort to retire in our projection period is made by individuals in their twenties today. Figures 2.1 and 2.2 report the estimates of the coefficients \( a_x \) and \( b_x \), with their associated 95 per confidence intervals. The constant term \( a_x \), monotonically increasing in \( x \), reflects the heterogeneity in mortality for different age groups, while \( b_x \) pins down the response of mortality rates at different age to the common (stochastic) trend in mortality \( k_t \) (note that this coefficient decreases roughly uniformly from age 70 onwards). The cross-sectional variability of the estimates \( b_x \) is a typical feature of the Lee-Carter model, reflecting the higher volatility of observed mortality rates in the right tail of the population distribution. Figure 2.3 shows the goodness of fit in the

\(^5\)See Appendix 1 for a full description of the adopted identification and estimation strategy.
cross section of ages by reporting the $R^2$ of each of the ninety equations estimated for mortality rates in the age range 20 to 100 over the sample 1965-1999. The model performs very well in explaining mortality from 40 to 100 years, while its power significantly drops as the observations on mortality rates become more volatile at very old ages. Still, the overall within-sample fit of the model is remarkable. Figure 2.4 illustrates the point by showing the performance of the model on the 65-years cohort. Out-of-sample projections are obtained by simulating the models for mortality rates at all ages jointly with the following autoregressive model for $k_t$ (standard deviation of coefficients in parentheses).

$$k_t = 1.0174k_{t-1} - 1.6165 + e_t$$

(4)

In practice, upper and lower bounds for projected $k$ are derived by first bootstrapping the above model, allowing for parameters uncertainty, to obtain 1000 simulated path for $k_t$ based on drawing with replacement from the empirical distribution of the estimated residuals. Projected mortality rates and their associated uncertainty are then derived by combining the simulated paths for $k_t$ with the estimated coefficients $a_x$ and $b_x$ and their associated uncertainty. The evidence reported in Figure 3 allows pseudo-out-of-sample model simulation by assessing the projected mortality, survivor and frequency of death over the period 2000-2008 against those observed ex-post. The overall performance of the model is overall satisfactory, as the realized ex-post data almost never violate the bounds of 95 per cent confidence intervals.

To further assess the performance of the Lee-Carter model on Italian data, we use the benchmark of an alternative mortality model for age above 20, such as the one proposed by Cairn, Blake and Dowd (2006) (CBD).

We have therefore estimated the following alternative stochastic model for mortality:

$$m_{x,t} = \frac{e^{c_1t+c_2t(x-20)}}{1+e^{c_1t+c_2t(x-20)}} + u_{x,t}$$

$$c_{1,t+1} = \beta_1 + c_{1,t} + v_{1,t+1}$$

$$c_{2,t+1} = \beta_2 + c_{2,t} + v_{2,t+1}$$

CBD features a logit specification of mortality because it has the intuitive property of constraining mortality, which is effectively a conditional probability, to lie between zero and one. The property of loglinearity in age of the CDB specification is also well documented to fit satisfactorily the empirical evidence for a number of countries. The Lee-Carter model
does not underperform the CBD model in out-of-sample performance and it does better for predicting mortality at old age, which is the main focus of our analysis. This point of graphically illustrated by Figure 3.5 that shows that mortality projections from the CBD model are not more precise than those from the Lee-Carter model. This evidence is relevant in that it speaks in favour of the particular specification for mortality that we have shown but it also gives us the opportunity to stress that our empirical strategy does not consider the impact of model uncertainty on the measurement of mortality risk. In fact, we have considered only one model of mortality. The Lee-Carter model has been evaluated against the available data and against an alternative specification, but we have not allowed explicitly for the possibility that there are many models of mortality. Giving a unit weight to one model and zero weight to all other possible alternative specifications is a strategic choice that leads to a conservative evaluation of the risk, as one layer of risk is actually removed.

3.2 From Mortality Projections to Retired Population Projections

Projections for retired populations and its age structure are immediately obtained by applying the projected mortality rates to the observed population pyramid in 2011. Figures 4.1-4.4 show our mean and lower-bound projections for the Italian retired population’s mortality, specifically of age 65, 75, 85 and 95 years old, from 2012 to 2050 and compare them to a benchmark offered by a constant-mortality scenario, i.e. the projections given by a random walk (without drift) model for mortality rates at all ages. Projected mortality for 65-years old people in 2050 is equal to 0.17% (while it stands at 0.94% in 2008) and converges to zero in the lower-bound case. Similarly, mortality rates of 75-, 85- and 95-years old people are expected to decline from 2.57%, 8.70% and 27.90% in 2008 to 0.49%, 2.01% and 10.78% in 2050, respectively. Figure 4.5 reports the expected residual life at 65 consistent with the path of mortality projections at ages of 65 and over. Expected life at 65 increases from 20 years in 2009 (fully consistent with the projections made by the Italian Institute of Statistics, ISTAT) to roughly 30 years in 2050 in the mean-mortality case, and to 36 years in the lower bound mortality (upper bound life expectancy) case. Figure 5.1 summarizes the results of projections of mortality at all ages by reporting the resulting over-65 population structure over the period 2012-2050. The projected retired population grows at an average rate of 1.65% per year from 2012 to 2050, almost dou-

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6We are grateful to an anonymous referee for having raised this point.
bling from an initial level of around 12.5 millions to 23.5 millions in 2050. Interestingly, projections based on constant mortality rates at all ages would on average underestimate the retired population by as much as 7.5 millions, and by 14 millions if the upper bound for longevity is considered.

4 Projecting the Future Payments of the Italian Pension System

Mapping the future structure of retired population in future pension payments requires a representation of the institutional design of the pension system. Several pension reforms have progressively changed the Italian Pension system over the last thirty years. Three main reforms, namely the Amato (1992) reform, the Dini (1995) reform and the Sacconi-Tremonti(2010), completed by the Fornero-Monti(2012) reforms, that have so far affected the system have determined a progressive shift from the retributive to the contributive pension system. We therefore identify three periods:

- Pre-Amato reform period (pre-1992). This period was characterized by a retributive method for calculating pensions. The initial annual pension paid to the retiree was 2% of the average income of the last five years before retirement, multiplied by the number of years of the individual’s contribution. Pensions were then revaluated with a perfect indexation to inflation.

- Amato reform (1992). The Amato reform was aimed at lowering pension expenditure by making the annual pension function of the income earned during the entire working life rather than that earned in the last years before retirement. The pension was calculated as 2% of the average income of all the contributing life, times the number of years of contribution. Pensions were revaluated at inflation plus 1%.

- Dini reform (1995). This reform shifted the Italian pension system from retributive to contributive. Under the contributive regime workers contribute during their working life with a share (33%) of their income to the formation of a capital. This capital is revalued each year at the five-year moving average of the nominal GDP growth. Upon retirement, an annual pension is then calculated to equate the present value of the total contributed capital at retirement to the resent value of total pension payments. As annual pension payments in real terms are constant, the equalization is
obtained by multiplying the accumulated capital by a transforma-
tion coefficient, that depends on life expectancy and a long-run
discount rate. In theory, life expectancy in the transformation co-
efficient can be automatically indexed to the evolution of mortality
over time, in practice this parameter has been kept constant from
1996 to 2007, it was then changed on a one-off basis in 2007, while
automatic indexation has been postponed until the 2010-2012 re-
form. The minimum age for retirement under this method was 57
years, the maximum one 65, and the reform fully applied for those
who started working in 1996.

• The 2010-2012 reform. This reform has moved the Italian system
to a fully contributive and it has introduced the indexation of the
pension system to the evolution of mortality after retirement. Two
aspects of this reforms are particularly important to us. The first
one is the indexation of the pension payments to the expected
length of life at retirement, the second one is the indexation of
retirement age to expected life at retirement.

To take into account the effect over time of these reforms, the pension
of a retiree as of the beginning of 2012 is computed as a function of his
working history with one of the three following alternative computation
methods: contributive, mixed or retributive. For all agents retiring before
1992, the Pre-Amato regime applies. This regime implies that

$$E \left( PD_{65+,(2012+j−r),2012+j} \mid \Omega_{2011} \right) = y_r \prod_{k=1}^{2012+j−r} \left( 1 + r_{t+k,r+k−1} + D_{1993} \times 0.01 \right)$$

$$1967 \leq r \leq 1992$$

$$y_r = \beta \bar{T}_{r−5,r} C_r$$

$$j = 0, ..., 45 − (2012 − r)$$

where $r$ is the year of retirement, $\beta = 2\%$, $C_r$ is the number of years
for which he has contributed at retirement and $\bar{T}_{r−5,r}$ is the average
labour income for the last five years before retirement. $r$ is inflation and
$D_{1993}$ is a dummy taking value of 1 from 1993 onward and zero otherwise.
This dummy captures the change in mechanism of indexation of 1992
that adjusted annual pension from 1993 onward with a mark-up of one
per cent on the annual realized inflation rate.
For all individuals retiring between 1993 and 1995 the Amato reform applies and we have:

$$E \left( PD_{65+ (2012 + j - r), 2012 + j} \mid \Omega_{2011} \right) = y_r \prod_{k=1}^{2012 + j - r} \left( 1.01 + \pi_{r+k,r+k-1} \right)$$

$$1993 \leq r \leq 1995$$

$$y_r = \beta \left( T_{r-5,r} (C_r - (r - 1993)) + T_{r-10,r} (r - 1993) \right) + \gamma_{r,2012+j} \sum_{t=1996}^{r} \delta I_t \left( 1 + gr \right)^{r-t}$$

$$j = 0, \ldots, 45 - (2012 - r)$$

where $T_{r-10,ref}$ is the average labour income for the last 10 years before retirement and all the other variables have the same meaning as in Equation 5.

For individuals retiring from 1996 onwards the Dini reform’s framework applies, with the necessary adjustments for the 2010-2012 reforms

$$E \left( PD_{65+ (2012 + j - r), 2012 + j} \mid \Omega_{2011} \right) = y_r \prod_{k=1}^{2012 + j - r} \left( 1.01 + \pi_{r+k,r+k-1} \right)$$

$$1996 \leq r \leq 2050$$

if $C_{1995} \geq 18$

$$y_r = \beta \left( T_{r-5,r} (C_r - (r - 1993)) + T_{r-10,r} (1996 - 1993) \right) + \gamma_{r,2012+j} \sum_{t=1996}^{r} \delta I_t \left( 1 + gr \right)^{r-t}$$

if $0 < C_{1995} < 18$

$$y_r = \gamma_{r,2012+j} \sum_{t=r-C_r}^{r} \delta I_t \left( 1 + gr \right)^{r-t}$$

if $C_{1995} = 0$

$$\gamma_{r,2012+j} = \left( \sum_{\tau=1}^{E(L|\Omega_r)} \frac{1}{\left( 1 + r_z \right)^\tau} \right)^{-1}$$

$$j = 0, \ldots, 45 - (2012 - r)$$

where $\delta = 33\%$, $I_t$ is income earned in contribution year $t$, $gr$ is the five-year moving average of nominal GDP growth and $\gamma_{r,ref,2012+j}$ is a coefficient, calculated by ISTAT, based on life expectancy at retirement, $E(L)$, conditional on the information set on life expectancy available at retirement, $\Omega_r$. This coefficient has been kept constant from 1996 to 2007, it has been then changed on a one-off basis in 2007 while automatic indexation (every three-years) has been introduced by the Sacconi
reform in 2010. We report in Table 1 the values of the contributive coefficients for different ages as of the beginning of 2012 (assuming a long-run discount rate $r_s = 1.5\%$). Baseline simulations will be performed by including this aspect of the 2010-2012 reforms in our analysis but not its second feature, which is the indexation of the retirement age. A specific section will be then devoted to the evaluation of the effect of this important modification of our baseline scenario.

4.1 Old-Age Pension Expense Projections

Projections of total pension expenditure over the period 2012-2050 require as input projections for future labour income and inflation. We adopt very simple models for these macroeconomic variables, as the main objective of our exercise is the evaluation the impact of longevity risk on the pension system. As we expect a low correlation between macroeconomic and longevity risk, the model adopted for macroeconomic projections should be very little relevant for the estimation of the effect of longevity risk. Historical data on labour income in Italy are taken from the annual Survey on Households Income (“Indagini sui Bilanci delle Famiglie Italiane”) made available by the Bank of Italy through its website for the annual sample 1965-2008\(^7\). These data are based on annual surveys conducted by the Bank of Italy on income, real wealth, financial assets’ diffusion, use of different means of payment, housing market, use of public services and quality of life. Given the availability of these data we construct a time series of average labour income from employment and self-employment, by excluding other sources of income that do not enter the computation of pensions (such as, for example, interest income). These computations make available a consistent time series for five types of categories: self-employed (other than entrepreneurs), entrepreneurs, employees (other than office workers), office workers and managers\(^8\). We then combine the historical time-series with forecasts for nominal labour income over the period 2012-2050. These forecasts are based on the prediction of a time-series model for real labour income and a scenario for inflation. Future real labour income growth is projected to move one-to-one with future real GDP growth. Real GDP growth is modelled, using data available up to 2011, as an AR(1) process. The following equation has been estimated by OLS:

$$r_{GDP,t} = \alpha + \beta r_{GDP,t-1} + \eta_t \quad (8)$$

Using the estimates of $\alpha$ and $\beta$, respectively equal to 0.0152 and 0.252, we project forward the AR model that converges to a long-run

\(^7\)http://www.bancaditalia.it/statistiche/indcamps/bilfai
\(^8\)Please refer to Appendix B for the analysis of the surveys and their elaboration.
equilibrium real GDP growth of 2.03%. The generated projections for the level of average real labour income imply that real labour income will more than double in the next forty years, going from the current value of around € 16,000 to a value of around € 35,000 in 2050. Given these forecasts for annual real labour income, we generate the corresponding nominal labour income by making the assumption that CPI inflation will be in the future determined by the ECB’s target of 2 percent. The resulting nominal incomes’ projections range from € 15,831 in 2009 to € 36,175 in 2050. The projections of the future numerosity of each cohort of retired individuals are then combined with the macroeconomic scenario and the institutional framework to generate total old-age pension expenditure. In particular, the computation of pensions with the retributive method is based on the assumption of an age at retirement equal to 65 years and 40 years of contribution. The retributive system is relevant for those who have retired between 1969 and 2012 (as the Fornero-Monti(2012) reform does not allow for retirement with the retributive method after 2011). The mixed system applies instead to those individuals who had less than 18 years of contribution at 31.12.1995, and in this case the retributive part of the pension is computed for the years of contribution before 1996, and the contributive part applies to the income earned after 1996, which is observable up to 2008 and projected by the AR model from 2009 onwards. The annual payment of the contributive part of the pension is then computed taking the transformation coefficient δ to be equal to 0.33 and using the method of computing the γ(E(L)) coefficients adopted by ISTAT - whose values are shown in Table 1 for the 2010-2013 period. Under simulation the coefficient γ(E(L)) is modified every three years to reflect mortality improvements and the change in life expectancy at 65. Finally, for those retiring from 2036 onwards, only the contributive method applies. By combining the information on pension payments to retired individuals of different cohorts with the projections on the population at different ages obtained with the Lee-Carter mortality model, we have derived mean estimate for future pension expenditure as a fraction of real GDP, and the upper bound of the associated confidence interval. The difference between

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9 We have also experimented with specifications allowing the long-run to be function of the demographic structure of the population. As the results obtained were not statistically strong and unstable over-time, we have preferred the simple AR model.

10 In our computation we have also taken into account the constraint posed by the minimum pension and its evolution over time. We obtained the data relative to the minimum monthly pension in Italian £ (from 1994 to 2001) and in Euros (from 2002 to 2011) from INPS’ website. From 2012 onwards, we let the minimum pension of 2011 grow at the constant ECB inflation rate of 2% already discussed when forecasting of average salaries, consistently with the assumption that revisions of minimum pensions
the mean and the upper bound can be taken as a measure of the impact of longevity risk on Italian Pension payments. By adding up pensions paid to each cohort, we have generated an estimate of total old-age pension expenditure ranging from € 197 billion in 2012 to € 1.09 trillion in 2050. Figure 5.2 reports total old-age pension expense as percentage of nominal GDP. Our results indicate that at constant (2012) mortality rates over the next 40 years, the ratio will pass from 11.70% in 2012 to 13.70% in 2040. The peak is reached when the cohort of those who are in their 35-50 years today retire. These constant-mortality projections are drastically different from those taking the model-generated pattern of mortality over the next 50 years. According to our mean mortality estimates, old-age pensions over nominal GDP will reach a peak of 15.58% in the middle of the 2040’s and will stay well above 15% until the end the period. Neglecting longevity improvements has an impact of 2.7% of GDP in 2050, when the difference between base and constant-mortality projections is the widest. Longevity risk for the Italian Pension System is represented by higher-than-expected longevity resulting into an unexpected increase in total old-age pension expense. Longevity risk can be measured by the difference between the upper bound of the total old-age pension expense and its mean estimate, ranging between 0.06% in 2012 and 4.35% in 2050. Total longevity risk over the period 2040-2050 is as high as 40 per cent of total GDP over the same period.

4.2 The Effects of Indexation of Life Expectancy and Retirement Age

The results derived so far have been obtained in simulations where retirement age has been kept constant at 65. In this section we investigate the impact of introducing changes in retirement age over time, as established by the 2010-2012 reforms. In particular, we present the results of an experiment made by adjusting retirement age to generate a constant (over time) expected pension period of 20 years at retirement. In this simulation retirement age is progressively adjusted to reflect mortality improvements in such a way that the pension period is kept constant at 20 years (retirement age is set to the age in which expected residual life is twenty years\textsuperscript{11}). In this scenario, indexation occurs every three years and it affects both the coefficient $\gamma(E(L))$ (as in the baseline model) and retirement age. Our analysis is positive rather than normative. We are made to preserve retirees’ purchasing power. Moreover, future pensions have been revaluated using projected inflation.

\textsuperscript{11}In formulae, we have that retirement age in Equation 7 is adjusted by a term $h$ reflecting the difference between expected life at 65 from 2012 to 2050 and expected life at 65 in 2009 (which is roughly equal to 20)
do ask the question of the optimality of the indexation mechanism but we rather propose a framework to assess the effect of the 2012 reform in reducing the impact of longevity risk on the pension system. The possibility of using mortality models to offer insights into the optimal design of an indexation mechanism is an interesting further application that goes beyond the scope of the current study. Figure 6 reports the upper and lower bounds of the pension payments to GDP ratio and the projected expected age of retirement in our simulation. The results shows that the indexation of retirement age has a very sizeable impact on longevity risk, which is reduced from four per cent per year over the period 2040-2050 in the baseline scenario to about one per cent per year over the same period in the alternative after-2010/12 reform scenario. The driver of this reduction in the impact of longevity risk on the Italian Pension System is the increase in expected retirement age that is sizably increased form 65 year in 2012 to 74 years in 2050\(^{12}\). Note that the indexation of retirement age does not fully eliminate longevity risk. This happens for two reasons: first, the indexation is based on expected residual life at retirement, if realized residual life is larger than expected residual life some risk still materializes, second indexation is not retroactive and there is some inertia affecting individuals that have retired before the reform. This evidence illustrates that an alternative system (such as the Swedish one) in which retirement age is flexible, but benefits are indexed to life expectancy is more espoused to longevity risk if individuals choose to retire earlier than when they have an expected residual life of twenty years.

Our results show that acknowledging longevity risk and implementing measures such as indexing retirement age leads to a sizeable reduction but not to a total elimination of longevity risk. Further action, such as risk sharing between governments and private sector or transfer risk to capital markets via longevity link securities, should be considered if the residual risk after the indexation of retirement age is still considered too high.

5 Conclusions

This paper has shown that pension systems in which the retirement age is not indexed to expected life at retirement have a very large exposure to longevity risk. This exposure is sizeably reduced, but not fully eliminated, by the indexation of retirement age to expected life at the cost of a remarkable increase of the retirement age over time. The stochas-
tic simulation of a mortality model to project future population over 65 illustrates that longevity risk might generate incremental pension payments as high as 4 per cent of GDP per year in the period 2040-2050, without indexation of retirement age. This exposure is reduced to one per cent of GDP over the same period when indexation of retirement age is introduced. The longevity risk that affects the pension system is not idiosyncratic and therefore not diversifiable. Our empirical analysis leads to two main conclusions that bear important policy implications. First, the diversification of the residual longevity risk requires specific instruments, such as longevity bonds or longevity swaps, which are not yet widely available. The introduction of these instruments would be particularly important if an indexation of retirement age is difficult to sustain after its introduction. Our results show that sovereign states, being liable for pension payments, should not increase their exposure towards longevity by issuing longevity bonds. However, exposure to longevity might help the diversification of a private portfolio. If this is the case, than the private sector could take the role of issuer of longevity bonds. In a companion paper Bisetti et al. (2012) offer some evidence on this issue by showing that including a longevity-linked security helps diversification of a portfolio of equity and bonds and it has a diversification effect that varies with the investment horizon. Second, indexation of retirement age, as all policies that are linked to age, raises some delicate redistributive and ethical issues. If the exposition to the common trend of mortality improvement is different across high- and low-income groups of the population, then the relevance of longevity risk poses serious (and most likely regressive) redistributive issues in pension payments which are not currently sufficiently debated. Similarly, the diversity of jobs and their associated physical requirements poses serious issues regarding the potential diversification of retirement age across different groups in the population of retirees.

6 References


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7 Figures and Tables

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- M65
- M65_CONST
- M65_LEEC_FIT
- M65 (Baseline Upper)
- M65 (Baseline Lower)
- M65 (Baseline Mean)

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Longevity risk when retirement age is indexed to the increase in life expectancy to deliver a constant expected retirement period of 20 years

Age at retirement when indexation applies
<table>
<thead>
<tr>
<th>Age at Retirement</th>
<th>Contributive Coefficient</th>
<th>Expected Residual Life</th>
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<tbody>
<tr>
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<td>4.903%</td>
<td>24.5</td>
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<td>58</td>
<td>5.049%</td>
<td>23.5</td>
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<td>59</td>
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<td>62</td>
<td>5.727%</td>
<td>20.5</td>
</tr>
<tr>
<td>63</td>
<td>5.925%</td>
<td>20</td>
</tr>
<tr>
<td>64</td>
<td>6.136%</td>
<td>19</td>
</tr>
<tr>
<td>65</td>
<td>6.361%</td>
<td>18</td>
</tr>
</tbody>
</table>

Table 1: Contributive Coefficient as Function of Age at Retirement in 2012. Source: www.inps.it

8 Appendix 1: Identification and Estimation of the Lee-Carter Mortality Model

The Lee-Carter (1992) consists of a system of equations for logarithms of mortality rates for age cohort \( x \) at time \( t \), \( \ln[m_{x,t}] \), and a time-series equation for an unobservable time-varying mortality index \( k_t \):

\[
\ln[m_{x,t}] = a_x + b_x k_t + \epsilon_{x,t} \tag{9}
\]

\[
k_t = c_0 + c_1 k_{t-1} + \epsilon_t \tag{10}
\]

\[
\epsilon_{x,t} \sim NID \left(0, \sigma^2_e\right) \tag{11}
\]

\[
e_t \sim NID \left(0, \sigma^2_e\right)
\]

where \( a_x \) and \( b_x \) are age-specific constants. The error term \( \epsilon_{x,t} \) captures cross-sectional errors in the model based prediction for mortality of different cohorts, while the error term \( \epsilon_t \) captures random fluctuations in the time series of the common factor \( k_t \) driving mortality at all ages. This common factor, usually known as the unobservable mortality index evolves over time as an autoregressive process and the favourite Carter-Lee specification makes is a unit-root process by setting \( c_1 = 1 \). Identification is achieved by imposing the restrictions \( \sum_t k_t = 0 \) and \( \sum_x b_x = 1 \), so that the unobserved mortality index \( k_t \) is estimated through Singular Value Decomposition. SVD is a technique based on a theorem of linear algebra stating that a \((m \times n)\) rectangular matrix \( M \) can be broken down into the product of three matrices - an \((m \times m)\) orthogonal matrix \( U \), a diagonal \((m \times n)\) matrix \( S \), and the transpose of an orthogonal \((n \times n)\) matrix \( V \). The SVD of the matrix \( M \) will be therefore be given by \( M = USV' \) where \( U'U = I \) and \( V'V = I \). The columns of \( U \) are
orthonormal eigenvectors of $AA'$, the columns of $V$ are orthonormal eigenvectors of $A'A$, and $S$ is a diagonal matrix whose elements are the square roots of eigenvalues from $U$ or $V$ in descending order. The restriction $\sum t k_t = 0$ implies that $a_x$ is the average across time of $\ln[m_{x,t}]$, and Equation 9 can be rewritten in terms of the mean-centered log-mortality rate as
\[
\ln[m_{x,t}] - \ln[m_{x,t}] = \tilde{m}_{x,t} = b_x k_t + \epsilon_{x,t}
\]
Grouping all the $\tilde{m}_{x,t}$ in an unique $(X \times T)$ matrix $\tilde{m}$ (where the columns are mortality rates at time-$t$ ordered by age groups and the rows are mortality rates through time for a specific age-group $x$), leads naturally to use SVD to obtain estimates of $b_x$ and $k_t$. In particular, if $\tilde{m}$ can be decomposed as $\tilde{m} = USV'$, $b = [b_0, b_1, \ldots, b_X]$ is represented by the normalized first column of $U$, $u_1 = [u_{0,1}, u_{1,1}, \ldots, u_{X,1}]$, such that
\[
b = \frac{u_1}{\sum_x u_{x,1}}
\]
On the other hand the mortality index vector $k = [k_1, k_2, \ldots, k_T]$ is given by
\[
k = \lambda_1 \left( \sum_{x=0}^{X} u_{x,1} \nu_1 \right)
\]
where $\nu_1 = [\nu_{1,1}, \nu_{1,2}, \ldots, \nu_{1,T}]'$ is the first column of the V matrix and $\lambda_1$ is the highest eigenvalue of the matrix $S$ (see Girosi and King (2007) and Giacometti et al.(2010)). The values of mortality rates obtained with this method will not, in general, be equal to the actual number of deaths. The authors hence re-estimated $k_t$ in a second step, taking the values of $a_x$ and $b_x$ as given from the first-step SVD estimate and using actual mortality rates. The new values of $k$ were obtained such that, for each year, the actual death rates would have been equal to the implied ones. This two-step procedure allows to take into account the population age distribution, providing a very good fit for 13 of the 19 age groups in the authors’ sample, where more than 95% of the variance over time was explained. For seven of these, more than 98% of the variance was explained.

9 Appendix 2: The Data on Italian Labour Income

- Data in Italian £
  - 1965-1969: data are available for monthly income in the various sectors and for the average monthly income. We consid-
ered 13 months of income per year to get the yearly average income.

- 1970-1971: data available for average monthly income, at which the various employment sectors are indexed (e.g. If the average monthly income is 130 and the index for managers is 120, then the monthly income for managers is \((130\times100)/120\)). Figures are then translated into yearly values by multiplying by 13 working months.

- 1973-1974: data available on total yearly income for each employment sector, on labour and mixed income (work into the unincorporated sector, valid for the computation of the pension) as percentage of total income and on employment sectors as percentages of total workforce. Overall labour income is then an average of the labour income of the various employment sectors, weighted by the relative amount of that sector on the total workforce.

- 1975-1983;1986: data available for average yearly income, at which the various employment sectors are indexed (e.g. If the average yearly income is 130 and the index for managers is 120, then the monthly income for managers is \((130\times100)/120\)).

- 1987;1989: figures on yearly labour income directly available from reports.

- 1991;1993;1995;1998: data are separately available for the total income from subordinated work, the total income from self-employment and the percentages of these two sources of income relative to total income. Average labour income is calculated accordingly as a weighted average between income from self-employment and income from subordinated labour.


• Data in Euros

- 2000;2002;2004;2006;2008: data are separately available for the total income from subordinated work, the total income from self-employment and the percentages of these two sources of income relative to total income. Average labour income is calculated accordingly as a weighted average between income from self-employment and income from subordinated labour.

- 2001;2003;2005;2007: no surveys available for these years.
Once obtained our nominal estimates of average labour income during the years between 1965 and 2008 for which surveys were available, first of all we converted all the data into the same currency by using the fixed exchange rate of 1936.27 ITL/EUR. We then interpolated nominal labour income for the years for which no surveys were conducted. Finally, using the CPI Index\textsuperscript{13}, we deflated average nominal labour income with which we subsequently produced our forecasts.

\textsuperscript{13}Obtained from the WorldBank’s website, http://databank.worldbank.org/ddp/home.do