

Raimond Maurer
Goethe-Universität, Frankfurt am Main, Germany
Chair of Investments, Portfolio Management, and Pension Finance
House of Finance (Uni-PF H 23)
Grüneburgplatz 1
D-60323 Frankfurt am Main
Phone: +49 (0)69 798 33649
Fax: +49 (0)69 798 33900
E-mail: RMaurer@wiwi.uni-frankfurt.de

Olivia S. Mitchell
Pension Research Council and Dept of Insurance & Risk Management
The Wharton School, University of Pennsylvania
3000 SH-DH, 3620 Locust Walk
Philadelphia, PA 19104-6218
Phone: +1 215.898.0424
Fax: +1 215.898.0310
E-mail: mitchelo@wharton.upenn.edu

Ralph Rogalla (Corresponding Author)
Goethe-Universität, Frankfurt am Main, Germany
Chair of Investments, Portfolio Management, and Pension Finance
House of Finance (Uni-PF H 23)
Grüneburgplatz 1
D-60323 Frankfurt am Main
Phone: +49 (0)69 798 33661
Fax: +49 (0)69 798 33900
E-mail: rogalla@wiwi.uni-frankfurt.de

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Abstract

Using a Monte Carlo framework, we analyze the risks and rewards of moving from an unfunded defined benefit pension system to a funded plan for German civil servants, allowing for alternative strategic contribution and investment patterns. In the process we integrate a Conditional Value at Risk (CVaR) restriction on overall plan costs into the pension manager’s objective of controlling contribution rate volatility. After estimating the contribution rate that would fully fund future benefit promises for current and prospective employees, we identify the optimal contribution and investment strategy that minimizes contribution rate volatility while restricting worst-case plan costs. Finally, we analyze the time path of expected and worst-case contribution rates to assess the chances of reduced contribution rates for current and future generations. Our results show that moving toward a funded public pension system can be beneficial for both civil servants and taxpayers.

Keywords: Public pensions, Defined benefit, Funding, Investing, Contribution rate risk, Conditional Value at Risk

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