Longevity swaps: the first pension fund deals

Following the announcement of the first longevity swap deals with a UK pension fund, Hewitt's Martin Bird looks ahead to the future and explains what longevity swaps can do

What is the attraction of longevity swaps for UK pension schemes?

There are a number of scenarios where this type of solution might be attractive. For schemes that want to de-risk, but cannot afford to do so, a longevity swap will deal with the longevity risk immediately and allow the scheme to gradually remove other risks at a more affordable pace. For those schemes that have already de-risked using interest rate and inflation swaps, longevity swaps provide the missing piece in the risk management jigsaw – in effect, by combining longevity swaps with a liability driven investment strategy, a pension scheme can construct a 'do-it-yourself' bulk annuity. Going forwards, any scheme considering a buy-in solution will be able to check how this compares to a DIY solution as part of assessing the value for money for this type of any risk reduction solution.

At the moment, sponsors and trustees typically want to understand the funding implications of entering into a longevity swap. If the swap can be entered into with having little or no impact on the funding position, or the cash contributions that are being paid to the scheme, then a longevity swap can be a very attractive proposition.

How can the approach taken by Babcock be replicated by other pension funds?

The recent announcement regarding Babcock International has undoubtedly led to a surge of interest in schemes considering following suit. Although longevity risk has been traded in both insurance and capital markets for some time, the first pension scheme deal is a major landmark for the UK pensions industry. That said, this remains a new and rapidly developing market, and although there is currently no shortage of capacity to write deals, we are likely to see a variety of different products being used to tackle the problem.

The Babcock deal was structured as a bespoke solution, tailored to the specific pensioners in that scheme. Most of the activity at the moment is focused on these types of solution. This is because the pricing is more competitive for large pensioner populations and because initial interest has tended to be for larger schemes looking for solutions that hedge as much risk as possible.

Index solutions provide protection against general increases in population longevity, but are not tailored to the individual scheme in the same way as a bespoke solution. These types of solution lend themselves more readily to dealing with non-pensioner member risk, particularly where there is uncertainty about the timing at which members will retire and the amount of pension that will be brought into payment. For example, when members elect to take tax free cash instead of taking all their benefits as pension, the amount of longevity risk is reduced. Options such as this do not integrate very easily with a bespoke solution which is aiming to match the actual pension payments as closely as possible.

Over time, as the market develops I expect we will see a combination of bespoke and index solutions being adopted as schemes look to deal with both pensioner and non-pensioner longevity risks.

What are the complications or pitfalls of using longevity swaps?

As with any investment transaction, careful due diligence is required, to ensure that all parties are comfortable with the value for money of the product and the risks that are being eliminated or retained. One of the frequently asked questions in relation to longevity swaps is on exit terms and whether a longevity swap precludes a scheme from moving to a buy-in solution later on. It is possible to agree the terms for exiting the swap to provide some comfort on this point. The method for agreeing the exit terms tends to be negotiated on a case by case basis at the moment, although I suspect that this will become more standardised once a number of deals are completed.

Schemes will also need to consider whether to purchase a swap in insurance format or as a derivative product, and agree the mechanics for calculating and posting collateral payments (to provide protection against counter-party risk for both the pension scheme and the provider). Whilst not a pitfall, the need to carefully address the issue of security will be a crucial step in the process.

How do you see this market evolving?

In terms of product design, I expect we will see more standardisation in terms of collateral mechanics, definition of exit terms and integration with inflation hedging strategies.

More widely, although the current focus is on the use of longevity swaps to manage pension risk, I expect the range of products to expand as schemes become more familiar with the concept of using longevity instruments. For example, mortality linked bonds (where the coupons are linked to a longevity index), longevity linked investment products (where the payouts are linked to a longevity index) and pooled longevity funds (where schemes can gain synthetic longevity exposure in readily tradeable format) are all likely to find their way into the pension risk management toolkit.

The need for longevity protection in a defined contribution context is also likely to fuel the development of suitable products for individual members.

And finally, continued innovations in modelling mortality rates (using approaches that use individual health, wealth and lifestyle factors, with address and postcode data being used as a way of accessing information on these individual characteristics) are helping to provide a better understanding of the factors that impact on member life expectancy and provide comfort to schemes assessing the merits of investing in longevity swap products. As actuarial and medical thinking continues to converge, we witness the start of more advanced techniques to capture the complex interdependencies between causes of death.

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