

## Issue 100: 100 Not Out!

### Celebrate with Spotlight... but can schemes really celebrate members living longer?

As Spotlight celebrates its 100<sup>th</sup> edition, it seems fitting that we turn our attention to the hot topic of longevity risk management. Data from the Office for National Statistics shows that, 30 years ago, a 65 year old Englishman had a one in 1000 chance of living to 100. Today, this figure has increased to one in 100, with over 10,000 people in the UK now having reached the age of 100. While these figures are generally accepted to be good news (and are conveniently in keeping with the Spotlight celebrations!), it is somewhat ironic that longer life expectancy could cause the death of UK defined benefit (DB) pension schemes. However, the emergence of new solutions to address the problem may well be cause for further celebration!

#### **New market in longevity swaps set to burst into life...**

While the level of buy-in activity seems to have slowed over the past six months (either because schemes can no longer afford the insurance premiums, because pricing is difficult, or simply due to a lack of capital), 2009 looks set to be the year of longevity only solutions. Following the recent announcement that Babcock International is set to complete the first longevity swap deal involving a UK pension fund, there has been a surge of interest from schemes considering following suit.

#### **What is a longevity swap?**

A longevity swap enables a scheme to remove the risk that members live longer than expected. However, unlike a buy-out or buy-in, the scheme retains control of the assets and so does not remove the potential future upside from the scheme's investment strategy - which remains a key part for most scheme financing plans.

Longevity swaps are straightforward in concept, set up as an arrangement between the pension scheme and the product provider (the counterparty) to exchange payments based on scheme cashflows. At the outset, the scheme agrees to make payments for a specified period of time (thereby locking into a known life expectancy), and in return the counterparty agrees to make payments for as long as the members are alive. Uncertainty relating to how long the members will live is therefore completely or largely eliminated from the scheme's perspective.

#### **Swap varieties—made to measure or off the peg?**

Longevity swaps come in a variety of flavours, ranging from "bespoke" to "index" solutions. Bespoke solutions are customised to the individual pension scheme and based on the specific members in the scheme. 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.

Most of the activity at the moment is focused on bespoke solutions that deal with pensioner members. 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 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.

As the market develops, it seems likely that schemes will start to use a combination of bespoke and index solutions to deal with both pensioner and non-pensioner longevity risks.

### **Why buy a longevity swap?**

There are a number of scenarios where this type of solution might be attractive. For schemes that want to completely 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 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. In the future,, 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.

### **Buyer beware! Are there any hidden pitfalls?**

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 regarding 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.

### **Current pricing—short lived fad or here to stay?**

Both insurance and capital markets organisations are currently lining up to provide longevity swaps to pension schemes. This rapid emergence of new solutions is reminiscent of the developments in the buy-in market over the past few years. At the moment, the providers seem very keen to write deals and this is being reflected in some very competitive pricing pressure. In some cases, prices are in line with funding assumptions, meaning that the longevity swap is removing risk without leading to the requirement for additional funding contributions. But it is difficult to know how long this will persist, and while it is easy to be cynical about "buy now while stocks last" sales pitches, early movers may well be in a good position to negotiate favourable terms.

Trustees and sponsors need to think very carefully about the life expectancy assumptions that are being used for funding purposes, how those assumptions are likely to change over the next few years and how much risk appetite the scheme has to continue to run longevity risk. With such aggressive pricing, the discussion is moving from one of whether to remove longevity risk, to whether there is any appetite to retain the risk.

***If you have any questions on this Spotlight please contact your usual Hewitt contact or [Martin Bird](#), UK lead, Longevity Solutions (+44 (0) 121 262 5059) or visit our website at [www.hewitt.com/longevity](http://www.hewitt.com/longevity)***

If you would like to receive these bulletins by e-mail, please contact [spotlight.enquiries@hewitt.com](mailto:spotlight.enquiries@hewitt.com).