



Although longevity risk is one of the key issues for pension funds, this has not translated into an increased interest in using swaps or hedging instruments. The market, which is seen as being the preserve of larger pension funds, has been slow to ignite. This could change though with recent industry developments as well as the index based contract launched this year from JP Morgan for the UK defined benefit pension scheme of Pall, a US engineering and technology group.

The transaction is noteworthy in that it is the first deal to hedge against higher life expectancy for a company pension plan's working members. Previous longevity deals have focused solely on pension plan members who have already retired, as hedging against increased life expectancy of members still working is not easy to measure. This is due to the difficulty in predicting the developments that might influence life expectancy over the lifetimes of younger people,

The JP Morgan longevity hedging trade, which covers 1,800 members in Pall's UK £120 scheme, involves hedging £70 worth of liabilities and a fixed ten year term. The fund's trustees can choose to adjust the size or structure of the deal. If the life expectancy improves at a greater rate than specified in the contract, the fund receives an insurance payout. The swap contract was based on future values of JP Morgan's LifeMetrics longevity index which was launched four years ago and is a toolkit for measuring longevity and mortality risk in England and Wales, US, Netherlands and Germany.

JP Morgan is the hedge

provider and collateral custodian while fund management group Schroder structured the Pall transaction. Although relatively small, the deal represents an important step forward in developing a tradeable market in longevity risks because it is written against an index and it has a fixed-term. This not only helps to limit the exposure of the party taking on the risk – JP Morgan in this case – but it also makes it much more suited for potential trading in the capital markets.

JP Morgan is also involved in another initiative to facilitate trading

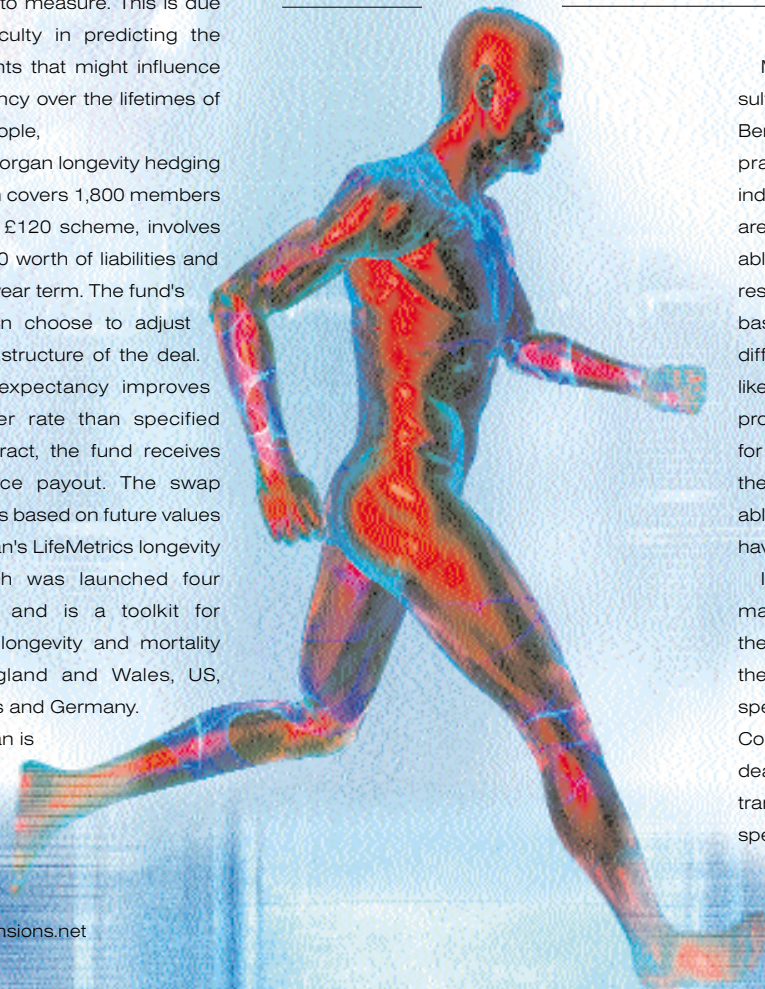
and raise longevity hedging's profile. Last year, the US bank joined forces with AXA, Deutsche Bank, Legal & General, Pension Corporation, Prudential, RBS and Swiss Re to form the Life and Longevity Markets Association (LLMA). The group's aim is to develop a standardised and transparent framework for designing, building and producing longevity indices. This will enable providers and schemes to calculate benchmark prices for longevity exposures and hedging instruments, allowing easier comparison and assessment.

Taking strides

Pension funds are adopting new and exciting ways of managing their longevity risk, says Lynn Strongin Dodds

Matt Wilmington, principal consultant in Aon Hewitt's International Benefits and Global Risk Services practices, says, "The LifeMetrics index, as well as the LLMA initiatives, are trying to develop a liquid, tradeable market in longevity and as a result I think we will see more index-based solutions in the future for different sectors of the population like the one from JP Morgan. These products are particularly well suited for smaller pension funds because they are generic and more affordable than the bespoke deals that we have seen in the past."

In the past five years, the longevity market has been dominated by the UK's largest pension funds with the deepest pockets. According to specialist insurer Pension Insurance Corp, there have been about seven deals totalling around £8bn. Each transaction has been tailored to the specific experience of the scheme involved, requiring a detailed





mortality profile. This is not only more complex but also expensive and time-consuming to build.

To date, the highest profile and biggest swap transaction happened in 2010 when German car maker BMW offloaded £3 bn of risk from its British pension scheme to Deutsche Bank's insurance subsidiary Abbey Life. A proportion of the risk was also passed to a consortium of reinsurers, including Hannover Re, Pacific Life Re and Partner Re. Last year also saw the first local council to enter the market – the £1.25bn Royal County of Berkshire pension scheme arranged £750m worth of longevity insurance with Swiss Re. The insurance company also launched a series of longevity-based Insurance-Linked Securities (ILS) notes, which marked the first time the risk of people living longer than expected was securitised in catas-trophe bond format.

Other headline deals included the market's first ever transaction between Credit Suisse and engineering group Babcock that initially covered £300m in liabilities, before being extended, as well as the £1.9bn longevity swap between RSA, the UK's largest commercial insurer and Goldman Sach's Rothesay Life insurance group.

Chris Mapp, head of the actuarial practice at Bluefin Corporate Consulting, says, "At the moment, the longevity swap market has been geared to the larger schemes because they are more customised and expensive. Also, interest and inflation rates risks are easier to understand whereas a longevity swap with all its different pieces is harder to explain. In general, smaller schemes tend to buy a bulk annuity from an insurance company to hedge longevity as well as inflation and interest rates risks. However, I think the longevity market could develop like the interest

rate swap market which when it started attract-ed only the larger schemes but in time became more standardised."

Costas Yiasoumi, Swiss Re's head of longevity solutions, notes: "It depends on the pension scheme and their requirements. For many plans, swaps are the right solution while other plans might choose bulk annuities or decide to retain the risk. However, when we look across the market, activity is steady and I expect it to remain stable over the next 18 months. We have a number of live cases going through the quotation process. I think trustees have done their homework and have a much greater understanding of the market, the products and pricing."

Although activity has mainly been in the UK, Yiasoumi sees interest picking up outside the country, for example in the Netherlands and Switzerland. This is because mortality tables have been or are being revised which will help bring pension plan longevity estimates closer to where reinsurers are pricing the risk"

Roger Douglas, co-head of the longevity markets group at Deutsche Bank, also believes that "activity will increase on both the index based as well as the swap market. I expect we will see pension funds who have already addressed their inflation and interest rates de-risking look at hedging their longevity risks. It is the next natural step."

Pretty Sagoo, project leader in the LLMA technical committee and director in the longevity markets group at Deutsche Bank, adds, "There are fundamental differences between the different risks. For example, interest and inflation rates have a more balanced demand/supply equation which is not the case with longevity swaps. There are currently a greater number of

providers than takers of these products. However, I think that will change with standardisation. It can be quite complex for a smaller scheme to do a bespoke transaction and while an index may not give them a way to get longevity protection that exactly matches the risks in the schemes it will allow them to do some hedging."

Other market participants though believe that the economic risks will take precedent for now. Charles Marandu, director of European institutional advice at SEI notes: "I do not think that longevity is the biggest immediate risk to the pension fund deficit. If you rank it in magnitude I think it comes in around fourth behind stock market movements and financial effects of interest and inflation risks. I think that a natural start to the risk management process would be for pension funds to develop their policies towards managing these big economic risks first before addressing the longevity risk."

Jay Shah, a partner at Pension Corp, agrees, adding, "Pension funds have to weigh the costs of pursuing swaps which includes operational and administrative expenses tied to managing the collateral over very many years, with doing a buy-in, where a scheme insures risks which include longevity, investment and inflation. I think we will see more buy-ins because they can be a more cost effective solution in meeting a pension fund's requirements." ?

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