

corporate briefing



Pension risk of improving longevity – solutions for companies

Summary

The impact of improvements in longevity is high on the corporate risk agenda.

Actions that companies can take include:

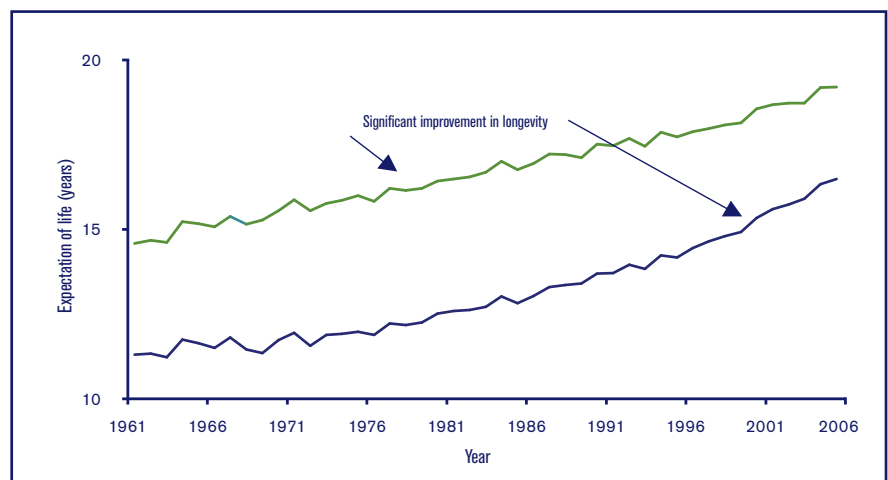
- scheme design – sharing the risk with members
- insurance – either in full or in part
- capital markets – new forms of risk transfer are emerging.

The majority of companies are considering one or more of these solutions.

Longevity improvements – what does the future hold?

The continuing increase in life expectancy and its financial impact on pension scheme deficits has been in the spotlight over the last few years – ‘New lifespan data threatens pensions’ (*Financial Times*, July 2007). Figure 1 illustrates the dramatic increase in life expectancy from retirement at age 65 over the last few decades.

Figure 1 | Improvement in mortality rates amongst 65-69 year olds



■ Males ■ Females

Source: JPMorgan LifeMetrics, England and Wales. Period analysis

Such increases have had a significant impact on the sponsors of defined benefit (DB) pension schemes, increasing balance sheet deficits and raising questions about the sustainability of future pension provision – particularly if the rate of change were to continue its recent acceleration or even to remain in line with recent trends.

Even amongst experts there are widely divergent views on the extent to which longevity improvements will continue (see last page), leaving companies uncomfortably exposed to great uncertainty. Companies are seeking ways to manage this risk – and there are an increasing range of solutions to meet the growing demand.





Scheme design – transfer risk to members

The majority of companies in the UK have already taken action to address future build up of this risk by introducing defined contribution (DC) pension benefits (either for new entrants or, increasingly, for existing DB members as well). In such designs, the members bear all of the risk, including longevity.

In addition, a handful of companies have introduced ground-breaking, 'longevity-sharing' designs (for instance, BAE, De La Rue, Northern Bank) which have enabled them to continue to support DB provision. In these designs, if life expectancy increases beyond that expected, either the amount of the benefit built up is reduced or the retirement age is deferred. In effect, the member bears the risk of increasing longevity before retirement and the company after retirement.

Amending benefits already built up is more difficult because of legislative constraints, although there are a number of actions that companies can take:

- Remove the ability to exchange AVCs for pension within the scheme.
- Review the terms on which pension is exchanged for tax-free cash at a member's retirement.

- Conduct an exercise to promote transfers out of the scheme for deferred members, possibly on enhanced terms.

Buyout (or quasi buyout) some/all of the liabilities

Insurance buyout has been the traditional approach to settling all pension risk, including longevity and has historically been unaffordable for most sponsoring companies.

Over the last few years companies have taken renewed interest in discharging the 'DB legacy', driven by the significant increase in cost, risk and regulatory burden. As a result, the market for settling pension liabilities is diversifying, for example:

- **New insurers have entered the market place:** competition has driven down the price although it remains unacceptably high for many companies.
- **Partial buyouts are starting to emerge:** it could be attractive to discharge part of the liabilities – issues to address include whether further buyouts will be with the same insurer, what happens on a subsequent wind-up, and what flexibility exists to deal with future corporate transactions.

'Buyouts' within the pensions regulatory environment (and specifically NOT with insurers):

these transactions involve the transfer of the pension liabilities to another sponsor and, because of the different regulatory requirements, may be feasible at a lower cost. The change of covenant in such a transaction would be critical – companies need to avoid the risk of 'abandonment'.

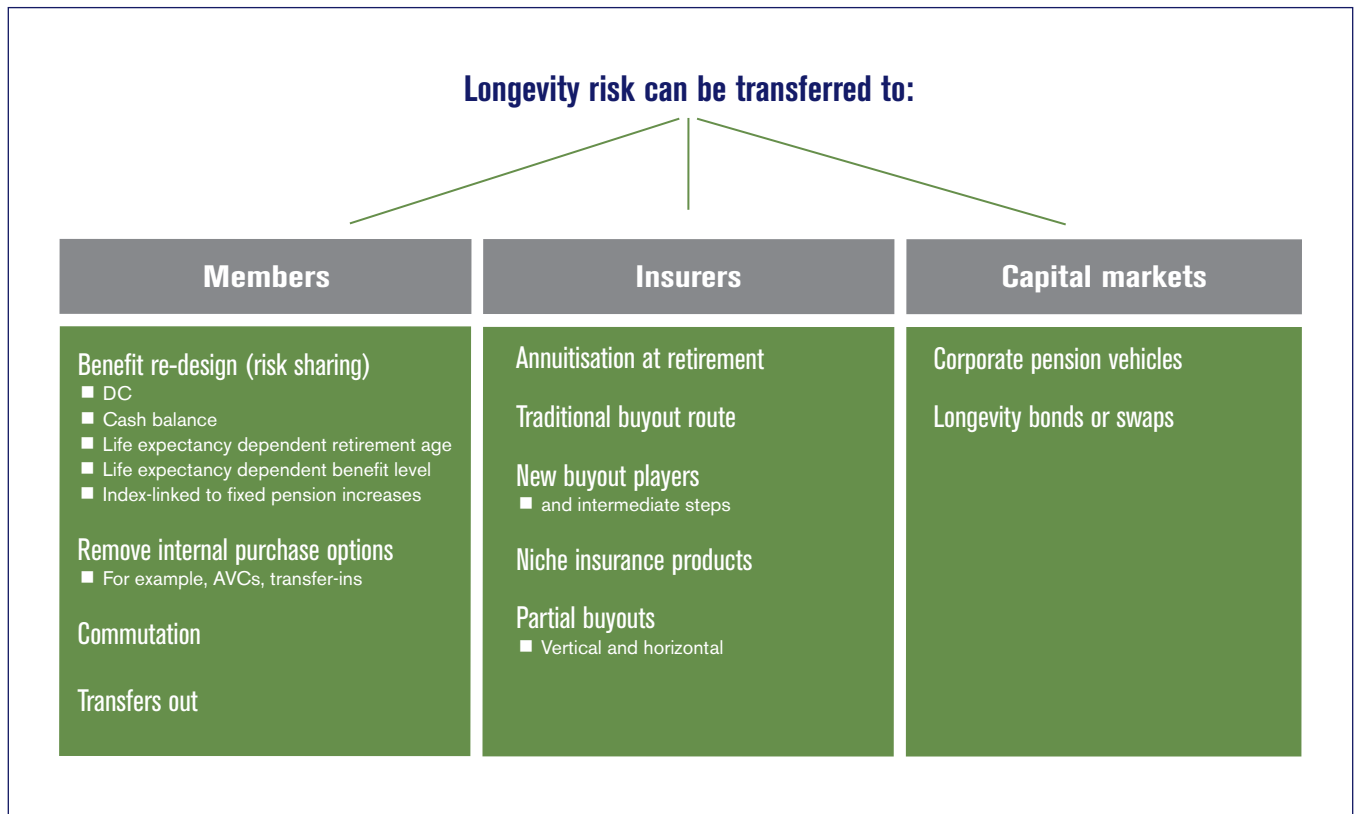
We expect to see further announcements and innovations in this market during the course of 2008.

Use capital markets to hedge longevity risk

A number of innovations in the capital markets have recently been launched (by JPMorgan and Credit Suisse for example) which allow companies to transfer some or all of their scheme's longevity risk to a third party. The products fall into two broad categories:

- Completely remove the longevity risk by exchanging the future longevity experience of the scheme for a known series of payments, for instance, a 'scheme-specific mortality swap'. Such arrangements provide the greatest risk protection though they tend to be the most complex, and therefore costly, to introduce.

Figure 2 | Transfer of longevity risk





- Buy protection against standardised longevity improvements, for example ensure that the company's balance sheet is protected against national longevity improvements over the next 10 years. For many schemes, this could protect against the most significant longevity risks at a more acceptable cost.

The price of protection will be the key consideration for any company. However other issues will be important, such as the covenant of the provider and the ability to unwind the transaction at a fair price in the future. Moreover in any transaction of this nature, great care is needed to define precisely how the mortality risk is measured – in the first example above, what is the fixed series of payments, and in the second, how are 'national longevity improvements' defined and measured in such a way as to be capable of timely calculation?

Conclusion

Companies are exploring a wide range of solutions to the longevity 'problem'. The issues are varied and complex and require a good understanding of the full range of risks associated with the pension scheme, to ensure that the risks are managed appropriately in terms of costs incurred.

Further information

At Watson Wyatt we have worked with companies on all of these options. If you would like further information please contact your Watson Wyatt consultant or:

Kathryn Armitstead
+44 (0) 117 989 7440
kathryn.armitstead@watsonwyatt.com

Forthcoming events

The pension buyout and settlement market – 26 March 2008 at 4.30pm.

Watson Wyatt's Corporate Consulting Group will examine the latest developments in the pension buyout and settlement market. More information on this event, including a booking form, is available at: watsonwyatt.com/pensionbuyout

The arguments for and against further improvements in life expectancy

One school of thought (as espoused by James W Vaupel, Max Planck Institute) is that the factors that have contributed to increased life expectancy in the past will continue to dominate in the future, for example:

- improved medical treatment of the major diseases
- increased use of statins, leading to a reduced incidence of heart disease
- use of vaccines
- improved targeting of vitamins.

At the other end of the scale are those who believe that the principal causes of improvements to longevity have already happened. Demographers such as S Jay Olshansky (University of Chicago) believe that such improvements will be offset by the effects of:

- increasingly sedentary lifestyle, and
- obesity-related diseases (for example, diabetes).

Any projections of the future are based, directly or indirectly, on assumptions as to how the above features will play out in practice.

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