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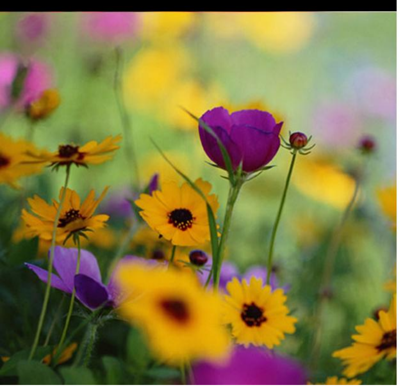

Sharing longevity risk

A practical approach to reducing pension risk

April 2007

Increasing life expectancy has had a major impact on the funding of defined benefit pensions schemes. Managing the risk of further improvement is therefore a key priority for companies. The possibility of sharing future longevity risk between scheme sponsors and members is now attracting great interest. This note examines the practical issues this raises.

Background

There are two key influences on pension liabilities: investment returns and longevity. In the last ten years these have combined to create a ‘perfect storm’ for defined benefit schemes, with a reduction in real investment returns coupled with a dramatic increase in life expectancy.

Longevity increases have a severe ‘gearing’ effect on pension liabilities. A 5% increase in life expectancy from age 80 to 84 means a pension payable from 65 will be paid for 19 years rather than 15; an increase of 27%. As a result, without a radical re-think, current and future pensioners will receive their pensions for far longer than their predecessors, when the cost of providing pensions has already increased substantially.

To mitigate the financial burden, many companies have introduced defined contribution arrangements for new employees and, increasingly, for existing employees going forward. This passes longevity and investment risk to employees. However, a ‘too simple’ defined contribution approach can have risks too – potentially leaving employees who are no longer suited to work unable to afford to retire – a real issue for both them and their employer.

Alternative approaches exist, for example the use of longevity bonds or insurance. Another option is sharing longevity risk with scheme members.

Sharing longevity risk – the business case

Developing a longevity risk sharing mechanism has several advantages:

- ***Lower risk:*** the cost of pensions is more stable and predictable.
- ***Better benefit design:*** companies are able to provide benefits which are more attractive to employees and better facilitate workforce planning.
- ***‘Fairness’:*** those individuals who benefit from increased life expectancy share the cost.
- ***Financial efficiency***: members benefit from collective risk management which is lost with a basic defined contribution scheme.

Sharing longevity risks – making it work

As an example of longevity sharing, defined benefits (eg '60ths') can be offered subject to life expectancy not exceeding a specified benchmark. If it is exceeded, the benefits are adjusted to maintain the original value to members by:

- Increasing the retirement age, or
- Reducing the accrual rate

The benchmark longevity must be carefully defined, particularly as changes in life expectancy are difficult to detect and emerge slowly over a long period of time. However, there is a wealth of information available from the actuarial profession, the life insurance industry, the experience of pension schemes and the Office of National Statistics.

Whatever benchmark is chosen, it needs to be transparent and free from influence by the company, members or trustees. For example, the new 'LifeMetrics' indices launched by JP Morgan, designed with input from Watson Wyatt and Cass Business School and calculated by Watson Wyatt, have been designed with these qualities in mind.

And communication with members is key - any lack of understanding could undermine trust and reduce appreciation of valuable pension benefits.

Sharing longevity risks – practical limitations

Before or after retirement

Post retirement longevity sharing is difficult on two counts:

- Legislation largely prevents reduction of a member's pension once it is in payment
- Sharing risks post retirement is difficult to communicate - what organisation would want to write to its pensioners to say their benefits are being reduced because they have lived too long!

It might be possible to share some risk after retirement by restricting future increases to pensions in payment but the potential is limited. Before retirement there is much more flexibility to adjust benefits to reflect longevity changes, so this is where risk sharing is more attractive.

Accrued benefits or future benefits?

Accrued benefits are generally protected by legislation and scheme rules but there is some scope for risk sharing. For example, members might agree changes to past benefits as part of an overall deal including continuation of some form of defined benefit accrual, with risk sharing determining the retirement age for the whole benefit. For future service, benefit design is mainly a company policy issue, so there is greater flexibility to introduce longevity risk sharing where the change can be justified on business grounds.

How can we help?

Sharing longevity risk is just one of Watson Wyatt's innovative and practical benefit design solutions to help you manage your costs and risks effectively, and enhance employee engagement. To find out more, please contact Andrew Reid on 020 7222 8033 or Steven Dicker on 0161 839 1600.