RISK MANAGEMENT

In it for the long run

Charlotte Moore **explains how the UK has taken the most aggressive steps in tackling longevity risk and why the rest of Europe is playing catch-up**

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Spend too much time in the company of actuaries and it's easy to become gloomy about the implications of the European population living for longer. While an improved lifespan is to be celebrated, careful financial planning at an employer, personal and state level is needed to ensure millions are not condemned to living out their last years in penury.

Concerns and complications

Concerned that a number of countries were not doing enough to stay on top of this problem, the Organisation for Economic Co-operation and Development (OECD) published a report in December 2014 examining which countries were keeping abreast of the continued improvements in mortality.

OECD head of the private pensions team Pablo Antolin says: "If existing pension arrangements do not accurately reflect the projected longevity then it will not be possible to fully fund people's retirement."

It is not only that people are living for longer but that it is also difficult to accurately predict how long people will live. To avoid being caught out, longevity is something that needs to be revisited frequently to ensure forecasts are up to date.

"If annuity providers do not take future improvements to longevity into account this, along with the uncertainty of this variable, can create significant problems," Antolin adds.

The OECD compared the longevity tables established by each country's regulator along with those used by pension funds and insurance companies against four traditional models of mortality improvements.

The organisation found most countries do not use accurate longevity assumptions. Antolin argues: "The problem is that most countries are not incorporating the ongoing improvements to mortality in their tables."

The worst offender in Europe was Switzerland in the mortality tables used by pension funds. In contrast, the Netherlands, the UK and Germany scored well.

Steps taken

Within Europe, the UK has taken the most aggressive steps to address longevity issues. A number of different factors coalesced to make British pension schemes take a highly sophisticated approach to addressing longevity. A growing number of pension schemes are entering into

deals to specifically transfer this risk to the insurance market.

Around a decade ago a large volume of research emerged in the UK showing just how much longer the post-war baby boomer generation were living compared with previous expectations.

"This started the conversation about how long the improvements could be expected to persist," Aon Hewitt head of risk settlement Martin Bird comments. The actuarial profession viewed this as such an important issue that it established the bureau for Continuous Mortality Investigation.

The scale of the impact of improving longevity assumptions on the UK cannot be over-stated and Mercer head of longevity swap consulting Andrew Ward states that "increased life expectancy assumptions have added around £250 billion to the value of the nation's defined benefit liabilities over the last 10 years".

COMPOUND INFLATION EFFECTIVELY DOUBLES THE EFFECT OF CONTINUED MORTALITY IMPROVEMENTS

Consensus

This focus on longevity improvements in the UK resulted in one very positive outcome: both insurers and pension schemes have reached a consensus view on modelling longevity expectations. In particular, they now agree on the rates of future improvement, based on work produced by the CMI.

In the past, there had been a fundamental mismatch between the two parties about the true cost of hedging this risk. Bird says: "Both industries are now using a similar approach to longevity and so the cost of hedging this risk looks proportionate to both parties." This has been a key factor in the development of the UK longevity risk transfer market.

While the use of the same set of assumptions by both the insurance and pensions industry has helped to establish the UK longevity market, this was not the only factor.

Quirks of the UK system have also pushed pension funds in this direction. Most UK defined benefit schemes have very strict rules governing benefit payments.

This gives pension funds much less flexibility than, for example, the Netherlands. Bird says: "In Holland, schemes are able to adjust the amount of pension being paid to reflect increases in life expectancy." This provides more 'wriggle room' – although longevity risk still needs to be addressed.

In addition, many British defined benefit pension payments are linked to inflation, which creates a double whammy.

"Compound inflation effectively doubles the effect of continued mortality improvements," Bird underlines.

The focus on appropriate funding rules has enabled UK pension schemes to actively tackle longevity risk.

"The UK regulator closely monitors pension schemes to ensure they are providing the appropriate levels of funding," Prudential Financial head of longevity risk transfer Amy Kessler points out. This debate around appropriate funding levels in the UK has led to a margin of error being baked into each scheme's funding target or technical provisions.

Kessler says: "This includes a healthy dose of longevity risk that allows much of the cost of

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mitigating this risk to be absorbed within the technical provision." This allows both trustees and corporate sponsors to take active steps to reduce this risk.

But with an increasing focus on the use of more accurate mortality improvement assumptions, managing longevity should become a more important issue around Europe and there are hopes that more countries will progress toward the level of sophistication seen in the UK.

At the moment, there is considerable variation around Europe regarding the level of expertise, both in the modelling of longevity and the improvement factors, which are added to mortality assumptions, Bird argues.

Kessler says: "In addition, in many European countries the funding rules are not as clear cut as in the UK and those objectives may not include a margin for longevity risk." This provides less incentive to European pension schemes to tackle this issue.

Optimism

Despite there being less incentive for European pension schemes to tackle the thorny issue of longevity risk, Kessler is optimistic more pension schemes will take steps to actively manage longevity risk throughout the continent.

The push to transfer longevity risk is likely to come from global companies, which reduce this risk for their UK subsidiary as a first step. Kessler says: "Once a company realises how much better life is with lower risk in the pension scheme, it starts to look at the other place where they can take similar steps."

The number of countries where it's possible to implement a de-risking strategy is rising. "It's possible to put longevity hedging in place in the Netherlands and it's likely that Germany, Switzerland and the Nordics will soon have their own solutions," Kessler outlines.

Innovative longevity structures will help to grow the continental longevity risk transfer market. BT's recent longevity swap involved the creation of an insurance vehicle in Guernsey, making it possible to transfer a large amount of longevity risk to the re-insurance market in a cost-effective manner.

Competitive pressure will also play a role. Reducing pension risk significantly reduces the volatility associated with shareholder's equity. Kessler says: "Once one company makes this move, its global competitors will notice the improvement to their balance sheet and follow a similar strategy."

According to Legal and General longevity risk director Joseph Lu: "Research by Grant Thornton has shown companies that reduce longevity risk see their share price increase by around 10 per cent."

An additional push could come from new financial services regulation, such as Basel III. These rules require banks to hold capital against the longevity risk associated with their pension fund.

Holding capital against longevity risk is not economic for banks as they generally do not have any mortality risk from the sale of life insurance to offset this risk – unlike insurance companies. "As banks come to grips with this additional capital requirement, they will be incentivised to reduce their longevity risk," Kessler concludes. ■