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CORPORATION

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Time for a unified view on longevity?

It is widely accepted that we are living longer, on average, than ever before. This trend seems likely to continue. Today's pensioners are dependent on their monthly payments for longer than the previous generation and tomorrow's pensioners are expected to live longer still. As the Pensions Regulator has highlighted, too many sponsors of corporate pension schemes are not adequately allowing for this continual increase in the length of our lives. They are not alone; even pension and annuity insurers have been urged by the FSA to be more cautious in their assumptions.

Predicting how long members of a pension scheme are going to live is certainly not an exact science. Clearly some will live longer than others and determining how long on average the group will live is not straightforward. Some fluctuations between what is assumed and reality are entirely expected. The problem arises when each year reality moves further and further from the assumptions which determine the funds required to continue to pay the pensioners.

Most people do not subscribe to the belief of a small minority that medical science will one day make it possible for us to live for 1000 years. However even relatively modest changes can have a significant impact with each additional year of expected life adding around 3% to the total liabilities. To give some indication, if a scheme has 1,000 members each requiring £30,000 a year who are currently aged 60 and who live for only 2 years more than expectations, the future cost to the scheme will be a not inconsiderable £60million.

The gap between the carried assumptions of a pension plan and current views of life expectancy would have to be funded by the corporate sponsor and recognised on the sponsor's balance sheet. It may be surprising to some people that there is a wide variation in pension plan assumptions on life expectancy. New research from KPMG's pension team found that pension fund life expectancies vary by up to seven years across almost 200 companies. Some variation in life expectancy can be explained between pension funds with different mixes of pensioners, however KPMG found that life expectancy varied by as much as five years for companies in the same sector. Such variations in life expectancy within the same sector can be expected to narrow as trustees, auditors and advisors focus more on this important issue. A five year variation in life expectancy can lead to more than a 15% difference in the carried value of the liability.

Whether now is the time for a unified view on longevity is a question illuminated by the differences between pension fund and insurance company assumptions on life expectancy. As recently as 2006 research by Lane Clark Peacock showed that only 2 of the 33 UK companies disclosing detailed mortality assumptions for their pension plans were using a level of improvement equal to that adopted by the life insurance industry. The FSA also has a keen interest in the life expectancy assumptions made by the insurance industry, and recently wrote to insurers to highlight the need for adequate improvement factors to be taken into account.

One could speculate that those companies who are not yet revealing their mortality assumptions in their financial statements are assuming even shorter life expectancies. Our experience shows that one of the major reasons that insuring a pension fund costs more than the pension fund liabilities is that the pension fund mortality assumption is not consistent with the latest data and expectations on improvement.

Over the past year pension funds have been enjoying the magical combination of rising equity markets and sterling bond yields. Consequently, for the first time since FRS17 was introduced in 2001, the UK's top 200 pension schemes have recently reported an aggregate surplus. Some may argue that there is therefore a safety margin against poor longevity experience, but markets can go down as well as up. On a single day in February 2007, market turmoil in China led to an £11 billion increase in pension deficits, the biggest single-day increase in UK pension deficits. Markets are proving quite volatile in July 2007 once again!

Moreover, if pension schemes are funded using overly optimistic assumptions, supposed surpluses could once again cause companies to wrongly take contribution holidays and improve benefits, only to slump in years to come.

The objective of corporate sponsors and trustees is to ensure that all the promised pensions are paid out. Many observers believe outdated longevity assumptions are unlikely to survive the scrutiny of trustees, auditors, shareholders, analysts and advisors. With the creation of the Pensions Regulator, the PPF, and the involvement of the FSA in this area, the industry is coming under increasing scrutiny. We believe the time is right for a unified view on longevity by pension funds, insurance companies and the capital markets. This would lead to a more efficient system of risk transfer between all market participants. After all, is there any valid reason why the life expectancy of a pensioner should be different depending on which institution owned the risk?