

FEATURE

LONGEVITY The risks associated with longevity are here to stay, and dealing with them as soon as possible will lead to a far better outcome than simply hoping they will disappear in time

Facing the music



AMARENDRA
SWARUP

When Jeanne Calment's lawyer agreed to pay her an annual income worth one-tenth of the value of her flat on the understanding that he would inherit the property on her death, it seemed like a shrewd bargain. Born in France in 1875, Madame Calment was 90 years old at the time and it seemed unlikely she had much longer to go on this particular journey. Unfortunately, bearing testament to perhaps one of the most misjudged investment decisions ever, Jeanne went on to live to the ripe old age of 122, dying only in 1997. Along the way, she also became the oldest rap artist ever, releasing an album at 121, but that is unlikely to have provided much consolation to her poor aforementioned lawyer. By then, he had long since died and his widow was still making the payments.

It's a situation humourlessly reminiscent of reality for many pension schemes. For individuals, increased longevity is desirable and it is of little surprise, therefore, that society spends a significant percentage of GDP annually on healthcare and medical research to ensure that we all have longer and healthier lives. But, like Madame Calment, living longer can often also create large unanticipated costs and it is clear this is seriously impacting the finances of pension funds and their sponsors.

In a field typified by extremes, the American civil war veterans' pension fund – one of the earliest – is another case in point. Originally set up during the war to pay pensions to disabled veterans, the



Conducting a review of longevity risks helps face up to the reality of the situation

“Longevity improvements have repeatedly defied the hopeful shackles of successive actuarial models, despite the most Orwellian filtering of data”

scheme was gradually extended to include all veterans and their dependants, making its final payment only in 2004 – nearly 140 years after the war ended. By then, the scheme had cost the US government hundreds of billions in today's dollars, well exceeding the original cost of the war, and at its peak in the early 1890s, had even constituted over 40% of the annual federal budget.

It's a stark warning for many pension schemes and their corporate sponsors today. Ever since the German chancellor Otto von Bismarck thought he'd pulled off a politically brilliant move back in 1889 by promising pensions at age 70 when the average German lived to less than 50 years, the continual improvements in life expectancies have rapidly unravelled the best laid pension plans. And today,

these lie at the heart of the huge liabilities stalking many schemes.

The problem is particularly acute for defined benefit (DB) schemes, as most of these pensions are indexed to inflation and can also be passed on to spouses. The waters are also muddied further by another fundamental problem – for most schemes, liabilities are calculated insufficiently frequently, using out-of-date longevity assumptions and often presenting a less than prudent valuation of the true costs of delivering pensioners full financial security. As people live longer – 15 minutes more for every passing hour, by some estimates – the immediate calculable costs can rise dramatically as outdated assumptions are updated and even more troubling, the current upwards trend shows little sign of levelling off (see chart one).

42 ALL HANDS ON DECK

Maintaining high quality customer service is no mean feat, especially during financially hard times, and buyout can be a way to achieve this



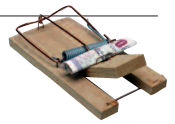
46 THE ONLY WAY IS UP

As the wrap market continues to expand, platforms will be pivotal to the sale of pensions and investment products in the UK



49 PRINCIPLES, PITFALLS AND PRACTICALITIES

No one involved in an in-specie transfer should assume they are a simple transaction, as many potential traps lie in wait



For their corporate sponsors, the impact is also painful. Though the increased pension fund liabilities are often longer-term than most corporate horizons, they must be carried on the company's balance sheet, reducing the net asset value and increasing the financial leverage of the company. Moreover, sponsors will likely have to fund at least part of these unexpected costs, giving them an uncertain command over their own cash flow and reducing future distributions to investors.

In recent times, the area has become all the more important because of increased regulatory scrutiny. The Pensions Regulator is now pushing schemes to adopt more realistic mortality assumptions that reflect the latest scientific evidence – a change that could significantly increase their total liabilities by 3% or more for every added year of life expectancy. For the DB industry as a whole, that equates to an additional cost of £27bn. This also presents additional shorter-term risks for sponsors as they may be ordered by regulators to divert extra cash into the scheme to meet these future liabilities via a contribution notice.

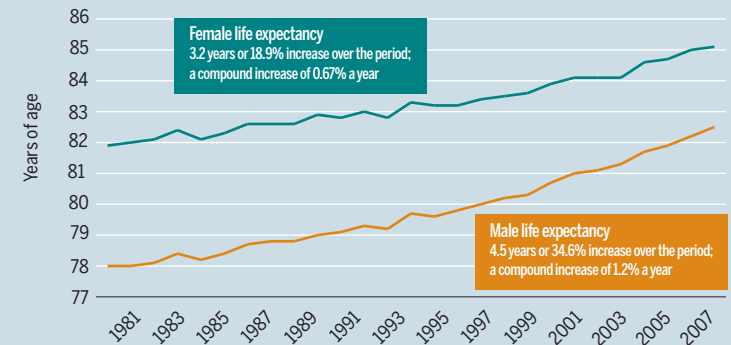
So how are trustees and sponsors to manage this new idiosyncratic risk? It's hard enough to judge your spouse's mood an hour from now or market returns over the next few years, without taking on the additional burden of estimating the lifespan of all the scheme members under your responsibility – past, present and future.

The answer today is largely a dark art. The current trend is unlikely to be your friend here – longevity improvements have repeatedly defied the hopeful shackles of successive actuarial models, despite the most Orwellian filtering of data by job, medical history and even postcode. The latest models – even if true – give scant comfort. By 2050, a 65-year-old UK male might live to be between 86 and 97 years old, up from 83 today.

Some have suggested that diseases such as obesity and diabetes – typically associated with a passive lifestyle – could save pension plans.

KEY STAT
£27bn
added cost to the DB industry if it adopts more realistic mortality assumptions

CHART ONE: INCREASING LIFE EXPECTANCY IN THE UK FOR 65-YEAR-OLDS



Source: Office for National Statistics

But though the incidence of these has been rising for over 25 years now, people are still living longer today than they were 25 years ago. Moreover, society itself has undergone huge behavioural changes that can make owning the risk of longevity ultimately an unrewarding and financially painful bet. The increasing intolerance towards smokers is just one recent example – it is estimated that 400,000 smokers across England and Wales quit since last year's ban on smoking in public places went into effect.

However, before we start decrying the imminent demise of the pensions industry, there are options. Like any other risk, these uncertainties can also be managed once understood. Moreover, new developments in the marketplace mean that there are now ways of reducing these risks and in some cases, even removing them altogether.

The key is to have a proactive and realistic approach. The ideal solution for most pension funds is a full insurance buyout of all liabilities to a dedicated insurer. This can improve the situation for pension scheme members as these specialist insurers are tightly regulated, operate within strict investment and asset-liability guidelines, and have to hold capital against any extreme losses. The cautious underlying assumptions used do often necessitate a large premium, though this should be balanced against future increases in liabili-

ties and an uncluttered balance sheet for sponsors thereafter.

Partial buyouts are often more affordable and can allow schemes to phase laying off their risk over time. They can also be very effective at enhancing shareholder value for sponsors. It is worth noting that when Delta announced that it was contributing £50m to facilitate the pension fund's buyout of its pensioner liabilities, the markets rewarded the company with a 10% rise in its share price on the day.

Yet even where buyout may not be affordable or preferable, other cost-effective options are appearing. For example, new products now allow pension funds to insure only the longevity risk of pensioners directly for the first time ever. Uniquely, these longevity insurance products can be scheme-specific, covering pensioners and their dependants for their entire lifespan. This caps the exposure of the liabilities to future longevity improvements and increases the chances of a buyout further down the line.

Whatever the route taken, the key to managing the longevity of pension liabilities is simple. Like any other risk, it needs to be understood and dealt with. Ignore it and schemes risk retreading the painful steps of Madame Calment's lawyer. **PM**

Dr Amarendra Swarup is senior quantitative analyst at Pension Corporation