Finding the right approach

Hannah Cook looks at how to structure and access the best pricing when longevity hedging

Many UK pension schemes have spent a large part of the past decade progressively reducing their investment risk. For them longevity risk has rapidly become the dominant residual risk. This means that most schemes have a real focus on how and when to hedge longevity risk and are incorporating this into longer-term planning and integrated risk management frameworks.

Structural options

While it is not possible for pension schemes to transact directly with the global reinsurers who have the appetite and capacity to take on longevity risk, a UK insurer or a special purpose vehicle (typically a captive) can facilitate the transaction. For pension schemes seeking to implement a longevity hedge, reviewing how to structure a transaction is an important consideration. The market has evolved over the past 10 years and a variety of structural options are now available:

- Fully intermediated: The pension scheme transacts with a UK insurer, who sorts all the reinsurance 'behind the scenes' and takes on the operational aspects of the hedge. Importantly, the insurer rather than the pension scheme is exposed to the reinsurer credit risk.
- UK pass-through: Similar to a fully intermediated approach, the pension scheme transacts with a UK insurer, but under this structure it is the pension scheme that is exposed to the reinsurer credit risk.
- Self-intermediated or captive approach: The pension schemes sets up its own insurance vehicle (typically an offshore captive) to access the reinsurance market capacity and takes on the responsibility for the operational aspects of the hedge, as well as more structural and legal risk.

Structuring varies by size

For £multi-billion transactions, the pass-through and captive approaches offer significant cost savings relative to the fully intermediated route. Of these two options, a UK pass-through approach tends to be appealing for a lot of pension schemes given the operational simplicity achieved. In our experience, schemes only tend to focus on a self-intermediated approach where they have sufficient scale to achieve material savings or have significant in-house resource to manage the day-to-day operational responsibilities this method requires. Regardless of the structuring approach, larger transactions are typically collateralised to mitigate any counterparty credit exposures.

In recent years, the UK longevity market has also increasingly become accessible to pension schemes with liabilities under £500 million. For schemes in this category, a streamlined approach is typically adopted to ensure cost effectiveness. This means that, unlike the larger end of the market, transactions tend to focus on a more simplified approach for day-to-day data management and reporting. It is also more typical to adopt an uncollateralised model as the costs of setting up and managing collateral accounts may outweigh the benefit of the protection this offers.

Getting the attention of reinsurers

The reinsurance market remains extremely busy with significant demand from both UK pension schemes as well as bulk annuity providers seeking

longevity reinsurance to support new business and for capital management of existing annuity business. All of this means that schemes engaging with the reinsurance market need to be focusing on actions that put them at the front of the queue. In particular, reinsurers are always keen to see that strong transaction governance processes have been established, that data and benefit preparation has been carried out and, crucially, that the scheme has a clear idea on how the transaction will be structured prior to engaging with the market.

Is now a good time to hedge longevity risk?

Early 2020 pricing was at a historical low point reflecting the change in trend towards lower future improvements in life expectancies in recent years. At the time of writing, and in light of the ongoing developments relating to Covid-19, pension schemes currently navigating through the longevity market will need to keep a very close eye on developments, to ensure pricing offers fair value and is reflective of the latest available information.

In summary, longevity risk is likely to be one of the most significant risks remaining for many pension schemes. The good news is that there is now a wide range of options for schemes of all sizes wishing to take steps to manage this.

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