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LONGEVITY AIN'T WHAT IT USED TO BE

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A number of innovative deals have transformed the potential of longevity swaps to help defined benefit pension schemes to manage longevity risk. Here, Stewart McLaughlin, Willis Management (Guernsey), explains the nature of the advance and what it might mean for this form of risk transfer.

In a matter of months, a couple of longevity swaps transformed the way defined benefit pension schemes can manage longevity risk.

Defined benefit pension schemes promise an annual payment to their pensioners for as long as their retirement lasts and (thankfully for humanity) it is lasting longer than previously expected. Past forecasts have consistently underestimated how long we will live so longevity risk for defined benefit pension schemes has been the elephant in the room.

A longevity swap transfers the risk of pension scheme members living longer than expected to another party. The payments of the pension scheme are thus fixed, based on an expected mortality assumption and the other party settles the actual payments to the pensioners.

In 2014, the BT Pension Scheme accessed the reinsurance market directly by establishing an incorporated cell company in Guernsey and hedged an astonishing £16 billion ($24 billion) with the Prudential Insurance Company of America. It remains the largest longevity transaction to date by a multiple of three.

Prior to this transaction, pension schemes were busy negotiating with a limited number of providers in the insurance market, each with their own capacity constraints. These insurers would then lay off the risk to their wholesalers, the reinsurers. Reinsurers have significant books of mortality risk and by taking on longevity risk they get diversification and reduced capital requirements. The problem then was that the pension scheme was not able to access the natural hedging party, the reinsurer, directly.

The solution was simplicity itself and did not require a leap of faith—certainly not for £16 billion of pension payments. Some 60 years ago Fred Reiss formed a captive in Ohio to circumvent an inflexible insurance market and access a reinsurer directly. All that was needed was to dust off this old technology and apply it to the new problem. Tried and tested technology was reinvented and refined for longevity.

Incorporated cells

Hot on the heels of the BT Pension Fund longevity swap was the establishment of Towers Watson Guernsey ICC Limited.

Guernsey provides world-leading insurance and risk management solutions and the Guernsey captive industry is renowned for its innovation. Protected cell structures were invented in Guernsey, and incorporated cell companies (ICC) are an evolution of the protected cell concept, itself an evolution of the rent-a-captive concept.

The cell concept is now well established in some 40-plus jurisdictions around the world. Each cell in an incorporated cell company is a separate legal entity. This is a more appealing structure than the protected cell company to a pension trustee looking for robust ring-fencing, given the size and nature of these transactions.

Towers Watson Guernsey ICC Limited is a 'longevity direct' solution, which provides a ready-made facility for pension schemes to access the reinsurance market directly. The Merchant Navy Officers Pension Fund was the first scheme to take advantage and hedged £1.5 billion ($2.3 billion) with Pacific Life Re. It is ready made, but not off the shelf, as each incorporated cell is a bespoke entity and the insurance and reinsurance contracts are tailored to each pension scheme and reinsurer. Longevity transfer is now possible for pension schemes with liabilities of around £500 million ($758 million), perhaps even less; an unexpectedly positive benefit of the captive solution.

Coincidentally, in 2014 Kelvin Re established itself as Guernsey's first rated commercial reinsurance company, paving the way for others to follow. Predicting the future is notoriously difficult but who would bet against a top

20 reinsurer establishing in Guernsey in the next few years? It is estimated that there is a staggering £2 trillion ($3 trillion) of defined benefit liabilities in the UK alone.

I am informed there are at least 10 reinsurers in the market with considerably more mortality risk than the longevity risk, so demand is high and pricing is stable, for now. If there is a steady increase in transactions it will inevitably lead to upward pricing.

At what point will the capital markets be required? At what point will the reinsurers face too much longevity risk concentration and need to adapt the way they facilitate their business? At what point will we see the first longevity ILS transaction?

Whether a longevity ILS remains uncorrelated with market risk, and the considerably longer maturity fits within the fund manager's universe, remains to be seen and I will leave it to the experts to work it out.

The non-life ILS market is a mainstream component of the reinsurance industry and has grown from zero to $65 billion in 20 years. A moderate longevity ILS transaction could double that in one transaction. That would be remarkable.

What is even more remarkable is that the components to enable a longevity ILS transaction are already in place, here in Guernsey.

The future is almost here.

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