Longevity Swaps

If bulk annuities look expensive and trustees would rather retain their assets, longevity swap contracts are an option that removes risk. A scheme pays a fixed premium in exchange for an insurer taking on the risk of members living longer than expected – if they die sooner, the insurer makes a profit.

CASE STUDY: BAE SYSTEMS

In February BAE Systems' pension scheme insured the longevity risk of its 31,000 pensioners – covering £3.2bn of liabilities – with Legal & General. In theory, if both the scheme and insurer have made perfect estimates of changing longevity no money will actually change hands.

Aon Hewitt's Martin Bird, partner and head of risk settlement, advised BAE on the deal. He said these types of contract were not only for large schemes, adding that there is plenty of supply in the market.

He says: "One of the attractions is that it's on an unfunded basis, there's no big upfront transfer of assets. For some schemes it is quite important they retain their assets – perhaps because holding growth assets is part of their long-term financing plan."

LDI strategy

Liability-driven investment strategies de-risk a portfolio by exiting volatile assets at the right time. This has meant buying into bonds and conventional and index-linked gilts to better match liabilities. Modern LDI strategies also incorporate more complicated derivatives contracts to allow schemes to be more nimble, useful with gilt prices at record highs. A successful LDI plan will better align assets and liabilities while improving funding levels, bringing an insurance solution within sight.

ETVs

Schemes can lower risk by offering members a higher pension in exchange for sacrificing additional benefits, such as annual increases pegged to inflation. Last summer the pensions industry produced a code of best practice on enhanced transfer values (ETVs) – including a ban on cash incentives. Buck's Colin Richardson notes a fall in the number of ETVs since the code was launched, but thinks the credit spread's impact has had an equal role in keeping numbers down.

But when's the best time to purchase annuities? Turn over to find out...

Exploring the annuities alternative

Now could be the time to swap assets for liability-matching annuities, says

Sammy Cooper-Smith

Over the past 18 months there has been much talk in the pensions de-risking market about 'gilts for annuities' transactions. Trustees often ask why they should exchange gilts for annuities rather than any other asset class.

To understand the rationale, remember the principles of fixed income investing. When you purchase a gilt, you are agreeing to receive a series of interest payments (coupons) and then at an agreed point in the future, a lump sum (the redemption amount). Even if some time after purchasing the gilt, someone else is prepared to buy it from you for more than you paid for it then, you will still only receive the same coupons and redemption.

Over the past two years the value of gilts has risen and consequently gilt yields have fallen: therefore a pension scheme that has owned gilts through that period has benefitted from value appreciation. However, the coupons and redemption amounts are unchanged. The only difference is that the scheme could sell the rights to those cash flows to the market for more than it originally paid for them.

We believe trustees should consider an annuity in the same way. That is, the value of an annuity is simply the value of the payments that will be made to their members – think of the pension payments as annuity coupons. So one way of comparing a gilt with an annuity is by thinking what proportion of your pension payroll can be met by gilts worth (say) £100m compared with annuities of the same value.

For much of 2012, a £100m annuity would have met more of a pension scheme's payroll than the cash flows emerging from a £100m portfolio of gilts. Although this is not currently the case, gilts still represent a strong 'currency' with which to purchase annuities because of the extra benefits that annuities bring. For example, if members live longer than expected, the annuity would pay a higher coupon, or if inflation were higher than expected then the annuity coupon would also increase.

Other fixed income instruments can be compared with gilts and annuities in the same way. If your gilts or corporate bonds have reached new valuation highs, you will be holding assets offering lower risk-adjusted yields. If you want to benefit from this rally you will need to sell and consider where to go next. It may be worth considering annuities. As well as being a well-matched FSA-regulated product linked to longevity and inflation, it could also offer an attractive risk-adjusted yield compared with the assets you are selling. ■

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