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LONGEVITY HEDGING ROUNDTABLE
ENCOURAGING INNOVATION IN THE LONGEVITY MARKET

IN DECEMBER 2019, INSIGHT WELCOMED A CROSS-SECTION OF KEY STAKEHOLDERS FROM ACROSS THE LONGEVITY MARKET INCLUDING REINSURERS, CAPITAL PROVIDERS, LAWYERS, ACADEMICS AND ADVISERS TO DISCUSS THE CHALLENGES FACING THE LONGEVITY HEDGING MARKET AND CONSIDER HOW WE MIGHT HELP TO DRIVE INNOVATION FOR OUR CLIENTS, AND THE WIDER INDUSTRY. IN THIS PAPER, WE SUMMARISE THE KEY DISCUSSION POINTS FROM THE ROUNDTABLE AND OVERLEAF WE SET OUT SOME OF THE SUGGESTED ACTIONS.

INTRODUCTION[1]

As pension schemes shift their focus from accumulation to decumulation, UK defined benefit schemes have continued to evolve their investment strategies. The majority of schemes have broadly de-risked regarding interest rate and inflation, and are now exploring further de-risking: longevity risk is the next material risk factor in line.

However, despite increasing demand, barriers exist that stem the flow of standalone longevity transactions. We explore some of these obstacles and ways in which the industry could make it easier for a scheme to transact.

Three options are typically put forward for a pension scheme looking to achieve longevity de-risking: buy-out, buy-in or longevity hedge. While many have undertaken a buy-in, the majority have not. Schemes that prefer to keep their assets on their own balance sheet will likely see longevity hedging as an increasingly important consideration. The longevity swap market is at its highest level for five years – some experts are predicting the market to hit £25bn in 2020. However, this could be the result of as little as five transactions[2], underlining that the current market is concentrated among only the largest pension schemes, and suggesting that the market is likely to continue to be dominated by small numbers of very large trades. This is something Insight would like to work to change; on behalf of our clients, we are keen to promote innovation and standardisation in the longevity market to facilitate more transactions.

Implementing a longevity hedge offers pension schemes the opportunity to hedge themselves against the impact of longevity expectations increasing quicker than forecast. However, the current market for indemnity-based longevity hedging transactions doesn't appear to fully address these needs.

[1]Views listed may not represent Insight's view. Information stated as at December 2019, unless otherwise indicated.

[2]https://www.professionalpensions.com/news/4009351/longevity-swap-market-post-record

KEY CHALLENGES

1. There seems to be a considerable disconnect between perceptions of supply and of end-user demand, leading to an imbalance within the market. The roundtable highlighted that there is considerable demand from pension schemes, in addition to substantial supply from reinsurers and alternative capacity providers; however, the number of transactions carried out remains relatively small.
2. Given the cost and complexity of implementing an indemnity-based longevity hedge, there is a potential market for simpler structures targeting the same outcome with less precision, but at a lower pricing point. By reducing cost, the longevity market could be more easily accessed by smaller schemes, increasing transaction volumes.
3. Lack of expertise from pension schemes – and long timescales – can make entering into longevity transactions appear overly difficult. However, with the recent increase in the number of professional trustees, pension trustee boards are now better able to handle complex transactions.
4. Lack of liquidity is perceived to be holding back the longevity market; pension funds are looking for structures that offer the ability to unwind longevity protection at a non-punitive cost as their circumstances change.
5. Overly complex, bespoke legal documentation is time-consuming and difficult to develop and interpret. Simplification and/or standardisation of transaction documentation could significantly benefit the market.
6. Deferred longevity risk is more challenging – and therefore relatively more expensive – for reinsurers to cover, given greater uncertainty over the longevity of younger pension scheme members; the extent of capital required to support the risk; and the associated administrative burden.
7. There is scope for innovation involving some longevity risk being passed to the capital markets in order to deepen the pool of capital supporting the market, but activity in this area is currently very limited.

SUGGESTED ACTIONS FROM THE ROUNDTABLE

The following table is an initial summary of the key suggested actions arising from the roundtable. By its very nature, it is not exhaustive, but is instead intended to be a starting point for future debate and discussion.

Market demand	• Despite the apparent disconnect between supply and demand in the market, there is serious interest among pension funds to engage on longevity. We believe that there is material demand in the market and that pension schemes are willing to pay for the protection, subject to reasonable secondary liquidity, particularly in respect to the potential to novate to a buy-in or buy-out.
	• Irrespective of whether longevity hedging takes off, pension scheme longevity risk will likely end up on reinsurer balance sheets when schemes reach their ultimate endgame and move to buy-out. Reinsurers have an opportunity to help pension schemes on their de-risking journey by taking on a scheme's longevity risk before it reaches its ultimate endgame. The industry should create an environment where stakeholders come together to make this happen.
Creating standardised processes and documents	• Making the implementation process easier would benefit the market. Employing a set of standard agreements and documents should bring transaction costs down. The buy-in market has already become relatively commoditised, indicating that this objective is achievable.
	• Adoption of fixed fee structures would incentivise consultants and lawyers to complete transactions more efficiently.
	• Standardised documentation better supports novation of longevity swaps to buy-in/outs, facilitating the journey to an endgame.
Data availability	• More transparency regarding existing transactions – and associated public availability of data – would allow more meaningful academic research, leading to a better understanding of the risk and ultimately encouraging more risk takers into the market.
More creativity	• Increased courage/boldness from key stakeholders in innovating the market: Starting with a few, simple such transactions could provide confidence to the market, which will ultimately result in a greater influx of capital and increased liquidity.
	• A change in the mind-set of trustees and consultants. There must be a willingness to consider a range of solutions; not simply focusing on solutions that others have already used.
	• If schemes are willing to think about longevity risk differently, and are able to better express what they are looking to achieve, there may be multiple ways to mitigate the risk
Involving regulators	• Engaging with regulators early will mean that when new approaches / structures launch within the market, there is sufficient understanding and support to ensure that they are relatively friction free.

NEXT STEPS

We are following up with roundtable participants in order to build on the views from the initial roundtable and will look to provide for further feedback in due course. Our objective is to support the market in developing solutions that help our pension scheme clients manage their longevity risk; we anticipate hosting further events with the objective of spurring innovation in the longevity market and would welcome engagement with other interested parties. If you are keen to see the longevity swap market develop, please get in touch with us so that we can exchange ideas and discuss the possibility of specific initiatives (see contact details below).

FURTHER READING

How to hedge longevity risk: Pension schemes are increasingly seeking to hedge longevity risk, which requires access to the reinsurance market – uncharted territory for most schemes.

FIND OUT MORE

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IMPORTANT INFORMATION

RISK DISCLOSURES

Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.