



LA DOLCE VITA



La Dolce Vita (Italian for “The Sweet Life”) depicted a classic love story in 1950s Rome. In our age of remakes and recycling perhaps we should have it re-shot and renamed “The Bitter-Sweet Life”?

WHY SO?

Well, the far fewer premature deaths over the 50 or so years since La Dolce Vita was first shot is a fantastic success story, leading to longer average lifespans. But this success is giving pension fund trustees an increasingly bitter taste, as they are left to manage the consequences.

Douglas Anderson, the founder of Club Vita, and Lindsay Davies, a partner at Hymans Robertson working in the firm’s governance and risk management practice, consider the special

characteristics of longevity ‘risk’ for trustees of defined benefit pension schemes. They go on to propose some things that trustees can do to control the risk in a practical and affordable way, making their governance processes sweeter.

THE CHARACTERISTICS OF LONGEVITY RISK

Longevity, it has to be said, is not as dramatic or as in your face a risk as the crash, bang, wallop of stock markets during their periodic free-falls. But, it is still a serious threat to financial stability.

Recent surveys¹ have shown that trustees perceive longevity as their second biggest risk, with only investment risk viewed as more important.

Before you can design risk management solutions, you need to appreciate the nature of longevity risk itself.

THE SILENT ASSASSIN

Longevity seems to have crept up on us from nowhere and stalks us: a silent threat to our financial well-being. You would struggle to see it coming from any trends emerging in even the largest pension schemes and if you thought you had caught a glimpse of it you would need to wait several years to be sure.

Coupled to this, the “risk” remains very distant - manifesting itself in the length of the “tail” of pension payments should death rates continue falling. It is risk that gradually accumulates and that operates in the background, disguised in a cloak of random statistical variation. By the time that you are sure that pensioners are really living longer, it could be too late to do anything about it.

¹ “Living with longevity” – Aberdeen Asset Managers, November 2008

In many respects, understanding longevity is most similar to the challenge posed by global warming. Indeed, longevity (or an ageing population) and global warming are arguably the two biggest threats to global stability.

VISIBLY REDUCE THE SIGNS OF AGEING

In the world of lotion and potion adverts, the 'science bit' claims to visibly reduce the signs of ageing. And so it is with conventional actuarial techniques which shrink the appearance of ageing on the pension fund's balance sheet.

What do actuaries and cosmetic surgeons have in common? They both have the ability to make your figures look better!

The convention of discounting (or reducing) liabilities for future asset returns means that the value placed on the tail of extra pension payments appears small but as pension schemes mature – the payments come closer to falling due – so this shrinking process goes into reverse and the financial strain which the elongated "tail" presents becomes larger.

Hence the need to focus on longevity risk, to better understand it and its consequences if left unchecked and to understand what can be done to better position trustees and other stakeholders.

To illustrate the problem, consider the example of the shrinking granny (see box).

This approach is particularly concerning at a time when so many schemes are under-funded as very few have the assets to cover what may be called the longevity improvement reserve. Put another way, those schemes have no capacity to generate the asset returns being anticipated in the reserve for longevity improvement. As schemes mature, any shortcomings of this traditional approach will be revealed over time.

Longevity is also dynamic risk. As pension schemes mature it presents a bigger and bigger issue. Moreover, and importantly, that dynamism means that trustees can see swings of fortune in both directions. Therefore, whilst past experience and current concerns may mean that we tend to worry about the risk of not having saved enough, trustees must be aware of the risk of setting aside too much.

A VERY DIFFERENT SORT OF RISK

Longevity is quite different to other risks that trustees face.

- The problem appears distant – affecting the length of the tail of pension payments.
- This is further compounded by the actuary's typical presentation of the issue in conventional actuarial valuations, as a 'discounted' value.
- In the worlds of medicine and demographics, there is no consensus on future rates of longevity improvement, so any assumption about future improvement is heroic. Past predictions have tended to be quickly exceeded. The actuarial profession has deliberately distanced itself from supporting any particular model for future improvement.
- Unlike investing in riskier growth assets, longevity offers no expected upside from the risk the fund faces. In the jargon of risk management, it is typically regarded as 'unrewarded'.
- But, that label suggests some silo thinking, as unlike most of the other drivers behind poor funding, scheme members are benefiting from it. That is, they are enjoying the reward personally.

We fear that solely presenting longevity risk as a discounted distant capital value leads to a false sense of security in the minds of some trustees: not only does the actuarial botox shrink the problem, but it also leads to more faith in the model for future improvements than is really merited.

HONEY, I SHRUNK THE GRANNIES

Consider a baby girl born in 1943, a war baby. This year, she will be celebrating her 65th birthday, with her children and grandchildren. She has a full active life, balancing work and her family life. Although she would like to stay in her job, perhaps moving to part-time working, she appreciates that despite the new age discrimination laws her employer can still ask her to retire at 65.

Club Vita calculates that based on the average mortality rates observed in 2007, the average life expectancy for a 65 year woman was 85.5 years (it was 82.7 years for men). So our granny could expect to look forward to around 20 years of pension (almost 18 years for men), even if there is no further improvement.

This represents a considerable increase on the past. Indeed, about 2 years have been added to lifespan over the last decade alone: or 12 minutes every hour.

Not only does the increase in longevity revealed by past experience add to the tail of pensions to be paid (and funded) but, as trustees have become increasingly aware of late, actuaries add on an allowance for future improvement. "Long cohort" is a common adjustment being considered these days and it adds, on average, around 4 years to life expectancy. This means that around 4 years of extra pension instalments will be added to the tail of pension payments beyond those that would be paid if today's death rates applied. Given the example of our proud 65 year old grandmother, for whom pension is expected to be paid for around 20 years, this additional allowance alone causes an increase in cash payments of around 20%.

The actuarial convention of discounting, which we mentioned above, means that actuaries talk with trustees about the scheme's liabilities in terms of current values – or how much money you would need to invest today at an assumed rate of interest, to meet the extra payments. The time before the extra payments that arise from improved life expectancy fall due means that the longevity 'risk' looks smaller than the 20% above - typically we might see an addition of perhaps 15% of the value of the liabilities to allow for anticipated future improvements.

MANAGING LONGEVITY RISK

So what support can be offered to trustees and stakeholders to manage longevity risk?

Until recently, the options for managing longevity risk in defined benefit pension schemes have been very limited and rather unappealing. Either traditional actuarial reserving – a kind of self insurance. Or, buying annuities: but this is out of the reach of the funding of most schemes and also seen as losing the potential upside if things go well.

But, the brave new world of longevity swaps or hedges has now opened up. Although attractive in theory, trustees will find it hard to enter into a longevity swap, without a good understanding of the subject.

This is one area where improved scheme governance can help. Schemes can develop a governance overlay to monitor longevity risk and actively manage it. It complements traditional actuarial reserving, and may be a prelude to later entering into a longevity hedge or annuity purchase.

PUT DEMOGRAPHICS AT THE HEART OF RISK MANAGEMENT

Trustees are generally familiar (if not comfortable) in dealing with the usual risks that they face. A decade ago, Kaplan introduced the four quadrant balanced scorecard, as a risk management tool. Many trustees adopt variations on this theme. It is common to develop a series of key performance indicators, or risk metrics. The idea is that the measures help the management to spot risks at an early stage, and nip them in the bud before they develop too far. But, most trustees have focussed on economic threats, operational risks, and latterly sponsor strength. There has tended not to be much focus on demographic risk, often leaving this to a three yearly review by the actuary as part of the valuation.

The chart illustrates a possible four-way split of risks for a defined benefit scheme.

<p>Economic threats</p> <ul style="list-style-type: none"> • Stock markets underperforming the anticipated asset return. • Lower expectations of future asset returns. • Inflation turning out to be higher than anticipated. • Investment manager underperformance. 	<p>Sponsor strength</p> <ul style="list-style-type: none"> • Performance of business. • Size of buy-out shortfall. • Ranking relative to other creditors. • Corporate activity that may affect pension shortfall.
<p>Operational risks</p> <ul style="list-style-type: none"> • Paying the right amount of pension to the right person at the right time. • Fraud prevention. • Value for money from advisers. 	<p>Demographic risks</p> <ul style="list-style-type: none"> • Frequency of ill-health retirements. • Sudden rush of members transferring out. • Fewer pensions ceasing than anticipated.

Hitherto, there has been little scheme-specific activity in the demographic quadrant, particularly relating to longevity risk.

ACTIVELY MONITOR DEMOGRAPHIC TRENDS

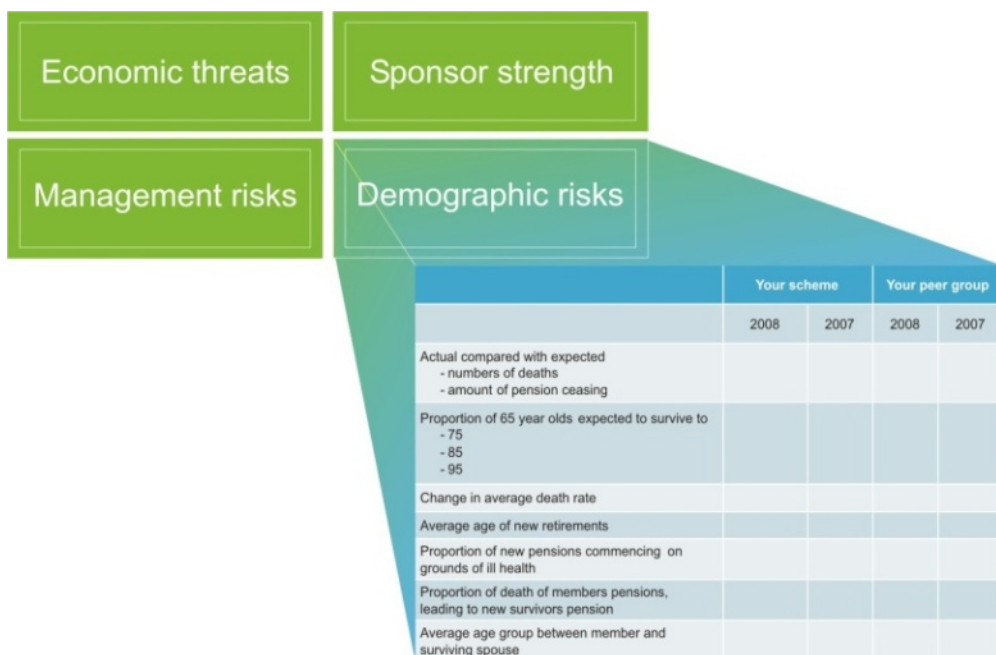
The first thing to do is to actively monitor what is actually going on in the demographic profile of your scheme and in the world around you. A data gathering exercise will consider issues such as:

- How are the death rates changing over time?
- How do they differ for different types of members (particularly when split by pay level and lifestyle indicators)?
- How many pensioners are survived by a dependant?

The problem with this is that an individual scheme’s data is so clouded in random variations from year to year, it is impossible to see the underlying trends. But, by pooling data between pension schemes it is possible to see trends and also to analyse the data in flexible ways, such as tracking people with the same earnings levels or similar lifestyles.

The monitoring information can provide a firm, objective foundation for adjustments to employers’ funding plans. It can determine the amounts of money to be paid into the scheme by the employer. It can also influence views on the level of future longevity improvement that the trustees and sponsor would be willing to enter into a longevity hedge.

We recommend that if you do nothing else, put a longevity update on the trustee’s agenda at least once a year.



DOS AND DON'TS OF MANAGING LONGEVITY UNCERTAINTY

Do	Don't
<ol style="list-style-type: none"> 1. Talk about longevity, not mortality. 2. Understand the particular characteristics of longevity risk. 3. Think about a 'Plan B', an alternative to higher contributions if pensioners' lifespans continue to exceed expectations. 4. Look for early signs of longevity problems ahead, giving more time to adjust. 5. Put longevity on your trustee's business plan, to consider the latest evidence at least once a year. 6. Work with your company's human resource team, particularly on influencing retirement behaviours. 7. Review your scheme's design and its actuarial factors for any opportunities to reduce exposure to longevity factors. 8. Consider the many new product innovations, for example longevity hedges instruments 9. Inform scheme members of how much longer they are living than when the scheme was first designed. 	<ol style="list-style-type: none"> 1. Simply rely on your actuary's reserve for the distant tail of longevity improvement in the valuation of liabilities. 2. Put your head in the sand, thinking that nothing is going on, or that there is little uncertainty. 3. Try to resolve it entirely within your own pension scheme, without looking for help from other parties (scheme members, the sponsoring employer, other schemes)

PRACTICAL EXAMPLES OF ADDRESSING LONGEVITY RISK

There is a long list of things that you can do on funding plans, actuarial factors and influencing retirement behaviours. Here are a few suggestions.

1. LINK PENSIONS EARNED IN FUTURE TO EMERGING LONGEVITY EVIDENCE

Pension amounts can be reduced (or retirement deferred) if further evidence of longevity improvements emerges. The opposite can apply too, with increases if the trend reverses.

To gain acceptance, this needs an objective measurement basis. The monitoring concept mentioned above can inform adjustments to the amounts of pensions awarded to new retirees allowing for the rate of longevity improvement. Legally, these adjustments can only apply to future service unless you gain member consent so you need to draw a line in the sand today, if you want to be able to call on this later. This might be considered to be a Plan B or an insurance policy. You need to set it up today to call on it later. The sooner you get started the better.

2. MAKE CONTINGENT ASSETS PART OF THE LONGEVITY SOLUTION

Mindful of the lessons learned from "over promising" in past times of surplus, there are strong arguments for not tying up excessive amounts of cash for potential future longevity improvement in the pension scheme. Reasons for this flow from the uncertainty associated with future longevity improvement - it will be many years before we know the answer - and the difficulties associated with returning money to the employer.

Where does that leave stakeholders if the monitoring suggests that action needs to be taken? In this situation contingent asset arrangements, increasingly being raised in funding and covenant discussions are ideally suited to handling this risk. Parking money for longevity improvement in an escrow account set up with prescribed rights of access to funds by both parties may appeal. Alternatively, taking a charge over any employer property assets may provide suitable cover for the longevity improvement reserve, though practicalities like marketability would need to be addressed in any event.

3. FOCUS ON RETIREMENT BEHAVIOURS

Once scheme members start to draw pensions, the options for actively managing longevity risk become narrower. Given the bulge of baby boomers on the cusp of retirement, attention should arguably focus as much on them as on the survival rates of pensioners.

The demographic monitoring ought to extend to all the demographic drivers of the health of the pension scheme, particularly retirement behaviours. How many early or late retirements are taking place? How many ill-health retirements are occurring? How much pension is being commuted for lump sum on retirement? How many pensioners are taking transfer values out of the scheme before they retire? These statistics – and their impact, (which will vary from scheme to scheme) – should be known by each schemes' trustees. They all affect the amount of longevity risk that schemes face.

There are many possible steps that can be taken when the above issues are understood. The steps that are beneficial and appropriate will vary from scheme to scheme. But the common factor is the need to understand the dynamics of the individual scheme. For example:

- Encouraging late retirements
- Offer part-time working and flexible retirement to older workers
- Review policy on transfers out before retirement
- Review conversion terms for pension to a fixed tax-free lump sum – and the amount that may be converted
- Consider options for pension guarantees or additional dependants' pensions

4. WHEN TO CONSIDER DIVESTING LONGEVITY RISK?

There are increasingly ways for schemes to offload their accrued longevity risk. For example, buy in or buy out, hedges, or swaps. For many schemes these may seem unaffordable luxuries in the present climate.

But where does longevity risk fit in the scheme's overall strategic plan? Trustees should have a broad strategy in place for long term management of longevity risk. Are options for offloading risk something to be considered now? Or at some point in the future... ..and if so what are the triggers for future investigation?

5. AND FINALLY... ..MIND YOUR LANGUAGE

The language in this article has deliberately concentrated on life not death: we talk about survival rates, not death rates; longevity not mortality. This is not just because we are glass-half-full people. Nor, is it just politically-correct semantics.

The positive language is intended as a constant reminder of the 'nice' problem that we have to address. Living longer differs from many of the other problems currently affecting pension funding in that scheme members are personally enjoying the phenomenon, through greater levels of fitness and healthiness than previous generations. The change of language also reflects a growing belief that individual people will increasingly need to play a role in developing a durable solution. For now, the attention should be focussing on the bulge in the population pyramid that is the about-to-retire baby boomer generation.

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For further information, or to discuss any matter raised by the Briefing Note, please speak to your usual contact at Club Vita LLP.

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