Pensions: **Corporate Agenda**

SUMMER | 2019

Longevity swaps

Under a longevity swap a pension scheme transfers the risk of its members living longer to an insurer. It will not always cover other risks such as inflation being higher than expected.

In a nutshell

If a scheme is considering a buy-in, it will often consider a longevity swap. Whilst it is called a longevity swap, this is still usually an insurance policy.

The scheme will enter into an insurance policy with an insurer. The policy will be an asset of the scheme. This is similar to a buy-in, but the only risk the insurance policy covers is longevity.

Should you do a longevity swap instead of a buy-in?

Whether or not a particular scheme should go for a buy-in or longevity transaction depends on the circumstances. It depends partly on the long-term objective of the scheme, what investment returns it is targeting, whether there is an intention to buy out at some point and the timetable for achieving this.

There are different structural options for a longevity swap

There are currently two main types of structure being used in practice:

- a fully intermediated structure; and
- a pass-through structure.

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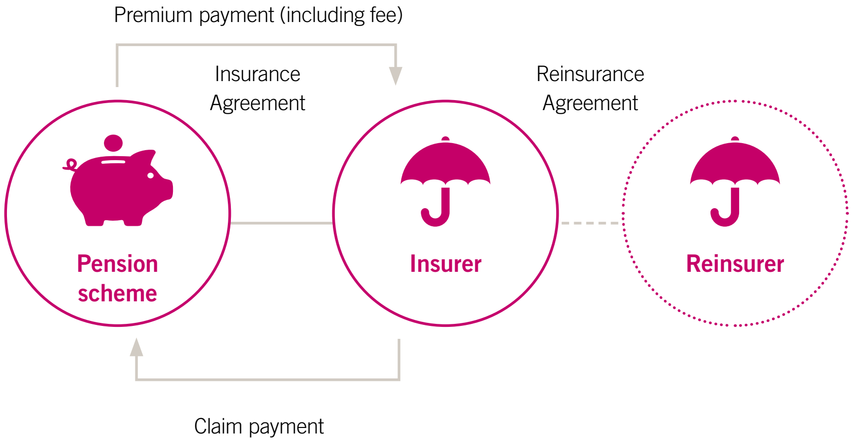
The fully intermediated structure is the “traditional” structure where the scheme enters into an agreement with the insurer and has no visibility over the insurer’s own hedging arrangements. Under this structure:

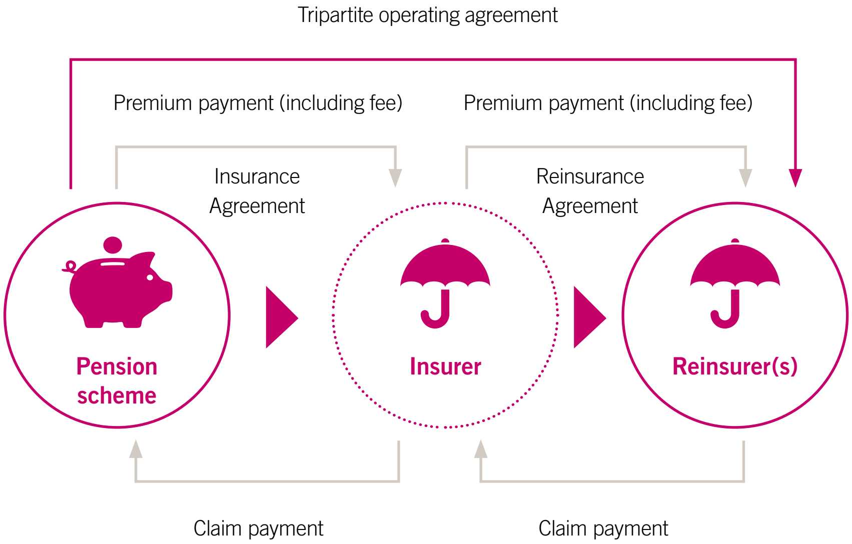
- the scheme contracts only with a UK insurer;
- the scheme takes no credit risk on the reinsurers;
- the reinsurance arrangement can terminate/default with no impact on the scheme contract; and
- the reinsurer has very limited rights directly impacting the scheme (for example, audit rights).



A pass-through structure or “dis-intermediated” structure is where the insurer acts as a “pass-through” or go-between as far as possible, and the scheme negotiates (and to a certain extent contracts) with the reinsurers as well. Reinsurers do not have the relevant permissions to insure the scheme directly, but this is a way of cutting out the “middle man” as far as possible. The market has developed different options for schemes to do this, including whether to establish their own “middle man”. This would allow the scheme to directly access reinsurers by establishing its own insurer, which can be onshore, offshore or using a cell company structure.

Under this structure:

> the insurer does not take credit risk on the scheme or reinsurer (it will be acting in a limited role);
> the scheme and reinsurer will take credit risk on each other; and
> care needs to be taken to meet regulatory requirements and ensure the reinsurer is not providing “insurance” to the scheme.



Which structure is best for you?

If a scheme is using a longevity swap, it will need to consider which structure suits it best. Issues to think about include:

> regulatory issues – these can be complex for pass-through structures;
> contractual issues – how complex the contractual documentation will be;
> the financial strength of the counterparty; and
> fees – the level of fees payable under each arrangement.

Getting ready for a longevity swap

The process for and considerations when entering into a longevity swap are similar to those for a buy-in or buy-out. The main difference is considering how to deal with the swap if the scheme ever wants to move to a buy-in or a buy-out. The scheme will want to make sure it can retain the flexibility it needs here.

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