Assessing the options

Legal & General explains the different choices available to larger pension schemes looking to insure longevity risk

This past year or so has seen interest in longevity risk management pick up pace, due to a number of ground-breaking arrangements. These have caught the eye of the industry due to their size, such as last year's £3.2 billion arrangement between Legal & General and the BAE Systems 2000 Pension Plan, the largest of its kind at the time.

As well as their size, some more recent arrangements have also used alternative structures. For example, the Aviva pension scheme completed a £5 billion longevity arrangement in March through using a sponsor-owned insurance company to access the reinsurance market.

While Aviva was already very familiar with running insurance companies, the BT Pension Scheme took the step of setting up its own and passed £16 billion worth of longevity risk through this to the reinsurance market in July.

These three landmark arrangements represent the three options large pension schemes have when looking to insure – or reinsure – longevity risk.

Intermediated solution

The BAE transaction is an example of the most common form of longevity hedging, the 'intermediated solution'.

This is when the pension scheme enters into a contract with an insurer, and the insurer in turn enters into contracts with one or more reinsurers, depending on the transaction size, pricing and reinsurer capacity.

Under this approach the pension scheme benefits from having an arrangement with a UK-based insurance company, which is subject to UK rules and therefore comes with protection from the Financial Services Compensation Scheme. The insurer takes on the credit risk of the reinsurer and accepts the administration costs and the risk of these increasing in future.

The main benefit of this type of transaction for the pension scheme is that it is so straightforward, just one contract with the insurer, regardless of how many reinsurers there might be, and the insurer takes care of the rest. The scheme also benefits from the expertise of the insurer, having put together these types of deals many times before, meaning that the contract will facilitate future de-risking through a buy-in or buyout.

Pass-through solution

The second option could be dubbed the 'pass-through' solution. This is where the pension scheme accepts terms directly with reinsurers, but there is a vehicle provided by an insurer to help facilitate this. However, none of the longevity risk sits with the insurer - it is all accepted by reinsurers.

This approach allows the scheme to benefit from some cost savings, although the scheme will typically take on the reinsurer credit risk and enter into negotiations with reinsurers itself, although insurers such as Legal & General can support with these. Finally, if there is more than one reinsurer the scheme must have multiple agreements and so the differences with the intermediated approach must be weighed up against any cost savings.

DIY solution

Finally, there is the 'DIY' option, as demonstrated with the BT deal earlier this year. This is similar to the 'pass-through' approach, with the scheme dealing with reinsurers directly. However in contrast to the 'pass-through' option, the 'DIY' choice requires the scheme to effectively set up and manage its own insurance vehicle and retain the risks associated with expenses or regulatory change. This approach may therefore only appeal to a small number of schemes.

Legal & General has the capabilities to provide an intermediated or pass-through solution. The former is tried and tested with Legal & General having implemented four arrangements covering almost £6 billion of liabilities in this way. Its pass-through solution would be based in Bermuda using a type of structure which has been commonly used in the insurance market for many years. This means that trustees can be confident of the robustness of the structure, whichever option they choose, and can implement the structure most suitable for their scheme.

Royal Voluntary Service

Legal & General's bulk annuities and longevity insurance team has spent the past 18 months supporting and fund raising for the Royal Voluntary Service (RVS). The RVS is a charity that supports old people across the community, providing things such as transport for hospital appointments and offering companionship.

Legal & General has not only provided facilities for RVS to train volunteers, it has also taken a more active role within the charity through helping out in a hospital shop.

Recently, 14 members of Legal & General's team completed a sponsored bike ride between London and Brighton to raise money for the charity.

To support Legal & General's fundraising efforts for the RVS, please visit https://www.justgiving.com/LGBPA

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