Insight partner

HOW MUCH LONGEVITY DOES YOUR LONGEVITY SWAP HAVE?

# What to consider before entering a swap, and how it can fit into your journey plan

**So, you're thinking of doing a longevity swap. Your advisers are probably excited to get underway, and as a trustee board you might be a little nervous about becoming involved in such a large transaction. You may be thinking about how this fits into a longer-term strategy in your scheme's journey plan – and if not, you should be.**

One of the issues you ought to be considering (and indeed may discuss with the scheme's sponsor prior to going to market) is whether your scheme needs a right to convert your longevity hedge into a bulk annuity in the future. Once upon a time, this might not have been on your radar, or in the contemplation of your counterparty, and some in the market had suggested in the past that novation of a swap just couldn't work. But recently we've seen a couple of developments in this space, particularly transactions in which BA and Rolls-Royce have converted their longevity swaps into bulk annuities.

So, are longevity transactions just another stepping stone on the way to full buy-out?

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**Stepping stone, or the bridge to self-sufficiency?**

Your longevity swap may just be another milestone on the journey towards full buy-out. It is perfectly reasonable for some schemes to look to the market to hedge longevity risk now whilst accumulating further investment growth in order to buy out the scheme at a later date. If this is the case, then you should think about whether your future bulk annuity opportunities would cover the entirety of the population under the longevity hedge, or whether you will need to tranche that population to seek smaller bulk annuity transactions (and split up the longevity swap in the process). This will impact your approach to setting the framework for this to happen with your counterparty. It may instead be that you and your sponsor think that the scheme has an opportunity to walk like an insurer, talk like an insurer, but remain a pension scheme meeting members' benefit payments well into the future. If this is the case, a longevity hedge is likely a long-term solution for your scheme (albeit that buy-in transactions may be regarded as a good investment opportunity down the line). A more flexible approach to setting the future conditions for conversion to a buy-in could be taken here with your counterparty.

**Why conversion might become the norm**

It seems reasonable to assume that we will see more conversions to annuity going forward, and we should therefore see more insurers and reinsurers in the market looking to accommodate such conversions. The longevity swap market had its ten-year anniversary this year, and solutions for smaller schemes are starting to sprout. Solvency II rules, noting that they have now been in force for three years, also have an impact on the way insurers and reinsurers deal with their longevity risk and this potentially opens up more opportunities for schemes to convert their longevity transactions to bulk annuities.

All of this means that, going forward, schemes should think clearly about their goals; in turn this will have an impact on how they approach the market and the contractual terms to get there.

**A note on structure**

It's worth noting that there are several possibilities for transacting a longevity swap: schemes can use the existing infrastructure available through a commercial insurer, or they can use a captive insurance structure, choosing either a commercial provider or putting together a completely bespoke structure (perhaps leveraging off their sponsor's existing business). Generally speaking, using a bespoke route yields more flexibility on the contractual terms as the trustees can negotiate directly with the reinsurer.

**Hard-boiled or soft poached?**

There are two main contractual areas to consider once you've decided whether conversion to a bulk annuity is the scheme's ultimate goal: restructuring and early termination provisions. Which is more important will depend on whether or not your scheme is consciously looking for a buy-out opportunity later on.

If buy-out is your goal, then consider how you will convert tranches of your longevity swap. Partial restructuring should be discussed with the reinsurer and you may wish to nail down some process around how the reinsurer will react to the scheme's proposal to convert part of the swap to a buy-out. It would be worth planning your exit strategy now. What kind of early termination provisions do you have in place to give some certainty that you can buy out parts of the longevity swap population without disturbing the remainder? Linking these partial termination provisions with the restructuring clause can provide the trustees with greater flexibility: if your reinsurer says no to your proposal to partially novate the swap to a bulk annuity provider, having that link would allow you to use the nuclear option and terminate that portion of the swap.

If, alternatively, you're looking to hold your longevity swap for the long-term, a more flexible approach may be more appropriate for you. An agreement to cooperate and engage with a proposal to restructure in good faith will go some way to pinning down an organisation for the future should the people involved in today's negotiation move on. Setting out a number of conditions for converting the swap could also add certainty and help you understand your counterparty's process for dealing with future proposals to convert the transaction.

Some reinsurers will be more flexible than others in terms of what contractual commitments they will make for future generations of the business. Trustees should remember that negotiating their rights around restructuring and early termination is both about getting clarity in the contract on how your counterparty will deal with particular circumstances, and putting your intentions and aspirations on the table with that organisation to ensure they're aware of and willing to support them.

> **There's lots to think about here, and strategising beforehand and looking for some engagement on the issue in your request for a quotation can be useful.**

Trustees and scheme sponsors should discuss with their advisers what it is they're after: how the swap fits into the journey plan for the scheme, and what the key concerns and requirements are for stakeholders in completing that journey.