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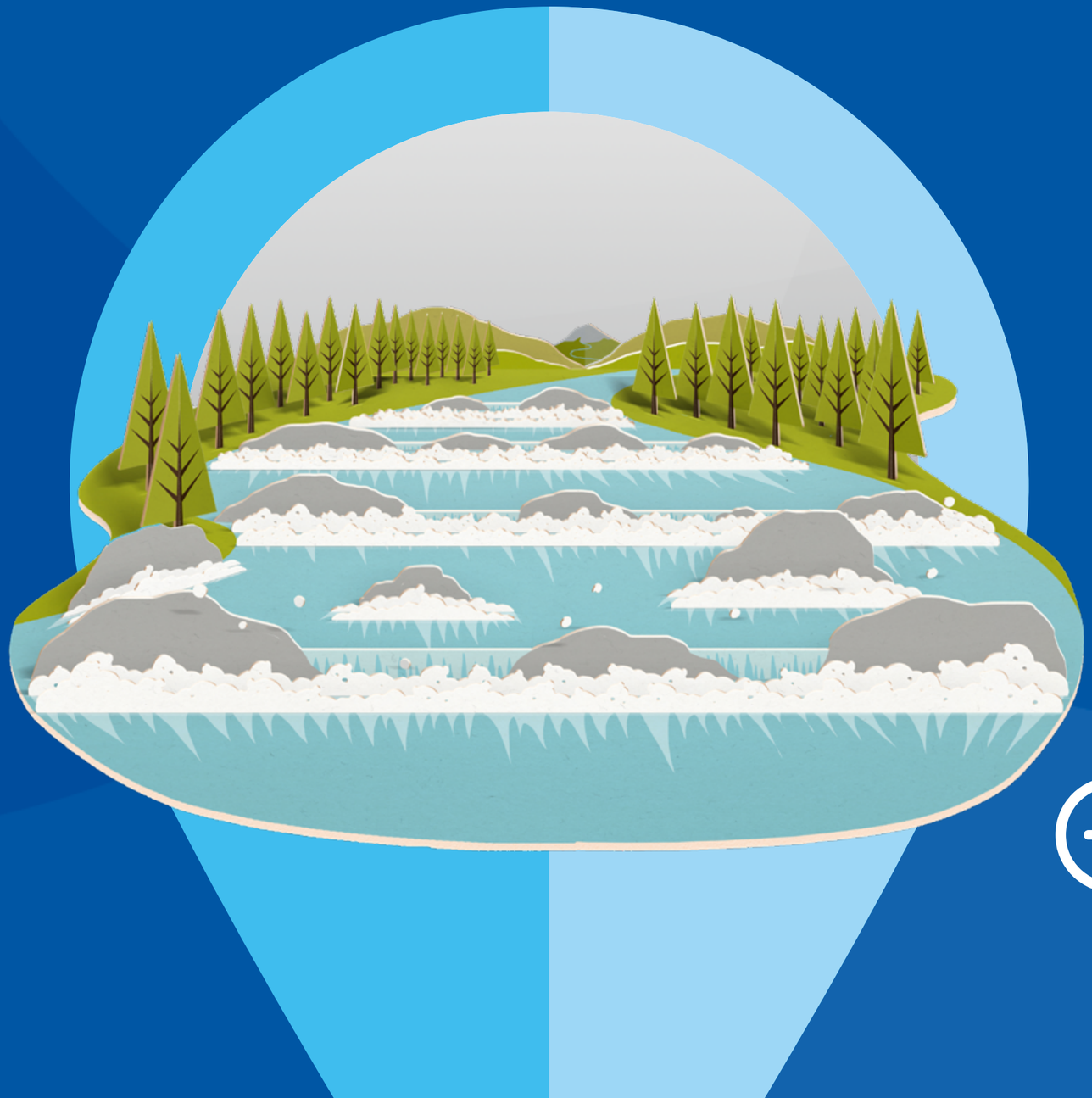
FTSE350 pensions

# Covid-19 impact on life expectancy



The total size of the FTSE350 companies' defined benefit (DB) pension schemes is vast, with over £800bn of assets put aside to meet future promised pension payments. The challenge of running these pension schemes and maintaining their solvency, alongside the shift to providing less costly defined contribution (DC) pension arrangements, has accelerated the trend of companies choosing to transfer this risk to the insurance market through buy-ins, buyouts and longevity swaps.

However, despite record volumes of pension de-risking activity in the last few years – with more than £100bn of UK DB pension scheme liabilities being transferred over 2019 and 2020 – there remains a substantial amount of DB pension scheme risk on FTSE350 company balance sheets.

For companies considering the potential cost and timing of approaching the insurance market, the pandemic has created additional complexity – not just in terms of the impact on asset values and financial markets – but in considering the life expectancy of pension scheme members and the resulting impact on valuing the pension scheme liabilities.

In this analysis of the DB schemes of the FTSE350 companies, we look at how the potential impact of Covid-19 on life expectancy may influence the DB schemes' journey to their endgame.

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# Possible impacts of Covid-19 on life expectancy

Whilst significant movements in financial markets became the primary concern for many pension schemes, the markets have broadly returned to their pre-pandemic positions. The most serious issue that schemes will now need to consider is the impact on mortality rates (the likelihood of pension scheme members surviving over a one-year period) as these are likely to be affected in the short to medium term as a result of the pandemic. This in turn affects members' assumed life expectancies and, accordingly, the value placed on the pension scheme liabilities.

The outlook for future longevity remains difficult to predict. This is due to uncertainty around how a number of key factors influenced by the pandemic are likely to play out over the next five to ten years:

Key factors

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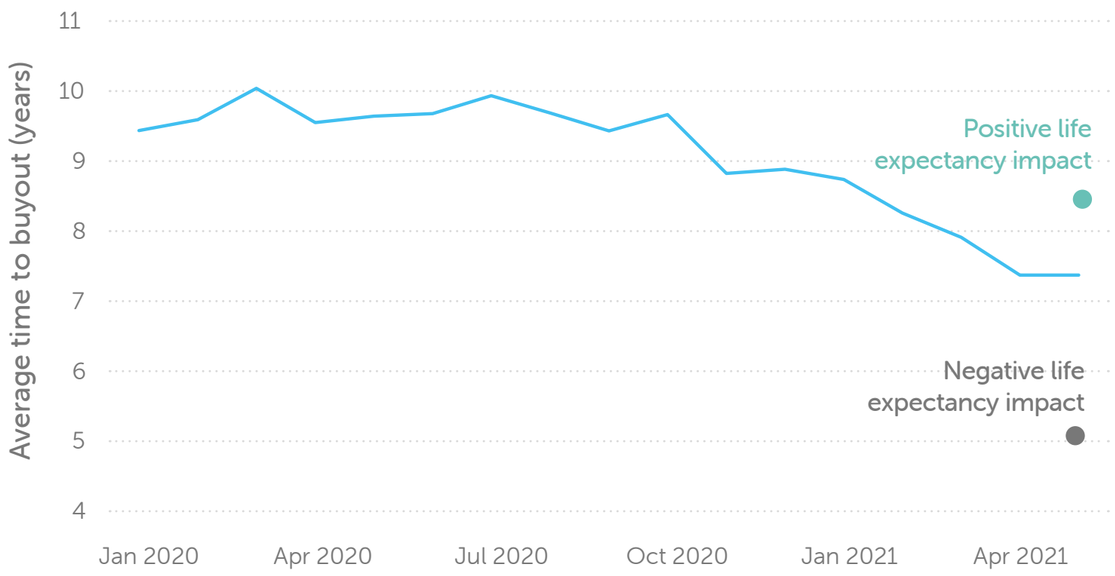
# Potential impact of longevity on time to buyout

As at May 2021, we estimate that the average time to buyout for the FTSE350 DB schemes is around seven years and five months. The following chart shows, as a blue line, how the average time to buyout has developed since January 2020, assuming Covid-19 was to have no impact on life expectancies.

The green dot gives an indication of how the scenario of a positive impact on life expectancy might affect the projected time to buyout (i.e. liabilities rise as a result of higher life expectancies and hence a fully funded buyout position is reached later), with the grey dot showing the scenario of a negative impact on life expectancy.

The green and grey dots represent the "most" positive and negative life expectancy impact scenarios respectively, assuming that all of the positive or negative impacts on life expectancies materialise. More likely, we might expect a combination of positive and negative factors, so the actual outcome will likely fall somewhere within the range of these outcomes shown in the chart.



Time to buyout

# Accelerating the DB endgame?

If the negative scenario plays out – and is reflected in the pricing offered by the insurance market – then FTSE350 companies may be much closer to their DB endgame than they expected. This is even more likely for schemes that may not have assessed their buyout position in detail for some time but have subsequently seen significant funding level improvements due to positive investment performance, additional contributions and a general slowdown in life expectancies prior to the pandemic.

Against this backdrop, we have started to see pension schemes bring forward their endgame plans and consider the investment, funding and administrative implications of potentially buying out earlier than expected. Companies are also considering whether an acceleration of already committed deficit reduction contributions will help to achieve buyout sooner and thus remove a potential driver of significant volatility from their balance sheet.

Of course, it is not guaranteed that life expectancies will reduce (and that this will be reflected in the insurance market) and there are some strong arguments to suggest the overall impact could be muted or even beneficial to life expectancies. However, the pandemic has certainly highlighted the level of risk and uncertainty associated with estimating life expectancy and where risk mitigation and management can be very valuable.

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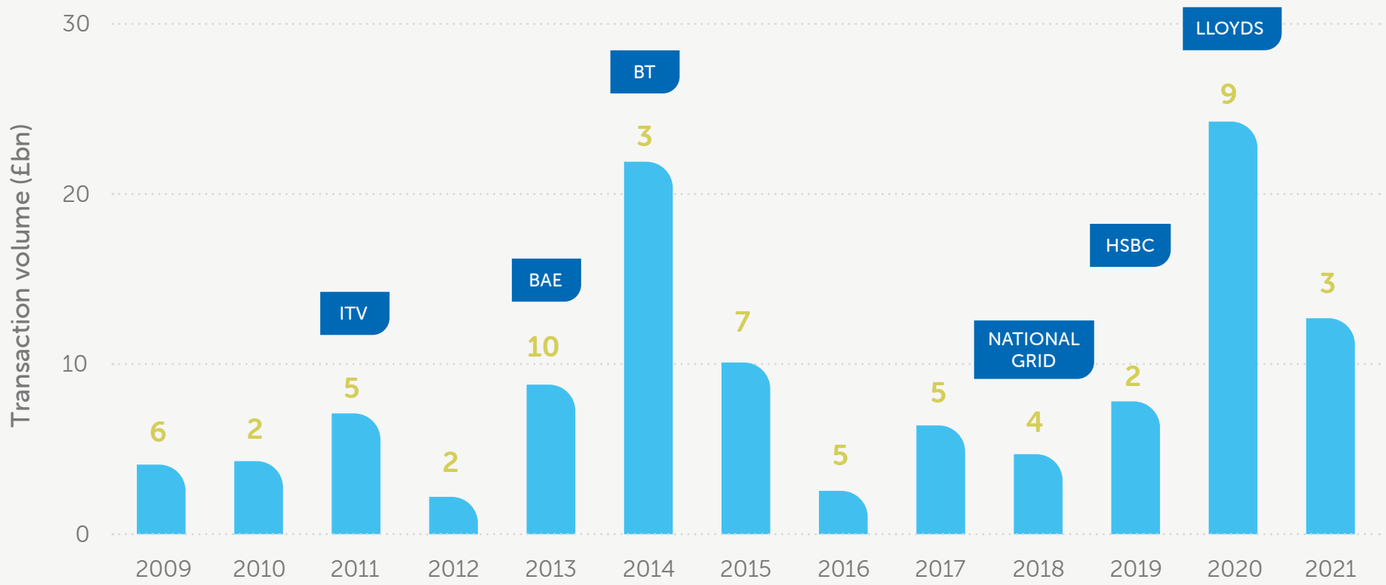
# Managing longevity risk

Longevity risk – the impact of pension scheme members dying sooner or living longer than expected – is unrewarded: schemes are not expected to benefit from holding the risk, unlike investment risk. This emphasises the importance for companies to consider whether this risk should be hedged.

While longevity may not pose as great a risk to pension schemes in the short term as, say, large falls in equity values, it can be an expensive risk to take over the long term. With the Pensions Regulator (TPR) requiring schemes to think about their long-term strategies, now might be an ideal time for trustees and sponsors to consider their management of longevity risk over the long-term, particularly where investment risks have already been hedged; e.g. through LDI strategies. For larger schemes, a longevity swap could be an effective way to manage this risk, bringing more certainty regarding the path to buyout or forming an integral part of a self-sufficiency strategy.

Longevity swap contracts are entered into with no upfront premium and, therefore, schemes are able to retain their assets and maintain their existing strategy. Furthermore, contracts have evolved over the last decade to become more flexible. Longevity swaps can be converted into a buy-in and can act as a stepping stone to future buyout rather than a barrier.

LONGEVITY SWAPS - TRANSACTIONS AND VOLUME




The chart above shows market activity since 2009, including examples of some FTSE350 companies that have entered into a longevity swap. (Figures above individual bars show annual number of transactions).

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# The value of a DB journey plan

The pandemic has highlighted the need for diligent risk management, with significant volatility in the financial markets affecting funding levels and lingering concern around the longer term impact on life expectancies. Schemes with journey plans in place – built around clear risk-reduction objectives and a robust decision-making framework – have been able to monitor activity and take strategic action to reduce risk as and when opportunities have arisen.

With a material improvement in funding positions, the DB endgame may be closer for some schemes than they expected and this may accelerate if some of the negative life expectancy scenarios play out. A good journey plan, reviewed regularly, should give a clear picture of where the scheme is on their path and how that should dovetail with the funding, investment and administration activity (e.g. getting the data ready for buyout) associated with risk-reduction exercises.

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Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:

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