Media Comments 2010

Bankrupt multinationals on hook for U.K. plan deficits, court says, By **Thao Hua**, ***Pensions & Investments*****, December 13, 2010**

Bankrupt parent companies based outside of the U.K. can be held financially responsible for the funding shortfalls in their U.K. subsidiaries' defined benefit plans, a London court ruled last week.

The unprecedented decision — which combined two separate cases before the U.K.'s High Court of Justice involving Lehman Brothers Holdings Inc. and Nortel Networks Corp. — also placed the priority of the pension liabilities imposed by government regulators before all unsecured creditors and some secured creditors.

“Other multinational companies will be looking with interest at the outcome here,” said **David Blake**, director of the **Pensions Institute** at City University's Cass Business School in London. “What is interesting about the Nortel and Lehman Brothers cases is that these companies are headquartered outside the U.K.”

Sources familiar with the cases said the decision is likely to be appealed by both companies.

Under U.K. law, The Pensions Regulator — the government agency responsible for regulating occupational pension plans — can issue a financial support direction or a contribution notice to companies with pension deficits. A support direction requires a company to have a plan to cover pension shortfalls within a certain period; a contribution notice under certain circumstances could constitute a one-off contribution to the pension fund.

Though rarely exercised, FSDs were implemented against the U.K. and overseas subsidiaries of Lehman Brothers and Nortel following their parents' bankruptcy filings in September 2008 and January 2009, respectively. The regulator required the companies to support Nortel's U.K. pension deficit totaling £2.1 billion ($3.3 billion) and Lehman's £148 million shortfall, according to data provided by the regulator.

“The Pensions Regulator welcomes the judgment. It confirms an FSD is valid if issued after an insolvency event. In particular, it supports the claims of the Nortel and Lehman pension trustees in their respective administration processes,” according to a statement published on its website following the ruling. Ben Lloyd, spokesman for the regulator, said agency officials had no further comment beyond what was published.

Attorneys at Linklaters LLP, which is representing Lehman Brothers, declined to comment. Attorneys at Herbert Smith LLP, which represents Nortel, could not be reached for comment by press time.

Other sources familiar with the matter said both companies had argued that they are not required to comply with the FSDs because the orders were issued after the date of the bankruptcy filings and that the assets of overseas subsidiaries cannot be used to reduce U.K. pension deficits.

Deemed void

Earlier this year, the U.S. Bankruptcy Court for the District of Delaware deemed The Pensions Regulator's FSD process void with respect to U.S. bankruptcy proceedings. Similarly, Ontario Superior Court of Justice Judge Geoff Morawetz ruled the actions of a regulator outside its jurisdiction, i.e. The Pensions Regulator in the U.K., null and void in relation to the Nortel case.

The cases "demonstrate that the U.K. Pensions Regulator is trying to use its power in the widest possible sense," said Peter Ford, partner and head of the pensions department at the law firm of Norton Rose LLP, London. Mr. Ford is not involved in the case.

The first issue decided by the court was whether the regulator can use its powers to issue an FSD or a contribution notice to insolvent companies regardless of location.

In his ruling on Friday, the judge wrote that corporate obligations within the context of the FSD "do not distinguish between companies which, and which are not, in an insolvency process."

Furthermore, he specified that "any time when the employer is a member of a group of companies, all the members of the group are jointly and severally liable for the whole or part of the employer's pension liabilities in relation to the scheme."

"Interesting question'

Jennifer Marshall, London-based partner at the law firm of Allen & Overy LLP who specializes in corporate insolvency, added: "If The Pensions Regulator can impose liabilities, then where do they rank" among creditors in bankruptcy proceedings? This raised an interesting legal question."

The High Court of Justice — which is the court of first instance in high-level civil cases in England and Wales — decided the pension obligations imposed by an FSD could be constituted as "administration expenses," or costs incurred during bankruptcy proceedings with "super priority" status that are paid before the administrator's own costs, some secured creditors' claims and all unsecured claims.

"This decision is a relief and welcome news for trustees and, in particular, The Pensions Regulator, but bad news for others, especially unsecured creditors," said Martin Scott, partner in the pensions group at Mayer Brown LLP based in London. Mr. Scott's law firm is not involved in the case.

There were two other options that the court could have taken. The first was to determine that pension obligations qualify as unsecured claims, placing the pension fund with other unsecured creditors and likely without preferential status. However, the liabilities must have been incurred prior to the company going into bankruptcy for the pension deficit to be classified as such, said Devi Shah, London-based partner at Mayer Brown who specializes in corporate restructuring and insolvency.

A second possibility was that the pension liabilities are not recoverable at all, a decision that would have been “disastrous for The Pensions Regulator,” Ms. Shah added.

If the court had ruled the liabilities are not recoverable, The Pensions Regulator's “main tool for dealing with underfunded schemes with weak employers would all but be removed in the situation in which it is likely to be required most,” according to a prepared statement from the regulator released prior to the ruling.

A key issue was where the pension liabilities rank in the order of payments to the parties involved in the bankruptcy proceedings.

“If (the court) says that the pension liabilities are not recoverable at all, that would be contrary to what the pensions legislation is essentially set up to do,” Ms. Marshall of Allen & Overy said in an interview prior to the ruling. “If it is determined that the liabilities had crystallized post-insolvency as a priority expense, that could have very serious implications for the whole restructuring industry.”

In his decision, the judge acknowledged that the option to give pension liabilities the same priority as other unsecured debt would be “obviously fairer as between scheme members and unsecured debtors and preferable as a means of resolving the underlying policy clash.” Nevertheless, he continued, “this is a case in which (the U.K.) Parliament has legislated to create financial obligations applicable ... in such a way that ... they create administration or liquidation expenses.”

The “knock-on effects” of the ruling will be to push banks and other creditors — including institutional investors such as money managers — down the ranks of parties to be paid, Norton Rose's Mr. Ford said. In the case of Nortel, for example, the £2.1 billion funding shortfall is more than the company's entire pool of available cash and cash-equivalent assets, sources said.

For corporations with large pension deficits in the U.K., raising capital might become more difficult, other sources said.

“Investors are not going to want to put money into a company in which all (assets) are going to go to the pension scheme if the company goes under,” said Mayer Brown's Ms. Shah. “It affects their rights as creditors.”

However, companies might be able to structure their U.K. subsidiaries differently in order to minimize any pension liabilities if the subsidiary becomes insolvent, pension experts added. “Of course, the U.K. Pensions Regulator could respond to this possibility by requiring multinational companies to guarantee the pension deficit of its U.K. subsidiary,” said Mr. Blake of the Pensions Institute.

We need to use our brains to budget better in retirement, By Emma Wall, *Daily Telegraph*, 19 Nov 2010

Four pension brainwaves: Four key behavioural changes could help people spend their pension more effectively, a study has found.

Britain is a nation of thrifty savers and retirement splurgers, if the latest report from the **Pensions Institute** at Cass Business School is to believed.

Its report, Spend More Today: Using Behavioural Economics to Improve Retirement Expenditure Decisions, found that while we have learnt to save adequately for retirement, once we get there we underestimate how much money we will need.

The study said there were four key behavioural changes that could help people spend their pension more effectively. It said that Britons saved diligently, but once they had built up their pension they sometimes made poor decisions about their annuity.

Laith Khalaf, a pensions analyst for Hargreaves Lansdown, said: "This report has a simple message: pension investors can make rational decisions, but sometimes we need to be nudged in the right direction."

David Blake, director of the Pensions Institute, says that behavioural economics – that is learned financial habits – can be used to encourage Britons to budget better in retirement. Mr Blake, and his co-author of the paper Tom Boardman, visiting professor at Cass, detail how behavioural economics have successfully been used to teach people how to save while they work.

Programmes such as pension auto-enrolment, and the Save More Tomorrow plan, under which your pensions contributions increase automatically as your salary goes up, have worked to ensure people are prepared for retirement.

"Auto-enrolment, which comes into place in 2012, will use inertia to encourage people to start saving for a pension," said Mr Khalaf. "After the initial 'nudge', people will continue to make contributions."

Mr Blake wants to see similar programmes put in place once they have retired to overcome the adversity people feel to paying out for an expensive annuity. Unless they cough-up the cash in the beginning, they may find themselves left with insufficient income, for an insufficient number of years.

The recommendation of the report is that retirees use a Speedometer (Spending Optimally Throughout Retirement) plan. This plan advocates four behavioural "nudges" – action points to change behavioural economics.

The first suggestion is that savers make a plan, with or without an adviser, for retirement. Then the report recommends "automatic phasing of annuitisation".

Mr Khalaf explained: "This refers to buying an annuity in stages. So if you have £200,000 in a pension, rather than buying an annuity in one go, you use £50,000 to buy an annuity. Then next year you come back and use another £50,000 to buy another annuity, and the next year, and the next year, you do the same."

The third behavioural nudge advocates money-back annuities, where if a pensioner dies within five years of taking out the policy, the remainder of the pension pot is returned to their estate. This encourages retirees to be more generous when buying an

annuity as the capital protection offered helps assuage peoples fear of losing their assets.

The final "nudge" is the paper's slogan – "spend more today". This may seem unusual for a retirement planning paper from the Pensions Institute, but Mr Blake and Mr Boardman say that by putting long-term plans in place we can ease the pressure of worrying about the future and enjoy our disposable income more.

Mr Khalaf said: "People can make good pension decisions, but policy-makers need to make sure incentives are right so individuals chose the most suitable option for them."

The study re-emphasises the importance that workers learn to make their pension pot last given that we are living longer, while research this week showed that once you have retired, you feel inflation at lot more keenly.

Behavioural nudge needed for retirement, By Pauline Skypala, *FTfm*, November 8 2010

Behavioural economics should be used to help people make the most of their income and assets in retirement, according to the Pensions Institute at Cass Business School.

It has been proven to work in the saving phase, according to Cass, through programmes such as auto enrolment and Save More Tomorrow, where pension contributions rise automatically with salary increases. It was needed even more in the spending phase, said David Blake, director of the Pensions Institute, who has co-authored a discussion paper* on the subject with Tom Boardman, visiting professor at Cass.

The paper considers how people can be “nudged” to spend accumulated assets optimally. The aim is to overcome the resistance to spending enough on an annuity to insure against outliving one’s savings.

Some people spend too much too soon in retirement, and some not enough, said Prof Blake, leaving more than they planned as a bequest. Many people underestimate how long they are likely to live.

The solution is a plan dubbed Speedometer (Spending optimally throughout retirement), which involves four behavioural nudges. People need to be encouraged first to plan how to use assets to generate an income. The plan should consider all assets, not just pension savings, said Prof Blake. “You have to take a holistic view.”

It should aim to secure the minimum income necessary to meet essential spending needs. For many people in the UK, this will be the basic state pension, if proposed reforms are adopted. For others, the default purchase should be an inflation-linked “money-back” annuity, which would pay something back in the event of dying within five years.

Also required is some means of meeting spikes in spending, either through insurance or a “rainy day” fund.

Those who can afford to should buy more annuities to raise their insured income to a level they aspire to that still allows them to make bequests.

Having put the plan in place, people will be free to "spend more today", in the knowledge they will not run out of money.

* Spend More Today: Using Behavioural Economics to Improve Retirement Expenditure Decisions

Behavioural economics can optimise savings, by Emma Dunkley, Professional Pensions, 1 Nov 2010

Behavioural economics can be adopted to improve the expenditure decisions of retirees, the **Pensions Institute** says.

The institute's latest paper, *Spend More Today: Using Behavioral Economics to Improve Retirement Expenditure Decisions* identifies how accumulated assets can be used optimally throughout retirement.

The report, by David Blake and Tom Boardman, said this can result in producing life-long income when required, make provision for contingencies such as unanticipated expenditure spikes and can optimize the size and timing of bequests.

To ensure accumulated assets are used optimally, the Pensions Institute uses a "speedometer" - or Spending Optimally Throughout Retirement - expenditure plan, which employs default within a certain architecture.

The plan involves four behavioural factors, comprising the initial stage of making a plan, ideally without an adviser. The next point is automatic phasing of annuitisation, designed to combat aversion to large irreversible transactions and losing control of assets.

The next point is capital protection - in the form of 'money-back' annuities which deals with loss aversion. The fourth factor is the slogan 'spend more today,' which reinforces the idea that buying an annuity is a 'smart thing to do'.

Annuity rule change criticised, By Nicholas Timmins, Public Policy Editor, Financial Times, September 30 2010

Government plans to remove the requirement for people to buy an annuity with their pension fund by the age of 75 risk a mis-selling scandal, a higher bill for means-tested benefits and greater difficulty for the government in selling gilts to cover its debt, leading pension analysts have warned.

"We believe the government should think again," said **David Blake**, director of the **Pensions Institute** at the Cass Business School.

"This is a proposal full of unintended consequences for the public finances that we do not think have been thought through. It is also likely to lead to an increased risk of poverty for those who make poor investment decisions with their wealth."

Removing the requirement to buy an annuity is a key coalition pledge.

The Treasury is consulting on how that should be done and on what minimum level of income people should be required to have in order not to have to buy an annuity – an income for life from an insurance company, bought with the accumulated pension pot.

Professor Blake and his colleagues have calculated that individuals would need an annual income of just over £14,000 ($22,000) and couples about £20,000, including the basic state pension, to ensure that they do not fall back on to means-tested benefits, such as pension credit.

However, those figures are very uncertain, Professor Blake said, and could still lead to significant entitlement to means-tested benefits in future years. Only about 28 per cent of retiring pensioners have enough wealth to secure that sort of income.

Moreover, "managing the decumulation of wealth is highly complex", Professor Blake said, involving investment returns, uncertainty over life expectancy, health status and attitude to risk and requires regular review. "It is not a one off exercise."

The choices are not easy to make, and significant numbers in their 70s and 80s suffer from cognitive impairment. "The government could soon find itself embroiled in another mis-selling scandal and this time involving vulnerable elderly people," he said.

If pensioners take more of the pot as a cash, insurance companies will need fewer government bonds to back their annuities – up to £5bn a year less if the proposal is extended to cover final salary as well as money purchase pensions.

Lower demand for government debt "would come at a time when the government is attempting to fund a vast deficit through bonds issuance", Professor Blake said.

Removing the requirement to buy an annuity will also change people's view of them – those who do buy one will be seen as "denying" their family a potential inheritance, he said. And as poor investment decisions leave pensioners in poverty, pressure will mount for more state support for the retired population.

Concern over UK plans for annuities, By Steve Johnson, FTfm, 27 September 2010

UK government plans to scrap compulsory annuitisation of pension savings risk creating a "mis-selling scandal" involving vulnerable elderly people, according to Professor **David Blake**, director of the **Pensions Institute** at London's Cass Business School.

Currently pension scheme members have to convert their entire savings pot into an annuity by the age of 75, but the government is consulting on plans to end this.

Individuals would still need to buy an annuity to provide them with an as yet unspecified minimum income requirement. But pension savings beyond this could be

used for any purpose, and Prof Blake feared the elderly could be dissuaded from buying a full annuity, even if this was in their best interests.

“The government could soon find itself embroiled in another mis-selling scandal, this time involving vulnerable elderly people.

“The IFAs [independent financial advisers] are salivating over the opportunities to manage this money,” said Prof Blake.

“If their children can also see this is their inheritance, they are going to say ‘I don’t want you to take an annuity because if you die we will get nothing’.”

The Pensions Institute is due to formally present its response to the Treasury’s proposals on Wednesday.

Pensions Institute: Mind the Gap - Closing Deficits in UK Pension Funds

BusinessWire - UK Pensions & Investments Summit 2010 London, 18 - 20 October

Interview with: David Blake, Professor & Director of the Pensions Institute, Cass Business School

Pension funds need to start looking towards Target-Driven Return strategies, states David Blake, Professor of Pension Economics and Director of the Pensions Institute at Cass Business School. In the mature UK pensions industry, having good returns some years and poor returns other years is no longer an option. A keynote speaker at the marcus evans UK Pensions & Investments Summit 2010, taking place in London, 18 - 20 October, Blake discusses Target-Driven Return strategies, diversifying portfolio risks without sacrificing returns, and the exciting longevity swap market in the UK.

What are some of the challenges facing the pensions industry in the UK at the moment, and what solutions would you recommend?

David Blake: "The size of deficits in pension funds and longevity risks are the two main challenges at the moment. Deficits need to be minimised now and completely eliminated in the near future as they are retracting resources from company investment programmes and shareholder dividends. Many pension schemes are closing themselves to new members, and in about a dozen years, we will see the end of the final-salary scheme in the UK which took 150 years to build up. Many feel that closing it, is the only way to deal with deficit issues, but they are simply capping their risks, and their exposure to risks. They are still going to have to minimise and eliminate deficits somehow; they cannot walk away from pension obligations.

Many funds are selling off their obligations to new insurance companies, which buy out liabilities and manage the risks themselves. But some funds are keeping assets as well as liabilities in their own books, and managing them through different types of swap arrangements, interest-rate swaps, inflation swaps and now longevity swaps.

The development of the longevity swap market in the UK is very exciting for the pensions industry."

What is the most effective way of closing pension fund deficits?

David Blake: "Pension fund sponsors are going to have to put in the necessary resources, there is no way around that. Traditionally, if the employer did not wish to contribute much, he would ask the trustees to consider a more aggressive (i.e. risk-taking) investment strategy in the hope that in time, the higher returns would close the deficit. They would have a 30 -- 40 year period to carry this out. However, regulators have now limited this to 10 years, making it far riskier to adopt an aggressive investment approach as a way out of the hole.

As pension funds mature and meeting payments to pensioners becomes their prime concern, Chief Investment Officers ought to pursue more bond-type investments and invest less in equities, in order to generate more reliable cash flows. Taking on risks is no longer a realistic strategy in today's investment environment. Capping risks and removing them is now the name of the game."

What long-term investment and asset allocation strategies would you recommend?

David Blake: "What we need to start looking towards is Target-Driven Return strategies, such as Diversified Growth and Absolute Return. Diversified Growth puts together a large range of asset classes, including alternatives, private equity, hedge funds and commodities, thus helping diversify the portfolio risks without sacrificing returns. Absolute Return tries to deliver a target return above inflation."

Australian pension reform in jeopardy, By Elizabeth Fry, FTfm, September 20 2010

The recent removal of Chris Bowen as minister of financial services as part of Australian prime minister Julia Gillard’s ministerial cabinet reshuffle is a sign that critical government reform of Australia’s A$1,300bn ($1,220bn) compulsory superannuation system will be further delayed.

The cabinet shake-up meant the exit of an experienced financial services minister committed to developing products to mitigate longevity risk.

If left unaddressed, longevity risk could cause a premature exhaustion of retirement savings, which is a worry for a country that has long been proud of its actions to achieve sufficient retirement savings through its compulsory wage levy.

David Blake, director of Britain’s **Pensions Institute** at Cass Business School, says while the Australian scheme is indeed a world leader in terms of the design of the saving phase it is only half designed because it has not seriously looked at the spending phase stage.

The current proposal to raise the contribution levy from 9 per cent to 12 per cent is impressive, he adds, but the Australian pension model falls down because there is no

compulsory requirement for people to buy an annuity when they retire and hence hedge the longevity risk they face.

He notes the voluntary purchase of annuities in Australia is minuscule – only 29 life annuities were sold in 2009, compared with 460,000 in the UK, where annuitisation by age 75 is mandatory (although the government has proposed scrapping the rule).

"Longevity risk is a problem for every country that has a pension system because the organisations running the pension plans, whether in the public or private sector, have no real idea how long they will be making payments for," says Mr Blake.

"They are not yet very good at quantifying the longevity risk they face, never mind hedging it, and that's as true for Australia as it is in the UK."

In his view, Australia's super system is enormously risky because of the real possibility that individuals will run through their retirement money and then fall back on the state.

There are other weaknesses. The 2007 market correction showed the danger of Australian pension schemes' overly high exposure to equities, which has resulted in the average balanced fund delivering a 4.5 per cent return over the past 10 years, barely beating inflation.

Richard Howes, chief executive of Challenger Life, one of two companies selling lifetime annuities, says Australia's reliance on market-linked retirement incomes reflects a gambling mentality that is dangerous and costly to the individual, society and the taxpayer. "There is a real risk that the cult of equities will keep a grip on post-retirement superannuation in Australia, even after the financial crisis decimated the plans of hundreds of thousands of retirees who were over-exposed to equities both directly and through managed funds."

The flaws in the pension system drove the federal government to commission several industry reports, one of which criticised the way risk is identified, analysed, disclosed and managed. It highlighted the problem that funds are often falsely labelled, leading savers to make ill- informed investment decisions. Most superannuation products and account-based pensions (which provide retirement income) do not carry a risk rating of any kind.

The Australian Prudential Regulation Authority has conceded this is a problem, saying it is impossible to compare like with like. Balanced funds, for example, may be conservatively invested mostly in bonds, or have more than 80 per cent of their money in shares. The regulator says it will introduce risk-based criteria for classifying investment options such as conservative, balanced, and growth funds and has further charged trustees with clearly stating the expected frequency of negative returns over 20 years.

The industry has been told to come up with appropriate risk levels for different investment options and disclose a standardised measure of the uncertainty or volatility associated with the return.

However, there has been no action taken to fast track the necessary reforms that will devise separate investment strategies for post-retirement that take into account not just market risk but also inflation and longevity risk.

Michael Sherris, professor of actuarial studies at University of New South Wales' School of Business, who prepared a report for one of the reviews, says although the issue of longevity risk was raised there was no technical detail on how to provide the right product.

He is calling on government to act now and find a way to convert compulsory superannuation savings into retirement income. Otherwise, it will be left to pick up the bill.

He says the sensible option is for the Australian government to provide life-time annuities to get around the credit risk issue, a sentiment echoed by Mr Blake.

He also suggests that the Australian government supply longevity bonds to help the private sector hedge aggregate risk, a risk that cannot be hedged using any existing financial instruments.

Mr Howes of Challenger wants the government to quickly remove the obstacles to the provision and use of deferred lifetime annuities, such as exempting them from minimum drawdown requirements and means test while in their deferral period, and allowing people over 65 to buy a prudentially regulated longevity product with non-superannuation money without meeting the work test.

Why the UK needs longevity bonds, by Amanda White, top1000funds.com, September 15, 2010

David Blake, director of the **Pensions Institute** at the Cass Business School in London, believes the UK government should issue longevity bonds to help create an efficient capital market for the transfer of longevity risk. But given the government's reluctance to do so, he says, perhaps the private sector should step up. The whole purpose of a pension plan is for an individual to hedge their own longevity risk, professor Blake points out.

"But if the pension plan has underestimated longevity risk there are severe problems, and this is happening now," he says. "Everyone is focusing on the accumulation of the pension fund, no-one's thinking seriously about de-cumulation. There are two questions that need to be considered: what age do you stop accumulating; and then how long do you live after retiring. It's no longer about investing, it's about optimal de-cumulation."

An economist, Blake first started considering the design weaknesses of pension plans when he was doing his PhD 30 years ago, and in a bid to work on an under-researched area, he concentrated on pension funds.

Now, as director of the Pensions Institute, his focus is on providing the intellectual leadership behind the creation of a new global capital market, namely the life market.

Within that context his argument is for the UK government to issue longevity bonds to help overcome the problem that there is insufficient capital in the insurance and reinsurance industry to hedge the longevity risk in all the pension funds in the country.

"The way an individual hedges their longevity risk is to buy an annuity, and in the UK you are obliged to do this. The annuity provider then has to deal with the longevity risk, but there are two components to longevity risk: a systematic or aggregate component, and an individual or idiosyncratic component. The insurance industry is very good at dealing with idiosyncratic risks, it simply pools these risks and this helps to reduce total risk by the law of large numbers. But it is the systematic trend risk that every annuitant lives longer than anticipated that is the real problem," he says.

"The insurance industry is unable to hedge this trend risk efficiently without an aggregate hedging instrument and that's where government-issued longevity bonds come in. Only the government can hedge aggregate risks such as inflation risk and longevity risk."

He argues that the UK government has done this in other areas of the capital market, for example by issuing inflation-linked bonds.

"Inflation is an aggregate risk, just like longevity risk," he says.

Within the de-cumulation phase of pension funds, Blake says there are three big risks: interest rates, inflation and longevity.

"Longevity is the only risk that can't currently be hedged, unless you buy overpriced annuities," he says.

The government is the obvious candidate for issuing longevity bonds, Blake says, and should have an interest in ensuring both an efficient annuity market and an efficient capital market for longevity risk transfer. The government is also best placed to engage in intergenerational risk sharing, which is what it would in effect be doing if it issued these bonds, he argues.

He also says £30 billion in longevity bonds would not be noticed in the context that the UK government is going to have to issue £700 billion in bonds in the next five years to pay for the financial crisis, but would be enough to create a capital market and a market price for longevity risk which is what the private sector needs to create longevity swaps market.

He argues for an initial issuance of four bonds with 10-year deferment: M65 (for males aged 65 and starting to pay coupons at age 75), F65, M75 and F75.

However the government has given little support to the idea, and part of the agenda at meetings such as the Sixth Annual Longevity Risk Conference that has just been held in Sydney, is to discuss whether the private sector can itself create the needed market without government support.

"A few years ago BNP Paribas tried to issue longevity bonds but the market was not ready and they failed," Blake says. "But when the investment banks and reinsurers moved in with longevity swaps, it was a success. Private banks could possibly issue in the future."

Blake says the BNP Paribas experiment showed that the market was not ready, but it also highlighted some design flaws and these have now been corrected.

A key design fault was that the BNP Paribas paid out coupons before they were really needed. Given a retirement age of 65, Blake, in his joint work with Tom Boardroom and Andrew Cairns, is recommending that there are no payments in the first 10 years since longevity risk does not really become a problem until after age 75.

A longevity bond is a combination of an annuity bond and a longevity swap, where the swap provides the hedge against annuitants living longer than expected.

To access the working paper written by Blake and Tom Boardman and Andrew Cairns click here: Sharing Longevity Risk.

UK industry gives a mixed response to pension plan, By Sophia Grene, FTfm, September 12 2010

The UK has the world's largest annuity market, with more than half of the world's annuities being sold in the country.

This is thanks to a pensions system that gives generous tax breaks to savers in return for those with defined contribution pensions converting most of their accumulated assets into a guaranteed income for life by the age of 75. Now the UK government is proposing to remove the requirement to annuitise pension savings.

In order to benefit from the increased flexibility, retirees will have to show they have provided themselves with a minimum, index-linked income, but beyond that, their arrangements will be between them and their wealth adviser.

The proposal has led to mixed reactions. For financial services providers, it is a huge opportunity, with a significant asset pool being made available for new products, but some commentators are concerned it may lead to retirees running through their pension savings and having to fall back on state provision in their final years.

"On the surface, this seems great, as [compulsory annuitisation] feels very much of a shackle on the pension system," says Emma Douglas, directot, defined contribution sales at BlackRock.

"[DC pension] members feel annuities are bad value, they don't like being forced to buy them, their dependants won't get anything if they die early."

The primary benefit of an annuity is that it provides longevity insurance, guaranteeing that, however long you live, you will not outlive your income. Investors, however, tend to underestimate this risk, while placing a high value on the ability to leave money to their children, known as the bequest motive.

“We’ve got government policymakers who don’t understand longevity risk, and investors who don’t understand longevity risk,” says **David Blake**, professor of pension economics at the Cass Business School and director of the **Pensions Institute**.

“The probability of dying the next day is extremely low and the probability of outliving your money is fairly high.”

However popular the move might be with savers, Ms Douglas is not convinced it will work out to everyone’s benefit. “I do worry about the implications when you have a bunch of old people having to make some very tricky decisions. If you do something silly with your drawdown pot, or if the market does something silly on your behalf, you could run out of money.”

The development does seem to lead the UK in the opposite direction from much of the rest of the world – following reforms to pension systems in many countries, annuities have moved higher up the agenda.

This is due to “the trend towards private pensions, especially defined contribution, after pensions reform”, says Juan Yermo, secretary of the working party on private pensions at the Organisation for Economic Cooperation and Development.

“I can’t think of any country that’s not looking at annuities as part of that.”

Countries such as Chile and Mexico that have relatively recently introduced compulsory retirement savings schemes have included some element of annuitisation in the plan for what happens after retirement. The eastern European countries that have been scrambling to put in private pension systems following their shift to capitalism in the 1990s have tended to focus first on making sure people put money in than on how they will take it out. But even here there has been a trend to including annuitisation in plans for pension payments.

The exceptions are the US, where the DC pensions market covers more than half of savers and almost half of pension assets and annuitisation is not compulsory, and Australia, where saving in the Superannuation schemes is mandatory but buying an annuity with the proceeds is not.

The Australian system is currently under review, however, with annuitisation on the agenda, and in the US, which has a longer established DC cohort already in retirement, problems are arising.

“I was recently in America and all the people I met at our offices said ‘What are you doing, taking away compulsory annuitisation?’,” says Ms Douglas. “They actually do find people run out of money.”

US pension plans have traditionally been reluctant to offer annuitisation as an option because they run the fiduciary risk of being liable if the annuity provider is unable to fulfil its obligations.

US asset manager Vanguard has just launched an online annuity platform in order to encourage savers to consider the option.

The problem of running out of money may not arise on the same scale in the UK, where retirees will have to use part of their pension pots to ensure a minimum income, which is likely to take the form of an index-linked annuity.

This means only those with pension savings above £300,000 are likely to be able to exploit the new freedom, according to Ms Douglas.

Since the average DC pension pot is currently around £30,000, most savers will not be affected.

This does not mean the pool of assets potentially available is insignificant, however, according to Russell Investments, which expects exciting developments as rich retirees look to do interesting things with their savings.

"The two needs are income and bequest and the two are in tension," says Don Ezra, director of strategic advice at Russell Investment Group. "This tension means we have new products growing up, but we have no idea what the future products will look like."

Possible directions for innovation include deferred annuities, income drawdown schemes with longevity insurance, or combinations of individual products, but Mr Ezra would not speculate on what a mature post-retirement market might look like.

"The state of the art is not nearly as advanced as I would like it to be, being aged 66."

Ms Douglas is less sanguine about the future: "I just hope we don't see too many horror stories before there's a backlash in favour of annuities

Cass paper lends weight to LLMA proposals, By Tom Selby, Professional Pensions, 7 Sep 2010

Schemes could "considerably" reduce longevity basis risk by utilising index-based longevity hedges, academics say.

The conclusion - made in the Cass Business School paper *Longevity hedging: A framework for longevity basis risk analysis and hedge effectiveness* - lends significant support to the Life and Longevity Markets Association's proposals for a standardised framework for longevity indices.

Using two country examples - the UK and the US - the discussion paper compares the experience of the national population with an affluent subpopulation which, on average, had enjoyed lower mortality rates and higher mortality improvements.

An evaluation of hedge effectiveness for a hypothetical pension plan with the same mortality characteristics as the affluent subpopulation for a static hedge was then conducted, based on a longevity index linked to the national population.

The paper argued that, from this analysis, "stable long-term relationships" between mortality experiences was evident.

"This has favourable implications for the effectiveness of appropriately-calibrated, index-based longevity hedges," it said. "From this, we conclude that longevity basis risk between a pension plan, or annuity book, and a hedging instrument linked to a broad population-based longevity index can, in principle, be reduced very considerably."

The LLMA Longevity Index Framework - designed to provide a consistent and transparent set of standards for developing longevity indices - is applicable for public indices based on national population longevity, as well as customised proprietary benchmarks created for specific pension plans *(PP Online, 23 August)*.

LLMA said the framework will bring greater standardisation to the longevity market, allowing pension plans to transact longevity hedges with greater certainty, over shorter timescales.

The authors of the report were Guy D. Coughlan, Marwa Khalaf-Allah, Yijing Ye, Sumit Kumar, Andrew J.G. Cairns, David Blake and Kevin Dowd

Another knock for DB pensions, By Ruth Sullivan, FTfm, August 1 2010

UK government proposals to scrap rules forcing pension scheme members to purchase an annuity by the age of 75 could put another nail in the coffin of ailing defined benefit plans.

Although the proposed policy change is aimed at defined contribution pension schemes, the move will have a knock-on effect on defined benefit plans, according to Professor David Blake, director of the Pensions Institute at Cass Business School in London.

Prof Blake argued that if savers in DC pension schemes were able to access much of their pension pot as an upfront lump sum, rather than having to use at least three-quarters of this money to buy an annuity, members of DB schemes would agitate for similar rights.

“It will not be long before DB scheme members will demand a lump sum from their pension, then fund sponsors will have to find the cash immediately rather than in much smaller amounts over a long period of time,” said Prof Blake, who also believed demand for lump sums could spill over into public sector DB schemes.

“This is going to be a big issue and the government is starting a huge tsunami,” said Prof Blake.

Such an unintended consequence would come at a time when many DB pension schemes are struggling with increasing deficits and a rising number are being closed.

The proposals by the Con-Lib government to end compulsory annuitisation could also affect the government bond market, Prof Blake argued.

There could be a fall in demand for long-duration sovereign debt if annuity providers – among the biggest buyers of such paper – saw a drop off in business as more of the pot of accumulated pension savings was taken as one-off lump sums.

Under the proposals individuals would still need to purchase a minimum annuity, the level of which the government is currently consulting on.

Londres envisage d'avancer l'entrée en vigueur de la retraite à 66 ans, NICOLAS MADELAINE, Les Echos, 25/06/10

L'horizon du passage de 65 ans à 66 ans pourrait être avancé de dix ans, et donc intervenir dès 2016. Le gouvernement regarde déjà vers le seuil de 70 ans d'ici au milieu du siècle.

Dans la foulée de son budget d'austérité présenté mardi, le gouvernement britannique a annoncé hier qu'il lançait une étude sur la nécessité de faire passer l'âge légal de la retraite de 65 ans à 66 ans avant l'horizon prévu de 2026. Et, alors que les travaillistes avaient fixé 2046 comme butoir pour les 68 ans, l'administration Cameron considérera également l'option d'un âge légal de 70 ans d'ici au milieu du siècle. Elle a annoncé qu'elle envisageait aussi de supprimer l'âge de la retraite « par défaut » à 65 ans. Il correspond à l'âge à partir duquel un salarié peut être remercié par son entreprise qu'il le veuille ou non.

Le lancement de cette étude signifie que le gouvernement veut certainement mettre à exécution la plate-forme de campagne des conservateurs qui prévoyait un passage à 66 ans dès 2016 pour les hommes et quelques années plus tard pour les femmes. L'âge de la retraite est actuellement de 65 ans pour les hommes et de 60 ans et quelques mois pour les femmes. Pour ces dernières, il est pour l'instant prévu un âgé légal de 65 ans en 2020.

« Stupéfiante » espérance de vie

Iain Duncan Smith, ministre des Retraites, a nié hier que le gouvernement voulait faire travailler les Britanniques *« jusqu'à ce qu'ils s'écroulent »*. Il a invoqué la *« stupéfiante »* espérance de vie : 89 ans pour les hommes et 90 ans pour les femmes, des chiffres qui anticipent une poursuite de la progression par rapport au niveau actuel.

En Grande-Bretagne, où on estime qu'environ 60 % des revenus des retraités proviennent du système étatique de retraites et 40 % des systèmes privés, le sujet d'inquiétude numéro un est le montant des retraites. *« A partir des années 1980, le gouvernement a abaissé le niveau de la retraite d'Etat »*, explique Carl Emmerson, directeur adjoint de l'Institute for Fiscal Studies. Aujourd'hui, pour simplifier, un retraité touche environ 98 livres par semaine de retraite d'Etat de base et peut au maximum doubler ce montant en fonction de sa retraite d'Etat indexée sur ses revenus, explique cet expert. Toute personne ayant travaillé trente ans, et atteignant

l'âge légal de la retraite, qu'elle continue à travailler ou non, bénéficie de ce traitement (si elle n'a travaillé que vingt ans, elle en touchera les deux tiers).

Revalorisation des pensions

Jusqu'à récemment, presque tous les salariés du privé bénéficiaient de retraites complémentaires relativement généreuses offertes par leur entreprise. Mais les employeurs ont pu rogner sur leurs engagements. Au lieu de garantir des annuités, ils ne se sont notamment engagés qu'à mettre de côté un certain montant par an dans un fonds. Pour **David Blake**, expert à la Cass Business School, « *la Grande-Bretagne est particulièrement mal préparée au passage à la retraite de ses baby-boomers, moins prêts à une diminution de leur niveau de vie que les générations précédentes.* »

Pour revaloriser les pensions étatiques, le gouvernement a annoncé l'indexation des retraites de base sur le plus avantageux de ces trois critères : l'évolution des prix, des revenus ou un minimum de 2,5 %. Il veut également que l'inscription à un système privé soit automatique au lieu d'être optionnelle. Le coût de la nouvelle indexation coûtera très cher. D'où le passage de 65 ans à 66 ans, et peut-être aussi de nouvelles contributions demandées aux actifs.

PP Investment Conference 2010: UK government should issue longevity bonds to mitigate risk, Professional Pensions, 2 Jun 2010, By Sebastian Cheek

The UK government should issue longevity bonds to help pension schemes and insurance companies address longevity risk, the Cass Business School says.

Cass Business School professor of pensions and economics, and director of the Pensions Institute David Blake said the government should set up a working party to carry out a cost benefits analysis to issue longevity bonds.

He said this would provide a benchmark for the pensions industry.

The bonds would pay a declining coupon to a cohort of the population, for example, 65-year-old males, payable until the age of 75.

The bonds would have a terminal payment to cover risk past 105 years. Blake added: "No one wants to pick up tail risk".

He said with £1trn in defined benefit liabilities, the largest plans were going to consider and need this. With £450bn in defined contribution assets, a longevity bond fund would reduce income volatility at retirement.

Blake said the issuance would be small compared with the overall size of government bonds.

He added the call had received support from the Confederation of British Industry, the International Monetary Fund, the Organisation for Economic Co-operation and Development and the World Economic Forum.

Pension policy will wreck savings plans: Retired people risk outliving their resources and also bear the responsibility of managing their financial assets, *The Times*, May 27, 2010

Sir, The new Government has confirmed manifesto promises to remove the requirement that individuals use their pension fund to buy an annuity at retirement. Such a policy would be popular, easy to implement and generate much-needed tax revenues. However, we have grave concerns that this will have serious consequences for the security of pensioners' retirement incomes and the public finances.

Without an annuity, retired people risk outliving their resources and also bear the responsibility of managing their financial assets. If things go wrong, they will surely turn to the taxpayer for help. The Conservatives propose a minimum annuity purchase, so pensioners never become eligible for means-tested benefits. We suspect that estimating such a minimum will be difficult, since benefits are calculated according to individual circumstances and these circumstances, together with the level of state support, are likely to change considerably over the next 30 years.

The proposal could lead to significant changes in the nation's savings decisions and tax payments. It could also encourage members of occupational pension plans — including those in the public sector — to access their entire fund as a lump sum rather than receive it as income. This would turn the current steady decline in defined-benefit pension plans into a rout, as pension fund sponsors — and that would include the Government — had to find cash immediately, instead of gradually over a long period into the future.

We suggest that the seriousness of the unintended consequences of their pension policy is fully recognised and that the policy proposal is re-examined.

Professor David Blake
Director, Pensions Institute, Cass Business School

Dr Edmund Cannon
University of Bristol

Professor Ian Tonks
University of Exeter

ANALYSIS-Who wants to pay forever? Hedging longevity risk

* Pension industry sees longevity risk concentrated on them
* Says nascent swaps market needs longevity bond to support
* Government, capital markets hesitate to buy in

By Sarah Hills

LONDON, April 7 (Reuters) - The ageing of Europe may open opportunities to sell savings products, but it also spells a real threat to parts of the financial services industry. Pensions experts call it the "toxic tail".

Like the subprime crisis faced by by banks in 2008, the risk of people living for up to 20 years after retirement seems to have crept up on an industry based on using historical data to calculate people's chances of an early death.

Now, pension funds and insurers say the mounting burden of protracted pensions payments is increasingly concentrated on a small group of providers: them.

Trying to spread this longevity risk to include capital markets and governments, they highlight concerns about corporate solvency and argue that fundamentally, provision for retired people who outlive expectations is a sovereign role.

"We don't want to see the equivalent of a banking crisis in the pension market," David Blake, professor of Pension Economics at Cass Business School, and director of the Pensions Institute told Reuters.

Nowhere better can the process be seen than in Britain, which is facing a crisis resulting from a combination of pension reforms and increased life expectancy.

As home to the world's second largest pension fund industry and one of the most sophisticated markets for private pensions, Britain's experience is worth exploring: other European countries are moving in a broadly similar direction, shifting the burden of old-age provision towards funded, private schemes.

^^

For a graphic showing 'tail risk' in UK longevity:

Source: Pensions Institute discussion paper - Sharing Longevity Risk: Why Governments Should Issue Longevity Bonds.

Reuters graphic/Scott Barber

*The fan chart shows the uncertainty surrounding projections of the number of survivors to each age from the cohort of males from the national population of England and Wales who are aged 65 at the end of 2006.16 The bars indicate the 90% confidence interval on the projected survivor rate for each age out to 115. The line in the middle of each bar indicates the expected proportion of the cohort to survive to each age.

The chart shows that there is little uncertainty out to age 75: we can be fairly confident that approximately 19% will have died by 75.

The uncertainty peaks at age 93: the confidence interval band is widest at this age. The best estimate is that 36% will survive to age 90, but it could be anywhere between 30% and 41%. This is a very large range. The Figure also shows the extent of the so-called 'tail risk' after age 90: there is some probability – even if small – that some members of this cohort will live beyond 110.

http://graphics.thomsonreuters.com/10/04/UK_FNC0410.gif

^^^

Global pension private-sector liabilities are of the order of $25 trillion, according to OECD data in a January Pensions Institute report, which cited estimates that every additional year of life expectancy at age 65 adds around 3 percent to the present value of some UK pension liabilities.

Several factors -- the market crash brought on by subprime lending, new solvency rules for insurers due in 2012 and the stampede of baby-boomers to retirement age -- are adding urgency to providers' efforts to spread their exposure.

The UK has seen a flurry of over-the-counter longevity swaps deals, the biggest of which so far involved German car maker BMW <BMWG.DE> in February offloading 3 billion pounds of risk from its UK pension scheme to Deutsche Bank's <DBKGn.DE> insurance subsidiary Abbey Life.

Abbey Life insured the longevity risk on the BMW pension scheme, taking responsibility for the payments and transferring a proportion of that risk to a panel of reinsurers.

Building on these deals, pension providers are working to construct capital markets instruments to slice and dice longevity risk into tradeable portions.

But the pensions industry says such markets should be underpinned by a roster of government bonds that are structured to help maintain payments to people who are tending to outlive even current expectations -- for example, those aged over 90.

If that seems like a small group, the evidence is it's the population segment most likely to grow. There are around 450,000 centenarians in the world today and experts estimate there could be a million across the world by 2030. For more details on how centenarians are the fastest growing demographic in the developed world, click here.

There's also mounting uncertainty about how many people will have died by age 90, and the Pensions Institute cites mortality projections which show some men at that age will live beyond 110 -- a long "tail risk" which may boost liabilities significantly.

"Longevity risk is a size that it should also go out to the capital markets," said John Fitzpatrick, a partner at Pension Corporation, which buys out liabilities and sponsors some pension funds. He is also a director of a fledgling venture to make such a market happen.

So far, neither capital markets nor the British government have been enthusiastic about the plan, although investment banks are behind the latest efforts to build a tradeable longevity swaps market.

Proponents of a longevity bond say they are receiving a more receptive response from the Conservatives, the party challenging Labour for government in elections due this spring, but the party declined comment.

WHO WILL BUY?

In a longevity swap like the BMW deal, the automaker reduced its exposure to its longer-lived pensioners by passing this liability to Abbey Life for 3 billion pounds ($4.6 billion). Typically, that premium is based on agreed mortality risks in the portfolio.

Abbey Life transferred a proportion of the risk to a consortium of reinsurers. The idea is that this risk is then passed onto investors such as Insurance-Linked Securities (ILS) investors, hedge funds and sovereign wealth funds.

They are attracted by the new asset class as an investment which would trade out of synch with traditional assets such as equities, bonds and real estate.

At the fundamental level, longevity risk is a good thing to own if you believe for any reason that more people will die sooner than currently forecast, if you have a portfolio that would lose money should such a catastrophe happen, or if you anticipate returns on the asset.

"Investors ... who own the risk of hurricanes, typhoons, earthquakes and lethal epidemics are ideally suited to take on longevity risk," said Fitzpatrick.

"There is no known correlation between the wind blowing and the earth shaking and how long UK pensioners live -- longevity offers a good diversifying risk for their portfolios," he said.

Capital markets players have already been involved in longevity transactions to a small degree: of the eight publicly announced swaps, the longevity risk was passed through to investors through reinsurers and investment banks.

But these have been bespoke deals. A key to developing such a market would be standardised indices. The Life and Longevity Markets Association (LLMA), of which Fitzpatrick is a director, was set up in February by a consortium of banks, insurers and pension experts to do just this.

HOT POTATO

Pricing the risk is complex. For a longevity transaction to happen, the investor, pension fund and investment bank have to agree on a forward projection of the cash flows related to either a population index or to a specific pension block.

And markets' resistance at current prices is palpable.

"Pension funds are marketing liabilities at unreasonable levels," said Andrea Cavalleri, head of Life at Securis Investments Partners, a fund dedicated to transferring insurance-linked risk to the capital markets.

"We often disagree with the mortality improvement assumptions provided by the pension funds in what can be outdated models," he said, underlining the basic problem -- people are living longer than previously expected.

"In reality, the capital markets should not be picking up the bill for unreasonable assumptions that the pension funds have on their books," he added, referring to liabilities the pension providers already hold.

Enter the government?

The many arguments in favour of a sovereign bond linked to longevity rest on one fundamental expectation: if pension providers can't pay, or become insolvent, governments will have to.

Longevity bonds could make the process neater, and more politically palatable, than the collapse of a pension provider.

"We will develop collateral mechanisms so investors can trade the risk themselves," said Fitzpatrick of the LLMA.

"But it would be helpful if the government did issue a longevity-linked bond, because such a system would reduce the amount of longevity risk that the government is likely to have in the future."

For a factbox on how a government bond would work, click here.

UNINTENDED CONSEQUENCES

A paradox in all this is that waves of pension reforms have been designed to shift the risk of providing for old age away from the state or corporates and onto the individual, and people have been encouraged to turn to capital markets to provide.

In principle, pension providers' liabilities have been reduced by moves away from the guarantees in Defined Benefit pension schemes towards less-secure Defined Contribution models, which are more like the U.S. 401(k) plans.

But in practice insurers say that even with the reforms, because people are living longer than expected, the risk of funding new schemes is becoming concentrated with them, especially in Britain.

"Insurance companies are beginning to play a big role in aggregating longevity risk in the economy," said the Pensions Institute paper, co-authored by Blake and Tom Boardman, director of retirement strategy and innovation at Prudential UK <PRU.L>.

When they retire, Defined Contribution plan members usually use capital accumulated in the schemes to buy an annuity -- commonly sold by insurers -- to provide their future income.

So sellers of annuities are the ones now exposed to the risk that holders will typically live longer than expected in pricing the product. This "aggregate longevity risk" cannot be hedged, Boardman says.

"The situation is particularly acute for insurance companies operating in the European Union," said the paper. The insurance industry's equivalent of Basel II for banks, Solvency II, is due to be introduced in 2012 and currently proposes that insurers be required to hold significant extra capital to back their annuity liabilities if longevity risk cannot be hedged.

As a result, affordable annuities are becoming harder to find.

"If the private sector is unable to hedge aggregate longevity risk, it increases the likelihood that insurance companies stop selling annuities or increase annuity prices, which would reduce pensioner income in retirement," said Boardman.

LONGEVITY FLOATERS

The pensions industry wants the government to issue bonds whose coupon payments, made to pension plans and annuity providers, depend on survivorship: if more people survive at each age than was expected, the government pays higher coupons.

If, on the other hand, survivorship is lower than expected, the bond pays out lower coupons. Pension plans and annuity providers would see their payments also fall.

Boardman argues that the private sector can hedge risks at an individual level, but the government needs to provide the hedge against the trend. The industry says the bond could be similar to inflation-linked gilts first issued for pension funds in 1981.

"The government helped the development of the inflation swap market by issuing an index-linked bond because it gave a pure price for inflation risk to the market," said the Pension Corporation's Fitzpatrick.

"Likewise, it would be helpful for investors to be able to see a pure price for longevity. A large traded market in longevity would develop as you have today around inflation swaps."

The government has so far been averse to the implication that by issuing a longevity bond, it would be assuming the risk of the old getting older that no-one foresaw when pension reforms were implemented.

But the pensions industry points that the government is already exposed to longevity risk: private-sector pension liabilities and public sector funded pension plans both exceed 1 trillion pounds each, according to Boardman's paper.

"Nobody wants to take on the tail risk," said Blake. "The government bonds are necessary because the investors who have recently become interested in taking the other side of the longevity swaps market have no appetite for hedging long-duration tail longevity risk."

Securis Investments Partners' Cavalleri thinks it's simpler than that.

Unless the starting assumptions are appropriate, the need for pension and annuity players to hedge is misleading, he said.

"It is about getting rid of unwanted and unattractive risks. Frankly, we don't see who would want to be on the receiving side of that -- at least on current terms."

(Editing by Sara Ledwith and Nigel Stephenson) ((sarah.hills@thomsonreuters.com))

FACTBOX - How longevity bonds may work

(This complements a story on longevity risk and capital markets. Click here for the article)

Apr 7 (Reuters) - Pension insurers have been lobbying the British government to issue bonds linked to the longevity of the population, to help pension schemes and insurers manage the financial pressure of increased life expectancy.

Similar to the introduction of inflation-linked gilts first issued for pension funds in 1981, the government could issue a series of longevity-linked floating-rate bonds, creating a hedge against the financial risks posed by increase life expectancy.

Here's how the bonds would be structured:

* The bond pays coupons that reduce over time in line with the actual mortality experience of a particular age group in the population, such as 65-year-old males from the national population: so the coupons payable at age 75, for example, will depend on the proportion of 65-year-old males who survive to age 75.

* The bond pays coupons only and has no principal repayment.

* Coupon payments are triggered when the longevity risk is high: so, for example, the first coupon might not be paid until the cohort reaches age 75. The coupon payments continue until the maturity date of the bond which might, for example, be 40 years after the issue date, when the cohort of males reaches age 105.

* The final coupon incorporates a terminal payment equal to the discounted value of the sum of the post-105 survivor rates to account for those who survive beyond age 105. The terminal payment is calculated on the maturity date of the bond and will depend on the numbers of the cohort still alive at that time and projections of their remaining survivorship. It is intended to avoid the payment of trivial sums at very high ages.

* If population survivorship is higher at each age than was expected, the bond pays out higher coupons. This is what pension plans and annuity providers need to help match the higher than expected pensions and annuity payments they need to make.

* If, on the other hand, survivorship is lower at each age than was expected, the bond pays out lower coupons. But the pension plans and annuity providers are not likely to mind this, since their pensions and annuity payments are also likely to be lower.

Support for the idea:

* The Pensions Institute has cited a number of organisations that support the concept of governments issuing longevity bonds.

* The UK Pensions Commission and the IMF agree the government should consider their use to absorb tail risk for those over 90, while the OECD and the World Economic Forum argue that governments could improve the market for annuities by issuing longevity indexed bonds and producing a longevity index.

* The UK Confederation of British Industry said the government should drive development of a market in longevity bonds.

Who benefits?

* Proponents say the government gains by having both a more secure defined contribution (DC) pension savings market and a more efficient annuity market, resulting in less means-tested benefits and a higher tax take.

It earns a market-determined longevity risk premium, further reducing the expected cost of the long-term national debt.

* Defined Benefit (DB) schemes have the opportunity to reduce longevity risks and can hedge longevity risk exposure prior to buy out.

* Insurers can potentially establish a mark-to-market longevity risk term structure, and hence hold the optimal level of economic capital or at least hold capital closer to the economic level, in line with current proposals for Solvency II regulation, due to take effect in 2012.

* Capital markets would get help to kick-start market participation through the establishment of reliable longevity indices and key price points on the longevity risk term structure.

They can build on this longevity risk term structure with liquid longevity derivatives.

* Investors get access to a new (longevity-linked) asset class whose returns are uncorrelated with traditional asset classes, such as bonds, equities and real estate

* Pension plan members would have a means of hedging the longevity risk associated with purchasing an annuity at retirement.

(Source: Pensions Institute discussion paper - Sharing Longevity Risk: Why Governments Should Issue Longevity Bonds) (Reporting by Sarah Hills; Editing by Sara Ledwith)

Jury out on top fund persistence, By Steve Johnson, *Financial Times, FTfm*, March 29 2010

Investment companies should reward their star fund managers more lucratively and sack poor performing managers more quickly, according to research by Cass Business School's Pensions Institute.

The Institute concluded that past performance is no guide to future returns in the fund industry because successful, skilled fund managers jump ship and the highest returning funds attract sizeable inflows that render them less nimble.

In contrast, poor performing funds that suffer significant outflows and fire their fund manager tend to improve their performance.

“Losing fund managers seem to be incapable of extricating themselves from losing positions without external prompting, so the investment management company needs to replace them much more quickly,” said Prof David Blake, director of the Institute and co-author of the report*.

However, a separate study by Aviva found that for multi-asset unit-linked life and pension funds, buying the previous year's winners was a successful strategy.

Over the past 20 years, Aviva found that top quartile funds returned, on average, 8.3 per cent in the following year, while previously bottom quartile funds made just 7.1 per cent.

Its analysis of the £200bn (€222bn, $297bn), 1,675-fund strong sector found funds were significantly more likely to be in the same quartile in consecutive years than if performance was purely random.

"I was taken aback to see not only was there persistence [of performance], but that it was statistically significant," said Jason Josefs, manager of Aviva's £16bn multi-asset book, who compiled the research. "You should think about buying the best performing funds."

However, the Cass study suggests that persistence of performance does not exist for mutual funds, even though some managers are more skilled than others.

Based on a sample of almost 4,000 US equity funds between 1992 and 2007, the research found if the manager of a "winner" fund (top decile in the previous year) departed, performance deteriorated, on average, by 1.21 percentage points the following year. If the fund also experienced above-average inflows, the deterioration rose to 2.29 percentage points.

A "winning" fund that both lost its manager and had strong inflows undershot a winning fund that saw neither of these effects by 3.60 percentage points.

"A successful fund is going to get an awful lot of flows coming in. If you try and scale-up the investments you dilute performance," said Prof Blake.

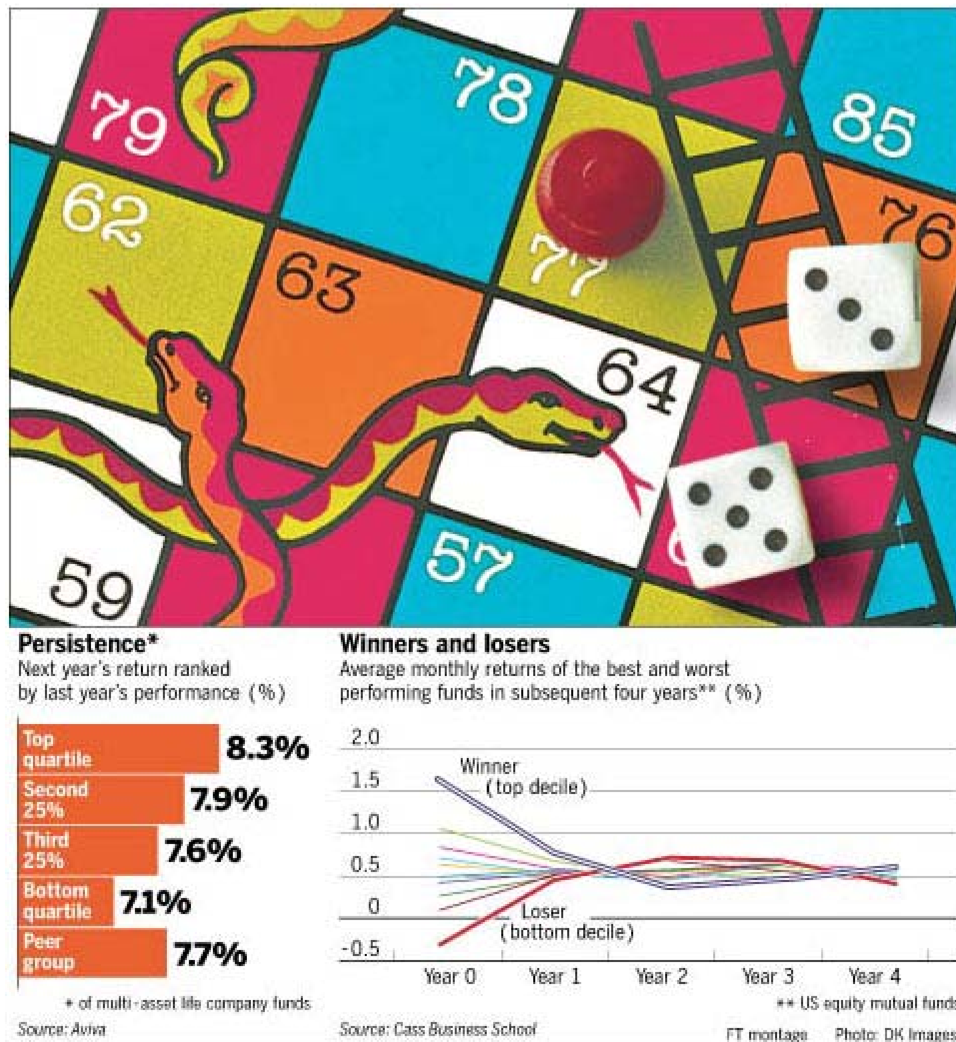
The effect is so strong that top decile funds in one year will typically be the very worst performing ones two years later.

The deterioration occurs even when the star manager of a large fund house leaves, the analysis found, suggesting even the industry heavyweights do not have large enough talent pools to compensate.

In contrast "loser", or bottom decile, funds that sack managers and suffer strong outflows improve their performance by 3.00 percentage points the following year.

Prof Blake believed Aviva's findings reflected a degree of momentum in performance from one year to the next, as well as the fact that life funds are less susceptible to damaging "hot money" flows than mutual funds.

* Why does Mutual Fund Performance not Persist? The Impact and Interaction of Fund Flows and Manager Changes by Wolfgang Bessler, David Blake, Peter Lückoff and Ian Tonks



Bring the 'golden cohort' to the fore, *Financial Times,* March 22 2010

From Prof J.H.C. Leach.

Sir, Although there has been much concern over the impact on pension schemes – especially the state scheme – of what appears to be the UK's unexpected, and therefore unpredicted, increasing life span, I have yet to see in your pages any discussion of one highly relevant matter, well known to actuaries: I refer to the "golden cohort". This body of persons is that which was born in, or around, the middle 1930s.

Of course, one can rightly refer to the decline in smoking, the abolition of childhood diseases, the NHS, and the overall rise in the standard of living. But there is another, non-recurring factor: food rationing. Those in the UK who were born in the 1930s, and are now in their late 70s, were faced with rationing from 1940 to its end in 1954. No chance then to glut oneself on dairy foods, or other deleterious foodstuffs: they were simply not available. And the fact appears to be that the said "cohort" is contributing markedly to what would have been otherwise an unexpected current rise in longevity.

This raises the question: when the golden cohort itself passes on (which it appears to be in no hurry to do), will actuaries' predictions of longevity revert towards their earlier assumptions? Or not?

The matter is of no little importance to pensions providers – as evidenced by the letter from David Blake ("Why government should issue longevity bonds", March 18).

J.H.C. Leach, London N6, UK

Government should buy protection, *Financial Times,* March 22 2010

From Mr Daniel Ah-Sun.

Sir, I fear that David Blake (Letters, March 18) has overlooked the key risk that increased longevity poses to the country: namely, it is the state that faces that risk at least equally with, and most probably to a greater extent than, private sector pension schemes and insurance companies. Be it through state pensions, care for the elderly, housing requirements or other state spending, it is the government that should wish to buy protection against increased longevity, not sell it.

While I agree that a liquid and tradeable market in longevity bonds is desirable and will surely be formed over the coming years, the idea that the government should be a seller and not a buyer in such a market seems to me to be entirely wrong-headed. Any engagement by the government in this issue, sadly ignored and pushed under the carpet for the last decade, would be a step in the right direction. However, when it comes to having capital to put behind any such sale, the current government may not have enough credibility in the markets to be able to back such a bond in any case. No bad thing.

Daniel Ah-Sun, London SW1, UK

State should sell annuities direct to our pensioners, *Financial Times,* March 24 2010

From Mr Paul Dare.

Sir, Prof David Blake (Letters, March 18) is confident that the UK could issue longevity bonds at prices that would benefit the taxpayer and that this would, if done, be carried out profitably.

However, it would be much safer and efficient for taxpayers if the government sold annuities directly to UK pensioners, rather than relying on the market to construct good annuities with the help of longevity bonds. This would cut out so many middlemen and avoid the risk of overly benefiting others if longevity bonds were issued, such as non-UK citizens needing good pensions and the investment bankers and so on who would become involved.

Everything needing to be known about these prospective UK annuitants is known already by the state. Their bank accounts (where they already receive their state

pensions), addresses, National Insurance numbers, ages and much more besides are on record. Further, the annuity products offered need not be sophisticated. The products could be kept simple. The selling process could be simple too, like the current one for deferring the state pension in exchange for a bigger pension later.

If it later transpired that the annuities sold were overpriced, the taxpayer would benefit as Prof Blake indicates. If, however, the annuities sold were underpriced, then taxpayers would have benefited through the opportunity they had to buy the cheap annuities.

Paul Dare, London SW13, UK

Why government should issue longevity bonds, *Financial Times*, March 18 2010

From Prof David Blake.

Sir, Your editorial "Sovereign equity; governments need new instruments for raising finance" (March 15) failed to mention longevity bonds as a source of new government finance. Not only would the government earn a longevity risk premium from issuing longevity bonds, the bonds would help private sector pension schemes and annuity providers hedge the aggregate longevity risk they face, a risk that cannot be hedged using existing financial instruments.

This issue will become increasingly acute over the next couple of years as the baby-boomers begin to retire, crystallising the longevity risk exposure of pension schemes and annuity providers. There is a risk that Solvency II will require insurers to hold significant additional amounts of capital to cover longevity risk as it will be deemed to be "unhedgeable". This could result in annuity rates falling by up up to 10 per cent, with a consequential increase in means-tested benefits and a reduction in taxation from pension incomes.

In short, there are three main reasons the government should issue longevity bonds: it has an interest in ensuring an efficient annuity market; it has an interest in ensuring an efficient capital market for longevity risk transfers; it is best placed to engage in intergenerational risk sharing and the longevity risk premium earned from issuing the bonds will be more than sufficient to compensate for the additional risk it would be assuming.

David Blake,
Director, Pensions Institute,
Cass Business School,
London EC1, UK

How firms 'avoid' pension costs, by Fran Abrams, File on 4, BBC Radio 4, Tuesday, 9 March 2010

Once, Steve Hall could have looked forward to a prosperous retirement thanks to his company's pension scheme. But now he is facing financial uncertainty.

"The worst case scenario is I could lose probably 30 to 40% of my pension - it's not just me as it must be 200 to 300 people that have an interest in the pension scheme that are going to have their futures affected," he told BBC File on 4.

Eight months ago the Worcester-based company he worked for, which was owned by former Tory cabinet minister Stephen Dorrell MP and made work wear, went into so-called pre-pack administration.

The assets were sold to a new business trading under a new name but without the pension liability of the old business.

Instead of drawing his planned pension, Steve Hall and others in the scheme will have to rely on the government's Pension Protection Fund (PPF), which was set up to ensure pensioners were not left high and dry when their former employers went bust.

The PPF is funded by levies on company pension schemes.

Pension cap

Most employees will receive 90% of what they are owed. But as a high earner Mr Hall said he would get less because payments are capped.

"All the pensioners are still in limbo as to what their pensions will be in the future, it just seems totally wrong," he said.

Mr Dorrell took his and his wife's pension out of the scheme before the company closed, in an attempt to reduce its liabilities.

He now has shares in the new company plus a director's salary in addition to his Westminster pension.

"My wife and I would have been better off if we had stayed in the fund and ended up in the PPF," said Mr Dorrell, who added that his family had lost the £500,000 it invested during 2007 to try and save the business.

He told File on 4 that administration had been a bitter pill to swallow for both his employees and himself but it had saved 400 jobs.

There is no suggestion that the pre-pack deal was illegal - the Pensions Regulator approved the scheme's admission to PPF.

But it has left a bad aftertaste for employees such as Steve Hall.

"Pre-pack is so easily arranged you can in a single day effectively remove a company's assets and leave the creditors and indeed the pension scheme out on a limb," he says.

"Immoral is perhaps too-strong a word but that's how I feel, it cannot be right that you can so easily rid yourself of liabilities."

Fund burdens

David Blake, director of the Cass Business School in London, also believes pre-pack administrations are being used to dump costly pension fund liabilities.

Under pre-pack adminstration the company's assets are sold immediately after it has entered administration and often the previous previous directors or management buy the assets from the administrator to set up a new company.

It has the advantage of enabling any profitable parts of a business to be salvaged quickly but Mr Blake believes it can also be used to exploit the PPF.

"It's obviously legal, because it has been accepted by the regulator, but whether it's moral or fair on everyone else is a different matter"

David Blake, director of the Cass Business School in London

"The pension liabilities and assets [of a company] go into the Pensions Protection Fund and then that company restarts under a different name and then finds itself doing business a few weeks later with its pensions liabilities off the books," he told File on 4.

"It's obviously legal, because it has been accepted by the regulator, but whether it's moral or fair on everyone else is a different matter."

The Pensions Regulator brief includes ensuring that companies do not place unfair burdens on the fund.

David Norgrove, its chair, defended the regulator's record.

"There are cases where companies set out deliberately to avoid their pension liabilities and we do have powers to prevent those, and I think we have been pretty successful at that," he said.

Mr Norgrove added that pre-pack deals were "particularly difficult cases and it is our role to act as a creditor with the PPF to make sure that the company really is inevitably going into insolvency and that the pension scheme is treated fairly in the restructuring".

Taxpayer bailout?

More than 30,000 people rely on PPF, but six times this number are waiting for their scheme to be accepted into the fund, which has a £1.2bn deficit.

David Norgrove said he was confident that the PPF could "continue to meet the claims on it".

He said fears that the fund might become insolvent were "greatly exaggerated".

However David Blake said the taxpayer could have to bail out the PPF.

"The fund will have a reducing fund of good schemes to charge levies to and an increasing pool of weak scheme it can't charge a fair levy on," he said.

"These trends will lead to increasing deficits in the Pension Protection Fund."

File on 4 is broadcast on BBC Radio 4 on Tuesday, 9 March 2010, at 2000 GMT, repeated Sunday, 14 March, at 1700 GMT. You can listen via the BBC iPlayer or download the podcast.

David Blake, director of the Pensions Institute at City University's Cass Business School, assesses contract-based DC pensions investment as 2012's reforms approach. Jenny Keefe reports for *Employee Benefits Magazine*, February 2010

Contract-based defined contribution (DC) pension schemes are the pensions equivalent of Ugg boots - they are loved and loathed in equal measure. In the UK, DC schemes are managed in two ways. They are either trust-based, where the employer provides a trust to represent employees' interests, or contract-based, where employees deal directly with the pensions provider and make their own investment decisions.

Contract-based schemes are cheap and easy to run, but many believe they have a downside because there are no trustees to protect members' interests. David Blake, director of the Pensions Institute at City University's Cass Business School, says: "The most important issue with contract-based DC pensions relates to governance. Trust-based schemes have a trustee board, which does all the due diligence work on key aspects of scheme design.

"Trustees pick appropriate minimum contribution rates and decide the range of retirement income options. They make asset allocation decisions, deciding how much will be in equities and how much in cash, and they choose the specialist investment advisers to carry it all out. Contract-based schemes do not have a board of trustees to provide such good governance.

"There is just the general impression that the default investment funds are not well designed to achieve their required purpose: a good-value retirement income for money that has been invested for so long."

Trustees not investment advisers

Of course, trustees, many of whom are employees, are not investment advisers. This raises the question of whether it would be better for staff to save on administration fees and just give the cash to an insurance company to manage through a contract based scheme. “If significant contributions from both employer and employee are going to be invested over 40 years, then it pays to get an appropriate, dynamic investment policy in place,” says Blake.

He concedes that "trustees do not have the skills to do this", and says it is worth appointing a good investment consultant.

When choosing between trust- and contract-based schemes, much depends on an organisation's size, says Blake. "Small employers with low governance budgets will

find it easier to hand the contributions over to an insurance company, especially if employees are not sufficiently interested to become trustees. It is this situation the National Employment Savings Trust (Nest) [formerly known as personal accounts] is intended to deal with.

"Larger employers with a workforce more interested in pensions might go down the trust-based route. The future, however, could be Nest for small employers and trust-based DC schemes for larger employers." Nest is due to be introduced in 2012 as part of the government's pension reforms, which will also see the introduction of auto-enrolment, and compulsory employer and staff contributions.

Feeling the economic pinch

Like other investments, contract-based schemes are still feeling the economic pinch. "Very few investment assets have done well in the recession," says Blake. "Equities led the way with falls of more than 25%. Yet, where the default fund in a contract-based scheme was an insurance company's managed fund, which, typically, has a significant holding in bonds, this might have fallen less than funds with heavier equity weightings. But where the managed fund had a large holding in bank bonds, these would have performed badly, too."

Some employers have encountered criticism that they have used the absence of trustees to cut their contribution rates to contract-based schemes. But Blake has not seen any evidence of this. "It is more likely that employer contributions were not that high in the first place," he says. "Employers do not currently have to contribute to stakeholder pension schemes."

Governance is not the only issue bothering Blake. “There is also the general impression that, with contract DC schemes, everything is commission-driven on the part of providers,” he says.

New FSA rules

But new rules proposed by the Financial Services Authority (FSA) could knock such practices into shape. The FSA's Retail Distribution Review, published in December last year, could mean consultants and advisers will no longer be able to cash in on commission from sales of group personal pensions (GPP), stakeholder pensions or group self-invested personal pensions (Sipps). The new rules will come into effect by the end of 2012.

"The FSA is proposing to end commission and replace it with fees for advice," says Blake. "It is likely the greater transparency this will bring will result in fee income being lower than total commission over the life of a typical scheme. Given that contract-based schemes come under the auspices of the FSA, this is likely to lead to advisers being much less willing to market the schemes."

Which brings us to Nest. Under the new system, employers will be obliged to enrol staff into a company scheme or open a Nest, to which they both must contribute. Significantly, the new schemes will be trust-based, run by not-for-profit trustee body, the Nest Corporation. "The Personal Accounts Delivery Authority is, in a sense, the

predecessor to the trustee board," says Blake. "It is putting a lot of effort into good governance planning, for example design of the default fund, which 90% of members are expected to adopt.

Need to increase take-up

"The government has learned some lessons from the poor take-up of stakeholder schemes. The most important of these is the need for auto-enrolment to increase take-up. If auto-enrolment fails because employers encourage employees to drop out, then the only remaining solution is mandatory participation. Even then, the 8% combined minimum contribution into Nest is not going to generate that big a pension in retirement above the state pension, especially when means testing could leave a number of people with little additional net benefit from their additional pension savings."

So the introduction of Nest could mean contract-based plans are on the way out. "The new accounts will be trust-based, so auto-enrolment into these will do little to improve the share of contract-based schemes in the future," says Blake.

He adds the new pension contribution limits for high earners could result in fewer contract-based schemes because staff on high incomes are less likely to be in this type of plan. "The importance of DC plans will continue to increase as [employers] move away from defined benefit provision. But contract-based DC schemes are likely to decline relative to trust-based DC plans."

Blake's top tips for contract-based DC pension investment

- Look long term. Remember that a pension scheme can last for more than 70 years: 40 years of contributing and 30 years of providing income.
- Bolster governance. Review the scheme's governance arrangements. Is it possible to introduce the equivalent of a trustee board to oversee investment performance and other issues?
- Add up contributions. Regularly review both employer and employee contributions to ensure workers are amassing enough to fund their retirement. Consider future investment returns and changes in members' life expectancy.
- Ditch dud defaults. Make sure the default investment fund offers decent returns without excessive risk.
- Keep a balance. Ensure the default fund shifts to lower-risk asset investments as employees come up to the age at which they want to retire.
- Earn extra income. Make sure workers have access to a range of annuities, including joint-life annuities for those with a partner and impaired-life annuities for people with a health condition. Encourage employees to shop around before buying an annuity.

Admin woes will distract from NEST investment strategy, *Professional Pensions*, By Emma Dunkley, 29 Jan 2010

The "administrative nightmare" of auto-enrolment into National Employment Savings Trust will divert necessary attention from the scheme's investment strategy, the Pensions Institute warns.

Director professor David Blake said keeping track of contributions for migrant and casual workers will be a major challenge for NEST Corporation and it could face problems managing cash flows.

He said: "Think of the problem of dealing with seasonal farm workers living in tents and moving every few weeks to another job. Think what would happen if there was a slight mistyping of their name or National Insurance number when this happened."

He added: "Tim Jones will be concerned to ensure that the money collected is properly allocated to each member's account. He will be far less concerned with investment strategy and stock market movements - the biggest problem will be losing track of cash flows."

A number of people previously recommended collecting contributions for NEST through the National Insurance system, however Blake said the government knew it could not cope with this degree of transactional frequency.

He added: "That's why the government went for a private sector solution."

Blake said PADA also wanted the default fund in auto-enrolment to be fairly low risk in the early years, in order to avoid any reputation damage if there are big falls in the value of members' accounts.

A PADA spokesman said: "PADA is very much focused on achieving excellence for both the administration and the investment strategy."

Genuine active managers can add value, By Marcus Whitehead, *FTfm*, January 10, 2010

Within the investment management industry there is the eternal question – does active management add value? To better inform the debate, I have reviewed the latest academic research in this area from both sides of the Atlantic and come to some interesting conclusions: passive is rational, closet indexing is not and unconstrained active may just be where the skill is.

The investment market rings with the Financial Services Authority's risk warning that past performance is not a guide to the future. Despite this there is a strong perception that in making decisions to hire and fire investment managers many pension schemes are strongly influenced by past performance – good or bad, and that this can lead to manager changes that add little to performance and in fact can be outright detrimental.

Research on decisions by more than 2,000 UK pension schemes over a 20-year period by Blake, Timmermann, Tonks and Wermers (http://www.pensions-institute.org/workingpapers/wp0914.pdf) in 2009 suggests managers were typically fired having significantly underperformed a UK equity benchmark, managers were appointed having recently outperformed the benchmark and that both the fired and hired investment managers produced returns broadly in line with the benchmark index after the change – that is they both performed in line with an index tracker.

A study by Goyal and Wahal in 2008 looked into similar hiring and firing decisions by US plan sponsors. It showed US equity managers were typically fired for poor performance and hired after significant outperformance. As in the UK, the outperforming manager, once appointed, typically produced returns broadly in line with the index. The fired manager proceeded to outperform the benchmark in the period after their removal.

This leaves us to conclude that pension schemes have failed to consistently add value when changing investment managers. But can active equity managers add value for pension schemes in the first place?

Research into more than 700 pooled funds available to UK pension schemes over a 25-year period by Clare, Cuthbertson and Nitzsche in 2009 found there was little evidence the managers studied could outperform their benchmark index. They also studied "performance persistence", – whether a manager outperforming in one period tended to outperform in the following period – again they found little evidence of persistence.

A further piece of research comes from the US by Busse, Goyal and Wahal, in 2008 where more than 4,000 US institutional equity funds were analysed over a 16-year period. They found no evidence of manager outperformance on average and also no evidence of performance persistence.

Therefore it seems rational for many UK pension schemes to select a passive manager, as the average equity manager has not exhibited skill and schemes have struggled to identify outperforming managers, despite being strongly influenced by past performance.

However, the academics seemed to bemoan the lack of depth in the data they had available, as they were working off little more than quarterly investment performance data. To dig deeper, we have to look to retail investment funds and in the US, in particular, where these funds must disclose full portfolio holdings on a quarterly basis.

Research into US equity retail funds by Cremers and Petajisto in 2009 used data on more than 2,500 funds over a 24-year period. They analysed the concept of "active share", which is the proportion of a manager's portfolio that does not overlap with the benchmark index. They define a closet indexer as a manager with an active share of less than 60 per cent. They found that managers with a high active share, the concentrated stock pickers, significantly outperformed the closet indexers. They also investigated past performance alongside a manager's active share, and found outperforming managers with a high active share showed strong performance persistence.

So have we found the Holy Grail – pick top performing managers with a high active share? As ever, there are lies, damn lies and statistics and one piece of research is not an irrefutable proof. However, for investors committed to active management, the message is clear that closet indexers should be avoided and the focus should be on genuine active managers.

Marcus Whitehead is a partner of Barnett Waddingham LLP