



MARKET & ECONOMIC REVIEW

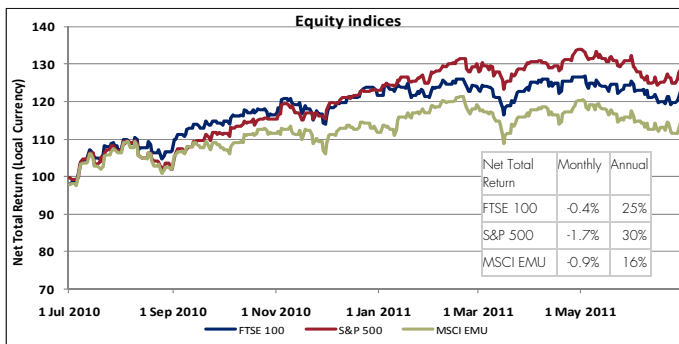
Overview

Despite violent rioting, Greek politicians approved key austerity measures which included tax rises, privatisations and cuts to benefits and public spending. This staved off the immediate threat of default and opened the way for further funds from the EU and the IMF; however, the problems in Greece are not yet over.

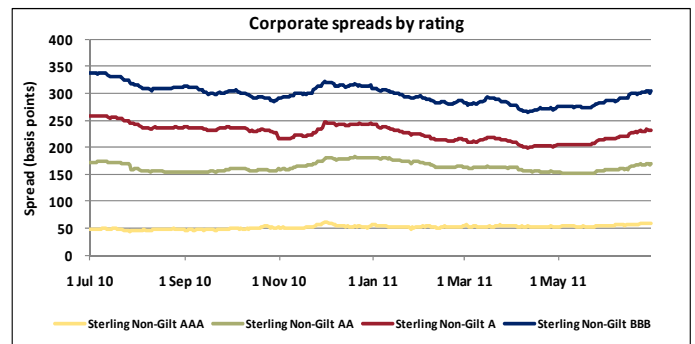
In the UK, CPI was unchanged at 4.5% in May, with upward pressure from food offsetting falls in transport services prices. Despite changes to the membership of the MPC, there was no change to the decision to hold the base rate at 0.5%. The minutes revealed a more dovish tone with new member Ben Broadbent voting to hold base rates at 0.5%, unlike the hawkish Andrew Sentance whom he replaced. Markets now expect no increase in interest rates for a year.

The Debt Management Office launched a consultation on the issuance of CPI-linked bonds to help build an evidence base to inform the Government's consideration of this issue. Given the recent shift to CPI for some occupational pension schemes the DMO asked what demand for these instruments was likely to be and the extent to which institutions are willing to hedge CPI liabilities with existing RPI instruments.

Equity markets declined slightly this month



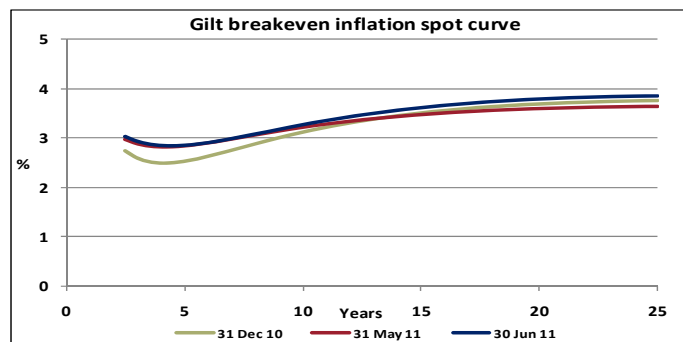
Credit spreads increased this month



LATEST ECONOMIC NUMBERS

Current Base Rate	0.5%
CPI increase May (%y/y)	4.5%
Halifax house prices May (%m/m)	0.1%
IPD TR property index May (%m/m)	0.7%
UK total trade balance Apr	−£2.8bn
VIX (volatility) index	16.52
\$/£ exchange rate	1.61
Numbers as at the end of month unless stated	

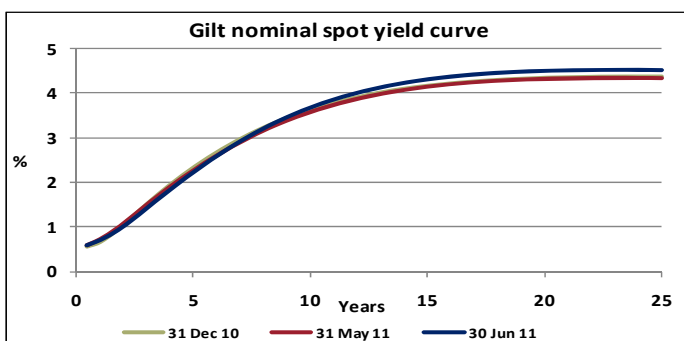
Breakeven inflation increased slightly at longer terms



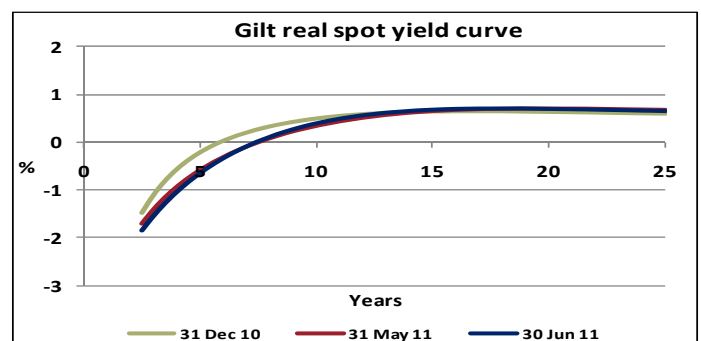
CALENDAR OF EVENTS AND DATA RELEASES

MPC interest rate announcement	7th July
Producer Price Index	8th July
UK Trade	12th July
RPI/CPI	12th July
Minutes of MPC meeting	20th July
GDP Q2 (preliminary estimate)	26th July

Nominal yields increased slightly at longer terms



Real yields remained unchanged this month





Longevity Hedging

It is now common practice for pension schemes to use 'Liability Driven Investment' ('LDI') strategies to hedge interest rate and inflation risks. These risks are sometimes described as 'unrewarded' risks for the scheme and the cost of hedging these risks is seen as good value in exchange for removing uncertainty.

Another 'unrewarded' risk is longevity risk – the risk that scheme members live longer than expected and hence increase the cost of the scheme. Until recently, the options to hedge longevity risk were limited. One option is to purchase annuities and pass the inflation, interest rate, longevity and investment risks onto an insurance company. This is not always a cost effective solution, especially for smaller schemes, and recent activity in longevity swaps suggests that pension schemes may soon be able to use alternative solutions to manage their longevity risk.

How to hedge longevity risk

There are two broad types of longevity swap: an indemnity-based swap and an index-based swap. Under the indemnity-based swap, the pension scheme pays a series of fixed cashflows, based on agreed longevity assumptions, in exchange for the actual pension payments paid to members.

Under an index-based swap, the scheme again pays fixed cashflows based on agreed assumptions, but instead receives payments linked to a mortality index. For example, the index may be based on published national longevity statistics. The swap therefore protects against general longevity improvements in the underlying index rather than the scheme's specific longevity risk as under the indemnity-based swap.

Market history and future development

The longevity market is still very much in its infancy - the first longevity swap was completed in June 2009 and the first index-based longevity swap completed in February this year. However, many expect the longevity swap market (especially index-based swaps) to continue to gather pace over the next few years due to a number of encouraging signs.

First, index-based swaps offer pension schemes a cost effective way of hedging the longevity risk associated with the longer liabilities of non-retired members. Typically, annuity purchases and indemnity-based transactions have tended to focus only on retired members—leaving the scheme exposed to long-term longevity trends.

Second, there is appetite amongst reinsurers and capital market investors to accept the longevity risk and act as counterparty to the swap contracts. For reinsurers, longevity risk is a natural hedge to the mortality risks that they underwrite. For investors, longevity is seen as a diversifying risk that has low correlation with many other asset classes.

Risks and Price

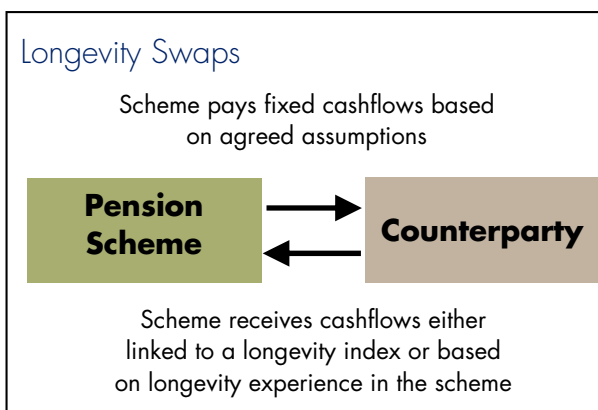
As with all swap contracts, one of the biggest risks with longevity swaps is the risk that the counterparty to the swap defaults on the payments they are obliged to make. This risk is mitigated by the collateral requirements of the swap and can be further managed by the scheme by selecting counterparties with good credit ratings.

Another important risk relates to the terms under which the scheme is allowed to close out the swap contract—for example when the scheme is in a position to buy-out all liabilities. This may be a complicated matter and it is important that the parties agree the terms for terminating the swap. Options may include converting the swap into an annuity policy or 'novate' the contract by passing it on to the insurer taking on the liabilities.

For index-based swaps there is the risk that the longevity experience in the scheme differs to the longevity index in the swap. This basis risk can be reduced by calibrating the hedging index to appropriately reflect the scheme's age, geographic, gender and socioeconomic characteristics.

Despite these risks, the key consideration for the scheme is likely to be the cost of the swap. In particular, the scheme will need to consider the longevity assumptions built into the fixed leg of the swap and how this compares against the expected scheme mortality rates and prudent assumptions used to determine the schemes technical provisions. For some schemes the cost of removing longevity risk may still be too high.

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