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LONGEVITY SWAPS

Andrew Birkett

June 2010

Babcock International Group Plc
www.babcock.co.uk

FINANCIAL TIMES

COMPANIES & MARKETS

Wednesday May 13 2009

Battered bonds
Why yields on government paper have been pushed higher **Page 39**

John Plender
Politics to determine race among financial centres **Page 38**

Supply chain strain
Housing slump hits entire construction industry **Page 21**

News Briefing

INDUSTRIAL TRANSPORT
First loss in 105 years looms for Marceg
AP Motor Marceg could be facing its first full-year loss in its 105-year history after its Marceg, Lane container shipping business lost sales (Chart) in the first quarter. Chief executive John Anderson (above) said the problems had been exacerbated by the effect of the weakening oil price on its exploration and production business. **Page 20**

BANKS
WestLB aid deal
WestLB will have to reduce its asset base and change its ownership structure by the end of 2011 in return for billions of euros in state aid guarantees. **Page 24**

CBS directors' reprieve
Citigroup came under pressure to overhaul its board after it revealed that two long-serving directors had survived a shareholder rejection because of a controversial role. **Page 24**

BoFA sells CCB stake
Bank of America sold its 10% stake in Citicorp Bank to a Chinese consortium. **Page 24**

Babcock pension to hedge risk of longevity

First scheme to offset costs of long lifespans
More company plans prepare to follow suit
By **Neville Cohen** and **Jeremy Loner**

Babcock International has become the first UK company to launch a longevity swap, a move that its retirees will live much longer than expected in a move that is likely to be followed by a number of pension schemes.

The company said it has agreed a so-called longevity swap under which it will be compensated for the additional cost of providing monthly payments to those whose lifespans extend far beyond the life expectancy of the average retiree. Such a risk has dramatically increased costs for defined-pension plans, with aggregate liabilities of £10bn, about double the £5bn of 2006, according to actuaries.

John Plender, partner at consultants Lazard Frères & Co, which said it was advising six big companies on similar transactions, said companies had been trying to reduce risk by joining a life insurer to in effect take longevity risk on its own books. But the reliance on actuaries has made that too expensive and in recent months and now companies are seeking more limited protection on longevity.

Mr Loner added that part of the attraction in setting up a longevity hedge is that, unlike equity investments, it does not require the scheme to make a big cash payment upfront.

Babcock made clear that its goal was to ensure some of the uncertainty connected with the longevity of pension promises it made in earlier years, which in

Tamiflu sales (in million)

Government antiviral stockpiles (% of population covered), as of Apr 12

Roche steps up production

John Authers
THE SHORT VIEW

The return of an appetite for risk in the past few weeks is palpable. This is nowhere more apparent than in corporate credit, a critical sector that was slower than almost any other to show signs of recovery.

The US CDX five-year industrial grade index shows that the cost of insuring against default is now back to its level in early 2007. In the meantime, the cost of insuring against default has fallen sharply (charting reduced perception of default risk) in the past month.

Even though corporate credit remains expensive by historical standards from the point of view of borrowers, the market has moved enough to persuade large companies to issue debt again, a sign of a positive development. But many companies have been led for government bonds, pushing up their yields. This raises disquieting questions over perhaps the single most crucial area of the credit market, the mortgage market.

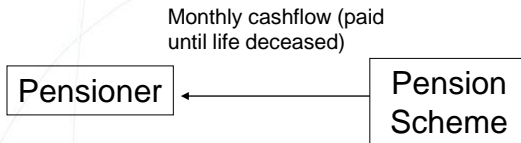
It is vital for US policymakers to make financing affordable. The lower mortgage rates can be forced, the better the chance of reviving the housing market. Government initiatives of the past year have had their effect

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LONGEVITY SWAP STRUCTURE



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The swap is structured around the following cashflows:

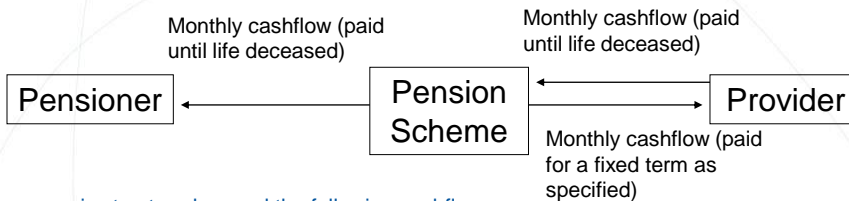
1. The Pension Scheme is obliged to pay a monthly pension until the pensioner dies

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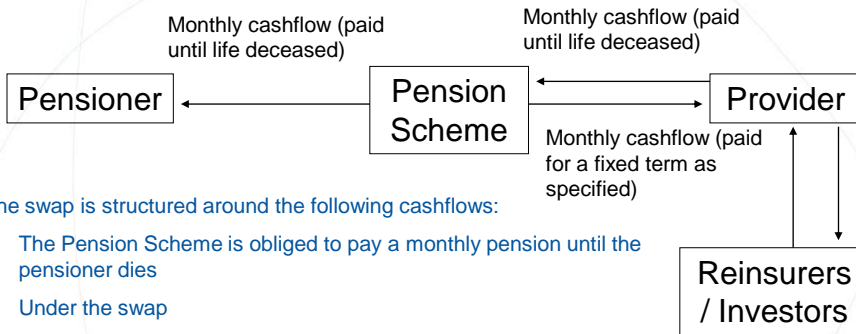


The swap is structured around the following cashflows:

1. The Pension Scheme is obliged to pay a monthly pension until the pensioner dies
2. Under the swap
 - a) the Provider will pay the Pension Scheme pre-determined monthly amounts (the "floating leg") until the pensioner dies (actual longevity)
 - b) The Pension Scheme pays the Provider pre-determined monthly amounts (the "fixed leg") for a pre-determined time (expected longevity)

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What have we done?



- Trustees entered into 50 year swap arrangement with Credit Suisse
 - Trustees pay fixed leg based on expected pension payments based on Credit Suisse's expectation of mortality
 - Trustees receive floating leg based on actual pension payments based on actual mortality
- Hedged out
 - Longevity risk for c14500 pensioners and their spouses and dependents
 - Higher than expected age difference
 - Higher than expected proportions married

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Who is Babcock International Group plc ?



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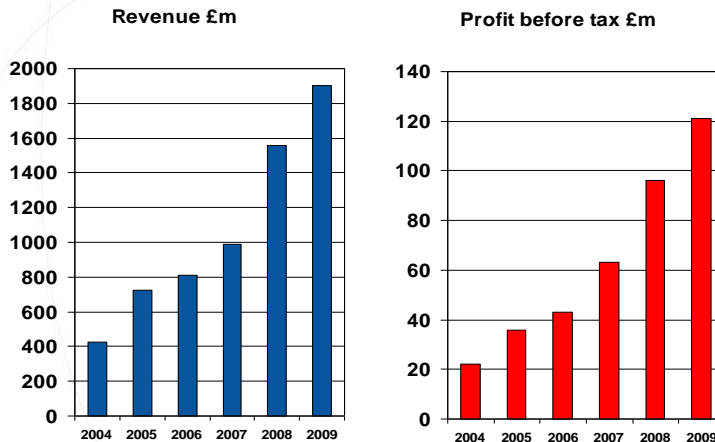
- Top FTSE 250 engineering support services company
- Have long term contracts with our customers who own large strategically important assets, typically Government or public bodies
- Operates in five divisions in UK
 - Marine; UK's leading Naval support business for the Royal Navy and the Ministry of Defence.
 - Defence; Largest provider of facilities management support to MoD
 - Rail; the largest track renewal contractor for Network Rail
 - Nuclear; one of largest specialist nuclear resources in UK
 - Networks; one of 3 key suppliers to National Grid
- 17,000 employees

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Sustained track record of growth



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Pension Scheme Information



- 5 UK final salary schemes
 - Babcock International Group
 - Devonport Royal Dockyard
 - Rosyth Royal Dockyard
 - Babcock Naval Services
 - Section of Railways Pension Scheme
- Number of overseas schemes
- 35000 DB members
- Pension liabilities c£2bn

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Pensions v the business



- At the time pension liabilities c£1.7bn v market capitalisation of c£1.1bn
- Pensions identified as a key risk to the business
- March 2008 accounts-statement of hedging intent
- September 2008 interims-hedging on track
- March 2009-needed to make statement

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DB Scheme Information



- 3 largest schemes
 - c14,500 pensioners
 - Pensioners liabilities c£750m (45% of total)
- Good starting point to hedge pensioner liabilities
 - Longevity
 - Inflation
 - Interest rate

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Actual or synthetic buy in?



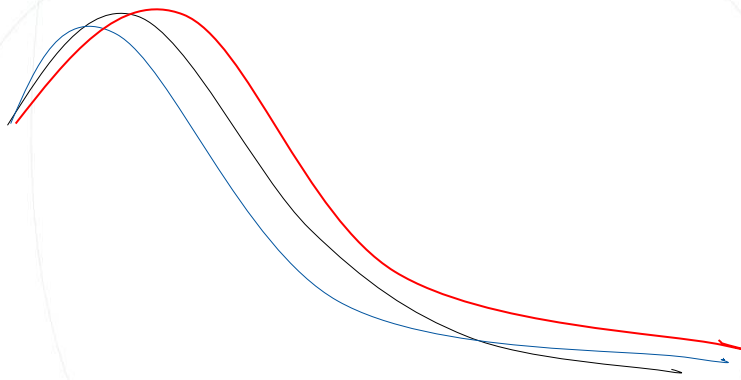
- Mercer carried out detailed mortality assessment for pensioners
 - 7,800 deaths
 - 150,000 exposed to risk
- Schemes ranged from v PA92 MC C=2007 ranged from +0.5 to +3
- Obtained indicative quotes for buy in and longevity swaps

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Future cashflows



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Actual or synthetic buy in?



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- Actual buy in
 - Too expensive
 - Have to pass over assets
 - Security is key issue for trustees
- Chose synthetic buy in
 - Did not have governance structure to hedge investment risk so
 - Phase 1-hedge longevity
 - Phase 2-put in place effective governance structure
 - Phase 3-hedge interest rate and inflation risk

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Longevity swap-key issues for Babcock



- Indexed hedge v scheme specific
- Security
 - Insurance v swap
 - collateral arrangements
- Flexibility of contract
- Cost-funding and accounting