Regulation drives longevity demand

There has been an increase in recent years in the amount of longevity risk being assumed by the global reinsurance market, Martin Membery Partner at Sidley Austin LLP looks at the reasons behind the trend.

The demand from reinsurers has been driven by a number of factors, but perhaps the most significant for life reinsurers with catastrophe books is that longevity risk acts as a natural hedge against mortality exposure and can create diversification benefits for regulatory capital purposes.

The two principal sources of longevity risk are defined benefit pension schemes and books of annuity business written by life insurers. There has been an increased level of transaction activity involving European-based life insurance groups looking to hedge longevity exposure in light of the additional regulatory capital that may have to be held under Solvency II in respect of annuity business. However, it is the demand from defined benefit pension schemes in the U.K. that has been the principal driver for the development of an active secondary market for longevity risk in which reinsurers have been the principal participants.

Record levels of activity

2013 was a record year for U.K. pension de-risking transactions. This intense level of activity has continued into this year, with the largest ever pension scheme longevity swap and bulk annuity deal both being announced in March 2014. The longevity swap involved an innovative structure whereby £5 billion of liabilities of the Aviva Staff Pension Scheme (covering 19,000 lives) were insured by Aviva Life & Pensions UK Limited and simultaneously reinsured by Munich Re, Scor and Swiss Re. The bulk annuity transaction saw Legal & General and Prudential cover £3.6 billion of ICI's defined benefit pension liabilities.

Factors fuelling the continuing growth of the pension de-risking market include the available capacity within the reinsurance market. Aon Hewitt reports that the number of reinsurers willing to assume longevity risk has increased in recent years from approximately 5 or 6 a few years ago to closer to 20, with around 10 reinsurers actively bidding to participate in longevity risk transfer transactions. This competition is in turn driving more attractive pricing and encouraging more pension schemes to evaluate their de-risking options.

Impact of the Budget

This may well be accelerated by the announcement in this year's budget that from 2015 investors in defined contribution pension schemes will have the option to withdraw the entirety of their accumulated investments in cash. It has been widely predicted that there will be a consequential reduction (perhaps as much 75%) in sales of new individual annuities. Some of the life insurers affected by these developments have already confirmed that they will be seeking to replace this lost income by acquiring more blocks of business through bulk annuity transactions. This in turn is likely to increase competition and potentially result in more attractive commercial terms for pension schemes looking to de-risk.

THE TWO PRINCIPAL SOURCES OF LONGEVITY RISK ARE DEFINED BENEFIT PENSION SCHEMES AND BOOKS OF ANNUITY BUSINESS WRITTEN BY LIFE INSURERS.

Transaction structures

For reinsurers contemplating the assumption of longevity risk, the key commercial decision is whether to secure pure longevity risk in the form of a reinsurance longevity swap or to write an asset-backed reinsurance. In the latter case, the reinsurance premium is paid upfront and the reinsurer therefore assumes the inflation, investment and interest rate risk as well as the longevity exposure in much the same way as a direct insurer writing a pension buy-in policy.

Other key structuring questions concern the form in which the longevity risk was originated. In cases where the front end arrangement involved a longevity swap with a bank as a counterparty, the longevity risk would be in derivative form and not capable of being directly reinsured. In situations such as this, transformer vehicles (typically based off-shore) will be used to convert the derivative exposure into insurance risk that can then be reinsured.

It is more straightforward for reinsurers where the pension scheme de-risking involved a buy-in or a buy-out to an insurance company or where a life insurer is looking to hedge its own annuity business. It is also possible for reinsurers without a direct insurance licence to offer bespoke solutions to pension schemes by engaging the services of a fronting insurer and creating a back-to-back arrangement, and there may well be more transactions of this nature adopting the structure utilised in the Aviva longevity swap.

To date, the vast majority of secondary market longevity business has been written by reinsurers, and such has been the available capacity within the life reinsurance market that the pricing has been competitive and there have been relatively few opportunities for the capital markets, ILS funds and others attracted by an asset class that is largely uncorrelated to the financial markets. However, with the strong growth in demand for longevity hedging, some are predicting that within the short to medium term, traditional reinsurance capacity may well become fully utilised, creating opportunities for new entrants to this market.