

Insurance: Is it time for long life?

BRAVE Partners has predicted that UK insurers will be selling their books of annuities in payment. The question is – are there any buyers?

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Annuity risks

Payout annuities have two main risk factors:

- Longevity risk. The risk that annuitants live longer than anticipated.
- Investment risk. The risk that the investment returns on the reserves do not reach the target required to meet the annuity payouts, expenses and profits.

The development of an annuity swap market (see note at the end of the document for a brief description of an annuity swap) now allows these two risks to be treated separately.

Opportune moment to sell annuity risk

In the opinion of BRAVE Partners, there are current market factors that are driving demand for both asset risk and longevity risk that make this an opportune moment to sell annuity risk. The supply factors for the strong appetite for both risks (longevity and asset) are likely to be overtaken by demand within the next 6 to 12 months. The pricing on annuities will then diminish, possibly for some years, with the supply in these markets.

Longevity risk markets

A number of life insurers have taken the view that longevity risk is at least diversifying, if not offsetting, their protection business. This is a reasonably recent development. For many years Swiss Re was reputed to be adamant that there was no relationship between their longevity and mortality risks. This was thought to be derived from an analysis of the 'flu pandemic of 1918 which impacted the younger population and not the elderly. Population dynamics are considerably different to 1918 and so views have changed.

Life insurance is not particularly asset intensive and many life insurers are not particularly comfortable with asset risks and management.

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Rapid supply growth

The result is that many life insurers have a strong appetite for pure longevity risk. This is delivered in the form of a longevity swap. As a result there has been a significant growth in supply of longevity risk.

Limit on supply

Whilst the supply of longevity risk has increased rapidly over the past several months, this supply has a fairly hard limit. The supply is created by life insurers looking to diversify or offset their exposure. There is a limited amount of life insurance available, so there is a limit to the amount of longevity risk that these players will wish to take on. Current estimates are that there is capacity for longevity risk that is equivalent to about \$5bn to \$10bn of annuity reserves. Much of this capacity will be used by UK pension business where transactions of £1bn to £3bn are not uncommon. Both BMW and British Airways have recently made sizeable transactions and there are more to come. Moreover, BRAVE Partners believes that recent changes to the UK tax rules means that all of the payout annuities in UK insurers will be for sale – which amounts to around £135bn of reserves (see "[Janus](#)").

BRAVE Partners predicts that the longevity markets will tighten in the next 6 to 12 months.

Asset risk markets

Banks currently have a significant appetite to utilise the cash reserves to fund their long term, illiquid asset bases. Regulators across the globe are currently increasing the liquidity needs of banks and Basel 3 is expected to bring strict criteria. Banks have responded by finding liquidity pools that can act as interim finance for their current holdings of illiquid assets. However, in the mid term – this area of activity is set to shift out of the banking sector into a non-bank lending business. BRAVE Partners is currently engaged on such projects.

Diminishing demand

As banks find funding for their illiquid asset bases, their appetite for further liquidity will diminish. This requirement will not be sustained as the supply of long term illiquid financing will shift to new non-bank lending business. Bank business will return to advisory and intermediation.

BRAVE Partners predicts that it will take 12 to 18 months for the banks to stabilise their funding needs. After this period, banks will have substantially less appetite for the large pools of funding offered by annuity reserves.

Market conclusions

BRAVE Partners believes that there is a 6 to 18 month window in which annuities will command unusually high prices. Once the factors driving this succeed it is likely to be several years before these, or other factors that will drive annuity prices, re-emerge. In the mid-term there is likely to be a drop in annuity prices as a large number of books become available driven by tax and regulatory changes in the UK.

There is a 6 to 18 month window where annuity will trade at premium prices. Thereafter, the supply of annuity books for sale will rise rapidly and the factors driving demand will diminish.

A longevity swap

A longevity swap is a structure that transfers longevity risk from one

party to another. The two parties agree on a mortality table. This mortality table is applied to the policyholder data and produces a set of fixed cashflows. The seller of longevity risk pays these fixed, known cashflows. The buyer of the longevity risk pays the actual cashflows that arise from the performance of the block of business. Each quarter the amounts owing each way are calculated and netted off. The net amount owing is then paid. Longevity currently trades at a premium – that is the present value of the fixed payments is usually a few percentage points higher than the present value of the best estimate of the actual payments to be made to policyholders.

BRAVE Partners' services

BRAVE Partners is highly active in the life insurance and reinsurance markets. Current projects include:

- Establishing a reinsurance business in Bermuda to write asset intensive business.
- Advising a management team that is developing a roll up strategy for mid-tier life insurers in Europe.
- Assisting a bank that is seeking to take asset risk on a life book.

The firm is deeply embedded in the asset intensive life insurance and associated markets. BRAVE Partners can advise both the buyers and sellers of annuity books on counterparties, transaction structures and deal economics and trends.

Interaction

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- A number of market factors have converged that make current prices on annuity books attractive.
- BRAVE Partners believes that these market conditions will persist for 6 to 18 months before the supply of annuity books begins to rise rapidly, causing the market to re-price.
- BRAVE Partners LLP can advise organisations that are looking to gain exposure, or sell exposure to annuity blocks.
- BRAVE Partners is highly embedded in the asset intensive life insurance and associated markets.

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