

Pensions: Born for life

Several large banks and insurers have clubbed together to form the Life and Longevity Markets Association (LLMA). Bloomberg could not resist using the sensationalist “Death Bonds” phrase in reporting on it. BRAVE Partners applauds the move. The large insurance companies are the natural market for longevity risk. However, even with Axa and the like behind the market, the firm still remains skeptical as to how much longevity risk capacity there is. The firm suggests developing ALM strategies to mitigate longevity risk.

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Bloomberg has been the latest news provider to succumb to a “Death Bond” title. Great for catching attention: BRAVE partner Christopher Cloke-Browne certainly read the story. However the Thomson

Reuters headline: “Association formed to transfer longevity risk to capital markets” just seemed more appropriate for the Life Reinsurance group that Chris runs on LinkedIn and for the BRAVE Partners website. “Death Bonds” is a tried and tested attention grabber. Business Week used the phrase on their front cover about three years ago. Such sensationalism masks the true economic benefit of a market in longevity and mortality. A good friend of the BRAVE Partners who is senior lawyer at a prestigious firm described the Business Week article as “uninformed yellow journalism”. Longevity is an economic problem. Progress to dealing with the issue should be applauded. Titles such as the one in Business Week might sell magazines, but when it drives the risk management policies of major financial institutions, as that one did, it is concerning on many levels.

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Longevity markets

Capital markets first became interested in longevity risk through the life settlements business. Although life settlements is a US driven business, many of the investors have traditionally been in Germany due to a tax break that existed there.

Life settlements

In the USA a policyholder pays a premium on a whole life policy from commencement for their entire life. When the policyholder dies, a death benefit is paid to the estate of the policyholder. At first blush the product might seem a little bizarre. However, the main market is for high net worth individuals who use the product for the tax efficient transfer of their wealth to their family.

The economic benefit of life settlements

The problem with a US whole life policy is that the policyholder must pay the premium for their entire life to receive the death benefit. Any failure to pay a premium will lapse the policy, meaning that the policyholder will get nothing. Clearly a policy that will pay out \$5m upon the death of a 85 year old in poor health has considerable value. The insurance companies, however, do not recognize this value. Most will buy the policy back, but the pricing is so low that it can be easily outbid in an open market. This open market is the life settlements market.

The purchaser of a life settlement is therefore exposed to longevity risk – in this case the risk that the policyholder lives longer than anticipated.

UK Pensions

Pensions in the UK is another significant source of longevity risk. The UK appears to be pretty much unique in its lifetime annuity pension product. There is some lifetime annuity product in Europe and some in the large corporate pension plans in the USA, however there does not seem to be any other country with such a universal product. This is driven by the legal requirement to annuitize a pension savings plan within the UK. UK pensions space is set to be the first area targeted by the LLMA.

Aims of the LLMA

Thomson Reuters reports:

Dramatic increases in life expectancy have left private sector pension funds and annuity providers with massive exposure to longevity, and there are few options currently available to hedge this risk on any significant scale within the private sector.

In the last three years, around 19.5 billion pounds of longevity risk has moved over from the pension funds to the pension insurers, which is a small amount compared to the total assets in the UK, John Fitzpatrick, a director of the LLMA and a partner at Pension Corp, told Reuters.

"The existing transactions between (re)insurers and the capital markets are relatively small. The association wants to build capacity in the capital markets and reinsurance sector in order to handle the likely increase in demand coming forward from longevity risk," he said.

"Longevity risk is a size that it should also go out to the capital markets."

"I am skeptical about the broad take up of longevity risk as an asset in capital markets. In order for a market to really flourish there either needs to be two natural sides to the market as there is with interest rate risk – borrowers and lenders – or groups of specialized investors who believe that they have a firm view on the risk – as with credit.

Longevity risk is so long dated, so uncertain and driven by many unknowable factors, such as medical advances in the next 20 years that it makes it tough to see any large scale investment in pure longevity risk.

Annuities work as a product because the investment risk swamps the longevity risk and this increases as the tenor increases.

In my opinion getting pensions and annuities right is about getting the investment strategy and environment right. This is the one issue that does not seem to be addressed in the industry."

Christopher Cloke-Browne
Managing Partner
BRAVE Partners LLP

Longevity in capital markets

Longevity is a major social and economic issue. Solutions are required and BRAVE Partners applauds all projects with this purpose. However, the firm has been, and remains, skeptical of the size of the appetite for longevity risk within the capital markets. There is clear appetite and expertise in the life insurance and reinsurance markets. A company like Reinsurance Group of America (RGA) will almost certainly become a major player. RGA is by far the largest and most expert reinsurer of life insurance. From that business it has great expertise in estimating lifespans and significant exposure to mortality. Leveraging their expertise to take on longevity risk is a logical business decision.

The capital markets, however, do not have a building full of life actuaries in St. Louis, nor do they have a large concentration of mortality risk. Certainly some investors might speculate on longevity as a diversifying asset, but the returns will need to look attractive and that will keep the pricing high.

What size is fun size?

As anyone who has ever bought a Snickers bar knows, Fun Size is somewhat smaller than anticipated. BRAVE Partners applauds the establishment of the LLMA, but the firm still suspects that until there is a clear natural axe for an investor group, longevity markets will remain smaller than many might anticipate.

The UK pension problem

The BRAVE partners believe that the longevity risk embedded in annuities can be well managed by creative investment strategies. Pension management is about asset liability matching (ALM). Many of the problems emerge because the assets and liabilities are not well matched. The firm sees the causes of this as twofold. Firstly, the liabilities are not necessarily well understood. Secondly there is often no bridge to the asset strategy, which has traditionally been as straightforward as taking a view of the split between bonds and equities and appointing appropriate fund managers.

Get in touch with your asset side

Music publishing is one example of a creative investment strategy that BRAVE Partners has recently seen. Music publishing is thriving, in contrast to music distribution. In fact a closer look at EMI's figures will reveal that the publishing business is probably the prop that is keeping the company away from the liquidator.

The music publishing business offers a long dated stream of income that so far has beaten inflation. Furthermore, the income appears to weather economic downturns well with a growth related to the global trends of increasing population and increasing wealth. This, in its own right, has to be attractive to pension funds. However there is a further twist: the copyrights that create the licence revenues last for 70 years after the composer's death. Thus arguably, the value of music publishing rights is inversely related to longevity. An investor will need to take a view on how the longevity of a pool of composers relates to that of their pensioners – so it is not straightforward, but at least there is the basis for an offset. If there are step changes in longevity due to medical advances then the publishing rights should cover that – assuming that there are no changes to laws and international agreements. Now there is an interesting twist to longevity.

BRAVE Partners Services

BRAVE Partners can advise owners and investors of longevity risk on the market solutions and structures. BRAVE Partners can advise pension plans and insurers that are exposed to annuities on asset strategies to mitigate that risk.

Interaction

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- *The capital markets are taking longevity risk seriously as an asset class.*
- *BRAVE Partners can advise investors on the longevity markets.*
- *BRAVE Partners can advise owners of longevity risk on appropriate solutions. The BRAVE partners see longevity solutions driven by both the growing longevity markets, but also through innovative investment strategies. The firm believes that the latter approach is under-explored by the owners of longevity risk and their advisors.*

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