

Pensions: The Scottish bond

"If it 'twere done when 'tis done, then 'twere well it were done quickly"

As Macbeth famously pointed out, some things if done at all, are best done quickly.

The UK government may well be wise to dither over the timing of bank asset sales – it's hardly an optimal environment for such activity – but when it comes to issuing longevity bonds, if the government is going to do it at all then there are arguments for swift action.

Professor David Blake, Director of the Pensions Institute at Cass Business School says: "We strongly recommend that the government issues longevity bonds as soon as is practically feasible. An ideal introduction date would be 2010, as this would give the market a couple of years to settle before Solvency II comes into effect in 2012."

Others have argued that we're currently enjoying historically low yields which would make it a good time to issue. Whilst this is true at the short end in fact the 50 year yield, now at 4.25%, has been relatively stable over recent years. Relative to earlier years the picture is marginally more enticing at 15-20 years, but not much. In any event the yield curve is currently upward sloping asymptotically which would likely encourage issuers to focus on the shorter end. Gone are the inverted curves of 2006/07.

But optimal timing or not, is the issuance of such instruments really an appropriate activity for government? The debate rages on.

More debt for the debt mountain ...

Those against the notion point to the fact that it seems somewhat suboptimal for the government to be adding to the country's debt mountain. Clearly the government will always issue debt, but there are concerns with regard to how much extra debt we're talking about here, and how potentially unfavourable its terms might be, given its long term nature.

But there's also a significant question as to whether transferring more risk from the private sector to the state is politically expedient. Are

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Northern Rock, Royal Bank of Scotland (RBS) and Lloyds Banking Group not enough of a problem?

Nationalised Northern Rock reported a loss of £270m for the first six months of the year. 84% government owned, RBS has this week reported a £1.5bn operating loss for the third quarter and at the time of writing its shares were trading at 35.7p. Meanwhile Lloyds is 43% government owned and reported a loss of £4bn for the first half.

Less risk for the financial services industry ...

On the plus side, longevity products can offer a useful hedge for the pensions and life community against the financial risks posed by increased life expectancy.

At present there are few options available to hedge longevity risk on any significant scale. And this risk, according to the Pensions Institute, amounts to a total private sector longevity risk of £1 trillion with DB plans and £125 billion with insurance companies.

Back in April a team from the Pensions Institute called for the government to issue these bonds partly because of the size of the government's borrowing requirement - £703bn over the next five years as announced in the Budget – and also because of the growing need for pension funds and annuity providers to hedge against people living longer. According to the Pensions Institute, if the government were to issue longevity bonds, "it would gain access to a new source of long-term funding which, by widening the investor base, should lower the cost of government issuance."

So if longevity bonds can stave off a private sector financial crisis of potentially significant proportions down the line, then maybe the government should take heed now.

And far from just adding to the government's debt burden, those in favour of having government issue these products suggest that they'll actually help meet the government's enormous borrowing requirement.

- True, but as we flagged earlier, at what cost?

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- All very well if you can actually widen the investor base which is questionable.

The Pensions Institute also argues that "the longevity risk premium attached to such issues will further reduce the expected cost of the long-term national debt."

Further arguments from the Pensions Institute suggest that:

- “The government has an interest in ensuring that there is an orderly transfer of DB pension promises to the insurance and capital markets”;
- “The government has an interest in ensuring there is an efficient annuity market, given its desire to encourage retirement savings in DC pension plans that rely on annuities to turn savings into guaranteed lifetime retirement income”; and
- “The government is one of the few agencies in society that can engage in intergenerational risk sharing on a large scale and enforce intergenerational contracts.”

Who’s who in the debate:

Besides the **Pensions Institute**, those in favour of longevity bonds include the **Pensions Commission chairman, Adair Turner**.

The **Bank of England** also, reportedly, likes the idea.

According to the Pensions Institute, the **Association of British Insurers** and the **National Association of Pension Funds** showed a lot of interest in its proposals.

Those skeptical include the **Debt Management Office (DMO)** which, in its Annual Review 2008/09 produced in August, said the government has no plans to issue longevity bonds.

Unsurprisingly the DMO mentioned the fact that “the issuance of longevity bonds raises significant policy questions, in particular around the transfer of longevity risk onto the government’s balance sheet.”

Further, it argued that: “the depth of the market for, and the potential liquidity of, this type of product are unclear.”

What do we know about longevity bonds?

Longevity bonds are considered by their proponents to be the natural hedge to the longevity risk carried by pension and insurance companies. But the lack of longevity bond issuers is a problem for the annuity industry, which desperately needs to offset the longevity risk caused by increased life expectancy.

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Indeed the issuance of these instruments via non-government entities has not been overwhelming as they're a hard sell. But both Goldman Sachs and JP Morgan have introduced indices to benchmark and trade longevity risk. JP Morgan's LifeMetrics index was launched in March 2007. Goldman's QxX.LS index was launched in December of the same year.

The EIB attempted to launch a longevity bond in 2004. This well-documented launch attempt never reached the market. Subsequently the market has not really evolved in any meaningful way.

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- But would the UK government be up for providing such alluring returns?

Indeed as put forward by Thomsen and Andersen¹, the most obvious challenge with longevity bonds is a lack of investors who would benefit from an unexpected rise in life expectancy. Pharmaceutical companies and health care companies are examples of investors with a possible interest in assuming this risk. But how do the managers of such companies square it with shareholders that they're going to benefit from investing in products that may influence profits a very long way down the line?

Given that a critical mass has not yet evolved in the longevity bonds space, immediate term growth prospects for this market are still limited. It's one of those chicken and egg scenarios, but outstanding volume is often essential for a market to develop. Nevertheless once the volume has passed a critical level, growth may then potentially be very strong.

But to summarise the ongoing catch 22: With investor attitudes widely believed to be cautious there are not yet enough issuers.

- So does it make it the right time for the government to come in?

If a single benchmark issue would make investors less cautious then yes. But we're not convinced that this would be all it would take.

- Could this become another chapter in the book of moral hazard?

Quite possibly. Government intervention doesn't always lead to sounder thinking in the financial services industry.

¹ Jens Thomsen and Jens Verner Andersen, Longevity Bonds – A Financial Market Instrument to Manage Longevity Risk, 2007

- Do we need to go back to the drawing board and rethink the product offering/s required to address the longevity problem?

Absolutely. If investors aren't interested and issuers are accordingly cautious, we've got the wrong product – no matter how clever it is.

So maybe, as with Macbeth, it would be best if it 'twere not done at all, quickly or otherwise.

BRAVE Partners Services

Brave Partners advises the financial services industry on ALM issues, portfolio composition, asset allocation and capital raising.

If you are interested in investigating investor appetite for longevity bonds in more detail then please contact us through www.bravepartners.com.

BRAVE Partners: Our thanks

The BRAVE Partners wish to thank Naomi Nikolajsen for writing this commentary.

- *BRAVE Partners believes that private sector solutions to longevity risk issues are the answer – not a government sponsored (and priced) market.*
- *As BRAVE Partners has stated before there is no clear, large scale taker of longevity risk.*
- *However, some expert takers of some risk are emerging.*
- *BRAVE Partners has the structuring expertise and market contacts to assist pension funds or life insurers to manage their longevity risk.*

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