Why the longevity transfer market is set to double

Jack Jones talks to Amy Kessler about the fast growing market in longevity risk

AT A GLANCE

- $260bn (£190.6bn) of longevity risk has been offloaded since 2007
- The market could double in the coming years
- But to meet demand beyond 2020, capital market investors will have to be brought in

The market in longevity risk transfers has grown rapidly in the last decade. Since 2007 the risk associated with more than $260bn (£170bn) of liabilities has been offloaded to insurers and reinsurers globally, around two thirds of that from UK schemes. But senior vice president and head of longevity reinsurance at US insurer Prudential Financial Amy Kessler believes this growth is only going to accelerate. Speaking at the 11th annual Longevity Risk and Capital Market Solutions Conference last week, she predicted the market would double in the next few years.

Eye-catching deals like BT's £16bn longevity swap (which passed the risk onto Kessler's firm through a captive insurer owned by the scheme) and growing interest in other countries suggest this is not far fetched. There is a strong appetite among schemes to shed longevity risk, and among reinsurers and insurers to take this on to balance mortality risk.

Demand

In the US, Prudential alone has £3.7trn of mortality in force – almost double the value of liabilities in UK private sector schemes. While its exposure to longevity risk is growing, Kessler says the firm is hungry for more.

She explains: "Our whole business objective is to be balanced and diversified, and there is a trend risk element to our mortality business. The primary risk in the longevity business is trend risk, and if the two are carefully balanced then the company should be stronger as a result of us having that diverse and balanced risk profile."

But the firm is not trying to match longevity and mortality risk 'one-for-one'. "The age groups are different, the countries are different, the trend risks across the first world are highly correlated, but they are not offsetting, so we do not think of them as a 'hedge' – that implies something stronger than it is," explains Kessler.

Supply

While there is every incentive for global reinsurers to increase exposure to longevity risk, there is very little incentive for UK schemes to hold onto it. Unlike credit or interest rate risk there has been no upside associated with it in recent decades, and as schemes grow increasingly mature and de-risk their assets, it is growing in significance.

Longevity risk is also a scarier prospect for UK schemes than those in jurisdictions with flat benefit structures. It has what is known as 'crossover risk' associated with it – paying benefits for longer than expected increases exposure to other risks such as inflation or interest rates. Inflation-linking effectively doubles this exposure.

Kessler says the increasing use of risk budgeting by schemes has highlighted this issue. She explains: "Plans want to shed a risk that they view as unrewarded. I have never seen a client come out of a risk budgeting exercise with a fervent belief that they ought to hang on to their longevity risk. We see client after client deciding they want to maximise their credit risk and their exposure to risky assets, to manage their interest rate risk and duration risk, and to shed their inflation and longevity risk."

> **"We love having both US and UK schemes. The US-focused business is primarily concerned with buyouts and buy-ins that see the insurer take on schemes' assets and liabilities, while the UK deals solely transfer longevity risk"**
> Amy Kessler, Prudential

> **"We see client after client deciding they want to maximise their credit risk and their exposure to risky assets, to manage their interest rate risk and duration risk, and to shed their inflation and longevity risk"**
> Amy Kessler, Prudential

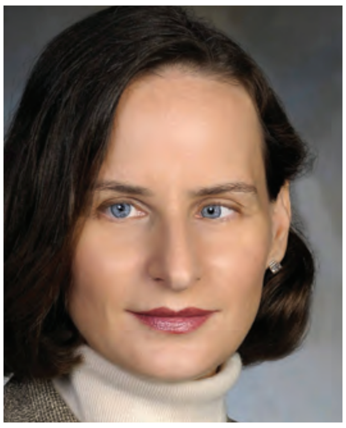
Last year's BT transaction is an illustration of this. As a "world class asset manager" the scheme had no desire to outsource the management of its fixed income portfolio to an insurer. But hedging its longevity risk meant it is now targeting a fixed cashflow, rather than managing its portfolio against an unknown future liability.

Constraints

UK schemes are often confronted by warnings that reinsurers' appetite for longevity risk could be satisfied elsewhere. US schemes, which could look more attractive with their simple benefit structures and massive scale, have woken up to the danger posed by longevity risk after watching the market develop for a few years, and are looking to transact.

But Kessler says this should not concern UK schemes weighing up a deal. "We love having both US and UK schemes," she says. The US-focused business is primarily concerned with buyouts and buy-ins that see the insurer take on schemes' assets and liabilities, while the UK deals solely transfer longevity risk – "a pure insurance risk play, which is very hard to find".

If the market continues to develop at the current pace, Kessler believes there will need to be a few innovations to attract



more capital. The main focus at the moment is finding a mechanism to trade longevity risk on the capital markets. While schemes themselves have shown little appetite for the index-based longevity deals this would allow, Kessler says it is an essential development if insurers are to balance their risks.

"If this market continues to grow as quickly as it is growing at the moment, the fact that the capital market solutions have been slow to materialise could – three, four or five years down the line – impede the continued growth of this market."

The problem so far has been attracting the attention of investors like insurance-linked security hedge funds, sovereign wealth funds or private equity. But investments by private equity houses in the likes of Pension Insurance Corporation and Rothesay Life show there is interest.

"But capital market investors are looking and thinking 'gosh, this is the space of the re-insurers, and they have legions of actuaries, and they have millions of life years worth of data'," says Kessler. "So how do they get comfortable with that investment?"

One way is through 'sidecar' deals that allow investors to effectively freeride on insurers' expertise. These deals, which are common in the property and casualty reinsurance sector, allow investors to co-invest on the same terms and economics as a reinsurer. Although these deals have so far been short duration, Kessler says this kind of deal could be key to making sure there is enough capacity in the market in future.

"The key is which investor is willing to stay in for a super long time," she says. "But there are a lot of them. If you look at Apollo [a private equity firm] and their Athene subsidiary, they have started an insurance company and reinsurance company that is focused on annuity risks. So clearly there are folks who are not afraid of how long duration this is."