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Aon Hewitt comments on the Basel Committee on Banking Supervision's longevity risk transfer paper

Introduction

This note sets out Aon Hewitt's comments on the recommendations in the Basel Committee on Banking Supervision's paper August 2013 paper, 'Longevity risk transfer markets: market structure, growth drivers and impediments, and potential risks'.

We have commented on the paper's recommendations from a general perspective. However, our clients are the sponsors and trustees of pension plans and insurers and reinsurers.

1. Supervisors should communicate and cooperate on LRT internationally and cross-sectorally in order to reduce the potential for regulatory arbitrage.

In theory, yes, but it is important to note that regulatory arbitrage is a standard feature of insurance markets and that longevity risk is not unusual in this regard.

2. Supervisors should seek to ensure that holders of longevity risk under their supervision have the appropriate knowledge, skills, expertise and information to manage it.

Agreed. We note that expertise varies materially by locale and expect this to be correlated with the locale longevity risk transfer activity.

3. Policymakers should review their explicit and implicit policies with regards to where longevity risk should reside to inform their policy towards LRT markets. They should also be aware that social policies may have consequences on both longevity risk management practices and the functioning of LRT markets.

We note that the State is typically by far the largest holder of longevity risk as a result of State and public sector pension provision. Accordingly, any review of privately-held longevity risk should also consider State-held longevity risk.

4. Policymakers should review rules and regulations pertaining to the measurement, management and disclosure of longevity risk with the objective of establishing or maintaining appropriately high qualitative and quantitative standards, including provisions and capital requirements for expected and unexpected increases in life expectancy.

It would help to have standard measures of longevity risk longevity risk uncertainty.

5. Policymakers should consider ensuring that institutions taking on longevity risk, including pension fund sponsors, are able to withstand unexpected, as well as expected, increases in life expectancy.

In locales such as the UK and the US the regulation of pension plan funding is fundamentally different from insurance company reserving. The treatment of longevity risk in pension plans should be consistent with the treatment of other risks such as investment risk and not singled out for special treatment.

We do think that it is important for pension plan sponsors, managers and members to understand the magnitude of longevity risk, including systemic tail risk.

6. Policymakers should closely monitor the LRT taking place between corporates, banks, (re)insurers and the financial markets, including the amount and nature of the longevity risk transferred, and the interconnectedness this gives rise to.

We agree that concentration of longevity risk needs to be monitored, but only in the same way that concentration of any particular financial risk needs monitoring.

We point out that the longevity risk transferred via longevity swaps and the like relates principally to pensions in payment, i.e. older lives. The largest risk relates to pre-retirement DB pension plan liabilities, but generally these are not hedged because of the difference in regulation. (Insurers have to carry larger longevity risk reserves for younger lives whereas pension plan valuation discount rates make risks relating to younger lives appear less financially material).

7. Supervisors should take into account that longevity swaps may expose the banking sector to longevity tail risk, possibly leading to risk transfer chain breakdowns.

We think that it is important to monitor and allow for the risk mitigation mechanisms in investment bank longevity risk transfer contracts. A systemic event such as a 'cure for cancer' is extremely unlikely to result in a substantial revision to calculated life expectancies overnight, in which case collateralisation will ramp up over time, and this can act to warn regulators.

8. Policymakers should support and foster the compilation and dissemination of more granular and up-to-date longevity and mortality data that are relevant for the valuations of pension and life insurance liabilities.

We think this is laudable but unrealistic:

(a) We share the scepticism referred to in section 3.3 of the paper of the efficacy of longevity risk indices based on national population data for hedging specific sub populations, e.g. specific pension plans. In other words, it is critical to match longevity protection as far as possible to the sub population being insured.

(b) While it might be possible in theory to accumulate useful granular data for locales that use register-based census methods (e.g. Denmark, Finland, Norway and Sweden), it is unrealistic to expect this in locales using traditional census methods (e.g. the UK and the US). In addition, there are severe data protection issues given that much of the data is necessarily personal data – even those locales that in theory have the data do not make it publicly available in sufficient granularity for use by longevity risk takers.

(c) For projecting future longevity, at least 20 to 30 years of consistent past mortality data is required, which means that what is possible is currently restricted by decades of past practice.

Further information

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