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Sent: 31 August 2013 20:53
To: baselcommittee@bis.org
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Subject: Longevity Risk Transfer Markets Consultation

Secretariat of the Joint Forum (BCBS Secretariat),
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Dear Secretariat

Longevity risk transfer markets: market structure, growth drivers and impediments, and potential risks

First let me congratulate you on producing a consultation paper on this important topic (at long last). I have been waiting more than 10 years for this issue to be taken seriously by regulators and policy makers.

The consultation paper is short and concise and up to date except I believe for one significant fact. Most of the investment banks have now pulled back from the longevity risk transfer market (most did this in 2012) as a consequence of the onerous requirements of the Dodd-Frank Act. There are only 2 left (Deutsche Bank and Goldman Sachs) and this is probably because they happened to own insurance subsidiaries that they used to execute the LRTs. There are different historical reasons for this: DB happened to buy a UK insurer (Abbey Life) before the LRT market started, while GS set up an insurance company (Rothesay Life) to help its mergers and acquisitions business: the presence of pension liabilities on company balance sheets was impeding takeovers and GS set up Rothesay Life to remove the pension liabilities and that was before the LRT market started in earnest; once the market started, GS decided to actively compete in this market too. Nevertheless even GS announced a few weeks ago that is selling a significant share in Rothesay Life. The effect of these developments is to concentrate more heavily the risk within the insurance industry and make it more difficult for it to be spread into the capital markets.

In terms of the paper itself, I would like to make a couple of comments on the role of regulation in either stimulating or impeding the development of the LRT market (prompted by the first full para on p9):

- By not giving capital relief on a longevity hedge unless it is perfect, there is a real danger of having no hedge when a very good indexed hedge is available. Once again, we have an example where the best is the enemy of the good
- Indexed hedges are available, but insurers do not get sufficient capital relief for using them. While there is residual basis risk, it can be shown that index hedges can reduce total longevity risk by around 85% (demonstrated in Coughlan et al. (2011) which you cite). While this does not meet current regulatory requirements for hedge effectiveness (95%+), this should be considered to be adequate for the current stage of the market

- Standardized instruments, such as index hedges, are essential to get a liquid traded market in LRT to develop. If this market does not take off, the concentration risk in the insurance industry can only grow.
- Another risk to be aware of is systematic or aggregate longevity risk. This is a slowly building trend risk, unlike all other financial market risks, with the exception of inflation risk. Just as a private sector institution such as an investment bank, could not credibly provide an inflation hedge in the form of an inflation swap out 50 years, without the availability of a systematic hedging instrument in the form of a government-issued index-linked bond, so a private sector provider of a longevity hedge could well face serious difficulties in future years if it underestimates trend longevity risk and has not hedged the systematic longevity risk with a government-issued longevity bond. I have been recommending that governments issue longevity bonds for more than a decade, but, as you can see, without success. Yet longevity bonds provide an effective way of sharing a huge intergenerational risk which is what longevity risk is. The young working generation bears the risk of the older retired generation living longer than expected in exchange for a risk premium built into the price of the bonds, knowing that it too is likely to live longer and in better health and can therefore work longer and pay taxes for longer. There would be no net increase in aggregate longevity risk therefore if the government indexed the retirement age to increases in life expectancy. The arguments are laid out in Blake et al (2013) which you also cite

Once again I am very pleased to see that your consultation paper will start the process of some serious global discussion of these critical issues. In the meantime, I attach a paper which is about to be published called 'The New Life Market' which summarises the state of the market to date

References

Coughlan, Marwa Khalaf-Allah, Yijing Ye, Sumit Kumar, Andrew J.G. Cairns, David Blake, and Kevin Dowd, 2011, "Longevity Hedging 101: A Framework for Longevity Basis Risk Analysis and Hedge Effectiveness," North American Actuarial Journal, Vol. 15, No. 2, pp. 150–76. pensions-institute.org/workingpapers/wp1013.pdf

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Yours sincerely

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