Subject: Joint Forum Longevity Risk Report comments

Dear Sir / Madam,

Thank you for the invitation to comment on the recent paper on longevity risk put out for consultation. Please find attached below some comments from our side.

For your information and by way of background, I am the Principal of Camdor Global, a strategic advisory firm, that most recently has been advising the Pensions Regulator in the UK on the development of their new investment regulatory framework as well as the links with other key pension risks such as sponsor risk. Prior to that, I was a senior partner at Pension Corporation, one of the largest pension buyout firms in the UK, where I ran their investments in alternative investments, acted as the Chief Risk Officer and also ran our macro research and thought leadership unit. I also have written or co-authored several well received papers on the pensions landscape, the macro implications of Solvency II and the historical parallels as well as socio-political implications of the European debt crisis, amongst others.

Comments

The report is very interesting and well written, as well as timely as it casts light on a little understood part of the market, which policymakers could otherwise easily overlook. Some thoughts:

- The pension buyout market is limited in size and capital constrained today but the players within it are growing rapidly and doing well. That has sparked interest from private equity and others, who see in this a rare opportunity to take part in a growth sector of the insurance industry, e.g. Blackstone's recent purchase of Rothesay Life from Goldman Sachs.
- That will create a growing concentration of pension liabilities and therefore, longevity risk in a few hands over time. This clearly has macroprudential implications, particularly given the socio-political dimension of pensions provision. Moreover, the financial institutions (i.e. insurers) taking these risks on are leveraged institutions, therefore, in a crisis situation, are at risk of finding they have inadequate capital to cover losses.
- The opacity of internal models, the complex interplay of risks within them, and the large part that expert judgment plays in the prudent assessment of risks as well as setting of assumptions – these are all additional factors within the buyout space that can make it hard for regulators to judge and understand the individual and systemic risks embedded within. As a simple example, most insurers use part of the bond spread as an additional discount factor for their liabilities (so-called illiquidity premium), thereby reducing them greatly. This then can be used to judge liabilities when acquiring new schemes, and if wrong, it means that the institution has actually taken on a far greater set of liabilities than it realises. Additionally, the mechanism is asymmetric as almost no insurers would apply a negative discount factor should the credit spread dip below the long-term average.

- On the longevity risk side, across all mechanisms, there is a bias towards older people. It is, therefore, much easier and cheaper to insure pensioners in payment than deferreds than actives. Consequently, the bulk of buy-ins are for the pensioner part of the scheme. Similarly, almost all longevity swaps are only for pensioners in payment. This is a natural evolution from the fact the uncertainty about these shorter-dated liabilities is far less and, therefore, palatable to those willing to take them on. However, there is a real possibility that over time, pension schemes will find that their risks on the shorter-dated liabilities are well managed but that the longer-term liabilities are left orphaned. This can lead to a loss of 'longevity' diversification and increase the volatility of the scheme's funding position. It also creates a potential 'last man standing' problem.
- The swap market has evolved a lot but currently (as noted above) has no real solutions for longer dated liabilities. Here, a common set of standards and widely accepted longevity index are imperative to get any further development.
- There is a collateral issue as you noted earlier. In particular, I would note that unlike interest rate or other common swaps, which are collateralised daily, longevity swaps often have contingent collateral only. Therefore, the possibility of an unexpected demand for collateral and the resulting cashflow-at-risk are high, i.e. they have significantly more counterparty risk.
- The possibility for diffusion of risk to rebound is potentially high. Many buyout provides typically have internal risk appetites that will drive them to lay off the bulk of their longevity risk. Many pension funds are similarly motivated as longevity risk is their largest one typically. However, the reinsurer pool that can take these is small and these risks are then often parcelled back out through their own risk mitigation techniques. One I would note is the rise of insurance-linked funds, which are a growing area of interest for institutional investors (due to their perceived lack of correlation). Many funds are pondering taking on longevity risk so unless properly managed, many pension schemes could end up laying off their longevity risk in the market only to find it reappearing elsewhere on their balance sheet under a different label.

Hope this helps and please don't hesitate to get back to me with any questions.

All best,

Bob

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