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Emerging Trends in Life Reinsurance: Non-Traditional Players **Enter Global Longevity Risk Transfer Market**

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Historically low interest rates, historically high equity market volatility and ever increasing life spans have made pension funding a hot topic and actuaries sexy. Financing the lifestyles of the superannuated through steadily improving investment performance is no longer a given. Market realities and stricter regulatory funding requirements are forcing plan sponsors to reduce overly optimistic assumptions about how well their investments will perform and increase assumptions about how long they will have to last. A growing number of well known corporations are looking for help in trying to make the math work.

Traditional reinsurers, including Swiss Re and Reinsurance Group of America, Inc. (RGA), have been active in taking on longevity risk—the risk of having to make annuity type payments to a retiree for a longer period than priced for, because the person lives longer than expected. Their appetite, however, is finite. Meanwhile, demand for alternative ways to manage longevity risk is expected to keep growing. In response to the unmet demand, some life insurers/reinsurers are teaming up with investment banks to help fill the void. A notable recent transaction involved Deutsche Bank and Prudential Financial Inc., who helped Rolls Royce transfer longevity risk on $3 billion of its pension liabilities.

MARKET POTENTIAL

There appears to be no official tracking of data in the global longevity risk transfer market, but reports indicate significant growth potential for almost anyone willing to stick their toe in. A Swiss Re estimate reported by Reuters puts global longevity exposure at about 21 trillion USD of asset protection, with 90 percent of that figure related to pension funds and 10 percent insurance contracts.

The exposure dwarfs any current solutions and is only growing. The world's largest 100 multinational corporations reported one trillion Euros of defined benefit pension liabilities going into 2011, according to a 2011 survey conducted by Lane, Clark & Peacock LLP (LCP), a London-based actuarial, investment and business consulting firm specializing in corporate pensions. The funding deficit for these 100 corporations was 290 billion Euros as of Sept. 30, 2011—almost double the 170 billion at the end of 2010—despite record company contributions of 80 billion Euros in 2009 and 2010, according to LCP. Other reports indicate that improvements in life expectancy over the past 15 years have added significantly to pension liabilities.

The UK market seems to be ground zero for longevity risk. This may be because, in addition to its legacy final salary (defined benefit) pension plan exposure, individuals in defined contribution type plans have been required to purchase payout annuities by age 75 to provide income for life. That requirement was apparently eliminated in 2011. Longevity risk, however, is a global problem, and more stringent regulatory funding requirements in a number of countries are likely to drive increased demand for alternative and capital markets solutions.

RECENT ACTIVITY

2011 was reportedly a record year for longevity risk reinsurance transactions. One of the most notable transactions involved Rolls Royce, Deutsche Bank and Prudential Financial, Inc. (PFI—no relation to Prudential plc). The transaction, which was completed in December of 2011, allowed Rolls Royce to transfer longevity risk associated with 3 billion GBP (4.7 billion USD) of defined benefit plan liabilities to Deutsche Bank through a longevity swap. Deutsche Bank in turn transferred pieces of the risk to a group of insurance/reinsurance companies, including PFI. PFI is reinsuring 500 GBP (over $780 million USD) of the risk. This was the largest of three longevity risk transfer transactions completed by PFI in 2011.

Rolls Royce is expected to have plenty of company in 2012. While many corporations did away with their defined benefit plans years ago, they are still dealing with difficult markets and increased life expectancies for existing members.

The capital markets have been skeptical about taking on longevity risk, due in part to complexity, illiquidity and very long durations. Starting in 2010, however, a consortium of banks, insurers and pension experts took significant steps toward developing a longevity risk transfer market with the formation of The Life and Longevity Markets Association (LLMA).

Swiss Re, a member of LLMA, issued the first longevity risk bond in December of 2010, which passed on $50 million of its own longevity exposure to the capital market in the form of an eight-year catastrophe bond sold via a special-purpose vehicle, Kortis Capital. Further development of the market will require good data and standardized indices, something which may grow out of increased activity.

THE ROLE OF TRADITIONAL LIFE REINSURERS

Traditional life reinsurers have limited appetite and capacity for taking on longevity risk. They are part of the solution, however. One example is U.S. reinsurer, Reinsurance Group of America (RGA), which has concluded longevity risk transfers together worth more than 3 billion GBP with the UK arm of French insurer AXA and with London-based Pension Insurance Corporation (PIC).

RGA views longevity risk as a way of diversifying, since it is essentially the flip side of what is traditionally known as mortality risk—the risk that an insurer/reinsurer has to pay a death benefit sooner than expected and priced for. RGA's primary focus is traditional mortality risk, and it limits longevity risk to a percentage of that.

An impetus for traditional life reinsurers to participate in the longevity risk market is the extended slide in one of their largest primary markets—the direct and retrocession market for individual life reinsurance in the United States. The U.S. market posted a 15 per-

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cent decline in recurring new business production in 2010, according to the Munich Reassurance Co. survey report. This was the eighth straight year of decline and the largest decrease since 2005. Retrocession business was down 50 percent in 2010 and has reached historic lows, according to the report. These declines are driven to a large extent by direct writers retaining more risk and redesigning products after reinsurers raised prices or stopped altogether assuming statutory reserve financing risk related to term and universal life products.

THE IMPACT OF INCREASED REGULATORY REQUIREMENTS ON THE LONGEVITY RISK TRANSFER MARKET

Plan sponsors in Europe are sounding the alarm that pension deficits could soar if Solvency II type rules are applied to defined benefit pension plans as proposed. LCP estimates that Solvency II would increase the liability measure used as the funding target in the United Kingdom and Ireland by 20 percent to 40 percent or about 50 billion Euros in aggregate for the 14 UK multinationals included in its survey. Solvency II is therefore expected to drive further reinsurance and capital markets activity in 2012, although it is likely to be a drop in the bucket.

In the United States, the Pension Benefit Protection Plan of 2006 increased funding and reporting requirements for defined benefit plans over the past several years. This combined with the financial crisis to highlight the gap between what many public and private pension plans have promised and what they may be able to deliver. Declaring bankruptcy and restructuring contracts has been the option of choice for seriously deficient plans, but that may change. It is very likely that stricter requirements growing out of Solvency II will have an impact on the U.S. market, which seeks equivalency with the European market. It is also very possible that new requirements will be imposed on defined contribution plans, which include the bulk of more recent hires. The bottom line is there will be no shortage of opportunities for all who want to take on longevity risk. Those who do, however, can and should be very selective about how they do it to protect their own bottom lines. ■