

European life undertakings, longevity risk and Solvency II

On 14 March 2011, EIOPA announced the results of the fifth quantitative impact study for Solvency II ("QIS5").

The QIS5 report confirms that, whilst market risk is the largest component of the standard formula solvency capital requirement across the European insurance industry, underwriting risk is the second most material module for life undertakings and longevity risk is, in turn, one of the two most significant sub-modules.

The importance of longevity risk for life undertakings has been further emphasised by AEGON's recent announcement of substantially increased levels of longevity-related provisioning, driven by strong projected increases in life expectancy in the Netherlands.

Improvements in mortality clearly present opportunities for European life undertakings. As populations continue to age, the demand for products which protect individuals and defined benefit pension schemes against the associated financial risks is projected to grow significantly.

Equally, there are important challenges. Many European life undertakings have significant existing exposure to longevity risk through existing annuity portfolios, and their ability to manage that exposure in a cost, and capital, efficient manner may depend heavily on the availability of cost-effective risk transfer solutions in secondary markets.

Demand for secondary market capacity has, in recent years, been reflected in an increase in the number of reinsurers offering longevity-only products (with recent new entrants including both Munich Re and Scor) – and, in the UK market, a number of substantial longevity-only reinsurances have been closed with companies such as Pacific Life Re, RGA, Hannover Re and Partner Re. Most of these transactions have been entered into in respect of risks originating from defined benefit pension schemes and transferred into the insurance (and in some cases capital) markets under Pension Buy-In policies or longevity swaps, such as the £3bn longevity hedge concluded by Deutsche Bank / Abbey Life with the Trustees of the BMW UK Scheme.

However, although reinsurance capacity has expanded, it seems unlikely to be sufficient in itself to support anticipated demand, even in the relatively short term. The importance of developing alternative capital markets solutions and (in the longer term) a liquid market for traded longevity risk is now widely acknowledged – as the establishment of the Life and Longevity Markets Association ("LLMA") in early 2010 and the subsequent transfer to the LLMA of JP Morgan's LifeMetrics Index attest.

For now, however, the longevity risk trading market remains relatively nascent. In the meantime, the QIS5 findings and the AEGON announcement suggest that, in the run-up to Solvency II and beyond, demand for longevity risk transfer solutions from European life undertakings, whether in reinsurance form or otherwise, is likely to grow. And if demand for similar solutions from defined benefit pension schemes develops as widely predicted, there is likely to be healthy competition for available reinsurance capacity in the coming years.

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