Swiss Re sigma study:
Annuities – a private solution to longevity risk

Zurich, 30 March 2007 – Insurers play a prominent role in providing private solutions for one of today’s most challenging issues: “longevity”. Contrary to common belief, longer lives can represent an enormous potential for profitable business, as long as the associated risk management challenges are suitably mastered.

Current demographic projections suggest that living to age 90 and beyond will become a reality for many people over the coming decades. While this is good news in one respect, anyone faced with the prospect of extended life expectancy would also be faced with the need to ensure current savings and anticipated pension income are sufficient to pay for their late-life needs.

According to Swiss Re’s latest sigma study, “Annuities: a private solution to longevity risk”, longevity makes annuities clearly one of the most promising insurance markets of the future. The assets backing the annuity business are huge: according to OECD statistics, pension and insurance assets add up to USD 20 000 billion for all OECD countries, with the US alone accounting for USD 12 000 billion. Furthermore, assets are growing at a sustained pace worldwide. Over the 2000–2005 period, annual average asset growth stood at 10% in the OECD countries, and over 20% in the Euro zone.

However, these growth opportunities are intertwined with significant risk management challenges, some of which are clearly identified in the sigma study:

- Asset/liability mismatch risks: the long duration of life annuity contracts – often spanning 30 years or more – together with the widespread practice of offering embedded financial options and guarantees can lead to complications. The upcoming implementation of Solvency II regulations will give insurers an incentive to get to better understand their asset/liability mismatch risks.
Insurance risks: annuities are particularly prone to the risk of mis-pricing and adverse selection. A mis-priced annuity contract may lock losses in for decades. Despite considerable progress made to date in understanding the drivers of longevity, there is still a long way to go, both in putting the acquired knowledge into everyday practice and in improving industry-wide comprehension of longevity trends. The financial risks associated with the population as a whole enjoying longer life expectancy is particularly relevant. This risk is systematic in nature, rendering traditional risk management techniques based on diversification ineffective. Systematic risks can be extremely costly to manage and keep on the balance sheet, as they accumulate instead of diversifying out.

The key instruments for appropriately managing these risks are product design, an integrated approach to asset/liability management and the adoption of financial-risk hedging programmes. Given the sheer size of the longevity risk and its predicted growth, it comes as no surprise that highly-exposed parties, which include not only insurers but also corporates and potentially governments, are looking for risk-transfer solutions. Corporates and governments in particular are looking for ways to offload their huge pension liabilities to other private-sector players, as they are attracting growing attention from financial analysts and economists. Solutions presented in the sigma study include:

- transferring longevity risk to reinsurers, who are showing more willingness to be part of the solution than in the past. In the UK, for instance, there are examples of annuity block-of-business deals entailing material transfer of longevity risk.

- distributing longevity risk through capital markets: there are promising solutions in the pipeline, though success is yet to be achieved in obtaining scalable and easily replicable solutions.

- hedging longevity risk on the books: in theory, (imperfect) hedges can be constructed by holding a book of mortality business on similar lives, by investing in the shares of industries that benefit from extended longevity (such as pharmaceutical companies and long-term care providers), or via more sophisticated structured solutions.
Governments have a crucial role to play in fostering a healthy development of private market solutions to longevity risk.

The *sigma* study sees Government actions taking four directions:
- fostering individuals’ financial awareness and education;
- sponsoring the issuance of financial instruments suitable for hedging longevity risk;
- eliminating adverse selection; and
- granting tax incentives to encourage self-provision.

Given the pressing nature of the problem at the societal level, *sigma* believes that, where market-facilitating mechanisms are in place, private-market solutions will emerge for the benefit of individuals, corporates and the public sector as a whole.

**Definition of annuities:**
Solutions offered by the insurance sector to help individuals provide for their financial needs in old age. A life annuity provides the policyholder with a series of periodic payouts up to their death, hence offering effective protection against longevity risk.

**Notes for editors**

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The English, German, French, Italian and Spanish versions of the *sigma* study No 3/2007, “Annuities: private solution to longevity risk” are available electronically on Swiss Re’s website, the versions in Chinese and Japanese will be available soon: [www.swissre.com/sigma](http://www.swissre.com/sigma)

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