New innovations in insurance risk transfer: longevity risk

Why is insurance risk transfer so important?

Regulatory capital management has never been more important for insurers. The degree to which an insurer has effectively transferred its insurance risk to others is a critical component in the calculation of its regulatory capital requirements. The twin drivers of the need to manage large and uncertain risks, such as those relating to longevity in the life sector and catastrophes in the non-life sector, and the ever-closer introduction of rules implementing Solvency II in the European Union, mean that insurers are devoting increasing resources to developing new ways of managing and mitigating their regulatory capital requirements. Insurers that achieve this effectively stand a better chance of growing their businesses and emerging as victors in the next round of consolidation in the industry.

Who are the main market participants?

Insurers need assistance from other market participants in order to achieve the objective of managing their regulatory capital effectively. Chief amongst these are the large reinsurance groups, but global investment banks also have dedicated groups advising on and arranging transactions involving the transfer of insurance risk. In addition, some current hedge fund strategies involve taking insurance risk and a number of hedge fund groups, as well as proprietary trading and asset management groups at investment banks, are operating in this market.

Ultimately, all of these market participants are working on ways of spreading insurance risk to new markets and risk-takers, including capital market and fund investors. The more widespread this becomes the more likely insurers will be in a position to write new risks and manage their existing books of business effectively.

This briefing note focuses on developments in longevity risk management which are high on the agenda of many UK insurers in the life sector.

What is happening in the market and what are the legal and regulatory challenges to transferring longevity risk?

We are seeing increasing numbers of innovative reinsurance transactions under which longevity risk is transferred to reinsurers. Swap transactions are also emerging as an important tool for longevity risk transfer. Cross-border risk transfer is likely to become increasingly common.

Some of the most important legal and regulatory issues that are arising on these transactions are listed below.
Reinsurance techniques

Developing reinsurance techniques include net reinsurance, deposit-back reinsurance and collateralised reinsurance arrangements involving security trust structures. The principal legal and regulatory issues that are arising on these transactions include:

- satisfying regulators as to the extent of the risk transfer involved (which has a profound effect on such matters as termination rights, warranty protection and premium adjustment mechanisms);
- of particular importance in the current turbulent credit environment, counterparty risk issues, including structuring security and/or collateral arrangements both for the insurer and, on some transactions, for the reinsurer and agreeing how these arrangements may evolve in response to changes in the credit and regulatory capital positions of the parties;
- rights and responsibilities in relation to the administration of underlying insurance policies and asset management and custody arrangements;
- providing the insurer with the flexibility to deal with the underlying book of insurance business in certain ways in the future (including in response to M&A transactions and as part of business restructurings); and
- the insolvency law analysis of the arrangements.

Swaps

Longevity swap arrangements are relatively new in the UK. They may be structured to allow an investment bank or other counterparty to the insurer to accept longevity risk from the insurer and then to transfer all or part of that risk to investors, either by means of issuing further swaps or the issue of specialised securities.

Longevity swaps involve an insurer making a series of fixed payments to the swap counterparty which have been calculated based on longevity assumptions against which the insurer has agreed to "lock in" its longevity risk. In return, the swap counterparty makes variable payments to the insurer which are calculated either against a longevity index or by reference to the longevity experience in some or all of an underlying book of insurance business. The challenge remains for market participants to establish a longevity index which can be applied widely to such transactions in the market.

While these swap transactions rely on ISDA documentation, they differ significantly from other swap transactions because they require modification to address regulatory issues and also require associated detailed administration arrangements relating to the underlying payment and liability calculations.
The principal legal and regulatory issues that are arising for insurers on longevity swap transactions include:

- the issues listed above that are arising on reinsurance transactions;
- analysing whether the swap arrangements themselves ought to be characterised for legal and regulatory purposes as a contract of reinsurance, and the consequences of such characterisation;
- establishing that rights under the swap amount to an admissible asset from the insurer’s perspective which can count towards the coverage that the insurer has of its technical provisions, and do not lead to a capital deduction for the insurer;
- the provisions relating to the calculation and adjustment of (i) any longevity index that is used and (ii) the swap payment flows; and
- legal and regulatory issues (as well as commercial issues) arising from the marketing of products designed by the swap counterparty to transfer the risk that it has assumed to institutional and capital market investors.

Swaps, insurance and financial regulatory expertise are required in order to address and resolve these issues.

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The issues introduced above require detailed engagement with regulators and require legal and regulatory advisers who understand the rules and policy objectives of those regulators and have the capability, resources and experience to develop solutions which recognise the legitimate concerns both of regulators and insurers. Your legal advisers need to combine insurance and regulatory expertise and swaps expertise is also required on longevity swap transactions.

Slaughter and May is the premier UK law firm for legal and regulatory advice on insurance transactions and we are at the forefront of developing new insurance risk transfer techniques. We have teams of lawyers combining expertise in insurance, regulatory and swap-related issues that arise when these techniques are applied.

We have recently acted on a large longevity swap transaction on which a vehicle formed by a global investment bank assumed longevity risk in relation to a large book of UK annuities.

Our capacity for new thinking and unparalleled understanding of the regulatory landscape mean that we are the first point of reference for insurers looking at new ways of managing their regulatory capital and risk. We offer technical excellence in the law and regulation, a capacity for innovative thought and a positive and commercial approach. All of our lawyers handle a wide range of work so that they provide not only a depth of legal and regulatory expertise but also a breadth of experience and sound judgement. Our lawyers also have extensive transaction experience, enabling them to be sensitive to the commercial objectives of our clients. They are accustomed to working closely with insurer and investment bank clients as well as with the regulators.
Global coverage

It has never been more important for global insurers and investment banks to receive the best quality legal and regulatory advice in all of the jurisdictions in which they operate. It is critical that their legal advisers have close and positive working relationships with regulators in all relevant jurisdictions so that they are best placed to achieve the client’s objectives. We have unparalleled access to the world’s leading law firms. These firms act for the largest insurers and investment banks and include some of the most highly regarded lawyers in Europe, the US and Asia, with strong and constructive relationships with regulators. We create integrated teams sourced from Slaughter and May and from appropriate experts from these law firms. Our working relationships with these firms are strong because, as a firm, we work together frequently with them, have long-standing mutual lawyer secondment programmes and share knowledge, experience and objectives to deliver the very best advice.

If you would like to find out more about new legal and regulatory developments in insurance risk transfer and regulatory capital management, and about how we might assist you in developing and executing transactions in this area, then please contact one of the partners named below or your usual adviser at Slaughter and May:

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