

Lessons for investors and issuers

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The story of the thirty maidens offers several lessons, of interest to investors and to issuers of financial products alike.

The first concerns model risk. The French state priced its annuities according to a simplified model that ignored the age of the lives. The Genevan investors exploited this weakness. Any issuer of complex financial products must ensure that its pricing models reflect the risks correctly, failing which astute investors will take advantage of them at its expense.

The second concerns counterparty risk. The Genevan investors mastered the mortality risk, but they remained exposed to the credit risk of a single debtor. A complete analysis of risks must cover all their dimensions, and in particular the soundness of the counterparty that has to honour the commitments.

The third concerns concentration. An excessive share of Genevan wealth was invested in a single type of investment, with a single debtor. The diversification of wealth across asset classes, issuers, currencies and countries is an essential protection.

The fourth concerns duration. Life annuities bound the parties for several decades. Over such a period, political, monetary and institutional risks become predominant. Very long-term investments demand particular attention to the stability of the framework within which they sit.

The fifth, finally, concerns ethics. Profiting from an issuer's error is lawful, but it can raise questions of good faith, particularly when the issuer is a state whose taxpayers will bear the cost. Making income depend on the lives of persons who are strangers to the transaction also raises questions of dignity. Contemporary regulations, which often require an insurable interest or regulate markets linked to human life, reflect these concerns.

Worked example. A pension fund pays pensions to 1,000 beneficiaries, calculated on a remaining life expectancy of twenty years. If actual life expectancy reaches twenty-two years, the fund must pay two additional years of pension to each beneficiary, an increase of 10 per cent in its liabilities, without any additional return or contributions. A gap of two years in life expectancy, which appears modest, is enough to create a substantial deficit. Although fictitious and without taking discounting into account, the figures show the importance of a prudent estimate of longevity.

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