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$270 Billion and Growing: The Rapidly Expanding Pension and Longevity Risk Transfer Market

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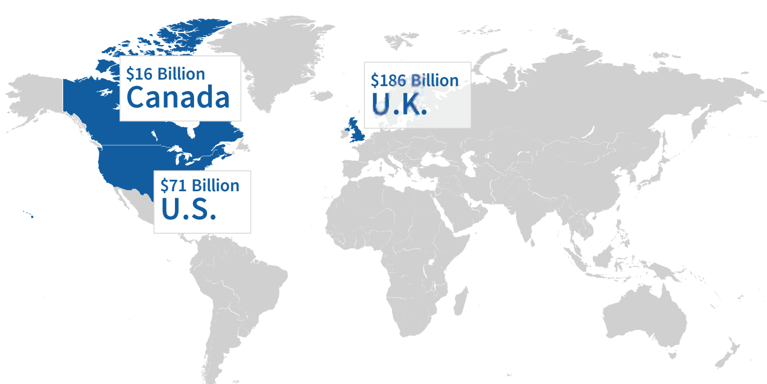
The global pension and longevity risk transfer marketplace has changed dramatically in the past decade. Since 2007, global transaction volume has exceeded $270 billion, with agreements having been completed in the U.S., U.K. and Canada (see Exhibit 1).

What's more, 45 pension plan sponsors around the globe have executed transactions of over $1 billion each. This growing trend in the pension space shows that plan sponsors from a wide range of market sectors, geographic locations and firm sizes are taking action to de-risk their defined benefit plans.

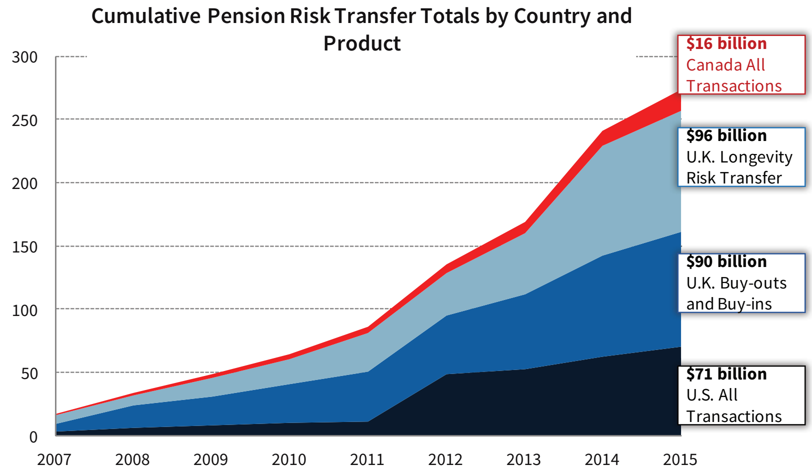
All this expansion begs the question, "Why so much, so fast?" The answer is clear, given that nearly 75 percent of all corporate defined benefit pension plans in the U.S. and U.K. are closed or frozen. And for many plan sponsors around the globe, divesting the pension risk inherent in their plans is no longer a question of "if," but rather "when" and "how."

Exhibit 1: Over $270 Billion in Pension Liabilities Transferred Since 2007



Data in USD. Sources: LCP, Hymans Robertson, LIMRA and Prudential analysis, as of September 2015.

Exhibit 2: Comparison of U.K., U.S. and Canadian Transaction Volume



Data in USD. Sources: LCP, Hymans Robertson, LIMRA and Prudential analysis, as of September 2015.

The de-risking marketplace is not limited to the U.S., U.K. and Canada, however. Companies in the Netherlands are now joining their British and North American counterparts in proactively de-risking pension plans—and many more countries are poised to follow.

De-risking solutions available today are flexible, so transactions can be tailored to meet the specific needs of pension funds and insurers. Every de-risking transaction is unique, and each comes with its own distinctive challenges. But they are all designed to help companies secure their retirees' benefits, while enabling the firms to achieve a lower risk future.

TREND SETTING IN THE UNITED KINGDOM

To date, the United Kingdom is the global leader in transaction volume, with $186 billion in liabilities transferred. The U.K. is also the recognized global trendsetter, having introduced innovative products and solutions that enable pension funds to customize their de-risking paths.

Despite the watershed moment the U.S. market experienced in 2012 with the groundbreaking General Motors and Verizon transactions, it remains second to the U.K., having completed $71 billion in transactions since 2007. The Canadian market has also emerged, with $16 billion of liabilities transferred over the same period.

Exhibit 2 illustrates the cumulative transaction volume in the U.S., U.K. and Canada, which culminates in $270 billion. The U.S. transactions—all of which have been pension buy-outs and buy-ins—are reflected at the bottom of the chart. It is notable that the combined total of U.S. and Canada transaction volume is less than the amount of buy-ins and buy-outs completed in the United Kingdom alone.

Roughly the size of California, the U.K.'s position as the global pension buy-in and buy-out leader is quite remarkable. Even more noteworthy is the country's additional market segment for longevity risk transfer.

Some of the largest and most sophisticated pension funds in the U.K. are managing their own assets and hedging their longevity risk. In fact, the first (and thus far, only) longevity risk transfer transaction to occur outside of the U.K. took place in early 2015, when Bell Canada transferred risk on $5 billion of pension liabilities.

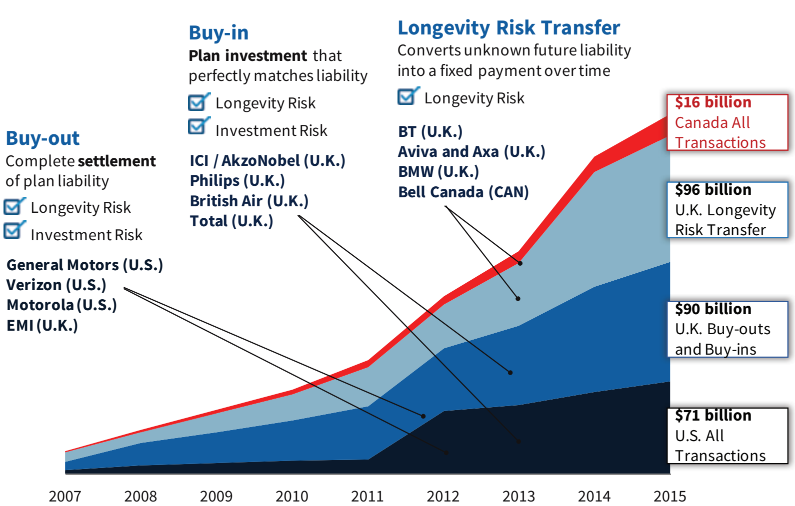
The firms engaging in longevity risk transfer today are demonstrating a disciplined focus on both sides of the risk profile; asset and liability. By moving 70 percent to 80 percent of their assets into absolute return and custom bond portfolios designed to closely match liabilities, these companies have reduced their asset and interest rate risk to manageable proportions. Such a strategy enables them to continue investing 20 percent to 30 percent of their assets in more unpredictable—but potentially more rewarding—asset classes like equity, private equity, hedge funds, commodities and real estate.

Maintaining a diversification ratio of 70 percent to 80 percent fixed income and the remainder in riskier asset classes, these firms are able to effectively manage their downside risk. Their upside earnings potential is limited, of course, and there is not enough upside earnings potential in the portfolio to outpace increases in life expectancy, should they occur. Accordingly, these sponsors hedge their longevity risk as a means of managing liabilities.

CHOOSING THE BEST SOLUTION FOR EACH PENSION FUND

Pension decisions made without longevity risk in the picture will consistently undervalue the benefits of risk management and risk transfer. Currently, only insurance solutions can address the longevity risk in large pension funds, but there are several insurance solutions from which to choose, and companies can select a solution that is tailored to meet their needs. Exhibit 3 presents the solutions currently available, a sampling of the firms that have implemented these solutions, and the volume of transaction activity in the U.S., U.K. and Canada.

Exhibit 3: Plan Sponsors Choose Insurance Solutions Based On Their Needs



Data in USD. Sources: LCP, Hymans Robertson, LIMRA and Prudential analysis, as of September 2015.

The most commonly used solution is the pension buy-out, whereby a plan sponsor pays a premium to an insurer to settle the liability, with the insurer then covering all investment and longevity risks for annuitants. This solution eliminates expenses associated with the pension plan, and removes the liabilities from their balance sheets.

Pension buy-out solutions are ideal for plan sponsors seeking to reduce pension liabilities, can be leveraged in corporate restructurings and are common in the U.S., U.K. and Canada.

Conversely, a pension buy-in enables plan sponsors to reduce pension risk by purchasing a bulk annuity from an insurance company and holding it as a liability-matching asset of the plan. A buy-in provides guaranteed payments to the plan to match the covered liability, and enables the plan sponsor to maintain a direct relationship with its participants. It also allows sponsors to preserve funded status, and does not trigger settlement accounting or accelerate pension contributions. A buy-in decreases the size of the pension risk—not the size of the pension plan.

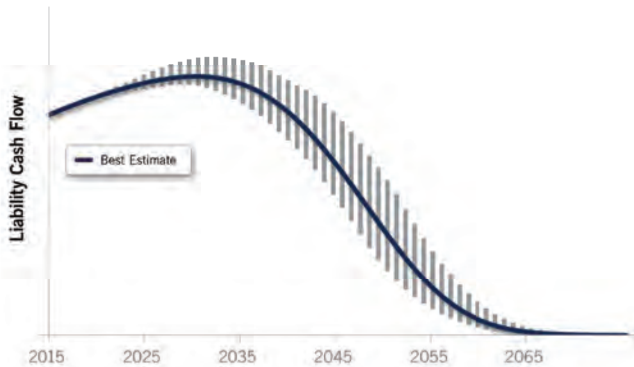
UNDERSTANDING LONGEVITY RISK TRANSFER

The fastest-growing solution in the U.K. and Canada is longevity risk transfer, which enables pension schemes to convert an unknown future liability into a fixed liability cash flow by locking in the life expectancy of the plan participants. For large pension funds, it is easier to manage an asset portfolio against a liability when the future obligation is fixed and known. And for many plan sponsors, longevity risk transfer is the last step in a "do-it-yourself" pension de-risking program.

Longevity risk transfer not only addresses funded status and asset risk concerns, it can also serve as the capstone to a pension hibernation strategy. This approach enables the sponsor to continue managing the plan on its balance sheet, with the risks and expenses managed within a tight tolerance. It is likely that captive insurance and reinsurance strategies will be used with greater frequency in longevity risk transfer transactions, as they help ensure cost-effective execution.

Perfectly suited for very large pension plans that have high fixed income allocations and healthy funded status, longevity risk transfer is utilized by plan sponsors who actually prefer to retain some risk, and choose to pay for de-risking over time. A pension fund that does not meet any one of those criterion is likely to prefer a buy-in or buy-out.

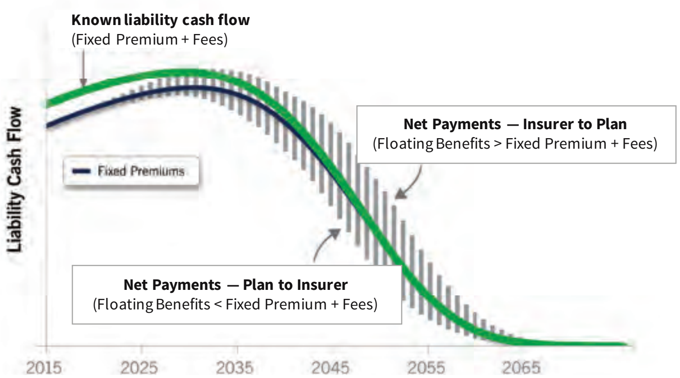
Exhibit 4: Hedging Longevity Risk



Source: Prudential

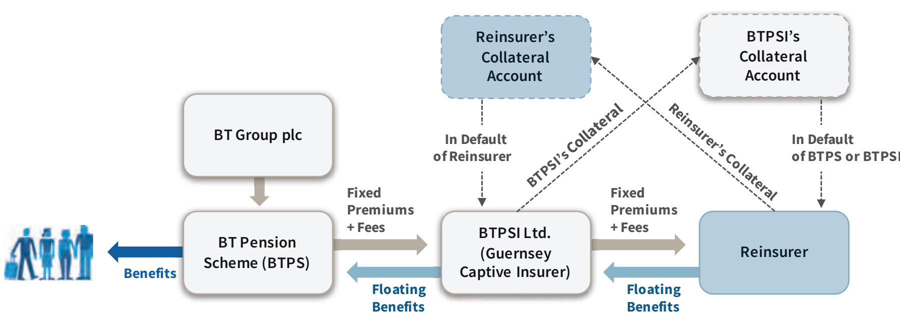
Exhibit 5: Converting an Unknown Future Liability Into a Fixed Payment Over Time

Not yet used by U.S. pension plans. **It has come to Canada!**



Source: Prudential

Exhibit 6: BT Pension Scheme Longevity Risk Transfer Transaction



- Largest ever completed at £16 billion ($27.7 billion)
- First to use an insurance captive owned by the pension fund
- Allows BTPS to immunize 25% of its longevity risk, combining a fixed and known future liability with the Scheme's own world-class asset management
- Allows BTPS to pay for its de-risking over time and shed an unrewarded risk
- Provides a proven approach for the world's largest pension funds to manage longevity risk

Source: Prudential

The curved line on Exhibit 4 shows the expected future liability cash flow for a group of U.K. retirees. The starting point is the total amount of benefits due to all living beneficiaries at transaction inception, with the curved blue line representing the best estimate of the benefits projected over the next half century.

The line is forced upward over time by cost-of-living adjustments, and downward by mortality. The vertical bars extending from the line represent the potential risk around the liability cash flow, demonstrating how future longevity improvements could differ from current expectations.

Viewing risk from this perspective is important, as future medical improvements are likely to occur and health and demographic trends will impact people's lives in ways we can't predict with certainty.

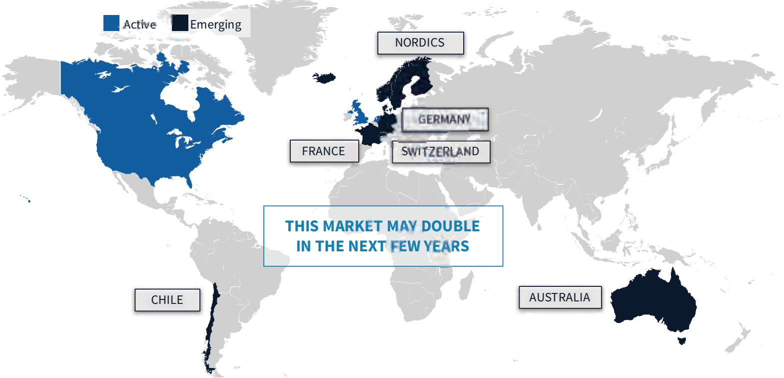
As Exhibit 5 illustrates, the longevity risk transfer transaction eliminates this uncertainty for pension funds by converting an unknown future liability into a known liability cash flow (shown as the green line). Specifically, the pension fund pays the green line, which is the expected liability plus a risk fee.

The insurers and reinsurers in the transaction receive the green line, and subsequently pay the pension fund the actual amount of benefits owed to the surviving beneficiaries, which is likely to be somewhere within the vertical bars, but could fall outside of them. If plan participants live longer than the stress scenario depicted here at the top of the vertical bars, the insurers and reinsurers in this agreement will pay the incremental benefits for as long as the beneficiaries live. This is referred to as "full indemnity cover."

There have been more than 24 transactions completed for U.K. pension funds using the structure illustrated in Exhibit 5, as well as one in Canada (but none in the U.S.). Looking toward the future to see what's coming next in pension risk transfer, we believe that the Canadian market will grow, and that the U.S. will eventually begin to use longevity risk transfer solutions—but that some other countries may do so sooner.

In 2014, the BT Pension Scheme in the U.K. executed the largest and most innovative longevity risk transfer transaction the marketplace has witnessed to date. To complete the transaction, the BT Pension Scheme created its own captive insurer located in Guernsey, which insured the longevity risk. BT's Guernsey captive then reinsured the risk to The Prudential Insurance Company of America, completing an arrangement that is fully collateralized. Exhibit 6 illustrates how the transaction was executed.

Exhibit 7: Future Potential in Market Globalization and Growth



Source: Prudential

The BT transaction was the largest ever completed, covering liabilities worth £16 billion, or nearly $28 billion USD. It was also the first longevity risk transfer to use an insurance captive owned by a pension fund. This arrangement is BT's preferred approach because the Scheme is a world-class asset manager in its own right, and it can continue to manage its assets against a fixed and known future liability. Moreover, it is much easier to manage an asset portfolio against that fixed liability cash flow than it is to manage assets against obligations that are unknown and unknowable.

Since this arrangement covers a portion of the Scheme's liabilities where the assets are in a matching portfolio of bonds, it can be thought of as a segment of the pension plan that has been immunized for a long and safe hibernation. Another benefit is that the transaction allows BT to pay for its de-risking over time rather than up front. And finally, it enables BT to shed a risk it views as unrewarded.

RECONSIDERING PENSION RISK

The BT Pension Scheme transaction stands as a beacon for the largest defined benefit pension plans in the world as they seek direction on how to best navigate longevity risk. This solution can be implemented by large pension funds in the U.K., U.S., Canada, the Netherlands, Australia and beyond.

Certainly, no two plan sponsors have identical goals, resources or definitions of success. That is why no two pension risk transfer agreements are the same. But perhaps the most remarkable aspect of this global pension de-risking trend is that firms of all industries, sizes, geographic locations and levels of funded status are starting down the de-risking path, having benefited from the experience of the many companies that have gone before.

The current hub of activity in the U.S., U.K. and Canada is well established—and well recognized. Insurers with large annuity obligations are now using longevity hedging to manage risk, just as pension funds do. And new markets are emerging and growing around the globe, catalyzed by different factors: the availability of appropriate mortality tables for pensioner longevity, an accounting and regulatory framework that encourages plan sponsors and insurers to hedge longevity risk (i.e., IAS, Solvency II and Basel III) as well as competitive pressure from corporate peers that have already decided to de-risk their pension plans or their annuity books.

There have been emerging opportunities in France and the Netherlands, which exhibit all or some of the above factors. But as the market matures and de-risking gains transaction, there is a real possibility that between now and 2020, pension funds or insurers in Switzerland, Germany, Australia, Chile and the Nordic countries will begin transacting.

Market volume is clearly rising, and we expect that the market may double within the next few years.

If recent transaction activity is any indicator, it's time for defined benefit plan sponsors and insurers with annuity obligations to reconsider pension risk—and to reexamine risk transfer solutions.

Those plan sponsors and insurers who analyze the assumptions surrounding their pension obligations will be able to confidently chart the right course for their pension beneficiaries—and their company. And they will be at an advantage relative to those who don't. ■

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