Now Trending: A Lower Risk Future

Records are breaking in the UK and the pension risk transfer market is more flexible and more global than ever.

By Amy Kessler, Senior Vice President and Head of Longevity Reinsurance, Prudential Financial, Inc.

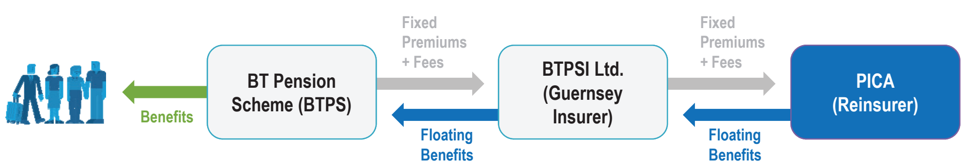
With less than nine months behind us, 2014 is already one of the most noteworthy years in pension risk transfer history. The UK market has seen:

- over £7 billion in pension buy-outs and buy-ins, including the ICI Pension Scheme transaction, which is the largest UK pension annuitisation ever completed; and
- over £21 billion in longevity risk transfers, including the BT Pension Scheme transaction, which is the largest longevity risk transfer ever completed.

In addition, the US market is poised to have one of its strongest years ever, the Canadian and Dutch markets continue to develop and the French market has seen its first longevity reinsurance transaction. These are not isolated events. Together, they demonstrate the strength of the increasingly global pension de-risking trend and the depth of the market that has developed to serve it.

BT Pension Scheme — £16 billion ($27.7 billion)

Longevity risk transfer transaction



The numbers will be surprising to many. Over £130 billion in pension risk transfer transactions have occurred since 2007 in the UK, US and Canada combined. There are over 25 examples of transactions in excess of £1 billion and at least eight examples of transactions in excess of £3 billion for the pension schemes of leading companies like BT, General Motors, Verizon, Aviva, ICI and Rolls Royce. Despite growing concerns about available capacity in the insurance and reinsurance markets for pension risk, each of these pension schemes has found ample capacity from insurers and reinsurers, healthy competition for their business and greater choice every year in the available pension de-risking solutions.

The recent BT Pension Scheme (BTPS) transaction is particularly important in terms of expanding the available solutions. On July 4th, 2014, the Trustees of BTPS announced a record-breaking longevity risk transfer transaction that will provide long-term protection and income to the Pension Scheme in the event that members live longer than expected. In an important step for the market, the Trustees established a wholly owned insurance company, which has reinsured the longevity risk with the Prudential Insurance Company of America (PICA). The transaction covers approximately £16 billion in pension liabilities or 25% of BTPS' longevity risk exposure.

The BTPS transaction is the largest transfer of pension risk to date and demonstrates that the biggest defined benefit pension funds in the world can manage longevity risk and follow a proven path to a lower risk future. They can combine their own world class asset management with cost-effective longevity risk cover, which is available in the global reinsurance market in the tens of billions. The innovative structure and approach pioneered by BTPS can be used in any country to prudently manage pension risk. With its immediate relevance to US, Canadian and Dutch pension funds, this important transaction represents a watershed moment in the global pension de-risking trend.

Amy Kessler
Senior Vice President, Head of Longevity Reinsurance, Prudential Financial, Inc.

The de-risking trend is growing because the hundreds of companies that have transacted to date all have one thing in common – they seek a lower risk future. They aim to reduce the risk in their pension schemes in order to create more consistent financial results, eliminate potential cash calls on the company and maximise their strategic flexibility, especially in challenging economic times. Their goal is simple – it is to ensure the retirement security of plan participants while improving the health of the company

"Leading companies around the world will continue to use buy-ins, buy-outs and longevity risk transfer solutions to manage pension risks."

from a corporate finance perspective by reducing pension volatility, firm beta and the cost of capital. As more companies act to manage the risk in their pension schemes, there is growing competitive pressure for others in their industry peer groups to follow suit.

While the goal of pension de-risking is universal, the strategies companies pursue are as unique as the firms themselves. Since 2006, the market has developed an array of pension de-risking solutions that are effective for plans of every size and situation. The BTPS transaction has now completed this line-up with a cost-effective longevity hedging solution for the very largest pension schemes. The structure employed by BTPS is ideal for a very large and sophisticated scheme that seeks to:

- manage asset risks on its own or with the help of its existing team;
- hedge longevity risk on some portion of its pension obligations;
- pay for its de-risking solution over time; and
- retain a modest amount of risk and volatility.

The BTPS transaction involved the establishment by the Trustees of a wholly owned insurance company – a step which will be most comfortable for very large schemes. Many smaller schemes with similar goals have employed a bank or insurance company to act as an intermediary for their longevity risk transfer transactions, while achieving the same overall risk management objectives.

Longevity hedging solutions are an alternative to buy-ins and buy-outs, which are full annuities that generally involve an upfront payment in exchange for a complete transfer of all asset and longevity risk. Buy-ins and buy-outs are ideal for pension schemes of any size that seek a holistic solution for pension risk and are happy to completely remove risk in exchange for an upfront payment today.

Leading companies around the world will continue to use buy-ins, buy-outs and longevity risk transfer solutions to manage pension risks. As this trend accelerates globally, spurred by the long-awaited recovery of the financial markets and an increasing awareness of longevity risk, another £150 billion in transaction volume is likely. For companies that are considering these solutions, preparation is key. Companies that have succeeded on the risk transfer path have worked closely with their advisors to have data in order and to choose a solution that meets their needs. These steps ensure that a transaction can proceed at the point where the pension scheme reaches its desired targets for de-risking. Being ready to transact is crucial because the last time most pension plans were at or near full funding, the favorable market conditions lasted for a few short months – only long enough to execute a transaction that was already planned.

Going forward, it will become more important to monitor pricing trends and market capacity. While we believe there is ample insurance and reinsurance capacity for the next £150 billion in transaction volume, it is likely that prices will increase as insurers and reinsurers take on more longevity risk and the market continues its aggressive growth. This next wave of transactions will build on the foundation of the pension risk transfer market that we can see so clearly today and will create retirement security for plan participants and a lower risk future for pension plan sponsors.

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