PENSION RISK TRANSFER GAINS MOMENTUM IN A LOW INTEREST-RATE ENVIRONMENT

The pension risk transfer space continues to proliferate, with plan sponsors from an array of market sectors, firm sizes and geographical locations proactively transferring pension risk to insurance companies.

In fact, over $250 billion in global pension de-risking transactions have occurred since 2007, with more than 43 transactions of over $1 billion each having been completed in the United States, United Kingdom and Canada.[1] In the US, a spike of de-risking activity has taken place among small- to mid-sized plans, with several mega transactions having been executed as well, including five de-risking transactions of $1 billion or greater since year-end 2012. The UK has been the world leader in pension de-risking, however, with approximately $167 billion in transactions and 36 transactions of $1 billion or larger.

British Telecom, Motorola Solutions, Bristol-Myers Squibb, AkzoNobel and Visteon are some of the more well-known firms to transfer pension risk in 2014, while 2015 has seen so far such industry leaders as Kimberly-Clark and Timken complete pension buy-out transactions, and Bell Canada Enterprises announced the first longevity risk transfer agreement to occur in North America. And while each of these agreements was unique in terms of strategy, they all shared the mutual goal of realising a lower-risk future.

INTEREST RATES REMAIN LOW

All of this pension de-risking activity has occurred despite an enduringly low interest-rate environment – an environment that has had an unfavourable impact on the funding levels of defined benefit plans around the world.

For example, in 2014 the overall funded status of the 100 largest US pension plan sponsors declined significantly to 81.7% at year's end – a 6% reduction since the close of 2013.[2] This descent is attributable to a lowering of interest rates combined with the introduction of new mortality tables. Together, these factors counteracted sizeable equity market gains that plan sponsors experienced in 2014. The United Kingdom's 100 largest pension plans also suffered a deterioration of funded status ratios, falling to 86.5% at year-end 2014 from 91% at the end of 2013.[3] A recent – albeit moderate – rise in interest rates and positive equity returns has caused funded status ratios in both countries to improve; in the US to 84%, and in the UK to 89%.[4]

Regardless of interest rates and funded status levels, the rationale for pension de-risking remains sound, as evidenced by the volume of de-risking activity taking place on a global scale. Lengthening life expectancies and heightening awareness of longevity risk have been driving factors behind many sponsors' decision to divest pension risk. Further, Pension Benefit Guaranty Corporation (PBGC) premiums in the US are expected to triple by 2016, providing forward-thinking plan sponsors with yet another tangible reason to mitigate pension risk, sooner rather than later.

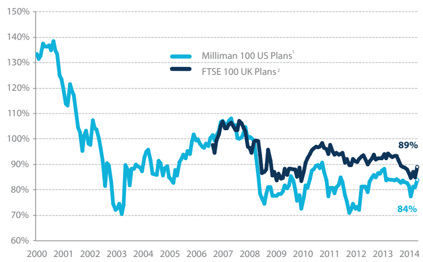
What's more, the current interest-rate landscape enables sponsors of underfunded plans to borrow capital at favourable rates, and in turn fund their pension deficits. Sponsors that do engage in pension de-risking activities can experience pension contribution certainty, and bolster the retirement security of their retirees and employees. In addition, recent transactions have demonstrated that mitigating pension risk not only improves financial flexibility, it could also create perceptible shareholder value.

PENSION DE-RISKING ON THE RISE

In the US and UK over two-thirds of corporate pension plans have either been closed or frozen. For many plan sponsors, pension de-risking has become a question of "when and how," rather than "if."

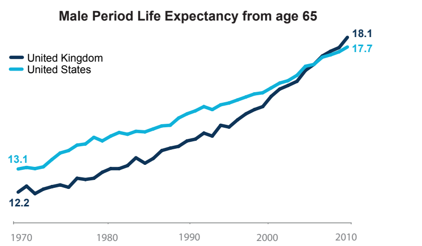
As evidenced by a recent US industry insight survey, pension risk remains a chief concern for many plan sponsors, regardless of the low interest-rate environment. In fact, nearly 25% of private plan sponsors surveyed indicated that they are currently considering transferring, or are very likely to transfer, pension risk in 2015.[5]

Exhibit 1: Funded Status Volatility in the US and UK



Sources: Milliman 100 Pension Funding Index, June 2015; Aon Hewitt "Global Pension Risk Tracker," as of June 2015. https://rfmtools.hewitt.com/PensionRiskTracker. Funding ratio (cumulative assets/liabilities) of all pension schemes in the FTSE index on an accounting basis.

Exhibit 2: Lengthening Retirement Lifetimes of US and UK Males



Sources: CDC, OECD, Aon Hewitt Global Longevity Tracker. https://rfmtools.hewitt.com/GlobalLongevityTracker/

REASONS TO DE-RISK ARE MULTIPLYING

Lengthening longevity, an ongoing low interest-rate environment, stricter funding requirements and asset–liability mismatch are creating a perfect pension storm for plan sponsors across the globe. When compounded by market volatility and escalating PBGC premiums in the US, these factors are producing significant long-term business risks for many plan sponsors.

When you consider that the funded status of corporate pension plans in the US has depreciated over 30 percent twice since 2000, you can see just how challenging sponsoring a defined benefit plan can be (see Exhibit 1). Over this same period, more than $572 billion in cash contributions – as well as substantial market gains – have been required to keep pension funds near healthy status. Pension plan sponsors in the Financial Times Stock Exchange 100 also suffered, having lost more than 25% in funded status during the financial crisis.

Further, this extreme volatility is at its worst in times of recession, and in falling-interest rate environments.

AWARENESS OF LONGEVITY RISK IS INCREASING

Defined benefit plan sponsors assume the real risk of participants living longer than expected. Exhibit 2 shows the retired lifetimes – or life expectancy at age 65 – of men in the UK and US, and illustrates how these expectancies have evolved since 1970.

The retired lifetime of the typical US male has increased 35% over the past 40 years, and men in both the US and UK can expect to spend nearly 18 years in retirement. Exhibit 2 demonstrates that improvements in life expectancy are occurring steadily over time.

Those US plan sponsors who adopted the new mortality and improvement scale assumptions (RP-2014 tables with MP-2014 improvements) recommended by the Society of Actuaries (SOA) during fiscal 2014 saw their pension obligation increase by an average of 4-6%. For some pension-heavy companies, increases in pension liabilities meaningfully impacted financial leverage. Moreover, when the Internal Revenue Service adopts the new mortality tables (most likely in 2017), firms will be obligated to fund a larger deficit over the Pension Protection Act-prescribed timetable (subject to MAP-21 relief), constituting a cash-flow negative for countless plan sponsors.

Previously, the cost of a retiree pension buy-out had been widely reported as being a 10% premium (approximate) over the corresponding Generally Accepted Accounting Principles (GAAP) liability. As plan sponsors updated their mortality basis from the current standard to the modernised tables issued by the SOA, the premium over GAAP liability has been reduced, even though insurer pricing has remained unchanged, making buy-outs appear more attractive.

PENSION PROTECTION PREMIUMS ARE ESCALATING

PBGC premiums in the US continue to be a significant drain for plan sponsors. Comprised of a fixed component that is based on the number of employees – as well as a variable component that is derived from the size of the pension deficit – the PBGC fixed rate premium for each plan participant is scheduled to increase from $57 in 2015, to $64 in 2016. Correspondingly, the percentage of unfunded vested liability that must be paid in variable premium will escalate from 2.4% in 2015, to 2.9% a year later.

In the UK, Pension Protection Fund (PPF) premiums have also increased. These fees are charged on a risk-based levy, with the highest amounts paid by poorly funded schemes possessing a risky asset portfolio, or by financially weaker plan sponsors. PPF premium hikes make it increasingly more expensive for plan sponsors to run a pension deficit.

TAKING ADVANTAGE OF LOW INTEREST RATES

Plan sponsors have several solutions for de-risking pension plans, including pension buy-outs, buy-ins and longevity risk transfer, which is the fastest-growing solution in the UK. The longevity risk transfer products currently available convert an unknown future liability into a fixed liability cash flow by locking in the life expectancy of the plan participants. Many of the largest and most risk-savvy pension funds in the UK have chosen to combine liability driven investing (LDI) and longevity risk transfer for an effective "hibernation" strategy on some or all of their liabilities. BMW, Rolls-Royce, Aviva, British Airways and British Telecom have all embraced this approach.

Plan sponsors that put off pension de-risking for

Exhibit 3: Market Reactions to De-risking Activities[9]

Kimberly-Clark	+0.1%	**February 23, 2015:** Annuity contract for approximately 21,000 retirees in the US
Bristol-Myers Squibb	+0.8%	**September 30, 2014:** Annuity contract for approximately 8,000 US retirees
Motorola	+2.3%	**September 25, 2014:** Annuity contract for 30,000 retirees and a lump sum offering to 32,000 term vested participants
TOTAL S.A.	0.0%	**June 9, 2014:** GBP 1.6bn buyin with Pension Insurance Corporation
ICI (Akzo Nobel)	-0.6%	**March 26, 2014:** GBP3.6 bn buyin with Prudential and L&G
NCR	+0.6%	**November 19, 2013:** UK pension annuitisation
Verizon	+2.6%	**October 17, 2012:** Annuities for management retirees ("lift-out"); Earning release also impacted announcement day returns
NCR	+6.4%	**July 31, 2012:** Lump sums to certain deferred vested; $100M NPV benefits disclosed
General Motors	+1.6%	**June 1, 2012:** Annuities (spin/termination) and lump sums to retirees
Ford	-2.5%	**April 27, 2012:** Lump sums to US salaried and term vested participants; Earning release also impacted announcement day returns
Honeywell	+3.4%	**November 15, 2010:** Accelerated funding; asset de-risking strategy MTM pension accounting
RSA Insurance Group plc	+0.7%	**July 14, 2009:** GBP 1.9bn buyin with Rothesay Life

more favourable future conditions may be underestimating the risk they are assuming. Because equities and interest rates are unpredictable, relying on improvements in market conditions to close funding gaps has proven to be precarious. In our estimation, sponsors with underfunded plans should instead consider borrowing money now to fund their pension plans as a part of a strategy towards a lower-risk future.

BORROWING TO FUND PENSION DEFICITS

Borrowing to fund pension deficits in the current low interest-rate environment enables companies to replace unpredictable pension debt with contractual debt. They are also able to swap escalating PPF or PBGC variable-rate premiums with a fixed interest expense, and accelerate tax benefits from deductible pension contributions.

The substitution of pension debt with contractual debt is likely to be viewed as credit neutral by the rating agencies. However, it is our position that treasurers and chief financial officers will consider the replacement of volatile pension debt with fixed obligations as a net positive. A number of industry icons, including Verizon Communications, Motorola Solutions and Kimberly-Clark Corporation, have issued debt to fund pension deficits while executing buy-out transactions.

HIGH ALLOCATION TO FIXED INCOME ASSETS

Plan sponsors that possess a high allocation of fixed income assets are significantly immunised against changes in interest rates. Firms such as these may consider transferring risk on a portion of their liabilities (the "retiree obligation") to an insurer, and can use their fixed income assets to pay the premium (an "in-kind asset transfer"). Once a firm invests assets in a fixed income portfolio, that an insurer is likely to accept, the pension plan is protected from further rate movement while it takes steps to finalise its transaction.

TAKING ADVANTAGE OF EXISTING CAPACITY

Currently there is capacity for transferring risk to insurers and reinsurers. And while capacity is expected to remain available in the future, costs may increase as pressures mount on the supply-demand imbalance for long-dated corporate bonds. Furthermore, the business mix of insurers may shift as their own exposure to longevity risk increases, causing capital to become less abundant and command a higher return.

REALISING THE ADVANTAGES OF PENSION RISK TRANSFER

Many plan sponsors and fiduciaries are now, more than ever, implementing appropriate de-risking strategies as a means to:

- Achieve plan contribution certainty and improve financial flexibility
- Ensure strategic flexibility and allow greater focus on the firm's core business; and
- Enhance their employees' and retirees' retirement security while increasing shareholder value.

ENHANCING SHAREHOLDER VALUE

Experts believe that pension de-risking diminishes the probability of very high levels of plan contributions being required because of such factors as equity market underperformance, persistently low interest rates and lengthening life spans. As such, pension risk reduction can raise the lower end of the valuation range of a firm, assuming a valuation is derived by discounting the projected future cash flows of the company.[6]

What's more, basing our opinion on research by Merton, Jin and Bodie,[7] it is our position that risk reduction measures can positively impact a company's valuation by lowering its weighted average cost of capital. We take this position because a firm's stock beta typically reflects the riskiness of the company – including its defined benefit pension plan. The level of uncertainty inherent in a pension plan is derived from how the plan's assets are invested, as well as the composition of the plan's liabilities. Both LDI and risk transfer solutions can reduce pension risk and firm beta, while favourably impacting firm valuation.

Financial markets reward organisations that proactively manage risk.[8] Several examples exist whereby companies implemented de-risking actions and subsequently experienced stock price outperformance relative to the market on the date of the de-risking announcement. Exhibit 3 illustrates returns relative to the Market Index on the days when the de-risking activities were announced.

IT PAYS TO BE PREPARED

The current financial market landscape has produced desirable conditions for pension de-risking. This environment could be fleeting, however, and we strongly believe it is incumbent upon companies to begin preparing to reduce pension risk now.

Regardless if a pension risk transfer transaction is immediately forthcoming, some distance in the future, or only being contemplated, there are specific actions plan sponsors can take today to prepare for a lower risk future.

FOOTNOTES

[1] Source: LIMRA Group Annuity Risk Transfer Survey, Hymans Robertson and Prudential Analysis.
[2] Milliman 2015 Pension Funding Study, April 2015.
[3] Aon Hewitt, "Aon Hewitt Global Pension Risk Tracker," as of December 2014, https://pensionrisktracker.aon.com
[4] Milliman 100 Pension Funding Index, June 2015, and Mercer's Pension Risk Survey, June 2015.
[5] "Pension Plan De-risking, North America 2015," Clear Path Analysis, May 2015.
[6] "Reducing Pension Risk: The Five Myths Holding Back Plan Sponsors," Scott Kaplan and Rohit Mathur, September 19, 2014.
[7] Jin, L., R. Merton, and Z. Bodie. "Do a Firm's Equity Returns Reflect the Risk of Its Pension Plan?" Journal of Financial Economics 81, No. 1 (July 2006): 1-26.
[8] Positive market reaction is notwithstanding one-time charges and cash contributions required to restore funded status. Companies that currently do not follow mark-to-market accounting may have to recognize a one-time charge to reflect actuarial losses in proportion to pension liabilities that are settled.
[9] Prominent de-risking actions including buy-in and buy-out transactions greater than $1billion in the U.S. For the rest of the world, the table shows buy-in and buy-out transactions greater than GBP 1billion.

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