If you can de-risk now, why wait?!

Pension funds in the US, UK and Canada have transferred nearly $400 billion in pension and longevity risk since 2007.[1] While these countries are the focal point of the market today, the Netherlands has been a vibrant market, and Germany recently opened for pension risk transfer in 2018 with two notable transactions, together worth more than $5 billion.[2] Several other countries will soon follow suit. In 2017, the US and UK set a combined record with nearly $50 billion in total activity[3], and 2018 is shaping up to be another outstanding year on both sides of the pond.

Why is the market growing so quickly? Today, many pension funds in these countries are at or near full-funding. When combined with competitive pension risk transfer markets and liability pricing at its lowest in a decade, many leading companies are locking in their gains and de-risking with the knowledge that such favorable market conditions will not last forever.

The Pension De-risking Market is Growing at its Fastest Pace in Years

Twice since 2000, funded status of US corporate pension plans lost more than 30% in market downturns (Figure 1). In the US, plan sponsors waited eight years after the end of the financial crisis to see meaningful and sustained improvements in funded status. Now, after a recent rush of discretionary contributions spurred by tax law changes in the US, coupled with market improvements, funded status of the average US plan is nearly 95%.[4] In other mature pension de-risking markets, pension funds find themselves even better funded, with UK and Canadian pension funds both sitting at 103% at the end of September 2018.[5] With such a healthy funded position, pension de-risking has become more affordable than at any point in the last decade.

The affordability of pension buy-ins and buyouts is also a result of solid alignment between growing market demand and vibrant competition with new primary insurers and reinsurers who are adding additional capital and market capacity. Two additional factors are helping to keep prices affordable. The first is new asset strategies, such as the use of new illiquid asset classes, including the securitisation of wind and solar energy in the UK. The second is that longevity has been improving at a slower pace than the historic average. The current slowdown in longevity improvement is due to several health advances occurring simultaneously between 2000 and 2010 (smoking reduction, stents, statins, etc.), a confluence of improvements that made the pace of longevity gains in subsequent years harder to match. But this slowdown is unlikely to persist as there are several possible health advances that could re-accelerate the pace of longevity gains in the years ahead.

Pension Risk Transfer Through a Divestment Lens

There has been a sharp increase in interest around corporate divestitures recently. Companies seek to simplify their businesses and sell operations to tighten their focus. A recent study by Ernst & Young[6] reported that 87% of executives interviewed plan to complete a divestiture within the next two years. This is up from 43% in 2017.

Much like an unprofitable business segment, pension funds divert resources from the core business, constrain cash flows and can limit performance. In fact, divestment decisions and decisions to de-risk a pension obligation are driven by the same economic triggers. Though the motives and circumstances may change among companies, there are three fundamental reasons most companies choose to divest: non-core business, prolonged underperformance, and need for capital.

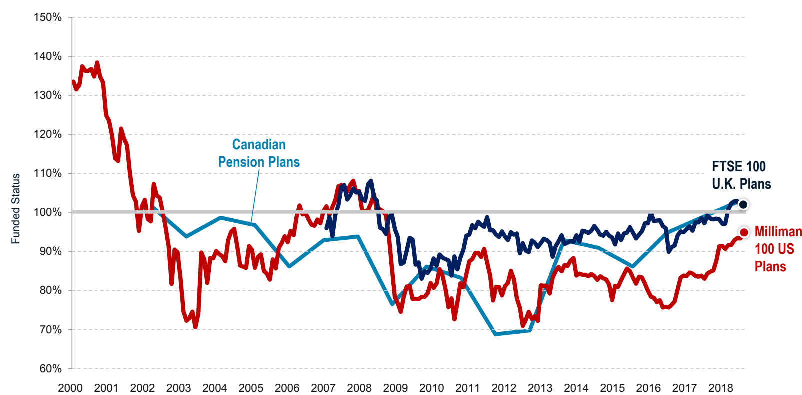
- **Non-core operation:** Defined benefit pension funds have been on a steady decline for decades in favor of defined contribution schemes that shift risk from employers to individuals. Many companies no longer view their pension funds as a talent recruitment tool. Instead, a pension fund exists as a subsidiary of the company that is its monoline pension annuity writer. When thought about in the same strategic way as mergers and acquisitions and divestitures, a pension fund is a subsidiary that only writes pension annuities. Risk should be managed and divestment decisions should be made accordingly.
- **Prolonged underperformance and additional need for capital:** When a business is underperforming, it is a common and financially sound reason to divest. When it comes to pensions, plan contributions can significantly drain free cash flow. Funded status is also volatile and costly as illustrated in Figure 1. Large cash infusions may be required, corporate income can be reduced, and balance sheet liabilities may multiply at the exact moment the underlying business is experiencing hardship.

There is Risk in Waiting

Pension funds today are at an inflection point, the likes of which we have not seen in over a decade. With such favorable funding conditions, pension funds face an increasingly asymmetrical risk and reward profile – upside is trapped in the pension trust and all the downside is borne by the sponsor. When you can lock in gains and move to a lower-risk position in an affordable and efficient market, one must ask, "Is it rational to keep the risk?"

Pensions that decide to keep their risk rather than hedge it – hoping for even lower prices – are maintaining a risky strategy. Managing high-risk market positions requires navigating the volatility of markets, interest rates and currencies, all of which are compounded by longevity risk. Pension risk transfer, by contrast, is an all-weather strategy for managing such risks. And when positioned as a divestiture of a non-core operation, pension risk transfer in today's favorable but fleeting market environment makes a whole lot of sense.

Figure 1. Pension funded status is the highest it's been in a decade [4,5]



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FOOTNOTE
1 Sources: PFI, LCP, Hymans Robertson and LIMRA Group Annuity Risk Transfer Survey. June 30, 2018.
2 Ottawa, B. "German insurer buys €1.8bn Pensionskasse in 'run-off' deal," Apr. 4, 2018, and "AXA Germany sells Pensionskasse to rival insurer," Feb. 1, 2018. https://www.ipe.com/.
3 Sources: PFI, LCP, Hymans Robertson and LIMRA Group Annuity Risk Transfer Survey. Dec. 31, 2017.
4 Milliman 100 Pension Funding Index as of Sep. 30, 2018.
5 Canada: Aon's Median Solvency Ratio, Canadian DB Plans as of Sep. 30, 2018. FTSE 100: Aon Hewitt, "Aon Hewitt Global Pension Risk Tracker," as of Sep. 30, 2018. https://PensionRiskTracker.aon.com, accessed Oct. 9, 2018.
6 Ernst & Young, "How Can Divesting Fuel Your Future Growth?" Global Corporate Divestment Study of 2018.

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