Is it time to get off the roller coaster?

The market for pension de-risking is growing at an unprecedented pace. Today, pension funds in the US, UK and Canada are simultaneously at the highest funded status they've experienced in ten years. In addition, these markets have attracted new entrants in pension insurance and reinsurance, so there is ample insurer capacity, vibrant price competition, and attractive buy-in and buy-out pricing.

Furthermore, seven years of lower than expected longevity improvements mean the lowest liability pricing from insurers and reinsurers in a decade. So, pension funds that can afford to de-risk are doing so now with the knowledge that such favorable market conditions are not likely to last forever. We saw more transactions in 2018 in the US, UK and Canada than ever before, and if markets hold we expect 2019 to break records again.

"Why wait?"

Pension risk is asymmetrical. When a defined benefit (DB) plan is at or near full funding, it is natural to think that the sponsor has both upside and downside risk, but the implications for the company of a rise or a fall are vastly different. If the funded status rises, the surplus is trapped in the pension trust. On the other hand, if the market doesn't hold and the funded status falls, the company will have to make further contributions.

These cash calls may come during a recession when preserving liquidity is critical or they may crowd out strategic acquisitions or investments that can be uniquely attractive in down markets. So, with the upside trapped and the knowledge that the company faces only downside risk, many are moving decisively to lock in gains and take risk off the table. Companies that can't afford to transfer risk can reduce it with liability-driven investing and hedging. Companies that can afford to transfer risk can join the thousands of pension funds that have already done so.

Pension funds in the US, UK and Canada have transferred more than \$400 billion in pension and longevity risk since 2007.[1] Figure 2 shows the cumulative transaction volume and builds up to that \$400 billion number. In these countries, companies of all shapes and sizes are transacting, and the solutions available to them are flexible and customizable. There are three primary types of transactions: buy-outs, buy-ins and longevity risk transfers. While each type of transaction is different, all three secure the benefits for members, while reducing risk for the pension scheme and its sponsor.

Buy-outs

Pension buy-outs have occurred in the US, UK and Canada. In a pension buy-out, the plan pays a single upfront premium in exchange for a complete settlement of a pension liability. The obligation leaves the corporate plan sponsor's balance sheet and transfers to the insurer, who issues annuity certificates to the plan participants and promises to pay their benefits for as long as they live and no matter what happens to the assets.

Buy-ins

Similar to the buy-out, a buy-in covers all asset and all liability risk, but the liability is not settled. In a buy-in, the insurer issues a group annuity contract to the pension plan to be held in the pension plan as a liability-matching asset. That means the risk stays on the corporate balance sheet while the insurer pays the pension fund the exact amount needed to cover the benefits owed to the plan participants for as long as they live and no matter what happens to the assets.

Longevity risk transfer

Longevity risk transfer converts an unknown future liability into a fixed liability cash flow by locking in the life expectancy of the plan participants. If the people live longer than expected, the insurer or reinsurer will pay the incremental benefits for as long as the people live. This frees up the pension fund to focus on funding and investing for the fixed and known benefit payments through the locked in life expectancy of the people. Longevity-only deals have been completed in the UK and Canada.

Longevity risk transfer is perfectly suited for very large pension plans that have high fixed income allocations and healthy funded status, where the plan sponsor actually prefers to retain some risk and prefers to pay for its de-risking over time. A UK or Canadian pension fund that does not meet any one of those criterion is likely to prefer a buy-in or buy-out.

A US pension fund will almost always prefer a buy-out because it eliminates Pension Benefit Guaranty Corporation (PBGC) premiums, and in the current favorable market for buy-ins and buy-outs in the US, UK and Canada, the vast majority of pension schemes are focused on today's opportunity to shed risk.

Beyond the big three

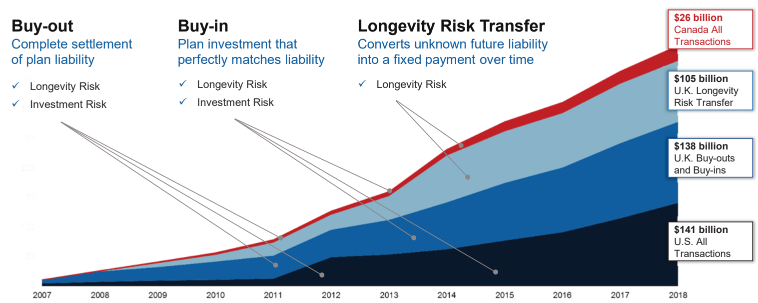
The Netherlands joins the US, UK and Canada as one of the largest DB pension markets in the world, where innovation is alive and well to help DB pension funds manage or transfer risk. While these countries have been the focal point in recent years, the German market opened in 2018 with at least two major transactions, together worth more than 5 billion euros. These German deals involved well-funded Pensionskasse and we expect more of these transactions to follow. In the years to come, we expect progress in several smaller markets, each with under a trillion in DB promises. These include Switzerland, The Nordics and Australia.

It is important to look at pension risk transfer activity globally because in many industries, leading companies in Europe and the UK compete directly with counterparts from abroad and there are many multi-national companies today on a path to de-risk their pension funds around the globe. There are known global de-riskers in the automobile, chemical, aerospace, technology, financial services and pharmaceutical industries, among others, and one of them may be a direct competitor to you or your favorite client. Once they transact, their shareholder's equity is more stable during market disruptions, they present more consistent financial results,

1. Pension funded status is the highest it's been in a decade

Figure 1 sources: Milliman 100 Pension Funding Index; the 100 largest US corporate pension plans, Dec. 31, 2018 (90%). Canadian Source: Aon's Median Solvency Ratio, Canadian DB Plans as of Dec. 31, 2018 (95%). FTSE 100 Source: Aon Hewitt, "Aon Hewitt Global Pension Risk Tracker," as of Dec. 31, 2018 (101%). https://PensionRiskTracker.aon.com, accessed March 6, 2019.

2. Since 2007, there have been more than \$400 billion in pension risk transfer transactions in the US, UK and Canada alone



Data in USD billions. Cumulative totals. Sources: LIMRA, Hymans Robertson, LCP and PFI analysis as of December 31, 2018. UK volumes as of 1H 2018.

their firm beta goes down, and from a corporate finance perspective, they are a stronger competitor. Simply put, companies that de-risk set themselves apart from their peers.

Pension risk transfer through a divestment lens

We can take the corporate finance focus even further. Imagine that your frozen pension fund is the company's insurance subsidiary; the block is in run-off and it has a single line of business: it has only written pension annuities. From a corporate finance perspective, how should you evaluate the decision to retain or divest this non-core subsidiary?

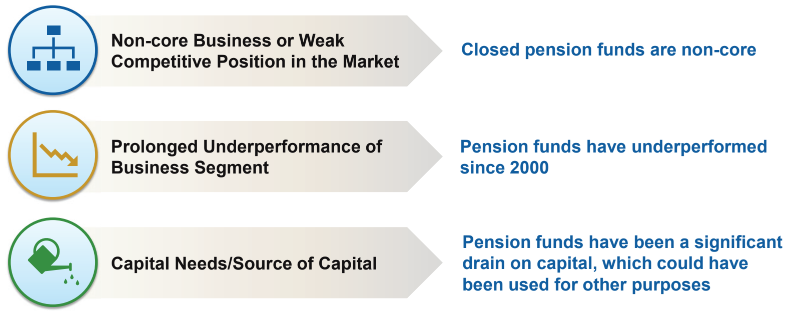
History is full of firms that have effectively used divestiture to create shareholder value by selling non-core operations and unprofitable segments. Divesting also allows management to focus resources on the core business, and studies show that markets reward companies that divest, especially if a transaction improves the performance of the company's remaining operations.

Pension risk transfer can be evaluated in just this way; it is like a divestiture. There has been a sharp increase in interest around corporate divestitures recently. A recent study by Ernst & Young[2] reported that 87% of executives interviewed plan to complete a divestiture within the next two years. This is up from 43% in 2017.

Though the motives and circumstances are different for every company, there are three fundamental reasons firms choose to divest.

First, the world's most disciplined companies are always looking to divest non-core businesses and those with a weak competitive position in the market. Closed pension funds are absolutely non-core. They are no longer needed to attract and retain talent. Second, companies divest segments with prolonged underperformance, and we know that pension funds have underperformed since the year 2000, draining resources that could have been focused on the core business. Third, companies divest segments that need substantial capital infusions, and with hundreds of billions having been contributed since the year 2000, pension funds have been a significant drain on capital. Those funds could have been used for acquisitions or other growth-oriented investments.

3. Why companies divest



At the end of 2017, $738 billion in cumulative pension contributions were made to pension funds in the US since the year 2000. This represents 48% of the Milliman 100's total pension assets today.[3] These contributions came right out of earnings, and in that sense, the $738 billion represents a staggering 9% of the total market cap of the Milliman 100 companies.

Just like an unprofitable business segment, pension plans have drained capital, diverted resources from the core business, constrained cash flows, and disrupted financial performance. They have also created competitive challenges for their sponsors who are increasingly competing with peers that have addressed their pension risk or never had a DB plan at all. The challenge is most acute for cyclical companies and those with limited free cash flow because the pension fund is likely to need capital at the exact moment the core business is in trouble.

As finance leaders think about allocating capital and management time, they are usually more focused on investing for growth and increasing shareholder returns. This is especially true in favorable markets when companies have the means to de-risk the pension plan or divest a non-core business. Investing for growth has more risk and should have a higher return hurdle compared to activities aimed at reducing risk, like repurchasing debt and transferring pension risk. Companies can set up a disciplined framework to evaluate these choices side by side using the appropriate hurdle rate for each opportunity. This can help a management team to know when to focus on divestitures. Without this approach, companies may miss out on fleeting favorable markets and later divest at a lower value or greater cost.

To put this opportunity in perspective, pension funded status has been rising steadily since 2016 after two major market disruptions since the year 2000. It's been a long road to recovery and now that things have improved, it may be a perfect time to get off this roller coaster.

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[1] Sources: LIMRA, Hymans Robertson, LCP and PFI analysis as of December 31, 2018.
[2] Ernst & Young, "How Can Divesting Fuel Your Future Growth?" Global Corporate Divestment Study of 2018.
[3] Source: Milliman 2018 Corporate Pension Funding Study. Total market cap at year-end 2017 was $8.2 trillion.