Opportunity exists for US, UK and Canadian pension funds who are prepared to de-risk

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We recently witnessed the end of a very important moment, when US, UK and Canadian pension funds were simultaneously at the best funded status they had experienced in ten years. At the same time, all three markets had new entrants in pension insurance and reinsurance with ample insurer capacity, vibrant price competition and attractive buy-in and buy-out pricing. Additionally, seven years of lower than expected longevity improvements meant the lowest liability pricing from insurers and reinsurers in over ten years.

In this very favorable market environment in 2018 and the first half of 2019, we saw more transactions in the United States, United Kingdom and Canada than ever before. Only once before have we seen market conditions this favorable—in the run up to the financial crisis—and of course that market did not last. Markets in which all factors are positive are anomalies, and once again, favorable market conditions like these have proven to be fleeting.

In today's market, with the continuing possibility of low interest rates, widening credit spreads, weakening currencies and mortality volatility, we believe that plan sponsors keen to reduce their pension risk should set a realistic price target and continually monitor funded status and insurer pricing. They should then be prepared to pull the trigger to transact on short notice when their price target is met. The current volatile market is likely to provide opportunities to those who follow this path.

De-risking Opportunities

- Low interest rates
- Widening credit spreads
- Weakening currencies
- Mortality volatility

Low rates and widening credit spreads

Low rates mean "borrow to fund" strategies are back in favor. With low rates, many highly rated sponsors can issue corporate debt at attractive yields and deposit the proceeds into the pension fund to improve funded status. Since the pension deficit is already considered debt of the corporation, this debt-for-debt exchange is likely to be considered credit neutral by rating agencies and stakeholders, though it can be credit positive if it allows the sponsor to take meaningful steps to de-risk the plan. For US plans, it also eliminates variable Pension Benefit Guaranty Corporation (PBGC) premiums, making borrowing to fund a very attractive potential opportunity for plan sponsors.

Another opportunity arises when falling risk-free rates are combined with widening credit spreads. These market conditions often mean the economy is in distress, but for US, UK and Canadian pension funds holding a cash flow- or key-rate duration matched portfolio of high-quality bonds, the interest rate risk is largely hedged. Gilts, treasuries and other high-grade bonds will likely appreciate if rates fall, and if, at the same time, the economy is in trouble and credit spreads widen, there is a real opportunity to transfer risk as buy-ins are backed by spread-bearing assets. Buy-in pricing is favorable when it has an implied return above gilts or treasuries, and when credit spreads widen, buy-in pricing improves. It is an excellent relative value trade for a pension fund to use freshly appreciated government bonds to pay for a buy-in that returns risk free plus a wide spread. This trade locks in the spread to government bonds implied in the buy-in price. This locked-in gain increases funded status after the buy-in is complete and transfers all risk to the insurer.

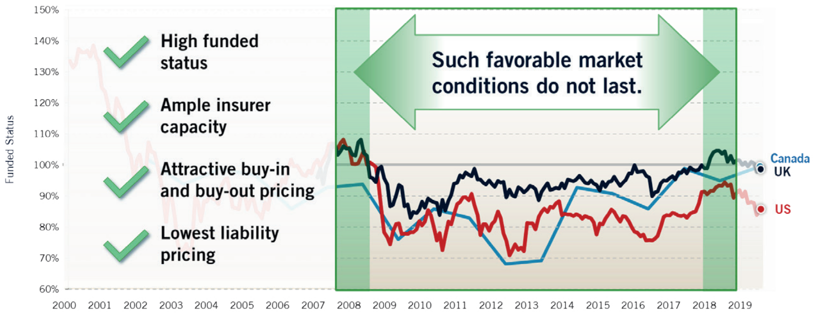
Weakening currencies

Another opportunity is for multinational plan sponsors to plug a pension deficit in a country with a weakening currency. Using the UK as an example, a multinational company headquartered outside of the UK that has a UK pension plan can more easily close a funding gap in the plan after the pound (£) depreciates. Since the first Brexit vote, the cost for a US parent to plug a deficit in a UK plan has gone down by roughly 20%[1]. The same logic holds for funding risk transfer premia. Today, a US parent with a UK plan can fund a buy-in premium for roughly 20% less than in early 2016.

Mortality volatility

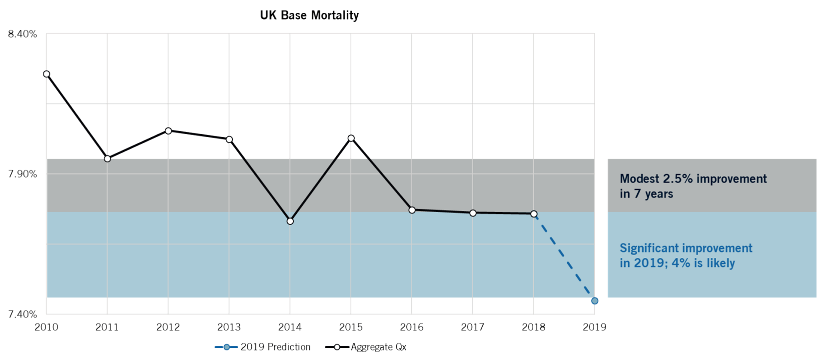
The next opportunity is driven by mortality volatility. From 2011 until 2018, we have seen very low longevity improvements. In fact, during this period, life expectancy hardly improved at all, and each year the liability charges from insurers and reinsurers fell. As a result, many UK pension schemes are bringing longevity swaps to market. Figure 2 shows the aggregate base mortality for retirees in the UK since 2010. When the line moves down, mortality is falling and longevity is improving. Over a seven-year period from 2011 through 2018, there was only a modest 2.5% improvement. The dashed line shows how quickly mortality fell in 2019.

Figure 1: Pension funding has peaked and market conditions are beginning to soften



US Source: Milliman 100 Pension Funding Index; the 100 largest US corporate pension plans, September 30, 2019 (85.4%). Canada: Aon's Median Solvency Ratio, Canadian DB Plans as of June 30, 2019 (99.3%). UK FTSE 100: Aon Hewitt, "Aon Hewitt Global Pension Risk Tracker," as of September 30, 2019 (99.7%). https://PensionRiskTracker.aon.com, accessed October 7, 2019. Funding ratio (cumulative assets/liabilities) of all pension schemes

Figure 2: UK pension schemes are bringing longevity swaps to market today because of a recent acceleration in



Source: ONS (Office of National Statistics) general population mortality data. [1] Aggregate base mortality (70% Male, 30% Female) based on expected death benefits by age for a typical UK longevity risk transfer transaction. [2] UK 2019 Qx prediction based on 2019 mortality improvement of 4% based on ages 65+ UK ONS provisional weekly death data (male + female combined) through 12/31/2019. Actual Qx may vary based on final UK 2019 mortality experience to be released in the second half of 2020.

We are expecting longevity improvement in the general population of 4% in 2019. However, it is important to note that improvements have been higher among pensioner populations. It's too early to tell if 2019 is an anomaly, an increase in volatility, or a trend shift, and market pricing is holding steady for the moment. In the meantime, pension funds are pouring into the longevity market to take advantage of today's attractive prices.

One pension fund that took advantage of this opportunity was the HSBC Bank UK Pension Scheme. In 2019, HSBC completed the second largest longevity risk transfer transaction ever in the market at £7 billion ($8.7 billion) with The Prudential Insurance Company of America (PICA). The arrangement is scalable and repeatable.

Fortune favors the prepared

Pension de-risking is the ultimate chess game where thinking three moves ahead is necessary in order to be prepared for opportunities that present themselves. Don't be afraid to take bold moves to achieve a lower-risk future.

FOOTNOTES

1 Source: Prudential analysis of currency change from Brexit vote, as of December 4, 2019