



PFI

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De-risking pension funds across the board

What are your expectations for the pensions de-risking market in 2017?

William McCloskey, Vice President, Longevity Risk Transfer, Prudential Financial (PFI): A decade of innovation in the management of pension and insured annuity risk has facilitated continued growth in the global pension and longevity risk transfer markets. Since 2007, more than \$280 billion in pension risk transfer transactions have occurred in the US, UK and Canada. The Netherlands is also a vibrant market. Key trends driving growth in these countries today and expected to continue in 2017, include: customisation of large buy-ins, buyouts and longevity risk transfers; capacity for large schemes to de-risk; assistance for companies seeking to de-risk pension funds in many jurisdictions; and proliferation of UK pension de-risking techniques in other countries. Territories that may emerge in the future include Australia, Germany, Switzerland and the Nordics.

Despite low interest rates, companies that have prepared for pensions de-risking are going forward with their plans. And, while most recent activity has been muted owing to volatile financial markets and diminished pension funded status, this is an opportune time to transact, with prices having recently fallen due to lower-than-expected longevity improvements.

Most de-risking activity is expected to occur in the UK, where over 60% of defined-benefit funds remain more than 90% funded, even after the Brexit market disruption. Looking ahead to 2017, there is a 'tale of two cities' among defined-benefit plans. Schemes that have increased their hedge ratios in a disciplined manner in recent years are still reasonably well funded, and can continue their de-risking plans. In contrast, the gap for those that have maintained high-risk profiles is as wide as it was just after the financial crisis. Many plans are in this challenging situation and require innovative approaches to get on a path to a lower-risk future.

Insurers that write annuities are also active in the longevity risk transfer market. Each year, more insurers add longevity hedging to their risk and capital management tool kits, and the UK is not the sole location these transactions occur. Recent insurer-to-reinsurer transactions have occurred in the Netherlands and France, and several more countries could be active in this market segment within a decade.

Our expectations for 2017 and in the years to come are for more growth, more innovation and more globalisation of this very exciting market.

Will longevity reinsurance become capacity-restrained and what would be the implications at that point?

William McCloskey: There is currently no meaningful constraint on longevity reinsurance capacity. As pension funds bring buy-ins, buyouts and longevity risk transfer transactions to primary insurers, they in turn seek longevity reinsurance for the blocks they insure. Many transactions are also done to reinsure blocks of individual annuities held on insurer balance sheets. Of late, there has been ample capacity among reinsurers to meet demand, and new reinsurers have entered the market almost every year since 2011.

The human capacity to price and close all transactions that come to market is also important. Analysing and pricing the longevity characteristics of each block is time consuming, involving big data techniques applied alongside expert underwriting. At times, there have been too many deals in the market to price them all. Therefore, we recommend coming to market with precise

data, reasonable timelines and a transaction team experienced in completing transactions collaboratively, expediently and in good order. In a crowded market, this can make all the difference for schemes and insurers. The proper approach to the reinsurance market can result in six or seven bids at attractive levels and plenty of choice over how your transaction proceeds.

While capacity exists today, the market's growth trajectory suggests that demand could someday outstrip supply. Sidecar arrangements may be a preferred solution to bring capacity into the market, allowing investors to co-invest with insurers and reinsurers in the pension and longevity risk transfer market. In some sidecar transactions, investors may be able to take a proportionate share of profits and losses alongside a reinsurer with its own capital at risk on the same terms. This would also enable investors to benefit from the insurance and actuarial expertise, as well as the access to big data that reinsurers use to analyse these opportunities. This is an intriguing vision for the future, as the market is not currently ready for this ideal version of sidecar investing.

Are many pension schemes following in British Telecom's (BT) footsteps of managing their own asset risk and hedging longevity? What developments are you seeing in this longevity-only segment of the pension risk transfer market?

William McCloskey: Since the 2014 BT transaction, several solutions have emerged for taking longevity risk to market. Pension funds can seek intermediation from UK primary insurers, or can employ captive insurance solutions, as BT and several other pension funds have done. With this approach, pension funds create their own captive insurers – typically in Guernsey, Malta or Bermuda – which insure the longevity risk. The captives then reinsure the risk to reinsurers in fully collateralised arrangements. These transactions enable schemes to manage assets against fixed and known future liabilities, rather than against unknown obligations. This technique has become the capstone to any strategy for hibernating pension risk on the balance sheet. No hibernation strategy is complete without longevity hedging, which also enables schemes to pay for de-risking over time and to divest risks viewed as unrewarded.

How vital will speed of execution be in transactions going forward, and why?

William McCloskey: The ability to execute de-risking transactions quickly and seamlessly is already a key differentiator. Time pressure is most acute when market opportunities make buy-in or buyout pricing particularly attractive, and the insurer and reinsurer must collaborate to assemble the transaction while a fleeting market window remains open. One example is a recent reinsurance agreement between PFI and a UK insurer that was executed just weeks after Brexit, and priced and completed in an exceptionally short period of time. The close consultative partnership between PFI and the cedant allowed for expeditious execution.

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