2018 U.S. Annuity Settlement Market Update

Innovation Drives Market Growth

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Empower Results®

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Introduction: Innovation Drives Market Growth

2017 was a year that saw U.S. pension sponsors and annuity providers continuing to work together in support of record transaction growth, with nearly $25 billion in liabilities settled through pension risk transfer (PRT) transactions. With the transaction pipeline growing each day, marketplace actors (sponsors, advisors and insurers) should continue to work thoughtfully to maximize transaction capacity.

Insurer price estimation techniques have become increasingly important in terms of supporting initial plan sponsor decision-making. Direct insurer price-quoting activities should be appropriately reserved for projects where organizational approval and management support have already been obtained.

As the pace and scale of annuity settlement transactions continue to accelerate, it is important to remember that PRT transactions are complex projects that deliver significant value to the pension plan sponsor. Furthermore, participants who are no longer members of the pension plan are also affected. Pension plan fiduciaries must continue to exercise prudence and diligence in executing these transactions with robust processes that fully consider the best interests of all plan participants.

Aon is proud of its extensive record of supporting U.S. pension risk transfer activity and looks forward to another year of continued market evolution. We have prepared this Market Update to help educate pension sponsors and other pension stakeholders on pension risk transfer strategies.

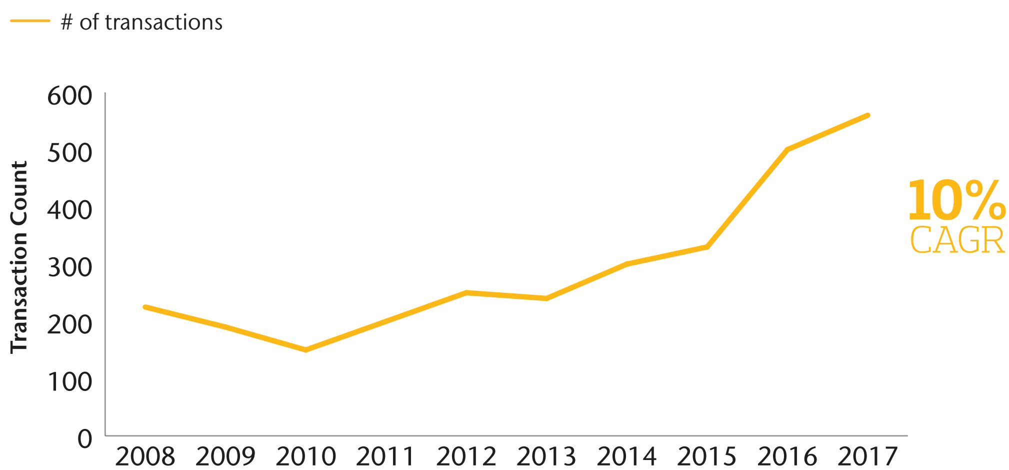
2017 U.S. Pension Annuity Settlement Market Review

Total premium placed throughout 2017 was nearly $25 billon (+75% compared to 2016) and represents the fourth consecutive high-water mark for annual sales.

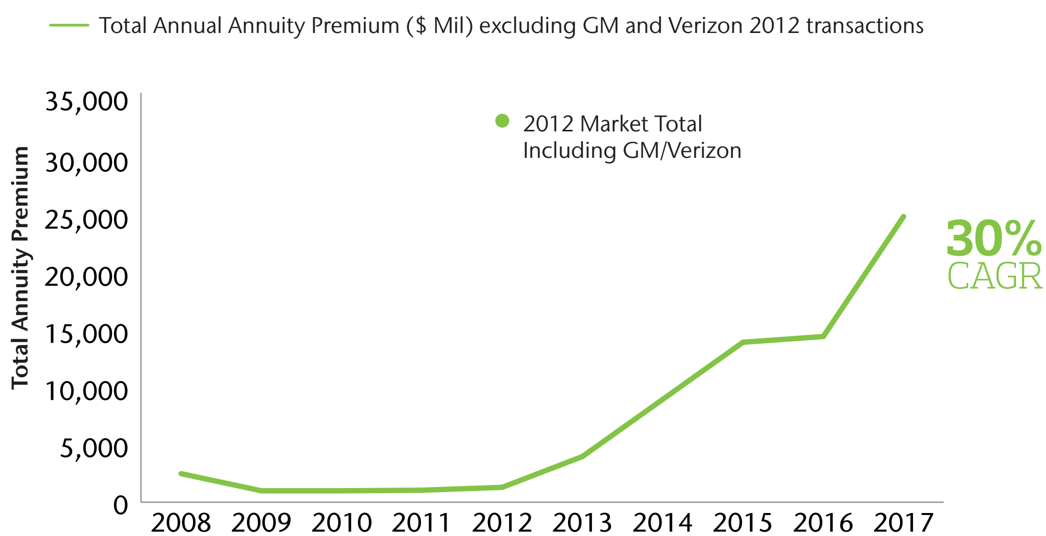
U.S. Pension Annuity Settlement Market Continues to Accelerate

2017 produced the fourth consecutive year of growth in the settlement of liabilities with group annuity contracts purchased by U.S. pension plan sponsors from a growing group of insurance companies.

Transactions



Premium



Source: Aon U.S. PRT Sales Survey data as of 12/31/2017.

A closer look at market transaction data referenced on the previous page reveals that, underneath this growing marketplace, pension sponsors are pursuing two distinct annuity-based strategies:

Plan termination. In this case, all pension plan assets and liabilities are discharged (often via a combination of voluntary lump sums and an annuity purchase), and the plan ceases to exist. A plan termination represents the traditional legacy approach for annuitizing pension liabilities.

Annuity lift-out. An alternate, more targeted strategy — often involving only some portion of current retirees — in which an ongoing pension plan remains. The lift-out strategy has become an increasingly popular way for organizations to more flexibly engage the transaction.

Retiree Lift-Outs Versus Plan Terminations

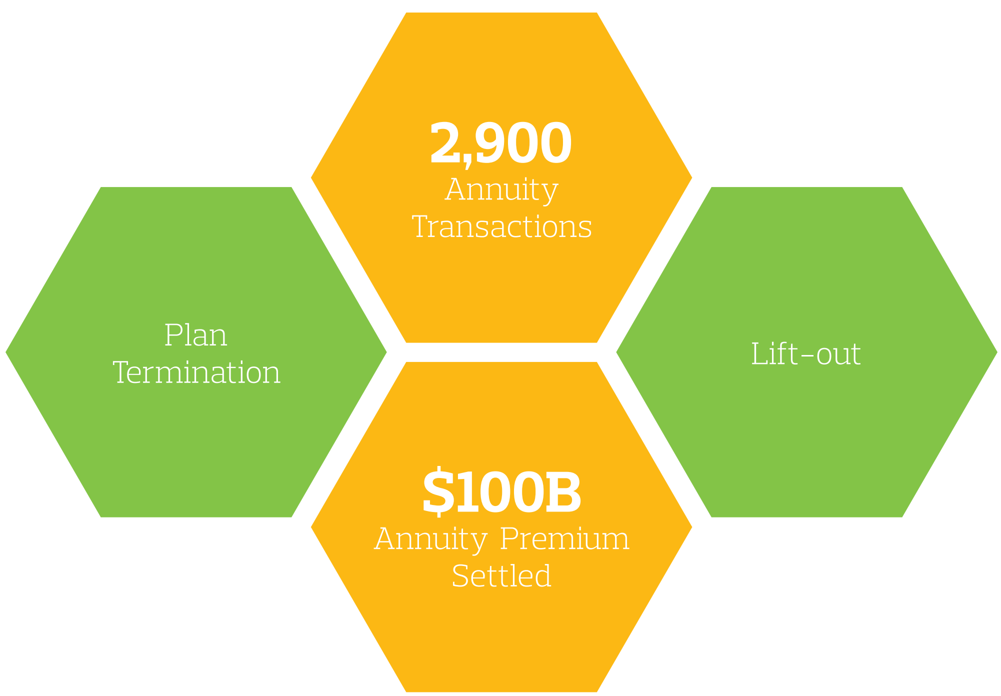
Prior to 2012, the vast majority of pension settlement transactions were executed in connection with a terminating pension plan program. However, since 2012, pension sponsors have begun more frequently utilizing annuity lift-outs as a method of de-risking. Lift-outs reduce the size of the pension plan and eliminate costs, including PBGC premiums. While both strategies principally involve the purchase of a group annuity contract from an insurance company, the sponsor objectives, project timing and cost of either strategy can differ significantly.

Issue	Plan Termination	Annuity Lift-Out
Participants Included	All participants (actives, terminated vested and retirees)	Typically retired lives only
Project Timing	12 to 18 months	3 to 6 months
Financial Impact	Higher; full funding and settlement accounting required	Lower; full funding not required and settlement accounting impact varies
Lump-Sum Window	Generally yes, although not required and not generally offered to retired lives	Not generally included
Remaining Pension Plan	No	Yes

More than $100 billion in pension liabilities have been settled via group annuity contracts in the U.S. since 2012.

In practice, two of the most important differences in executing either of the above strategies are the cost and timing involved. Lift-outs represent a shorter, less complex and less costly project, but involve a trade-off: The sponsor must continue to manage pension risks for the remaining plan. Alternatively, a plan termination eliminates all pension risks, but requires a longer, more complex and higher-cost project.

While the attractiveness of either strategy varies by plan sponsor, one thing remains clear: The popularity of both strategies is rising. More than $100 billion in pension liabilities have been settled in the U.S. since 2012. On a total premium basis, lift-outs represent the majority of the market, given that many of the largest transactions have been executed as lift-outs. Plan terminations, which tend to be smaller, have represented the majority of the marketplace on a transaction count basis.



Source: Aon U.S. PRT insurer Sales Survey data 2008 - 2017.

88% growth in U.S. annuity providers since 2012.

The advantages and disadvantages of either of the above strategies depend on the specific circumstances of the individual plan sponsor. Some additional factors we have observed that may affect plan sponsor decision making include:

- Pension plan materiality (size of plan relative to sponsor's business)
- Funding level
- Access to cash for additional contributions
- Competition from other internal opportunities

Insurer Participation: Supply/Demand Dynamics Driving Market Segmentation

A side effect of the significant marketplace growth has been the continued emergence of new annuity providers. While the list of providers has grown and may continue to grow, each insurer has a unique business, capability and strategy. Thus, each insurer chooses to participate in the market in different ways. The chart below outlines the current group of the most active U.S. pension annuity providers.

Insurer Enterprise	U.S. Life Insurance Group Assets (Billions)	Public/Mutual	Insurer/Holding Company Parent Location	Market Entry
Prudential	$589	Public	U.S.	Pre-2012
MetLife	$432	Public	U.S.	Pre-2012
New York Life	$317	Mutual	U.S.	Pre-2012
AIG	$285	Public	U.S.	Pre-2012
MassMutual	$247	Mutual	U.S.	Pre-2012
Principal	$186	Public	U.S.	Pre-2012
Pacific Life	$132	Mutual	U.S.	Pre-2012
Athene	$69	Public	Bermuda	Post-2012
Securian	$45	Mutual	U.S.	Post-2012
Western and Southern	$43	Mutual	U.S.	Post-2012
OneAmerica	$36	Mutual	U.S.	Post-2012
Mutual of Omaha	$30	Mutual	U.S.	Pre-2012
Mutual of America	$20	Mutual	U.S.	Post-2012
CUNA Mutual	$18	Mutual	U.S.	Post-2012
Legal & General America	$4	Public	U.K.	Post-2012

Most active U.S. PRT marketplace annuity providers. Source SNL Financial: Group Admitted Assets as of 9/30/2017.

The U.S. annuity marketplace remains anchored by a core group of large domestic insurers that were active prior to 2012 and remain committed to the pension risk transfer product category. A group of seven newer entrants is diversified across size, geography and organizational structure, which should help contribute to a sustainable marketplace. Insurers have been retooling their businesses with an increased strategic focus on the pension risk transfer line of business. The significant sales growth of 2017 required several insurance companies to take some or all of the following actions:

- Hiring additional pricing and conversion-support staff
- Raising minimum quote thresholds
- Obtaining management approval for additional capital to support higher sales targets

An additional by-product of this sustained market growth is the emergence of different market segments. We have observed the development of four high-level market segments:

Small market (less than $10 million)
More often plan terminations; largest transaction flow historically

Middle market ($10–$100 million)
Balanced between plan terminations and lift-outs; increasing transaction flow

Large market ($100 million–$1 billion)
More often lift-outs; increasing transaction flow

Jumbo market (greater than $1 billion)
More often lift-outs; transaction flow is episodic year to year

U.S. DOL Interpretive Bulletin 95–1

"Safest Available Annuity"

An effective pension risk transfer transaction must balance settlor (firm or organization) and fiduciary (plan participant) interests.

DOL 95-1 outlines six core criteria that plan fiduciaries and their advisors should analyze in conjunction with annuity provider selection:

1. **Lines of business**
2. **Size of the insurer**
3. **Investment portfolio**
4. **Capital and surplus**
5. **Additional protections available from state guaranty associations**
6. **Contract structure**

An independent annuity expert can be retained to help support plan fiduciaries with the items above.

The market segment sizes from the prior page refer to annuity transaction size, and may not directly translate to the underlying pension plan size. Often, small and middle-market transactions are pursued by larger pension plans with assets in excess of $1 billion. For instance, a larger pension plan may execute a mid-market annuity lift-out in order to maximize PBGC expense savings.

Additionally, it is common for large corporations to sponsor several different pension plans — for example, those that have been acquired through M&A activity. This may create the need for a large corporation to execute a small market annuity transaction in connection with the termination of a smaller pension plan, especially after a lump-sum window further reduces the size of a required annuity transaction. We have observed that, while insurers may work across multiple market segments, they typically focus on a particular segment.

The illustration on the next page provides a more specific view into the current annuity transaction preferences of U.S. annuity providers. It is important to note that insurer appetite can change over time and is based on a variety of market factors. Transactions remain individually underwritten and insurers continue to review all transactions to confirm bid participation.

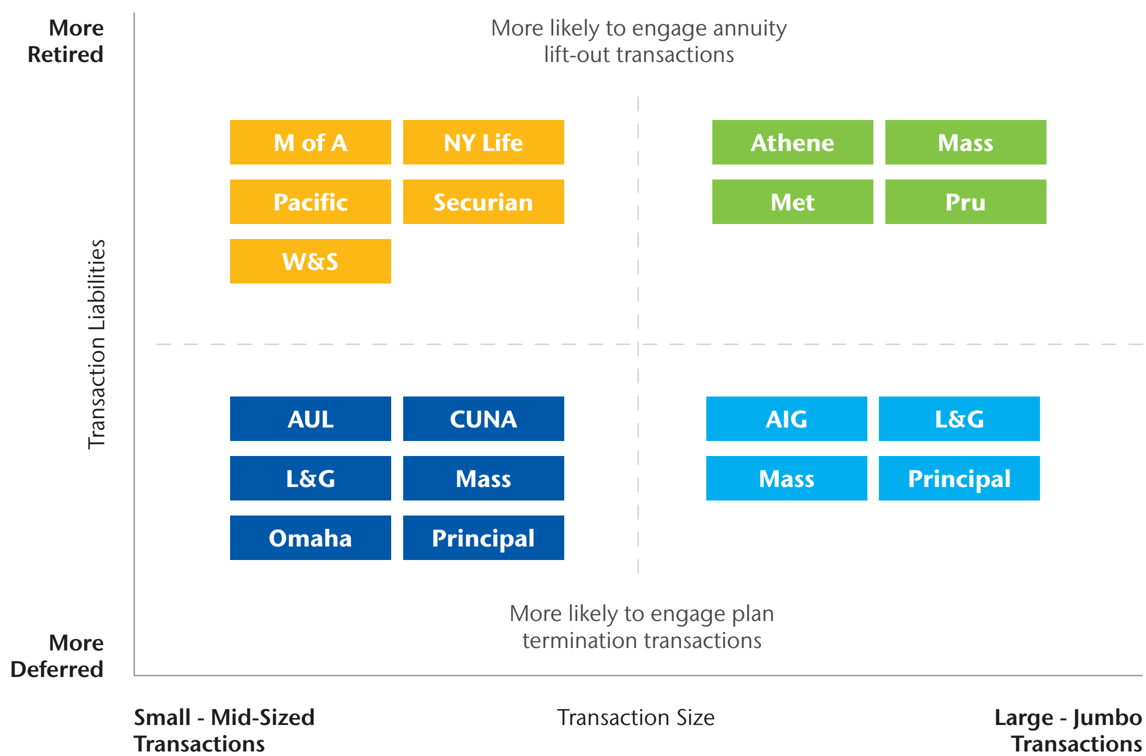
U.S. Pension Risk Transfer Insurer Transaction Preferences

Transaction Size

Insurers located in the left quadrants are more focused on smaller transactions. Insurers located in the right quadrants are more focused on larger transactions.

Transaction Type

Insurers located in the top quadrants are more focused on annuity lift-out transactions. Insurers located in the bottom quadrants are more focused on plan termination transactions.



This illustration is a general indication of insurer bidding appetite based on Aon's experience working with U.S. annuity providers. Each insurer's bidding appetite can vary over time and based on the specific facts and circumstances of any individual transaction.

The U.S. annuity market continues to grow, with 2017 market volume nearly $25 billion across two distinct transaction types: plan terminations and annuity lift-outs.

Several insurers have begun focusing more on annuity lift-out transactions, which tend to be less risky from a pricing perspective and easier to support administratively. This is because a lift-out covered population is typically comprised entirely of retired lives.

Annuity lift-out transactions at the $50 million to $250 million level tend to be the most marketable transactions. Conversely, smaller plan terminations may be more lightly engaged in by insurers, with as few as one or two bidding insurers.

Putting It All Together

New insurer entrants and market segmentation have helped to balance the marketplace growth. As the marketplace continues to grow, sponsors and insurers must work together thoughtfully to support the subsequent continued growth in transaction capacity.

Insurer Pricing Competitiveness and the Aon Annuity Purchase Tracker (Aon APT)

103%

of AA Above Median PBO

101%

of Citigroup PBO

Aon APT as of 3/29/2018

A New Tool for Analyzing Annuity Pricing Competitiveness

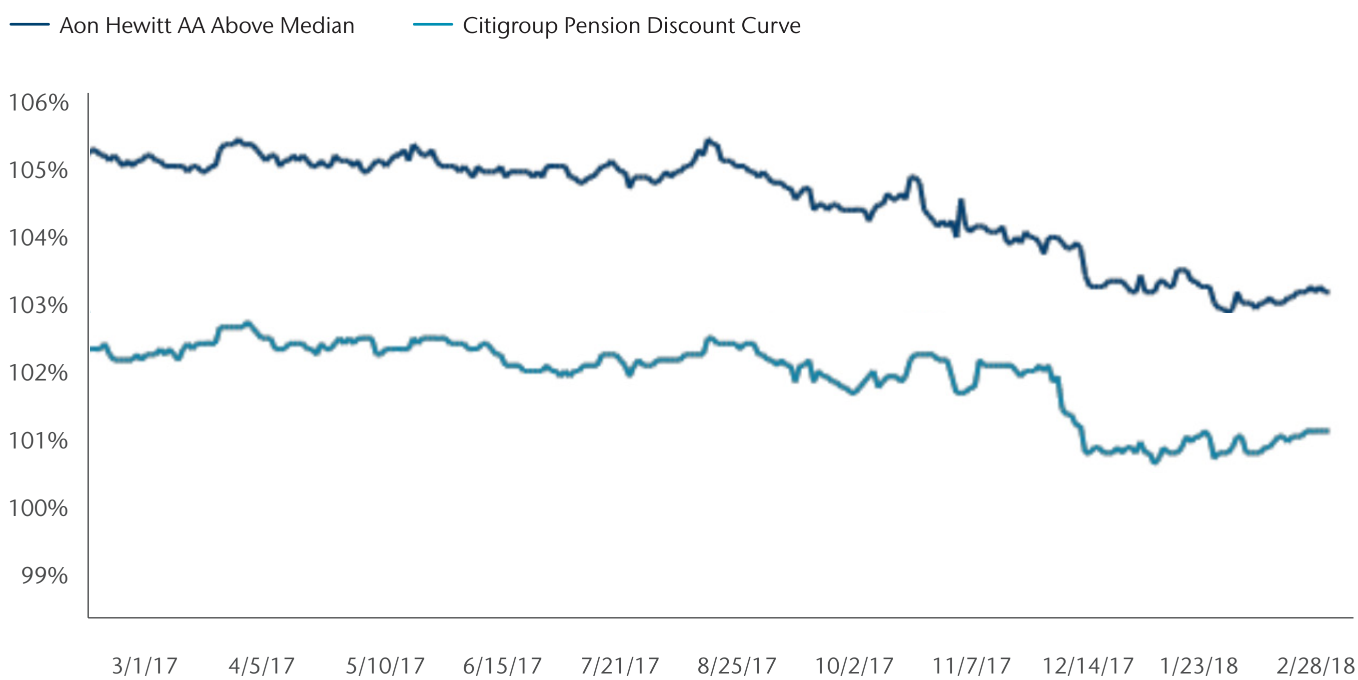
As the U.S. annuity marketplace continues to grow, its competitive market dynamics have become increasingly complex. Assessing the competitiveness of insurer pricing has become an important component of pension risk transfer transactions.

Aon has developed the Aon Annuity Purchase Tracker (Aon APT) in order to help clients better understand the daily relationship between expected and actual insurer prices for a retiree population. By using the APT metric, a pension sponsor can gain a better understanding of the annuity transaction cost. Transaction pricing must be validated as fair and reasonable from both a settlor and fiduciary perspective, and the APT helps support pension sponsors in this regard.

Aon Annuity Purchase Tracker

The Aon APT shows estimates of daily annuity purchase costs as a percentage of estimated accounting liabilities for a typical retired annuitant population.

2017 Estimated Annuity Purchase Cost as a Percent of PBO



Source: Aon Annuity Purchase Tracker data.

The chart on the previous page shows the 2017 relationship between an estimated insurer price and an accounting-type (PBO) liability.

Using surveyed information collected directly from insurers, combined with analysis of interest rate markets, we are able to estimate annuity pricing to help plan sponsors quickly and easily perform financial analysis.

We observe the following from this chart:

1. During 2017, the pricing for retiree transactions ranged from 100 percent to 106 percent of PBO.
2. Pricing as a percentage of PBO trended down modestly during 2017.
3. Understanding the PBO measure is important, as the often-quoted "percentage above PBO" stat must be understood by the sponsor.

APT focuses solely on retired lives, which are the large majority of annuitized dollars. Estimating annuity-provider pricing for non-retired lives is more difficult, because additional assumptions with respect to benefit timing, form of payment and potential lump-sum and/or cash balance features must be included. Plan sponsors seeking estimated pricing for non-retirees should perform a more robust, plan-specific analysis.

Ultimately sponsors intent on annuitizing pension liability typically work with their advisors to engage with insurers and obtain formal annuity quotes, which help validate whether the expected pricing can be supported. Aon recommends in many instances that sponsors conduct an initial financial analysis and seek preliminary organizational approvals without obtaining formal insurer pricing.

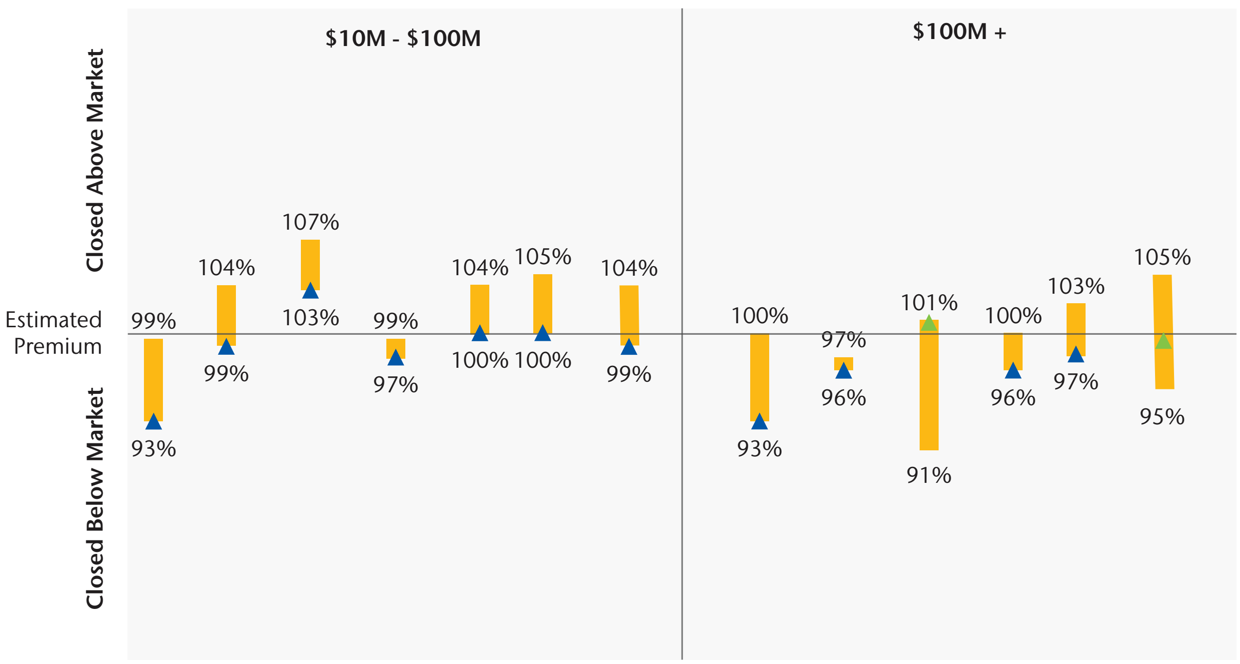
Actual Insurer Price Competitiveness

Insurers have been pricing recent annuity lift-outs in line with, or slightly better than, expectations — as indicated by a sample of 2017 fourth quarter Aon lift-out transactions detailed in the exhibit below. This exhibit confirms how actual final transaction pricing compares to expected transaction pricing.

4 Reasons to Wait to Engage Insurer Price Quotations

- Preserving internal plan sponsor staff resources
- Preparing data
- Maximizing insurer engagement
- Minimizing advisory costs

Insurer Pricing Efficiency: Actual Retiree Annuity Premium Compared to Estimated Annuity Premium



Source: Aon U.S. PRT annuity transaction data. Sample of actual retiree lift-out transactions executed in 2017.

The data on the previous page illustrates how actual insurer pricing compares to expected insurer pricing on specific transactions supported by Aon. Combining these metrics in this fashion allows us to assess whether the final transaction price closed above or below the expected market price. We note the following about this chart:

- More than 80 percent of the deals closed within 3 percent of our APT estimate.
- The range of pricing is generally 5 percent from lowest to highest.
- Smaller deals may be more expensive.
- The lowest price is often selected.

It is also important to note that the data above represent “final” insurer pricing, reflecting an insurer’s most competitive offer. Annuity transactions often involve an earlier, preliminary pricing round that provides a dry-run pricing opportunity and allows for price negotiation to occur prior to final transaction pricing. Aon has observed that insurers’ pricing may move 2 percent to 5 percent lower (assuming no change in market interest rates) between preliminary and final pricing.

Finally, the range of pricing can be affected by a variety of different factors. Since insurers typically provide premiums quoted on a net “all-in” basis, it can be difficult to precisely assess which factors are causing specific insurers to offer higher or lower pricing. The following are some potential factors we have observed that can influence price quotes.

Factors Contributing to the Range of Insurer Pricing

Deal Size

The scale of larger deals may be more attractive to larger insurers, with some smaller insurers preferring smaller transactions.

Life Count

Transactions with a large life count may have a larger administrative burden, which could affect pricing for insurers in different ways depending on their administrative cost structures.

Mortality Expectations

Insurers sometimes have different processes for setting mortality assumptions. This could lead to differing views of insurer mortality, especially on transactions that involve white-collar (more expensive) or blue-collar (less expensive) population groups.

Insurer-Specific Factors

Insurer capital and sales management decisions, along with other internal investment opportunities, are additional factors that can affect insurer pricing.

Other Transaction-Specific Factors

Inclusion of mortality experience data (MED), asset-in-kind (AIK) transaction funding and negotiation of custom group annuity contract (GAC) terms are transactional factors that can affect insurer engagement and pricing.

Looking Ahead to 2018—5 Market-Driving Themes

We expect 2018 to look similar to 2017, with deal flow in the $25 billion range as insurers continue to seek their sweet spots in the market. We believe the following will be drivers:

1. **Tax reform will be a significant tailwind** to annuity transactions as more plan sponsors fund their pensions to take advantage of the 35 percent corporate tax deduction, as applicable. While plans of all different funded statuses are potential players in the pension annuity market, those with higher-funded statuses are more likely to transact.

2. **"Select retiree" annuity lift-outs will dominate the 2018 market**, similar to the small annuity trend that started in 2016. The original premise for small annuities was to avoid expensive PBGC premiums while providing a de-risking opportunity, and that strong business case still exists. Many organizations with funding strategies designed to avoid PBGC premiums differ on which tranches of retirees they consider to be economically sound transactions, whether by dollar-benefit size or other characteristics. And we expect to see more organizations looking at multiple transactions as different retiree (or even non-retiree) groups are analyzed.

3. **Plan terminations are becoming more popular** as more pension plans are fully frozen and become better funded. Remember that plan terminations can take as much as 12 to 18 months to complete and typically include significant lump-sum payouts, so different solutions will be deployed to lock in economics during this lengthy process.

4. **Plan sponsors need to prepare census data that is transaction-ready.** Insurers continue to improve their processes and are rightfully applying more pressure on plan sponsors to lessen the gaps in their census data. Additionally, the ability to share historical mortality and demographic trends helps insurers understand specific plan populations and typically improves pricing.

5. **Robust fiduciary processes must exist.** While the market has become more mature in the past few years, the need for a comprehensive fiduciary process cannot be a casualty of that experience. Each transaction is unique and requires the fiduciary to ensure that it is protecting all pension participants during a proposed transaction.

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About Aon

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