Global Institutional Annuity Market Update

Liability De-Risking/Plan Terminations

First Quarter 2014

Brief Description: This report reviews the international annuity market in the first quarter of 2014, sample annuity rates in the market and three factors accelerating U.S. pension annuity settlements.
First Quarter International Market Update

United States

In the first quarter of 2014, there were 49 cases settled with a total premium of $222.76 million. The first quarter is typically the slowest in any given calendar year, but this figure is lower than those of the first quarters of 2012 and 2013. As the average placement size was under $5 million, the players in the smaller end of the market had the most activity.

Insurance companies currently surveyed include:

- American General Life
- ING Life Insurance & Annuity
- Massachusetts Mutual Life ("MassMutual")
- Metropolitan Life ("MetLife")
- New York Life
- Pacific Life
- Principal Life
- Prudential Insurance Company of America
- Transamerica Life
- United of Omaha Life

The data comes from a Hewitt EnnisKnupp survey of true pension annuity closeout deals (in addition to buy-ins and carve-outs in advance of full closeouts) from insurance companies active in the annuity marketplace. Other industry sources report similar data but may include other types of placements, such as early retirement incentive programs, annuitization of defined contribution plan balances and internal conversions of unpurchased defined benefit annuities.
While first quarter placements were down, HEK has noticed an increase in retiree-only annuitizations which are not time constrained like plan termination driven annuity placements. This may allow sponsors to more effectively time an annuity purchase. Given the decrease in interest rates during the first quarter, this could be one of many reasons which explain the reduction in placements. We will continue to monitor and analyze the transaction data in the quarters ahead to validate placement trends.

No single insurance carrier has monopolized the industry in the last several years. Industry sales leaders in terms of total premium have been:

<table>
<thead>
<tr>
<th>Year</th>
<th>Market Leader</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>Principal</td>
</tr>
<tr>
<td>2006</td>
<td>John Hancock</td>
</tr>
<tr>
<td>2007</td>
<td>Transamerica</td>
</tr>
<tr>
<td>2008</td>
<td>MetLife</td>
</tr>
<tr>
<td>2009</td>
<td>MassMutual</td>
</tr>
<tr>
<td>2010</td>
<td>MetLife</td>
</tr>
<tr>
<td>2011</td>
<td>Prudential</td>
</tr>
<tr>
<td>2012</td>
<td>Prudential</td>
</tr>
<tr>
<td>2013</td>
<td>MetLife</td>
</tr>
</tbody>
</table>

The data comes from a Hewitt EnnisKnupp survey of true pension annuity closeout deals from insurance companies active in the annuity marketplace.

Regardless of the first quarter 2014 annuity placement data, client inquiries have been consistently high, even with the continued low interest rate environment. As sponsors decide to de-risk their pension plans, they are contemplating various options such as partial plan settlements, dollar cost averaging strategies and other liability risk management solutions.
Annuity purchase rates have fallen each month from year-end 2013 through May 30, 2014. The chart below illustrates annuity pricing and market interest rates since January 2007.

Note: Rates are derived from a Hewitt EnnisKnupp survey completed monthly by insurance companies active in the marketplace. The rates since 2011 are derived from the highest (most aggressive) interest rates available in the marketplace on plain vanilla cases as of the last working day of the calendar month. Since rates vary so much intraday, quotes are generally held open for only a few hours on the day they are published.
Immediate Annuity Rates | Deferred Annuity Rates
--- | ---
| Low | High | Low | High |
| 5/31/2014 | 2.83% | 3.10% | 3.43% | 3.81% |
| 4/30/2014 | 3.02% | 3.30% | 3.62% | 4.00% |
| 3/31/2014 | 3.08% | 3.33% | 3.73% | 4.11% |
| 2/28/2014 | 3.11% | 3.41% | 3.79% | 4.17% |
| 1/31/2014 | 3.12% | 3.42% | 3.86% | 4.24% |
| 12/31/2013 | 3.36% | 3.66% | 4.11% | 4.49% |
| 11/30/2013 | 3.22% | 3.52% | 4.02% | 4.40% |
| 10/31/2013 | 3.09% | 3.39% | 3.82% | 4.20% |
| 9/30/2013 | 3.17% | 3.47% | 3.88% | 4.26% |
| 8/31/2013 | 3.29% | 3.59% | 3.97% | 4.35% |
| 7/31/2013 | 3.15% | 3.45% | 3.89% | 4.27% |
| 6/30/2013 | 3.11% | 3.41% | 3.78% | 4.16% |

Note: Rates are derived from a Hewitt Ennisknupp survey completed monthly by insurance companies active in the marketplace. Pricing interest rates can vary for many reasons. For estimate purposes, the low end of the range should be the starting point for cases that have complex plan provisions, contain data that has not been scrubbed, have cash balance and/or employee contributions, etc. Extra conservatism for such circumstances possibly should be added to reduce the estimated rate even further.

According to the Aon Hewitt Pension Risk Tracker, the aggregate funded ratio of pension plans in the S&P 500 Index declined from about 91% to 89% at the close of the first quarter of 2014. Pension funded ratios are impacted most by two key market factors: interest rates (composed of changes in treasury rates and credit spreads) and equity markets. During the first quarter:

- Pension liabilities increased by 4.2% as rates declined over the quarter. The 10-year Treasury rates were down by 0.31% over the quarter and credit spreads narrowed by 0.04%, resulting in a 0.35% drop in the discount rate over the quarter for an average pension plan.
- Return-seeking assets experienced a continued uptick with the Russell 3000 Index returning 2%. Bonds outperformed equities during the quarter with the Barclay’s Long Gov/Credit Index returning 6.6% over this time frame. Overall pension assets increased by 1.5% over the quarter.

Over the last 12 months, the aggregate S&P 500 funded ratio improved. This improvement was due to a notable reduction of $36 billion in liabilities and a continued increase of $94 billion in pension assets.
Canada

The first quarter of 2014 closed with total annuity placements of $356 million (compared to $180 million for Q1 2013) based on information provided by LIMRA. An increased interest in de-risking among defined benefit pension plans was seen in the market. During the first quarter of 2014, three insurance companies dominated the market with a bit more than half of the purchases, divided equally among them.

In May 2014, the Canadian Institute of Actuaries (CIA) published its revised discount rate guidance for estimating the cost of purchasing non-indexed group annuities for hypothetical wind-ups and solvency valuations. Since June 2013, the cost of purchasing non-indexed annuities has been estimated using the duration of the liabilities plus the Government of Canada (GoC) long-term bond yields (CANSIM series V39062).

Effective March 31, 2014, the discount rate guidance above unadjusted CANSIM series V39062 is:

- Low duration (<7.7%) +50 basis points
- Medium duration +80 basis points
- High duration (>12.3%) +100 basis points

For the first quarter of 2014, interest rates have been declining. The GoC bond yield decreased from 3.11% on January 1 to 2.82% on March 31 with an average of 2.87%. Rates reached a low of 2.74% during the quarter on February 3.

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United Kingdom

Risk Transfer Settlements

The first quarter of the year saw nearly £10 billion of risk transferred from company pension schemes—a new watermark that resembles the typical volumes for an entire year. This continues the increase in de-risking witnessed since last summer. The £4.4 billion of bulk annuities in Q1 represents a new record level for a quarter in the UK. We expect the total bulk annuities placed this year to exceed £10 billion, passing the previous 2008 record of £8.1 billion. There were only four transactions over £100 million during the quarter.

Two well-known employers provided the largest bulk annuities placed in Q1. The ICI pension scheme—now part of the AkzoNobel group—undertook a £3.6 billion pensioner buy-in exercise, splitting it into a £3 billion transaction with Legal & General and a further £0.6 billion secured with Prudential. The L&G deal represented the largest UK bulk annuity to date, surpassing the £1.5 billion EMI deal secured with PIC last year. GKN placed a £123 million pensioner buy-in (advised by Aon Hewitt) with Rothesay Life, representing a section of its pensioner liabilities carefully chosen to support future potential transactions. This was the first deal for the restructured Rothesay Life since Goldman Sachs sold more than half of the business to external investors last year.

Legal & General remains the leading insurer in terms of the value placed in the first quarter, due to the ICI deals. It wrote seven deals for a total of £3.1 billion. Prudential and Rothesay Life were the next leading in terms of total value. Aviva wrote 17 cases, the most in the first quarter.

Other

Changes to the 2014 budget will reduce the demand for individual annuities. This will likely cause companies focusing on individual annuities to shift their focus to group annuities.

Specialists Partnership and Just Retirement continued to write bulk deals to develop medically underwritten transactions from company pension schemes, with a £36 million transaction from the latter understood to be the largest deal so far to be priced using health information. Material price savings have been witnessed on some of these deals versus traditional pricing without health information. Further new entrants to the bulk market with competing offerings are expected to arise in the next year or two.

The volume of longevity swap transactions in the first quarter was near last quarter’s volume of £5.3 billion.

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Mexico

In Mexico, pension plans are relatively new. As mentioned in previous issues, the retirement savings culture is not widespread. However, the Mexican government has been making efforts to promote it since the social security law change took effect in 1997. In 1997, social security law passed from a defined benefit scheme (Law 73) to a defined contribution scheme (Law 97). Employees in Law 73 are the transition generation. They will be entitled to select the benefit they want to receive (either Law 73 or Law 97).

The annuity market is linked to social security pension payments, and there are 10 insurance companies that provide social security life annuities. Only a couple of companies offer private retirement life annuities.

<table>
<thead>
<tr>
<th>Period Ending</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>March</td>
<td>$276,450</td>
<td>$288,034</td>
<td>$336,527</td>
<td>$348,713</td>
</tr>
<tr>
<td>June</td>
<td>$591,354</td>
<td>$555,705</td>
<td>$650,583</td>
<td>$830,410</td>
</tr>
<tr>
<td>September</td>
<td>$884,334</td>
<td>$877,212</td>
<td>$1,010,902</td>
<td>$1,211,807</td>
</tr>
<tr>
<td>December</td>
<td>$1,219,116</td>
<td>$1,211,473</td>
<td>$1,356,385</td>
<td>$1,546,080</td>
</tr>
</tbody>
</table>

Obtained from the Mexican Commission of Insurance and Guarantees. Exchange rate: $1 USD = 13 Mexican pesos. Figures are in $USD (thousands).

Every year more pension plans are implemented. While the transition generation of social security is shrinking and the new generation is growing, the annuity market and retirement savings culture will acquire greater importance in Mexico. Due to the aging population, the market grows every year, and there are more campaigns in terms of retirement savings.

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Three Factors Accelerating U.S. Pension Annuity Settlements

U.S. pension annuity transaction volume for 2013 was nearly $4 billion. Notwithstanding the massive marketplace volume in 2012 (driven by GM and Verizon), 2013 annuity placement levels were the highest seen at any point over the last 15 years. The recent growth of the U.S. pension annuity marketplace is attributable to a variety of factors, some of which are detailed below.

Reason #1: Funding Improvements

Generally speaking, typical pension funding levels have recovered over the last 18 months from levels as low as 75% to current levels of almost 90%. Generally, annuity transactions increase following a rise in funding levels. This situation reduces the employer cost to fund additional insurance costs incorporated within the annuity premium.

A healthy corporate balance sheet, related low borrowing costs and a shift toward mark-to-market pension accounting are additional company-specific factors that can influence the decision regarding whether to execute a pension annuity transaction.

Reason #2: Rising Pension Costs

In contrast to improved current pension funding, the outlook for future pension funding is challenged by increasing PBGC insurance costs and updated mortality tables not currently reflected in liability valuations. Generally speaking, these looming additional costs are expected to increase pension liabilities by 5% to 10%. Higher pension costs narrow the cost advantage associated with self-insuring pension obligations and decrease the gap relative to a private insurer’s annuity cost.

Reason #3: Increased Awareness

While 2013 did not witness any billion-dollar jumbo annuity placements, the impact of $30+ billion GM and Verizon transactions was clearly felt across the pension plan marketplace in terms of heightening the level of marketplace dialogue. Actuaries, investment consultants, ERISA counsel, asset managers and pension sponsors themselves are becoming increasingly educated and conversant on important annuity settlement-related topics like:

- Retiree lift-outs
- Asset-in-kind transfers
- DOL 95-1 “Safest Available Annuity Provider”
- General versus separate accounts
- Independent fiduciaries

Moreover, pension sponsors of all shapes and sizes are actively executing terminated vested lump-sum windows to effectively begin the settlement process. These projects are driving organizations to become more aware and prepared to eventually execute annuity settlements in the years ahead if funding levels and interest rates continue to improve.
Conclusion and Recommendation

Significant U.S. pension annuity volume in 2013 validates a shift in pension risk management and decision making. While current interest rates are still near historic lows and annuitization remains the exception rather than the rule, the foundation has clearly been laid for continued acceleration in annuity transactions in the years ahead.

For sponsors where annuitization can be reasonably expected over the short- to medium-term time horizon (one to five years), we offer a simple but effective recommendation based upon our experience: Solicit input and perspective from your current pension advisors (actuary, investment consultant, ERISA attorney, etc.). Querying their experience and capabilities can be a productive and informal starting point for becoming more educated and prepared.
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