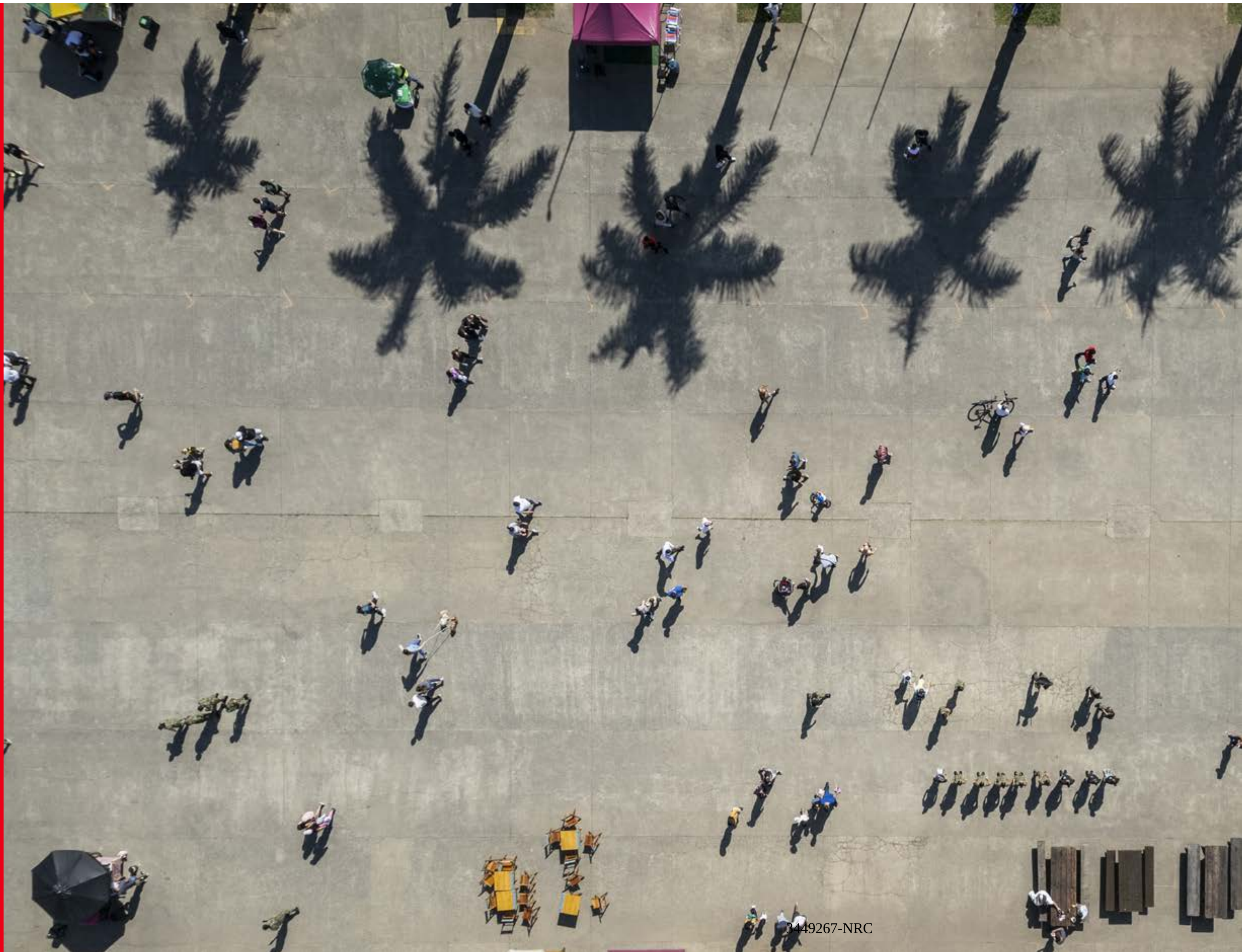
U.S. Pension Risk Transfer

2023 Reflections and Looking Ahead

March 2024



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Introduction

The U.S. pension risk transfer (PRT) market saw another record-breaking year in 2023. After setting record highs for total premium in 2021 and 2022, the market set a new high-water mark for the total number of transactions in 2023 with 773 deals closing during the calendar year. These transactions resulted in $45 billion of premium transferred. Since 2012, $318 billion of pension obligations have transferred from plan sponsors to insurance companies. Interest in PRT has been, and continues to be, propelled by the following factors:

Funded Status Improvement: At the start of 2012, the aggregate funded status for S&P 500 firms with pension plans was 78%. Over the last decade, appreciating equity values, increasing interest rates, and plan sponsor contributions improved the aggregated funded status of those plans to 101% at the end of 2023.

Rising Interest Rates: In the prior decade, some plan sponsors felt interest rates were too low to engage in PRT. The 10-year Treasury rate consistently hovered between 1.5% and 3.0% for much of the 2010s. That headwind no longer exists today after the Federal Reserve increased interest rates dramatically over the last two years in their effort to combat inflation. As of the end of February 2024, the 10-year Treasury rate sits above 4.0%. Transacting at a time with higher rates means the premium – purely from a dollar perspective – is lower.

Increasing PBGC Premiums: The Pension Benefit Guaranty Corporation (PBGC) provides a backstop for pension plans in the event the plan sponsor becomes distressed. To fund this protection, the PBGC charges a flat rate premium per participant and, if the plan is underfunded, a variable rate premium. In 2012, the per participant premium was $35 and the variable rate premium was $9 per $1,000 of unfunded vested benefits. Fast-forward to 2024 where these have escalated to $101 per participant and $52 per $1,000 for the underfunded variable rate.

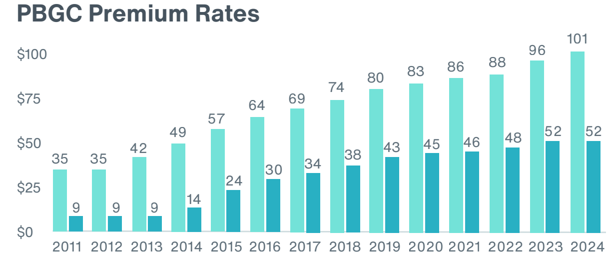
S&P 500 Pension Funded Status

Source: Aon's Pension Risk Tracker at pensionrisktracker.aon.com

10-Year Treasury Rates

Source: 10-Year Treasury Rates per Federal Reserve Economic Data

PBGC Premium Rates



Source: PBGC Rates per pbgc.gov

On the other side of the equation, insurer interest has never been higher. Insurer pricing for PRT remains competitive across deals of all sizes, especially with new entrants over the last few years. These factors, coupled with the factors above, demonstrate the positive momentum in the PRT market as we look ahead. In this paper, we will recap the highlights of the 2023 PRT market and then shift out focus to the future, exploring the emerging adoption of buy-ins as a precursor to plan terminations and looking at potential changes to the Department of Labor's 95-1 guidance.

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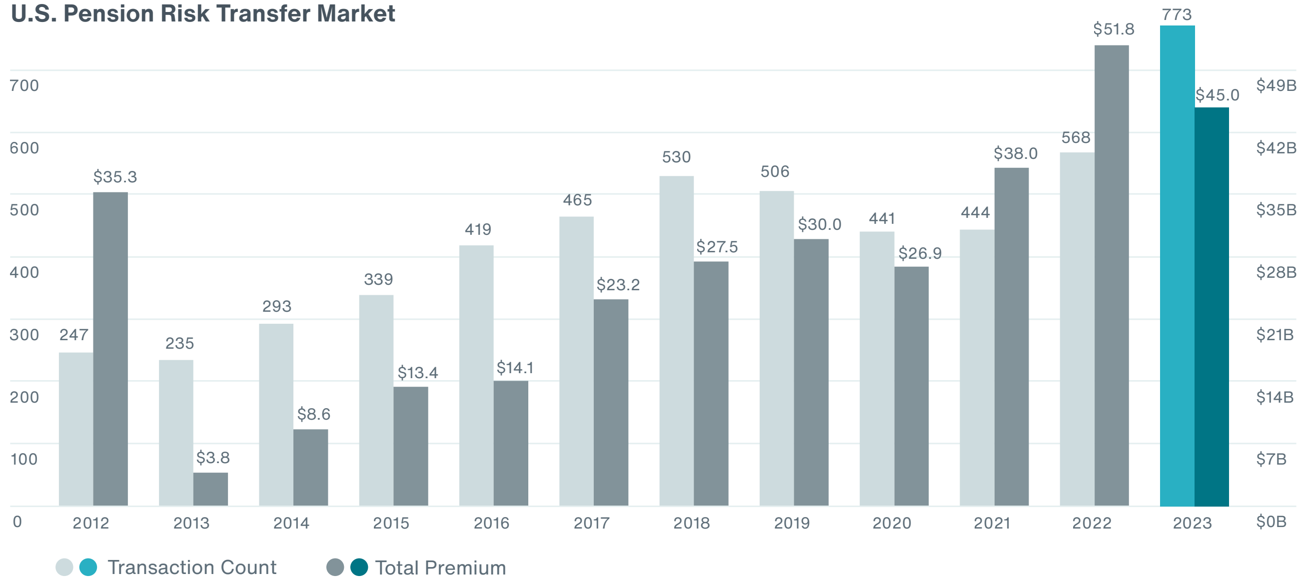
2023 Market Highlights

U.S. Pension Risk Transfer Market

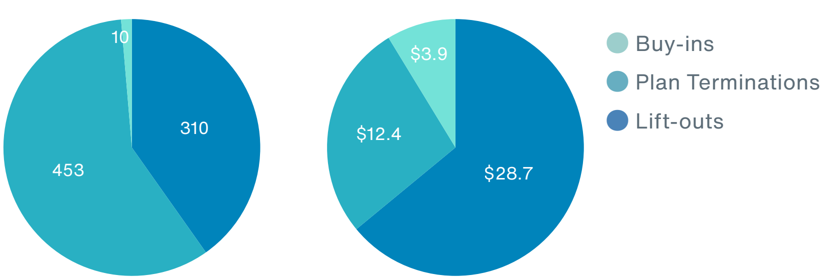


Source: Aon U.S. PRT Insurer Sales Survey as of December 31, 2023; includes lift-outs, plan terminations, and buy-ins

In 2023, there were 773 transactions totaling $45 billion in premium. This includes buy-outs, either as a lift-out or plan termination, and buy-ins. The 773 transactions set a new annual record. As seen in the table below, plan terminations led the transaction count, but it was a record year for all deal types. From a premium perspective, lift-outs drove the total premium, which is consistent with past years. The total premium can be somewhat skewed from year to year by mega-jumbo deals. For instance, IBM's $16B transaction in 2022 and AT&T's $8B transaction in 2023 significantly impacted the total premium in those years. It is hard to predict when these mega-jumbo deals will hit the market. Another factor influencing the premium amount is interest rates. The call-out box to the right illustrates the impact of rising interest rates on premium.

2023 PRT Transaction Count

2023 PRT Premium ($B)



773 Total Transactions

$45B Total Premium

Source: Aon U.S. PRT Insurer Sales Survey as of December 31, 2023

The impact of rates on PRT premium

When rates rise, the liability falls and so does the insurer premium. Over the last two years, rates have increased substantially. This table shows an approximate liability over the last three years using the average 10-year Treasury rate and a liability with duration 10.

Year	Interest Rate	Liability
2021	1.5%	$100M
2022	3.0%	$85M
2023	4.0%	$75M

Despite these headwinds, the volume of PRT premium has remained strong.

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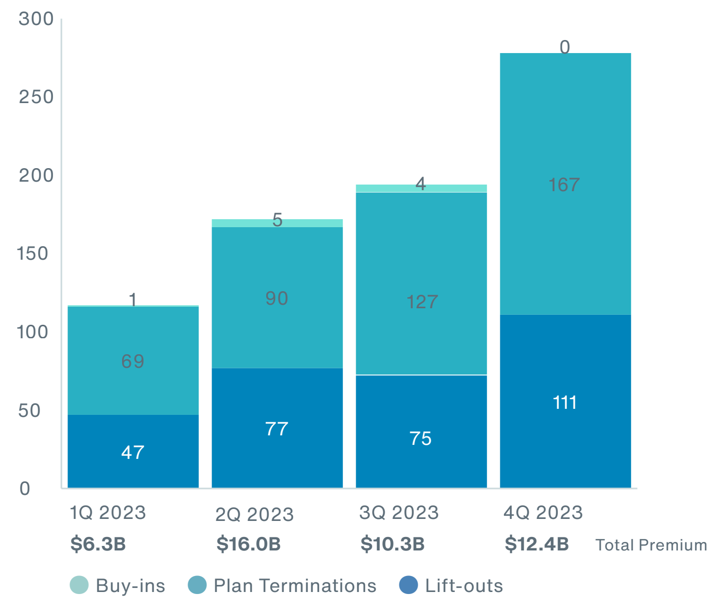
It is important to understand that the market is bifurcated between small deals and large deals. Using $100M as an illustrative split of the market, 2023 PRT activity can be summarized as follows[1]:

Deal Size	Number of Transactions	Insurer Premium ($B)	% of Total Deals Count	
			Count	Premium $
Under $100M	696	$9.9	90%	22%
Over $100M	77	$35.1	10%	78%

The smaller end of the market is more streamlined to handle a larger volume of cases, which are often plan terminations. Conversely, the larger end of the market sees a higher level of insurer engagement and customization, which inherently limits how many deals insurers can focus on at one time.

The PRT market has always been backloaded in terms of when transactions strike on the calendar and this remained true in 2023. Plan sponsors lifting-out retirees will often want to get the deal completed by the end of the calendar year to save on the following year's PBGC premiums. While one might guess plan terminations would be more evenly distributed throughout the year, the data from 2023 reveals a surge in the 4th quarter like lift-outs. This uptick is likely due to internal plan sponsor goals of closing the deal by the end of the year. The increased activity in the 4th quarter is also true regardless of transaction size – in Q4, there were twice as many small deals and three times as many large deals compared to Q1.

2023 Transaction Count by Quarter[1]



[1]Source: Aon U.S. PRT Insurer Sales Survey as of December 31, 2023

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Insurer Review and Pricing Experience

The demand for PRT from plan sponsors continues to be met by insurers with a health supply of capital and engagement. For insurers, PRT is a growth market that gets significant visibility from senior leadership. Each insurer focuses on different segments of the market, whether by size (small versus large), type (lift-out versus plan termination), or solution (buy-out versus buy-in). The table below reflects where we see insurers tend to focus and find success.

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insurers sold more than **$1B** in PRT premium in 2023

There are currently 21 insurers in the PRT market. In 2023, 15 insurers sold more than $1B in PRT premium[2]. While it is not surprising insurers at the large/jumbo end of the market exceed $1B in sales, it is worth noting many insurers who focus on the small/mid-size end of the PRT market are able to write over $1B per year as well.

Insurers in U.S. PRT Market

Small/Mid-Size	Mid-Size/Large	Large/Jumbo
American National	Fidelity & Guaranty	Athene
CUNA	Global Atlantic	Corebridge
Mutual of America	Nationwide	Legal & General
Mutual of Omaha	New York Life	MassMutual
OneAmerica	Pacific Life	MetLife
Sammons	Principal	Prudential
Western & Southern	Securian	RGA

Source: Aon's assessment based on experience with U.S. PRT insurers, as of February 2024

Besides the factors mentioned above, insurers operate within a set of underwriting guidelines that impact their participation. There may be certain plan features insurers are not able or not willing to take on. Insurers will analyze the mortality profile of the population – some plans may be more or less attractive to an insurer. Insurers also need to manage their resources. The surge in deals towards the end of the year means insurers cannot quote on everything they want to due to human capacity constraints. In some situations, insurers may hit their goals for the calendar year and pull back from the market at the end of the year. With these considerations in mind, let's dig into Aon's pricing experience with these insurers in 2023.

How do insurers think about mortality?

In a recent survey, 95% of insurers indicated they use zip code in setting their mortality assumption[3] as zip code is proving to be a useful consideration in predicting longevity.

Generally, insurers have not made material adjustments to their base mortality assumptions due to the pandemic. It is a situation they continue to monitor.

[2]Source: Aon U.S. PRT Insurer Sales Survey as of December 31, 2023
[3]Source: Annual Aon survey and questionnaire of U.S. PRT insurers, as of February 2024

Pricing Experience

Plan sponsors closely monitor their plan's accounting liability, the Projected Benefit Obligation (PBO), and often use it as a benchmark to compare against insurer pricing. This metric – insurer pricing as a percentage of PBO – varies depending on the transaction population. Based on Aon's AA Above Median Yield Curve, retirees are typically priced close to or below PBO, while deferred participants (those actively working and terminated) are often priced somewhere between 110% - 120% of PBO. These are only rules of thumb though, as the yield curve, mortality assumption, and a variety of other factors used to determine PBO may differ from what the insurer uses to determine their price.

The graphic above on the right captures key metrics from Aon's 2023 PRT experience. These are consistent with year-over-year trends. Approximately two-thirds of Aon lift-outs had final pricing below PBO. The nature of the population and the competitiveness of the insurer market continues to make lift-outs a good strategy for plan sponsors. In roughly three-quarters of cases, the lowest bid was selected. In situations where fiduciary committees decide to pay up for a different insurer, it is most commonly due to account structure, brand recognition, and experience, among other justifiable reasons. Lastly, the range of final quotes in 2023 hovered around 5%, meaning the most expensive quote was about 5% higher than the lowest quote. Notably, pricing tended to be tighter earlier in the year and on larger transactions.[4]

The number of insurers bidding on a deal will vary by a few factors. In 2023, on average, retiree lift-outs attracted 4 bidders and plan terminations saw 3 bidders. The smallest and largest transactions had fewer bidders, while deals in the middle tended to bring out the most participation. We also saw fewer bidders in the 4th quarter compared to the rest of the year. While having more bidders does not guarantee lower pricing, it does create a more competitive bidding process and offers fiduciary committees more options when selecting an insurer.[5]

Larger transactions often attracted better pricing from insurers compared to mid-size and smaller transactions in 2023 for both lift-outs and plan terminations. We suspect this is due to a combination of factors: expense efficiencies, better sourced assets, larger pooling of risks, and more precision with mortality assumptions amongst other reasons.

Aon's 2023 PRT Pricing Experience

69%
of lift-outs had final pricing below PBO

77%
of time, the lowest bid was selected

5%
average range of final bids from low to high

Source: Aon U.S. PRT Transaction Data as of December 31, 2023

Pricing in the second half of 2023 was generally higher than the first half of the year, particularly for small and mid-sized deals. We believe there were two drivers. First, the narrowing of credit spreads in the second half of 2023 was greater for lower credit quality fixed income instruments than the contraction in credit spreads in high quality corporate bonds. Movements in credit spreads at different credit qualities captures the market's appetite for more/less risk. This resulted in higher insurer quotes relative to accounting liability. Second, we saw some insurers pull back in the 4th quarter after achieving their goals for the year. This trend was captured in real time by Aon's Annuity Purchase Tracker (APT), which is an effective tool for monitoring market pricing.

Of course, it is important to acknowledge that experiences vary by transaction and there are exceptions to the general conclusions described above. When a deal comes to market, plan complexity, mortality profile, insurer capacity, and desire to win can all influence results.

[4,5] Aon U.S. PRT Transaction Data as of December 31, 2023

3

Buy-ins as a Precursor to Plan Termination

In 2023, there were 10 buy-in contracts executed, totaling $3.9B in premium[6]. Buy-ins are viewed as a niche solution with versatile applications. One option gaining popularity with plan sponsors is what we describe as a precursor to plan termination. This approach addresses plan sponsor concerns regarding the costs and timing associated with plan termination.

While many plan sponsors utilize a liability driven investment (LDI) strategy to hedge interest rate risk, challenges remain with longevity risk, administrative expenses, and potentially some basis risk with the hedge itself. If a plan sponsor wants to terminate their plan and transfer those risks to an insurer, it can take 12 to 18 months to go through the entire plan termination process. In a standard plan termination, the annuity contract is purchased at the end of that timeframe. Sensitivities to interest rates, lump sum window election rates, and the annuity cost may be within an acceptable tolerance for most plan sponsors, but for larger plan sponsors, these sensitivities can lead to an uncomfortably wide range of outcomes from a pure dollar perspective. To address this concern, we are seeing large plan sponsors consider purchasing a buy-in contract prior to starting the plan termination process.

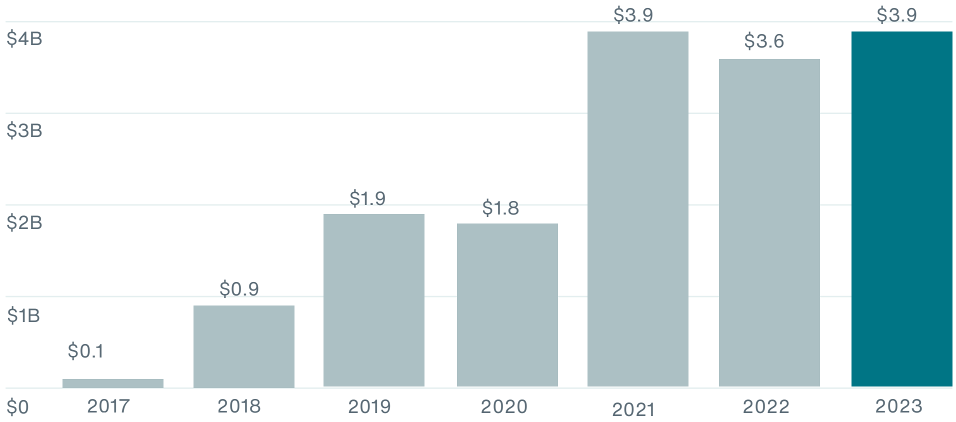
Quick facts on buy-ins...

- Assets transfer from the plan to the insurer
- The buy-in contract is then established as an asset of the plan
- The plan maintains all administrative responsibility (no change from a participant perspective)
- Each month, the insurer reimburses the plan for benefit payments as the buy-in contract provides financial backing
- The plan still pays PBGC premiums
- No settlement under GAAP accounting until the buy-in is converted to a buy-out

Often times, these are plan sponsors who are close to or fully funded. They are contemplating plan termination but are uncertain about the financial feasibility. A buy-in bridges that gap. The buy-in locks in the annuity cost and can be converted to a buy-out, at no charge, at any point in the future. The buy-in might be held for a couple months or even years before the plan sponsor is ready to terminate. Buy-ins can take different forms, such as an ability to include a lump sum window within the contract, which allows for greater economic efficiency for the overall plan termination since lump sums are often a more cost-efficient way to de-risk than deferred annuities.

[6]Aon U.S. PRT Insurer Sales Survey as of December 31, 2023

Buy-in Premium in the U.S.



Source: Aon U.S. PRT Insurer Sales Survey as of December 31, 2023

Interest for buy-ins is growing, although there are currently limitations to be aware of. Buy-ins are complex in terms of purchasing the contract as well as while holding the buy-in contract. About half of the insurers in the PRT market offer a buy-in solution, however, they each have different capabilities in terms of customizing the buy-in. Generally, these insurers are focused on serving the large/jumbo end of the market.

For all those reasons, we tend to see the strategy described above – using a buy-in as a precursor to plan termination – concentrated for large plan sponsors. Historically, plan terminations for large plans were rare. But as funded statuses improve, PBGC premiums continue to rise, and plans reach the end of their lifecycle, more large plan sponsors are considering plan termination. For organizations who want to fully de-risk but are not ready to settle the liability, and/or for those who want to take advantage of current competitive insurer pricing, this application of the buy-in is one tool in the toolbox to help transfer the risk.

Full-Plan Annuity Transactions Over $500M Since 2021

Transaction Structure	Number of Deals	Premium ($B)
Traditional Plan Termination	6	$4.0
Purchased a Buy-in Contract	8	$9.7

Source: Aon U.S. PRT Insurer Sales Survey as of December 31, 2023

The table above captures annuity purchases between 2021 – 2023, where all participants were included in the transaction. These annuity purchases were over $500M; the total size of the plan termination may have been larger if a lump sum window was included. The buy-ins captured above (i) are considering terminating in the near term, (ii) are in the process of terminating, or (iii) have already terminated.

4

Fiduciary Responsibility

With every PRT transaction, the company (settlor) decides to lift-out a portion of the population or terminate the entire plan. It is the fiduciary's responsibility to implement this decision by evaluating and selecting an annuity provider with the best interest of plan participants in mind. To assist fiduciaries, the Department of Labor (DOL) issued Interpretative Bulletin 95-1 ("95-1") to give guidance to consider in pursuit of the "safest available" insurer – a designation the DOL notes could apply to more than one insurer.

While the 95-1 guidance has been effective in that no insurer issuing PRT contracts has failed since 95-1 was released, it has been nearly 30 years and the PRT market continues to evolve. Considerations such as cybersecurity and administrative capabilities have more significance today than when 95-1 was created. Newer entrants to the PRT market, backed by parent companies associated with private equity, have caused some stakeholders to ask for a closer review. And others have brainstormed different ways to evaluate insurers.

As new criticisms emerge, there is often a rebuttal from PRT insurers. This back and forth recently caught the attention of Congress. The SECURE 2.0 Act instructed the DOL to re-evaluate 95-1 and recommend changes by the end of 2023. As of the writing of this paper, the DOL has not formally released any recommendations to 95-1. We can share an update as to what occurred in 2023:

- The Employee Benefits Security Administration of the Department of Labor solicited input from dozens of stakeholders about suggested changes to 95-1, which they summarized in a Consultation Paper for the ERISA Advisory Council. Stakeholders interviewed included plan sponsors, insurers, plan participant representatives, consultants, academics, and various industry groups. Aon participated in these interviews as well.
- The ERISA Advisory Council met to discuss the stakeholder input. A majority of the Council supported the addition of insurer administrative capabilities as a 95-1 consideration. Other changes were recommended by a few members but not endorsed by the majority.

What this means is still to be seen. At Aon, we believe the fiduciary process is a vital part of any PRT transaction. We have a team dedicated to continually monitoring insurers from a 95-1 perspective. Since our clients take their fiduciary obligations seriously, we also guide them through a wide array of considerations beyond 95-1. Our process will continue to evolve as the PRT industry evolves, regardless of how 95-1 changes or does not change.

What about "Independent Fiduciaries"?

A plan's fiduciary committee can hire an Independent Fiduciary (IF) to outsource the insurer evaluation and selection. There are many considerations involved when making this decision. The plan's fiduciary committee gains the expertise of someone who has been through a number of PRT transactions but also cedes control over which insurer is selected. IFs are rarely used for transactions below $1B and almost always used above $3B. In between those ranges, it should be a thoughtful decision if an IF is needed or not – Aon's clients in that range have used an IF about 50% of the time.

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What Else We Are Talking About

Demographic Horizons™

With insurers using zip code as a key input in setting their mortality assumption, as mentioned earlier in the paper, it is important for plan sponsors and advisors to understand how this might impact a PRT transaction. Aon's Demographic Horizons model enables the creation of customized life expectancy estimates based on the socioeconomic status and geography of the underlying population. This cost/benefit analysis and deeper understanding of expectations better positions Aon before a PRT transaction goes to market. For more insights into the Demographic Horizons model, you can reach out to any PRT contact listed on the last page for a copy of the Demographic Horizons paper.

The Last Mile

This paper looks at investment considerations for the 24 months before plan termination. This "last mile" is the most complicated yet most impactful. It is important to understand the complexities of the underlying liabilities and have an investment consultant with the knowledge to manage the investments during this period.

A Leader in the UK and Other Global Activity

Interest in PRT extends beyond U.S. borders. In 2023, there was £50B+ in PRT in the UK and $7B+ in PRT in Canada. In the Netherlands, our Aon team led a €13B longevity transaction. The Aon UK team recently released a paper demonstrating our leadership in the UK market. We see global organizations working through settlements across different countries. We expect plan sponsors around the world will look to lock-in funded status gains in the current higher interest rate environment through more lift-outs and/or plan terminations.

A Strong Start to 2024

The year is already off to a busy start with recently announced deals from Shell ($4.9B lift-out) and Verizon ($5.9B lift-out). Indications suggest 2024 will be another strong year in the PRT market with $40B+ in premium. Be on the lookout for an update from us regarding the PRT market in mid-2024.

Aon Consulting Inc.

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