MORNEAU SHEPELL

Pension Risk Bulletin

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Morneau Shepell publishes original content that provides insights for pension plan sponsors and pension plan administrators on the topic of pension risk.

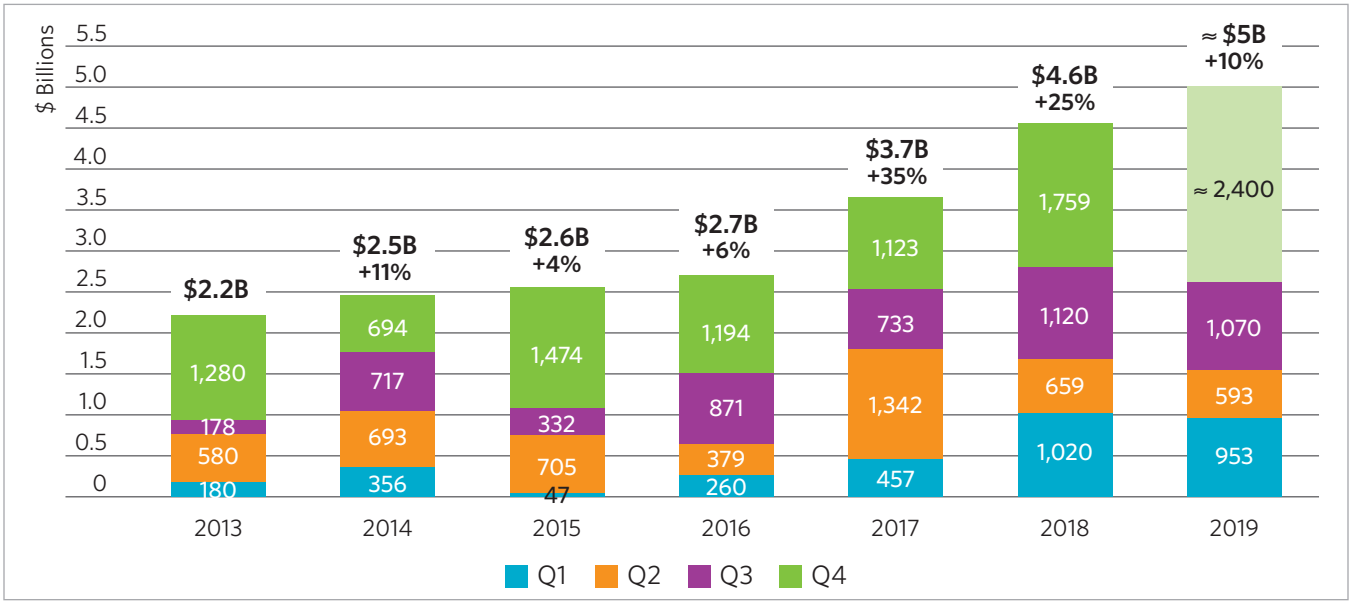
Our goal is to draw upon our research and our experience to advance the conversation on a spectrum of topics related to pension risk management and transfer.

Improving lives. Improving business.

2019: Record year for pension risk transfer activities... again!

Against a low interest-rate environment backdrop, 2019 was another great year for the Pension Risk Transfer market for defined benefit pension plans in Canada. Preliminary statistics suggest that the total volume transacted has reached the $5 billion mark, another record for Canada.

This represents an increase of about 10% from last year's volume. Reaching $5 billion is a big milestone for Canada considering that the volume was at $1 billion or less before 2013.



2019 was also notable for the number of groundbreaking transactions in the market:

- 10 transactions with volume above $100 million of which 7 were above $250 million;
- A jumbo transaction involving 4 insurers provided up to 5 layers of Assuris protection for plan members;
- A new record for the amount awarded to a single insurer as part of a transaction at $560 million.

Buy-in group annuities represented a large part of the total volume in 2019, reinforcing the fact that they can represent a desirable short- or long-term investment strategy vis-à-vis a low-risk liability driven investment strategy.

When it comes to indexed annuities, market competitiveness increased with the addition of a few insurers willing to provide quotes and to take on these liabilities; however, pricing for fully indexed group annuities is still very expensive when one compares insurers' pricing or the solvency proxy with break-even inflation built into the fixed-income products. Fully indexed benefits that have caps are typically much better priced than benefits with unlimited indexation. The demand for inflation-linked annuities continues to increase and insurers did broaden their offering, but there remains quite a bit of work to be done until we see the market for fully indexed annuity becoming significant.

Activity level throughout the year

The first half of the year was somewhat slower than in prior years but activity picked-up in the fourth quarter where about half of the year's volume was transacted, making Q4 of 2019 the busiest quarter of all times for the Canadian market.

A heavier volume of transaction in Q4 seems to reinforce the perception that waiting for Q4 to benefit from insurers trying to meet their objectives is yielding better pricing. Transacting in Q4 can be a double-edged sword. In fact, during 2019, many insurers didn't have much appetite to take on additional risk towards the end of November, with some having reached their annual capacity and others having used their best-yielding assets on prior transactions. Pricing or market competitiveness for small- to medium-sized opportunities can be significantly impacted if a large transaction goes through and freezes the insurers' resources. Waiting for Q4 on purpose leaves a lot of uncertainty in the execution of a successful transaction which is not desirable for most organizations.

Our clients experienced great pricing throughout the year. Careful planning and an ongoing dialogue with insurers is of paramount importance for successful transactions. These steps yield a more predictable and desirable outcome over trying to take advantage of insurers' unmet goals.

Pension risk transfers in the news

We are of the general opinion that the analysts and investors community appreciates and values the proactivity and transparency of a plan sponsor managing its defined benefit pension risk. Pension risk transfer activities are often significant activities on a plan sponsor's right-risking journey and controlling the messages to all stakeholders around these transactions is seen as a superior approach than being reactive to concerns or questions raised by any stakeholder. We observed a considerable number of significant pension risk transfer transactions being publicly announced in 2019.

Sample of public announcements

- Navistar Canada ($333 million)
- Wabush Mines
- Stelco Inc. Hamilton Works ($885 million)
- Rayonier Advanced Materials ($293 million)
- Domtar Corporation ($360 million)
- Iron Ore Company of Canada ($560 million)

For many organizations, such transactions are perceived as a win-win situation for all plan members, the plan administrator and the plan sponsor. A well-formulated communication plan that considers all stakeholders, including all plan members, not only those covered by the annuity contract, goes a long way to make these transactions successful.

Statutory discharge

The number of legislations allowing plan administrators to obtain a statutory discharge upon an elective buy-out continues to grow in Canada. In 2019:

Nova Scotia passed Bill 109 allowing a statutory discharge for annuities purchased for former members, retired members and other insured annuitants. Bill 109 will come into force upon proclamation, and further regulations are expected.

Ontario extended its statutory discharge rules to include the purchase of an annuity covering a surviving spouse; such discharges were already available to former and retired members.

The Federal government adopted Bill C-97 allowing a statutory discharge upon purchase of an annuity for a former member, retired member or survivor. Bill C-97 will come into force upon proclamation, and further regulations are expected.

As of the end of 2019, statutory discharge following an elective annuity purchase is possible in Québec, Ontario and British Columbia, by following the proper steps as stipulated in the applicable legislation/regulation. In some cases, where full discharge isn't yet possible, we have been successfully discussing alternative strategies with regulators to diminish the fiduciary risk for the plan administrator after an annuity purchase.

Cybersecurity risk

Data breaches continued to make the headlines worldwide in 2019 and we have seen heightened scrutiny on cybersecurity risk as part of pension risk transfer transactions. Given the significant cost related to fixing data breaches and long-term legal implications, plan sponsors and administrators are concerned about the ability of an insurer to protect its data. The due diligence process as part of selecting insurers needs to incorporate important elements of cybersecurity such as:

- Cybersecurity standards and how they compare to industry standards;
- Ability to demonstrate compliance to standards;
- Detailed plan in case of data breach.

We expect insurers to provide or to continue to provide the cybersecurity documentation required to help decision-makers assess the risk built into pension risk transfer transactions.

Presence of reinsurers

The increasing size of transactions has contributed to a greater involvement of Canadian reinsurers in the pension risk transfer market. Their involvement has mostly consisted of working with insurers and consultants on pricing significant pension risk transfer transactions. Reinsurance can help insurers better diversify their longevity risk and improve their pricing basis or simply increase their capacity for certain transactions. As transaction size keeps increasing for group annuities, reinsurers will have an important role to play to support an insurer's appetite for growth and to provide overall stability in the pension risk transfer market.

Expectations for 2020 and beyond

We expect the volume of pension risk transfer activities to remain high in the foreseeable future:

The demand is still strong even though it is heavily influenced by the financial health of the pension plan. Corporate plan sponsors, the leaders in pursuing pension risk transfer solutions, are more determined than ever to carefully reduce the size of their defined benefit pension liabilities and assets. As the plans' solvency ratios increase, the demand will only accelerate.

The supply has never been as high. Insurers are better at rewarding interest rate and longevity risks within their business model than plan administrators are within the framework of pension regulations. The insurance industry has expanded its appetite for this type of business. More and more insurers are allocating a larger amount of financial and human resources to pension risk transfer activities. The size of transactions is also getting bigger. A couple of transactions in the last few years have neared the $1 billion mark.

A buy-in group annuity can be a sound and well-priced alternative to a liability driven investment strategy considering that the buy-in also eliminates the longevity risk. The specific benefits of one alternative over the other will vary based on the plan administrator's objectives, the plan characteristics and the economic environment at the time of the comparison.

As insurers, reinsurers and consultants are trying to make the best use of all sources of mortality/longevity data and expertise, we expect that longevity insurance might pick up steam in the next few years, particularly for plan sponsors or administrators seeking plan sustainability over the long term, such as those in the public or quasi-public sectors. As mentioned above, the insurers and reinsurers are typically in a better position than a pension plan to reap the rewards of taking on longevity risk as part of pension risk transfer transactions.

We also expect the due diligence process to select insurers to incorporate qualitative factors such as quality of services provided by the insurer, cybersecurity and adaptability to client needs, rather than focusing mostly on pricing or quantitative factors such as credit ratings.

There is so much geo-political risk and economic uncertainty that it is again impossible to predict the direction of interest rates or whether we are going to experience another great year for equities or negative returns. However, we do expect that plan administrators will continue to closely manage their pension risk in 2020 and beyond. The asset allocation decision is critical in reaching your right-risking objective but pension risk transfer activities such as group annuities or longevity swaps can continue to bring several benefits for plan sponsors/administrators for years to come.

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