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Featured Insurer: Prudential Financial Inc.

Interview with John Strangfeld
Shifting Retirement Risks (Back) to Insurers[1]

by Etti Baranoff

John Strangfeld is Chairman and Chief Executive Officer of Prudential Financial, Inc., a financial services leader with operations in the United States, Asia, Europe and Latin America. With nearly 140 years of life insurance and asset management expertise, Prudential is focused on helping individual and institutional customers grow and protect their wealth through its life insurance, annuities, retirement-related services and investment management businesses.

Q1. Retirement readiness is a critical issue in the U.S. and countries around the world. How can life insurers help meet that challenge?

Retirement readiness is a big challenge and a big opportunity, and meeting retirement challenges is one of the major growth drivers for our industry.

You may ask what's new about this. 'What's new' is not the macro forces…they have been prevalent for some time. What's new is the way we can participate. I suggest this is a step-function opportunity to take our business to an entirely different level.

Let's bring it down to the essence of what we do, what we have done for many years, helps people manage risks. We help protect against the financial consequences of dying early and the risks of outliving retirement savings.

More specifically, we assume risks are better borne by an institution than by an individual. The risks that seem random to an individual—a pool of one—become much more predictable when pooled across large numbers of people.

That leads to our ability to provide cost-effective retirement solutions and take financial uncertainty out of the equation for individuals.

Q2. You've talked about bringing these risks 'back' to insurers. Why is that?

Decades ago, defined benefit pension [DB] plans were the norm in corporate America. And insurance companies managed a significant portion of pension risks.

Over the years, management of those risks was assumed by many employers, on their balance sheets and through their own or third-party investment management resources. Today, it is increasingly shifting to employees, as defined contribution [DC] plans have grown in popularity and are replacing pension plans. The result is a significant burden on individuals.

But we can help fill the retirement protection gap by shifting longevity and investment risks back to insurers. We have the expertise and scale to manage them much more effectively than individuals or even employers.

In the process, we can increase both our impact on society and our share of the broader financial services marketplace.

1 This Q&A discussion draws on a speech delivered by Mr Strangfeld at the International Insurance Society's 51st Annual Global Insurance Forum on 16 June 2015 in New York, NY.

That's the premise. It's up to us collectively as an industry to make it a reality.

Q3. How can the insurance industry embrace that reality?

Let's look at two key needs: helping employers and helping individuals.

First, we have a significant role to play in helping employers deliver on their pension promises.

Today, there is a spectrum of solutions available to manage or even transfer pension risk, including liability driven investing, longevity insurance and pension risk transfer.

The U.K. has been the leader in **longevity insurance**, with over 20 transactions closed to date. Global reinsurers play an important role by providing the capacity necessary to assume longevity risk.

At Prudential, we have participated in 10 pension longevity risk transactions in the U.K., covering over USD 35 billion of pension benefits.

The participation of global reinsurers in assuming U.K. longevity risk is a compelling example of how the global reinsurance community can strengthen a domestic insurance market.

Then there are pension risk transfer (PRT) solutions—often called buy-outs and buy-ins—which are the most complete risk transfer solutions. In these transactions, all risks associated with a pension obligation transfer from the employer to the insurer.

PRT has been around for decades. In fact, Prudential has been offering buy-out solutions to plans since 1928. What is new is how PRT has been updated, adapted and delivered with scale during this decade.

Since 2007, USD 240 billion in pension liabilities have been transferred through PRT solutions. The largest of these transactions have taken place in the U.K., the U.S. and Canada, where a total of 39 transactions have exceeded USD 1 billion in liabilities.

The U.K. market is the most developed. Over 20 per cent of the companies in the FTSE 100 that have pensions have completed PRT transactions—companies like British Telecom, Astra Zeneca and British Airways.[2]

The PRT trend has crossed the Atlantic…and it does not need to reach anything close to a 20 per cent penetration to be a really big number.

In the U.S., GM, Verizon, Motorola, Kimberly-Clark and Bristol-Myers Squibb represent plan sponsors that have transferred USD 1 billion or more of pension risk.

Earlier this year, the Bell Canada transaction by Sun Life, and reinsurers RGA and SCOR, established the Canadian longevity insurance market.

Q4. Prudential is recognised as a leader in PRT. Could you give us some more colour about how Prudential got into the business?

Like most things in life, it was not exactly a linear experience.

In 2006, we created a dedicated team to examine plan sponsor needs and what it would take to assume pension obligations in a large-scale and sustainable way.

In fact, in 2007, I made a presentation to our Board about new ideas in the works, and PRT was one of those ideas. It had the scale, promise and fit with our capabilities to make it a natural opportunity for us.

Had I known the timeline for development, I would have held off on the presentation for a few years. Despite being off on the timing, we were indeed on to something.

It was an R&D initiative that we sustained through the financial crisis. We made a very conscious decision to 'keep the pedal down' rather than trim it back.

We developed our capabilities and engaged with sponsors and regulators for about five years before doing our first transaction in 2011. In 2012, we had a breakthrough when we executed a U.S. buy-out transaction with General

2 See Lane, Clark and Peacock (2015) 'Buy-ins, Buy-outs and Longevity Swaps', from *http://www.lcp.uk.com/our-services/pensions/buy-ins-buy-outs-and-longevity-swaps/*

Motors, covering USD 25 billion of pension liabilities.

Our original PRT team was only five people. Today, it is a business system of over 150 dedicated professionals and many others across the company who provide support to the team and our clients.

Q5. What is driving the trend towards PRT?

There are five converging factors:

The first is capital markets volatility. Twice in recent years, U.S. corporate pension plan sponsors saw their funded status fall by 30 per cent or more. U.K. and Canadian pension funds fared only slightly better.[3]

The second is legislation that created more rigorous and increased pension funding requirements, resulting in cash flow volatility for the plan sponsor.

Third is increased accounting transparency that makes pension losses more readily apparent.

The fourth factor is increasing longevity. According to Prudential analysis, new longevity assumptions will add approximately 6 per cent to the accounting liabilities of the typical U.S. pension plan.

Lastly, and perhaps most importantly, defined benefit plans have increasingly become legacy obligations, rather than part of the value proposition for current employees.

Q6. Why do you think insurers are the appropriate intuitions for assuming pension risks?

Life insurers take on substantial mortality risk, which makes us well suited to also manage longevity risk. In addition:

- we have the actuarial skills to measure, model and manage longevity risk;
- we have the investment capabilities to manage large-scale transactions and the experience investing assets to meet long-dated liabilities; and
- we have the operational and service capabilities to take on large groups of new customers—the millions of people ultimately receiving the pension payments.

That said, there is a critical talent and culture aspect, as well. These solutions are complex. They require a business culture that supports and encourages company-wide collaboration, and a talent management strategy that ensures the right expertise at every point in the process.

Put another way, PRT solutions require multiple skills and disciplines from the insurer, delivered in a way that creates a single client experience. To us, that's as much a cultural capability as it is technical.

Q7. What is the key advantage PRT offers employers?

Pension risk transfer will play an important role in helping employers keep their pension promises. At the same time, it provides insurers with an attractive growth opportunity that leverages core strengths.

In a sense, you can think of pension risk transfer as an opportunity of the present arising from corporate commitments of the past.

Q8. Let's turn our attention from the employer to the individual. How can insurers help individuals meet their retirement needs?

Our industry has a critical role in helping individuals who cannot rely solely on pension benefits or social insurance programmes to achieve secure retirements.

This theme is certainly not new. But again, we believe there are step-function opportunities ahead.

The shift away from defined benefit plans has placed tremendous responsibility on individuals' shoulders. It's up to them to:

- join a retirement plan;

3 See: Ehrhardt, J.W., Perry, A.L. and Wadia, Z. *Milliman 2015 Corporate Pension Funding Study*, Milliman, Inc.; *Aon Hewitt Global Pension Risk Tracker*, from *https://pensionrisktracker.aon.com*; and Towers Watson (2015) *Canadian Pension Finance Watch*, from *http://www.towerswatson.com/en-CA/Insights/Newsletters/Americas/pension-finance-watch-canada*

- contribute enough;
- invest appropriately; and
- at the right time, convert their savings into retirement income.

That's a lot to ask of people—it's a lot of 'do it yourself.' And it presents a lot of opportunities for suboptimisation, neglect and unrealistic expectations.

When individuals take on these responsibilities, they also take on the risks that go with them, risks that few are well-equipped to manage.

Just as employers are increasingly transferring pension risks to insurance companies, individuals are also in need of a trusted counterparty that can assume many of their retirement risks and, in the process, narrow that gap.

Q9. How specifically can insurance companies help deliver retirement security?

We can help in three key ways:

- expanding retirement plan coverage;
- enhancing savings; and
- guaranteeing retirement income.

First, let's look at expanding retirement plan coverage. The workplace is perhaps the most effective and efficient platform to promote retirement savings and to create pension-like outcomes. That's especially true for less affluent households, which might not be as likely to work with a financial advisor.

However, not everyone has access to a retirement plan at work. In the U.S., only about half of all workers at small employers are covered by a retirement plan. Those who are not covered are persons with disproportionately lower incomes, women and people of colour.[4]

Retirement plan coverage must be expanded. Our industry is working with policymakers to recommend solutions to do just that.

In the U.S., Prudential has worked with policymakers and influencers to put forth a proposal for a multiple employer plan that would allow small employers to band together to jointly offer a retirement plan, lowering costs and easing administrative burdens.

Q10. How can insurers help enhance retirement savings?

Whether inside or outside of a workplace plan, people need to save enough to adequately fund their own retirements. This is no easy task.

In fact, the Center for Retirement Research estimates that half of U.S. workers are at risk of not being able to maintain their standard of living in retirement.

Clearly, government, employers and the financial services industry, working together, must continue to promote and facilitate retirement saving.

As an example, in the U.S., legislation passed in the last decade has eased the way to modifying DC plans in ways that make good savings and investing behaviour 'automatic'.

It is becoming common for plans to automatically enrol employees, increase their contribution rates and adjust their asset allocations.

These automatic features help overcome participant inertia and other behavioural challenges that create barriers to retirement security. They are having an impact in terms of higher enrolment and higher contribution levels.

For insurers who are also DC plan providers, like Prudential, it is incumbent upon us to offer redesigned, fully-automated DC plans.

4 See Bureau of Labor Statistics and United States Census Bureau (2014) Statistics of U.S. Businesses—Employee Benefits in the United States (2011 data), March, from *http://www.census.gov/econ/susb/*

Q11. How should we approach the challenge of guaranteeing retirement income?

Saving is only half the battle. DC plans must go further and make it easier, even automatic, to convert savings into income that cannot be outlived. Policymakers can do more to facilitate this.

Although social insurance programmes that provide an income stream exist in many countries, they are only part of the solution. They must be supplemented by income from workplace plans and personal savings.

The opportunity for insurers is clear: only annuity products can guarantee a stream of income for life—whatever the length of that life is. And only insurance companies can offer annuity products.

Yet, today, the retail annuity marketplace represents just a small fraction of accumulated savings.

In the U.S., there is about USD 2 trillion in individual annuity products. That may sound like a big number. But it represents only about 5 per cent of the more than USD 40 trillion in private DC plans and personal savings accounts.[5]

Having 5 per cent of total savings in the form of income for life is not optimal.

Q12. How can we increase ownership of annuities?

The relatively low utilisation of annuities is a puzzle researchers and providers have been trying to solve for years.

There is a clear and growing need for individuals to create their own streams of retirement income. Yet, individuals are reluctant to give up control of the assets they took years to save.

Compounding this is the complexity associated with annuity products. Complexity that, in many respects, is of our own creation.

Sometimes, the best innovation—and the most challenging—is creating simplicity, not complexity.

Our challenge is to meet the need for guaranteed retirement income in different, more creative and more simplified ways.

In sum, helping more individuals and employers create more certain retirement outcomes—in easy, comprehensible, public-policy supported ways—is a key challenge and a clear opportunity for our industry.

5 Source: ICI, Federal Reserve Board Flow of Funds, (LIMRA, Cerulli and Prudential analysis).