ERIC

THE ERISA INDUSTRY COMMITTEE

FocusOn Conference Call

December 8, 2014

DE-RISKING AND DEFINED BENEFIT PLANS

Prudential
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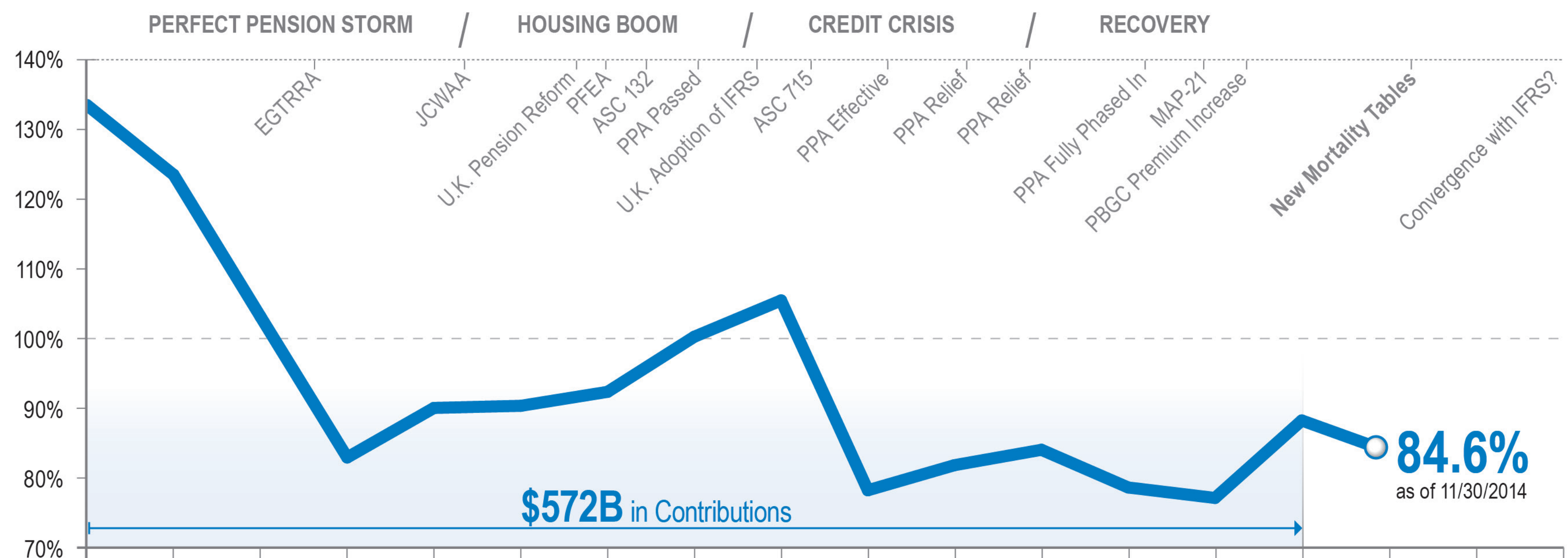
INTRODUCTION TO
PENSION DE-RISKING STRATEGIES

FUNDED STATUS ROLLERCOASTER

Pensions have made the round trip twice in recent years.



	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
S&P 500 Index (EOY)	1,469	1,320	1,148	880	1,112	1,212	1,248	1,418	1,468	903	1,115	1,258	1,426	1,848	2,068[1]	—	—
Discount Rate (EOY, Duration ~15)	7.51%	7.18%	6.61%	6.05%	5.75%	5.50%	5.75%	6.20%	6.35%	5.82%	5.44%	4.78%	4.02%	4.68%	3.89%[1]	—	—
ERISA Mortality	1983 Mortality Table						RP 2000 Projected with Trend								**New Mortality Table**[2]		
PBGC Flat Rate Premium	$19	$19	$19	$19	$19	$30	$31	$33	$34	$35	$35	$35	$35	$42	**$49**	**$57**	**$64**

Source: Milliman 100 Pension Funding Index; total contributions from the Milliman 2014 Corporate Pension Funding Study.

[1] As of Nov. 30, 2014

[2] New mortality table expected to be published in 2014 and effective by 2017.

RISK RETENTION vs. RISK TRANSFER

RETAINING RISK → TRANSFERRING RISK

Status Quo	Plan Design	Asset	Transfer
• 60% equity, 40% fixed income • Take advantage of MAP-21	• Benefit curtailment • Freeze benefits • Cash balance	• Glide path • Liability-Driven Investing (LDI)	• Lump sum • Buy-in • Buy-out • Longevity only

RISK RETENTION vs. RISK TRANSFER

Lump Sum

- Current PPA corporate bond basis allows for favorable pricing

Buy-in

- Plan asset that perfectly matches liability
- Convertible to buy-out

Buy-out

- Complete settlement of plan liability for transacted group
- Assets transfer to insurer

Longevity only

- Sophisticated sponsor may want to keep asset risk but transfer longevity risk
- Fee based

WHY THE HEIGHTENED INTEREST IN RISK TRANSFER NOW?

Improved funded status of average plan

- From 77.2% at 12/31/2012 to to 84.6% as of 11/30/2014
- Significant increase in the number of plans at or close to full funding

Increasing PBGC Premiums

- Fixed premium from $35 to $64 per person
- Variable premium more than tripled, from 0.9% to 2.9% of unfunded vested liability

Interest rate environment less important

- Low rates here to stay?
- To the extent using bonds for transaction, interest rate risk is not that important
- Waiting for rates to increase has its own costs

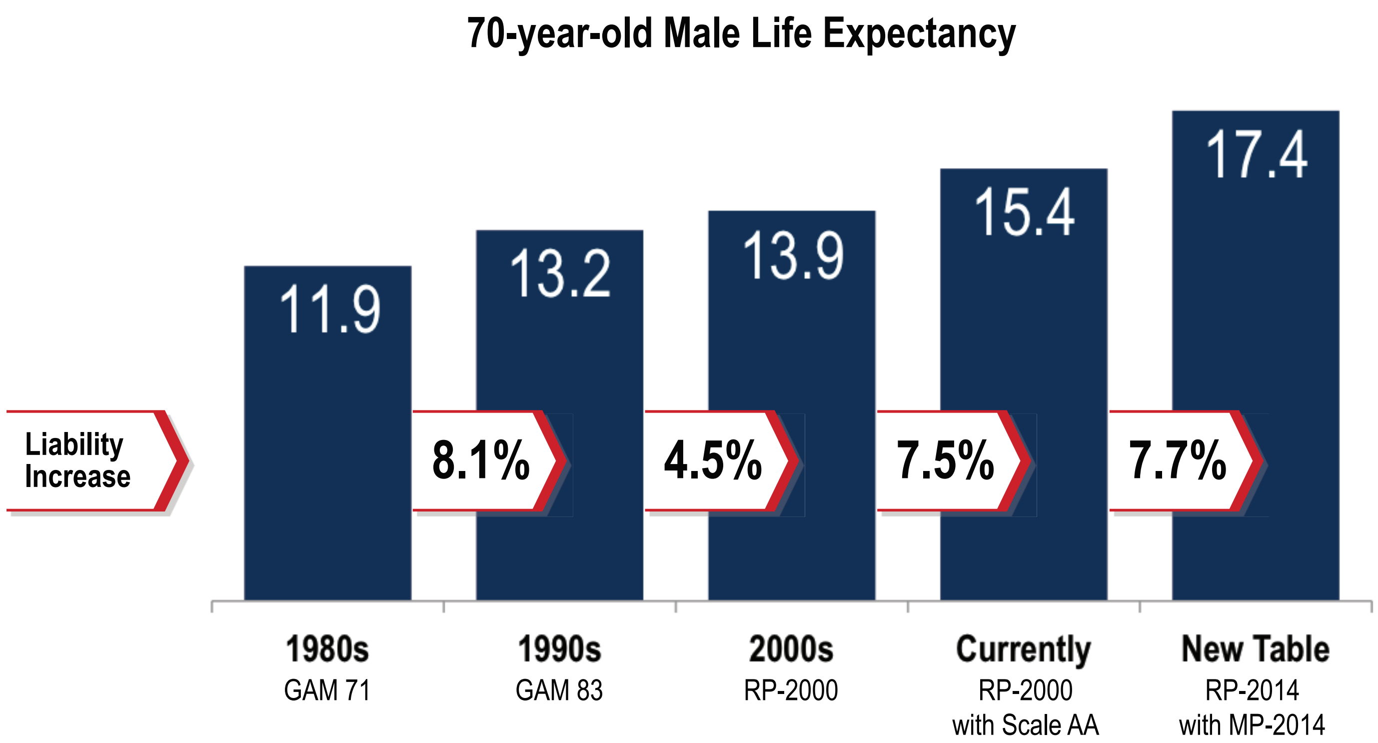
Increased media attention resulting in intensified conversations in Washington and on the state level, leading to speculation of forthcoming legislation

Increased awareness of longevity risk

- Many sponsors moving to RP-2014 and MP-2014 will see a 6% or more increase in liability
- No way to hedge this risk other than transfer

U.S. SPONSORS FACE AN INCREASING LIABILITY DUE TO NEW MORTALITY TABLES

Custom tables may be the optimal approach for large U.S. plans



Source: Prudential calculations. An update to the required table is expected to be finalized in 2014.

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PENSION DE-RISKING
IN THE PUBLIC ARENA

A WASHINGTON PERSPECTIVE

What We Are Hearing

From participant and retiree advocacy groups

- Losing ERISA and PBGC protections
- Offering/failure to offer retiree lump sums
- Adequacy of participant disclosures

What We Know

- ERISA Advisory Council Recommendations (2013)
- Wyden-Harkin Letter to Treasury, Labor, PBGC and CFPB
- GAO Report
- State-level activity
- Litigation

A WASHINGTON PERSPECTIVE

And, we speculate possible next steps

Congressional Activity

Legislation

Administrative Activity

Regulatory/ non-regulatory guidance

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EMPLOYER'S DECISION
TO ANNUITIZE

ERISA FRAMEWORK

Fiduciary and settlor have different roles in de-risking, each subject to different duties

- Fiduciary must act solely on behalf of participants and beneficiaries
- Settlor may act on behalf of company and shareholders

Decision to settle liabilities is a settlor role

- Designing a lump sum program
- Annuity purchase in connection with plan termination or buy-out
  - Insurer issues certificates directly to individuals
  - Individuals may enforce rights directly against insurance company
- *Lee v. Verizon* addresses decision to buy-out

Implementation of decision is a fiduciary role

- Annuity selection
- Participant communications

DECISION-MAKING PROCESS

A person may wear two hats

- But large annuity purchases have involved independent fiduciaries

Large purchases also often require parallel tracks

- Settlor considers whether to annuitize by investigating pricing
- Fiduciary negotiates contract to be able to make final selection when settlor makes final decision

Sometimes enter into purchase contract in advance of closing (like M&A deal)

INSURER APPROACH TO PRICING

As a first step in pricing, the insurer projects expected cash flows based on:

Expected benefit payment amount for each participant

- Known for retirees
- Payments for deferred lives not yet known
  - Commencement date is unknown
  - Extent of early retirement adjustments are unknown until retirement
  - Existence of a lump sum option adds to complexity

Expected payment duration – mortality/longevity

- Insurer view may consider variables such as:
  - Industry
  - Collar/union status
  - Geography
  - Benefit size
- Generally helpful to provide plan-specific mortality data where possible

INSURER APPROACH TO PRICING

Once cash flows are calculated, the insurer models an investment portfolio to meet the cash flow obligations considering the following:

Desired end-state portfolio

- Capital regime discourages use of equities
- Most commonly, the portfolio will be made up of a mix of corporate bonds, private placements, private mortgages with some cash and alternatives

Time to rotate into the desired portfolio

Make-up of premium portfolio

- Usually cash
- For large transactions, an in-kind portfolio can increase efficiency

Certainty of the cash flow obligations

- Run multiple scenarios to understand the sensitivity of alternate cash flow patterns

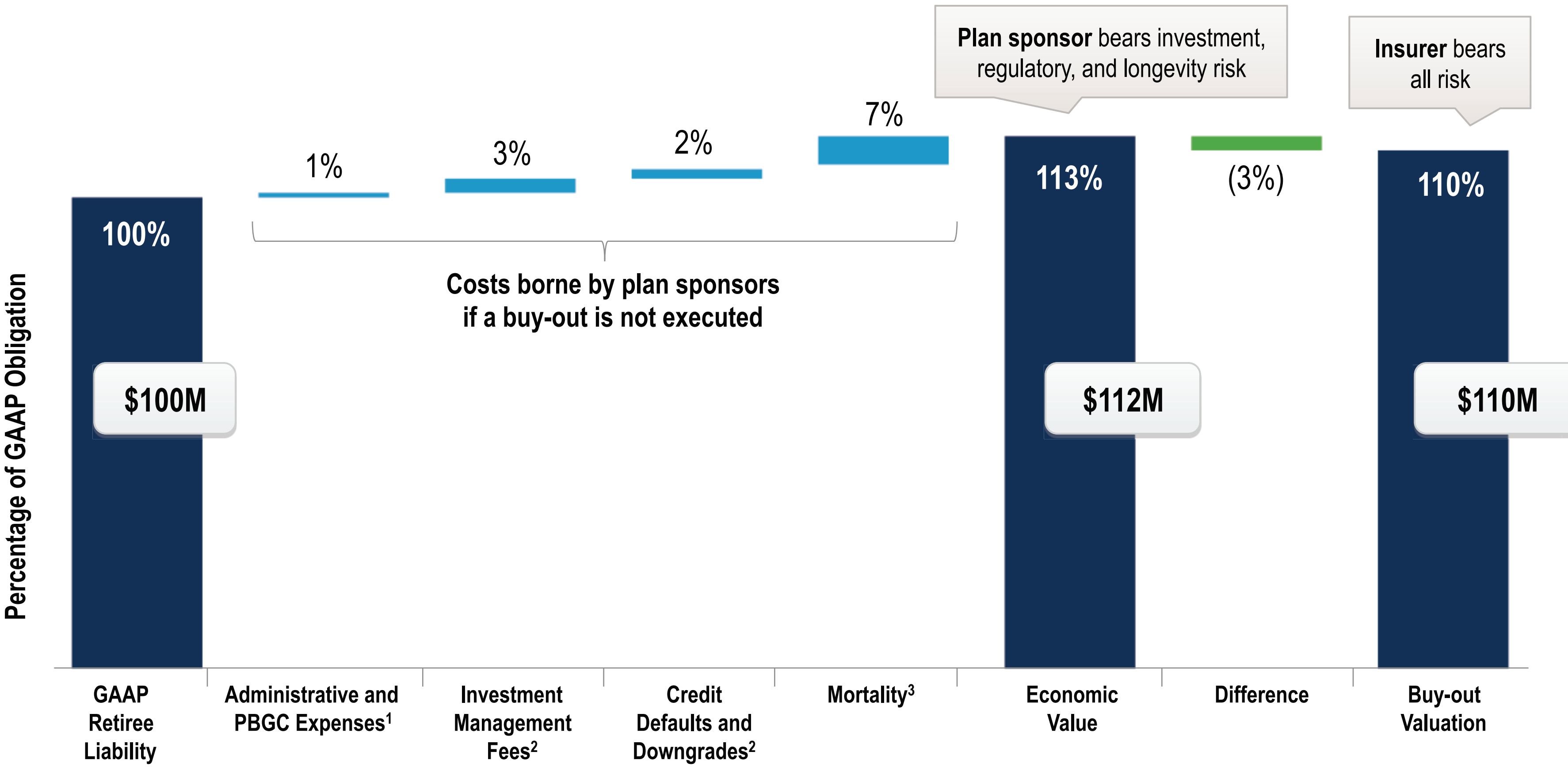
INSURER APPROACH TO PRICING

The premium is determined by modeling the combination of:

- Cash flows
- Portfolio returns
- Statutory and GAAP reserve requirements
- Required Capital
- Required ROE
- Taxes
- Expenses

EVALUATING A RETIREE PENSION BUY-OUT

GAAP Mortality Basis: RP-2000 with Scale AA



1 Costs not included in the GAAP retiree obligation include per person administrative expenses of $40 per year and PBGC expenses per person of $49 in 2014, $57 in 2015, $64 in 2016 and indexed after 2016.
2 GAAP obligations are discounted using rates unadjusted for investment management fees and the risk of credit defaults and migrations. These are estimated at 30 and 24 basis points per annum, respectively.
3 This exhibit reflects a change in the mortality basis from the RP2000 Healthy Annuitant Table with Scale AA to the RP-2014 mortality table with MP-2014.

Pricing is indicative and provided for discussion purposes only. Percentages represent present value of estimated future costs.
Pricing is subject to change per market conditions and specific client demographic information.

NEW U.S. MORTALITY TABLES

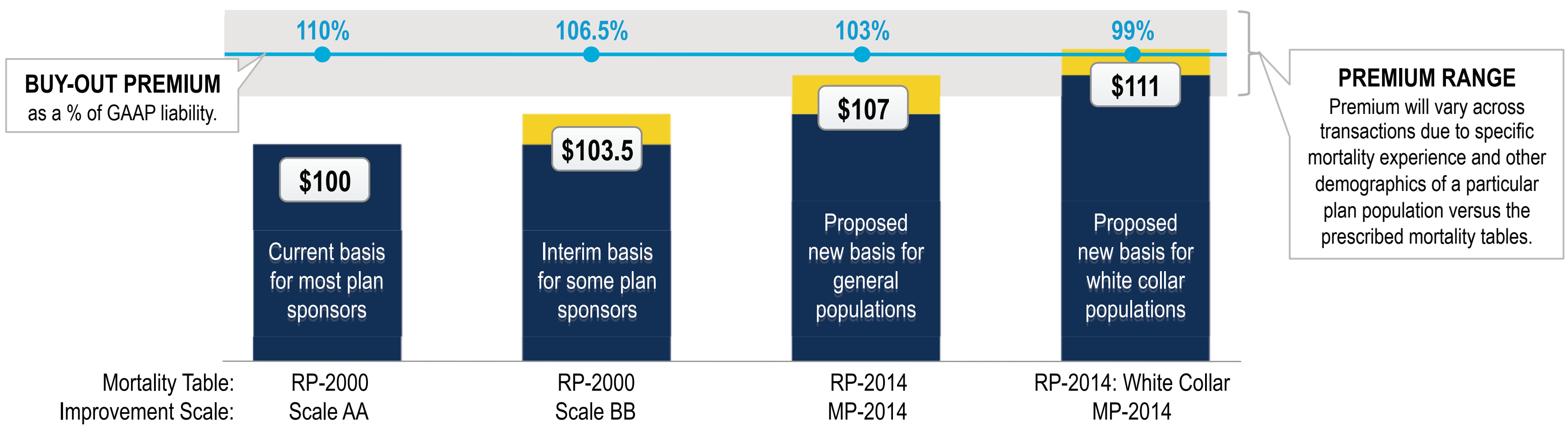
Will increase GAAP liabilities and reduce the perceived buy-out premium

New draft mortality tables expected to be adopted by the IRS in 2017 and are expected to increase reported U.S. pension liabilities by 6% to 9%

- Likely to be required by auditors for GAAP calculations, perhaps before 2016

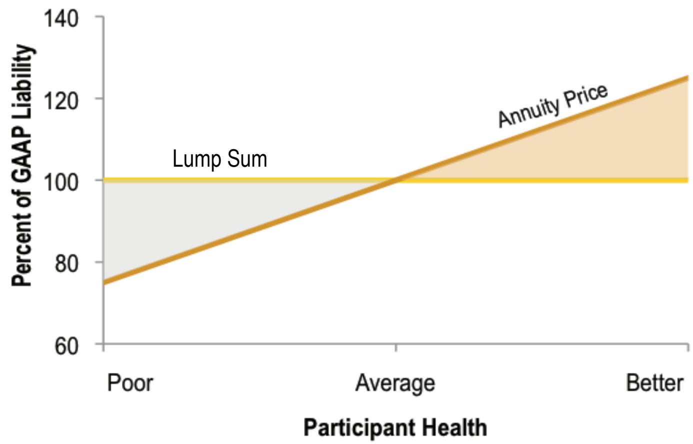
Once adopted, the new mortality tables will narrow the gap between the value of the accounting liabilities and the cost of a buy-out transaction

Retiree buy-out premium vs. accounting liability—adjusting for mortality basis



For a sample retiree population. Assumes no change in interest rate basis.

RETIREE LUMP SUMS FROM AN INSURER PERSPECTIVE



A lump sum window for retirees introduces an opportunity for anti-selection

- Reasonable to assume that the population of retirees remaining after a lump sum window will be healthier than the original retiree population

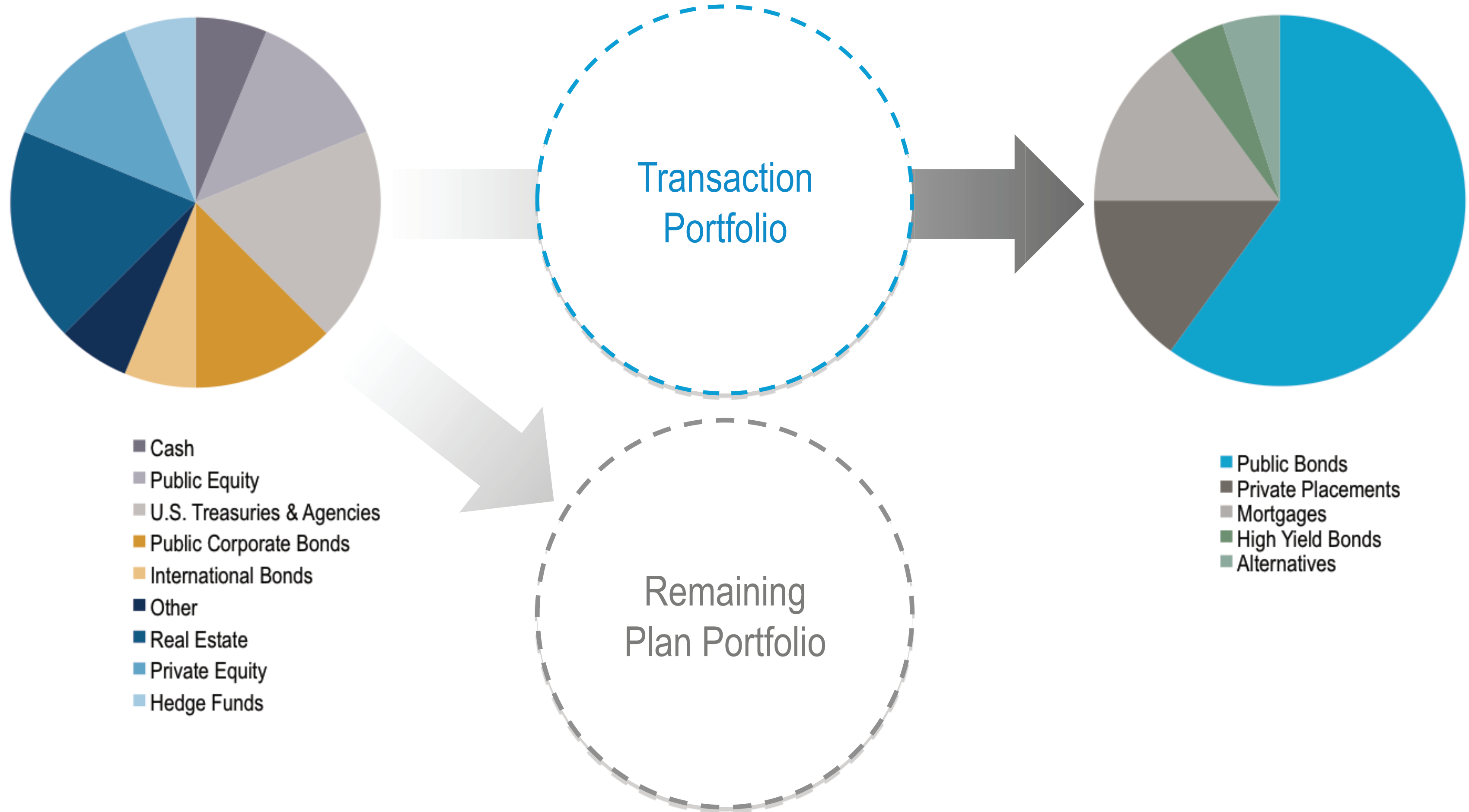
How does this phenomenon play out over time?

- The sponsor will experience actuarial losses over time unless mortality assumption is adjusted
- If the sponsor decides to annuitize remaining retirees, the insurer will adjust premium for anti-selection

IN-KIND PREMIUM ANALYSIS

Illustrative Existing Plan Portfolio

Illustrative Future Insurer Portfolio



CREATING THE TRANSACTION PORTFOLIO

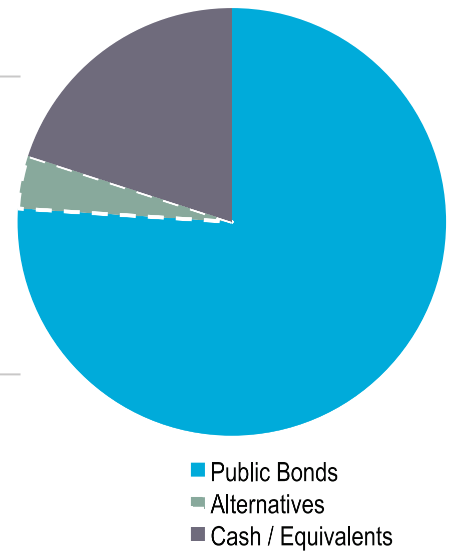
Insurer's capabilities can be leveraged to produce the optimal transaction portfolio

Insurer will provide guidance to develop the most efficient portfolio with regard to:

- Key rate duration/maturity profile
- Credit quality
- Sector/single issuer limits

Insurer may have an appetite for some alternatives

- Very important to some transactions
- Will vary widely among insurers
- This appetite can change quickly



RETIREE LUMP SUMS FROM AN INSURER PERSPECTIVE

The determination of any anti-selection charges will be highly customized and based on the specifics of a given situation

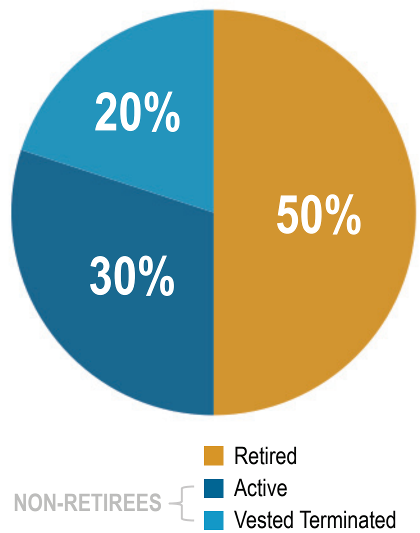
Factors that influence the amount of anti-selection charged include:

- Base population mortality
- Age of retiree at time of lump sum offer
- Amount of pension benefit
- Lump Sum election rate

Plan sponsor may find, particularly for older retiree groups, that a retiree lump sum is not economically favorable

LIABILITY SEGMENT STRATEGY

Based on the status and duration of three participant groups.



NON-RETIREES
Lump Sum

Assume 80% take rate and annuities for the remaining participants

Lump sum payment is 100% of GAAP

RETIREES
Buy-out

Purchase buy-out

Current Mortality Table

105% — 110%

107.5% of GAAP to fully exit[1]

New Mortality Table

104% — 103%

103.5% of GAAP to fully exit[1]

[1] Estimated cost to exit based on a hypothetical plan of 50% retirees and 50% non-retirees.

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POST ANNUITIZATION

STRUCTURE OF ANNUITY CONTRACTS

SEPARATE ACCOUNT VS. GENERAL ACCOUNT

Buy-out contracts can be structured using either
the General Account of the insurer or a Separate Account

Regardless of the vehicle, insurers are subject to a very strict regulatory regime and are required to hold capital for additional protection

General Account

- Assets are invested in and owned by the insurance company's general account
- Guarantees are supported by the entire general account of the insurance company, and effectively the ultimate claims paying ability of the insurer
- The assets in a general account are not attributable to any single policyholder or liability
- The assets in a general account are subject to creditor claims, but as policy holder claims would have preference over the claims of unsecured general creditors and shareholders of the insurance company

Separate Account

- Assets are segregated from the general account of the insurer
- These insulated assets are for the exclusive benefit of covered liabilities and are not subject to creditor claims
- In the event that separate account assets are insufficient, the general account steps in to make up any potential shortage.
- Because insurance companies are required to compensate the general account for the guarantees made in support of a separate account, the premium for a separate account contract would be slightly higher than the general account contract
- Large transactions may be able to use a single-transaction separate account, smaller transactions may be comingled to allow contract-holders to benefit from the scale and diversification benefits of a large account

CORPORATE PENSION vs. INSURER

Corporate Pension Defined Benefit Pension Plan	Provider	Insurer Group Annuity Contract
• Guaranteed income is provided by the pension plan • Plan sponsors establish a pension fund to generate stable, long-term growth, to provide pensions for employees when they retire	Providing Guaranteed Income	• Benefits provided under annuity contracts are guaranteed for the entire amount • Funding requirements are carefully calculated subject to state regulation and monitoring • Insurers selected by plan fiduciary under DOL fiduciary standards (DOL IB 95-1) typically must carry capital above the required minimum
• If a DB plan fails, the Employee Retirement Income Security Act (ERISA) requires guaranteed payment of benefits through the Pension Benefit Guaranty Corporation (PBGC)	Additional Layers of Protection	• Insulated Separate Account assets used exclusively for annuitant benefits covered by group annuity contract
Pension Benefit Guaranty Corporation (PBGC) • Only guarantees payments up to specified limits and is not supported by a separate reserve fund • For those annuitants whose benefits are paid by the PBGC, 16% had their benefits reduced (the percentage is higher for multi-employer plans)[5] – Those benefits were reduced by an average of 28%[5] • Permitted to operate with a long-term deficit—currently $36 billion	Supervisory Safeguards	**State Guarantee Associations (SGAs)** • Each state (including Puerto Rico and the District of Columbia) has an SGA operating under individual state laws • In the unlikely event of an insurance company failure, state insurance regulators provide annuitant protection through their SGA • Regulators place policyholders and annuitants first in priority for claims on a failed insurance carrier's assets

[5] Source: PBGC's Guarantee Limits—an Update. A PBGC study describing the effects of the statutory and regulatory limitations on PBGC guarantees.

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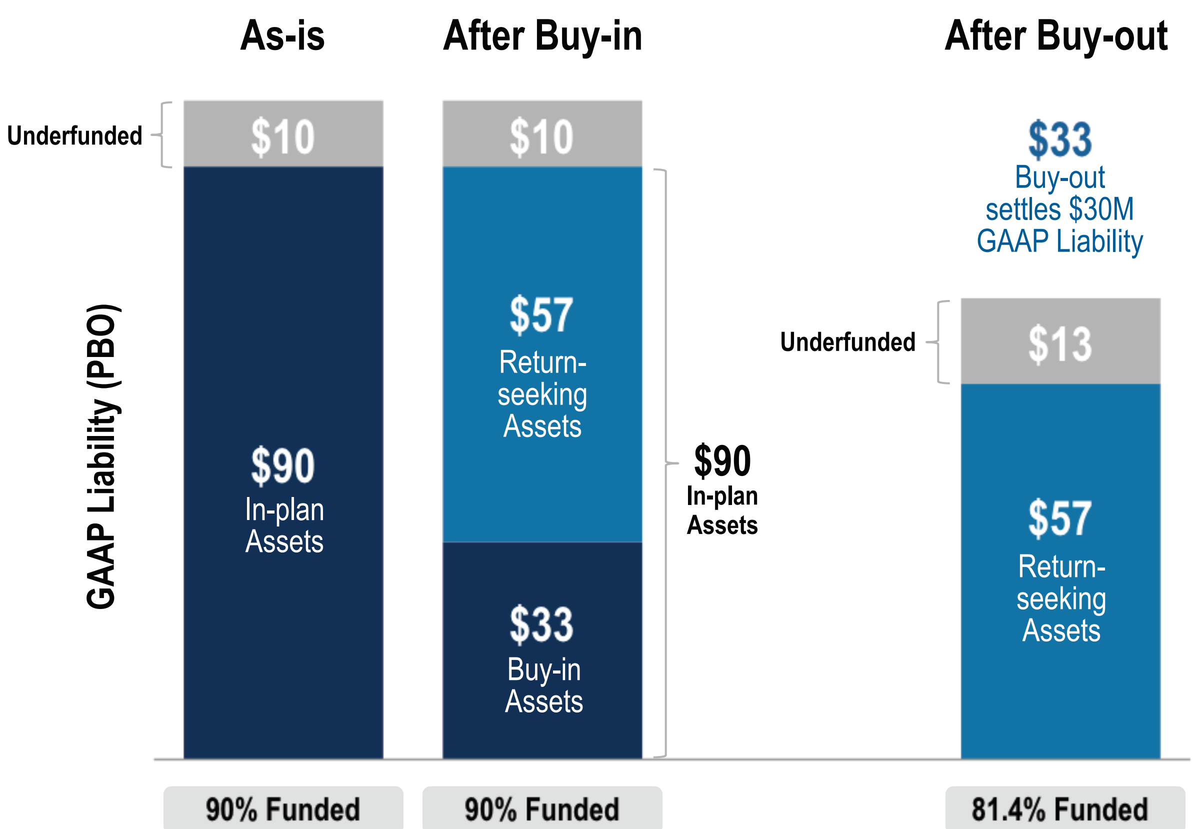
APPENDIX

BUY-IN AND BUY-OUT TRANSACTION MECHANICS

Hypothetical example for a plan with $100M of liability,
30% of which is associated with retirees, and $90M of assets.



- Buy-in preserves the plan's funded status while hedging liability risk
- Plan sponsor holds buy-in contract as plan asset
- Benefit payments arising from the buy-in are paid directly to the plan to provide for its benefit obligation

In $ millions.

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