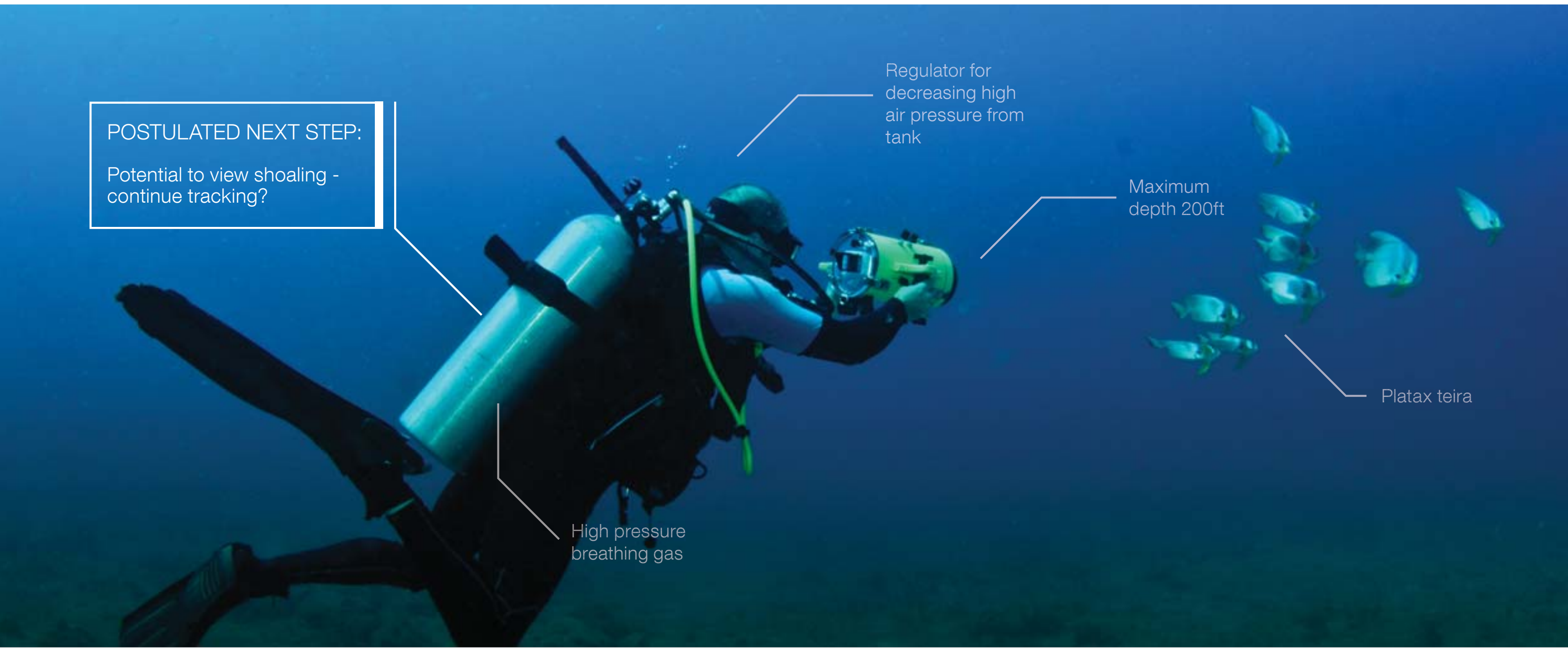
Buyout Market Watch

An Update Report From JLT Pension Capital Strategies as at 30 June 2011

Strategies to Solutions

JLT PENSION CAPITAL STRATEGIES

Buyout Market Watch



The PCS Buyout Market Watch Update – September 2011

Executive Summary

After a disappointing Q1, business levels increased significantly during Q2, with approximately £1.4bn in buyout and buy-in deals being written during the quarter. This has taken the total business written during the year to £1.7bn. Insurer confidence for the second half of 2011 remains high, backed up by insurers reporting busy workloads and a number of deals already being announced during Q3.

News from the market

Bulk annuity prices remained stable during Q2 and the early part of Q3 despite economic uncertainty due to the eurozone debt crisis.

- 3 bulk annuity deals over £200m were completed during Q2, including the £240m Law Society deal with MetLife and the £203m LSE deal with PIC.
- Partnership have entered the bulk annuity market. They are particularly interested in schemes wishing to assess the longevity risk specific to their scheme in order to take advantage of the favourable terms available in respect of impaired lives.
- Most insurers are now able to quote for CPI increases, although schemes are unlikely to see any significant savings compared with RPI increases due to the lack of a liquid market for CPI assets. Insurers are offering schemes the option to switch to CPI in the future, under a buy-in structure, which could be more suitable for schemes wishing to benefit from the switch to CPI while a market in CPI assets develops.
- The majority of deals completed are still pensioner buy-ins, due to the relative affordability of pensioners compared with deferred members. However an increasing number of transactions include deferred members and are in respect of schemes wishing to wind up in the shorter term.
- Insurers are continuing to offer flexible payment options to assist schemes in completing transactions.
- For larger schemes, some insurers are prepared to offer an "all risks transfer" approach, with transactions able to include data and benefit specification risks, missing beneficiaries and GMP equalisation risks.

Longevity Hedging

- No bespoke longevity transactions were finalised in Q2.
- Credit Suisse announced during Q3 (August) that they had completed a £1.7bn longevity swap with ITV for 12,000 of its members.
- We understand that negotiations continue on several very large schemes, with an expectation that further transactions will be completed during the second half of 2011. It is likely that this will be for a small number of large schemes as bespoke longevity swaps remain mostly available to larger schemes only due to the contracts' complexity.

Our view of the market for the remainder of 2011

- It remains to be seen what effect the persistent crisis in the eurozone sovereign market will have on the bulk annuity market. During the early part of Q3 the insurers' pricing bases remained unchanged, although changes in financial conditions have resulted in price increases of around 5 to 7% by the end of August.
- Provided that the economy remains "flat", and we do not see a "double dip", we believe that prospects for the industry remain excellent. The interest in de-risking solutions remains high as more schemes enter "end game" territory.
- The volatile market conditions make it even more important for schemes to prepare in advance, so that a transaction can be undertaken quickly once conditions allow. Advance preparation will include obtaining an initial quotation, assessing any changes required in a scheme's investment strategy and setting up the required Governance infrastructure, possibly even appointing an Independent Trustee to supply any missing expertise.
- Advance preparation is also more important as the number of contract structures available in the market grows. Trustees and sponsors need to be aware of developments in the market and understand the implications for their own scheme, if they want to maximise their chances of striking an optimal solution at the right time.
- With the final impact of the Solvency II requirements on bulk insurers still uncertain, we expect a number of Trustees and employers to push for transactions to be completed prior to the implementation of Solvency II.

PCS Affordability Index

Some of the most recent developments affecting the prices and attractiveness of a bulk annuity solution are considered below:

Regulations

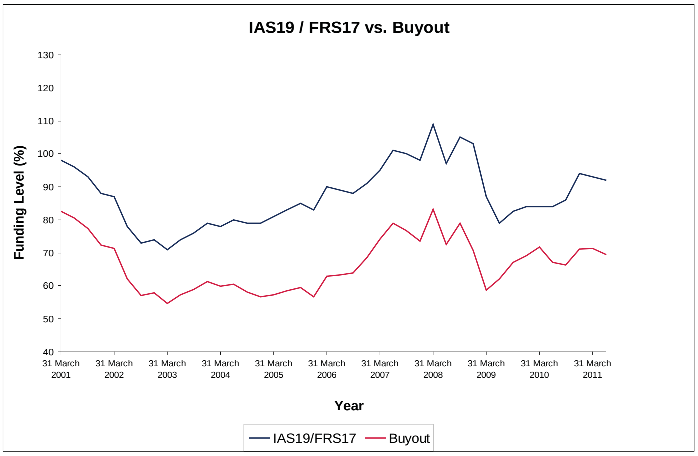
Calls for the implementation of Solvency II to be delayed until 2014 have been backed by the European Parliament. Solvency II is the EU backed Directive reviewing the capital adequacy regime for the European insurance industry. The final impact of the Solvency II requirements on bulk insurers remains unclear, leaving an element of uncertainty in future pricing bases. Recent discussions with insurers have suggested that previous confidence that changes made to their reserving basis would be sufficient for them to comply with the new framework may have been a little hasty. We believe that some insurers will be looking to make further changes to their pricing basis, which may mean some increase in prices.

The Pensions Minister Steve Webb once again reiterated his desire to stamp out bad practices when conducting Enhanced Transfer Value exercises. There is no suggestion that these exercises will be prohibited (which would be hard to justify when individual transfer values are a statutory right). However any restrictions may impact on the ability to improve the funding position for deferred pensioners, which in turn would be detrimental to buyout activity. It should however be noted that insurers will assess whether an ETV exercise has resulted in some selection bias in the residual population - pricing may be affected if this is judged to be the case.

Financial health

We regularly track the funding position of all UK private sector pension schemes under the standard accounting measure (FRS17/IAS19) used in company accounts. We then compare this against the buyout basis to monitor how relative prices move with changing financial conditions and assess how attractive a buyout type solution is at a given time

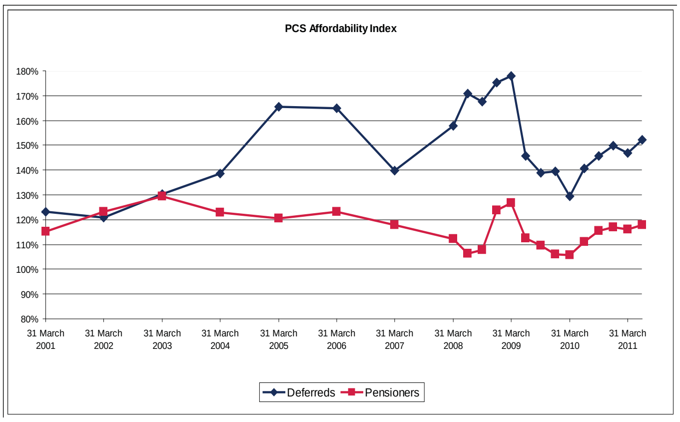
Our figures show that over the last quarter accounting liabilities and deficits were relatively stable as there was little movement in bond yields over the period. The buyout gap also remained stable.



Affordability Index

Our affordability index tracks prices in the buyout market against FRS17/ IAS19 values and shows the relationship between the buyout price and the “average” accounting liability for pensioner and deferred members.

Our figures show that buyout prices for pensioner members were broadly stable over the quarter. Deferred prices increased slightly during the quarter, possibly a result of a change in insurers’ attitudes to Solvency II.



Market Sentiment

Market sentiment towards bulk annuity deals continues to be favourable as the solvency deficit is increasingly looked at by analysts in conjunction with the accounting liability when assessing the effect of a pension scheme on a company. Many companies are looking for solutions for managing the risks associated with their pension schemes, and are putting together strategies for offsetting these risks in stages, either in preparation for some form of corporate activity or simply to reduce their overall risk.

PCS Market Analysis

During the second quarter approximately £1.4bn in buyout and buy-in deals was transacted, which included three deals in excess of £200m.

The top 10 largest bulk annuity deals struck over the last 12 months are illustrated in the table below:

Scheme	Date	Value	Insurer
BA	Jul-10	£1,300m	Rothesay Life
GlaxoSmithKline	Nov-10	£900m	Prudential
Alliance UniChem	Q3 2010	£310m	PIC
Unknown Prudential Deal	Q2 2011	£280m	Prudential
Unknown Deal	Q2 2010	£230m	Legal & General
Law Society	Jun-11	£240m	MetLife
LSE	May-11	£203m	PIC
Unknown PIC Deal	Q2 2011	£170m	PIC
Next	Aug-10	£124m	Unknown
Unknown Deal	May-11	£120m	Legal & General

There were no longevity swap deals completed during Q2, although in August ITV announced a £1.7bn longevity swap with Credit Suisse.

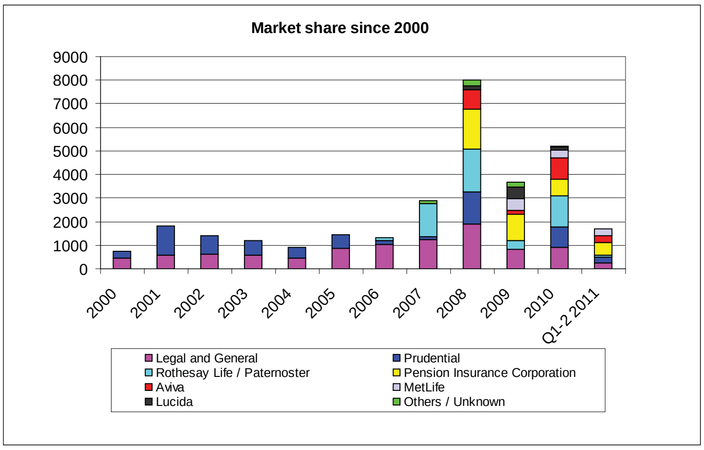
The major longevity swap deals completed to date are illustrated in the table below:

Scheme	Date	Value	Counterparty
BMW	Feb-10	£3bn	Abbey Life
RSA	Jul-09	£1.9bn	Rothesay Life
ITV*	Aug-11	£1.7bn	Credit Suisse
Babcock International	May-09	£1.2bn	Credit Suisse
Royal County of Berkshire	Dec-09	£0.75bn	Swiss Re

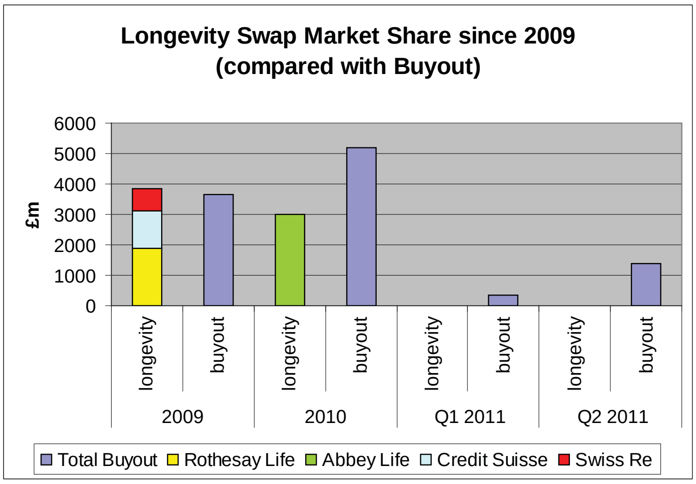
*Announced in Q3

Market Stats

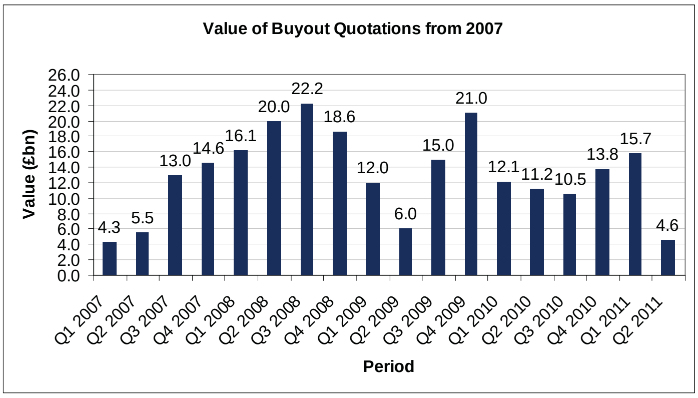
A breakdown of the various insurers' buyout market share since 2000 is illustrated in the graph below.



A breakdown of the various insurers' longevity swap market share since 2009 (up to end of Q2 2011) is illustrated in the next graph. The graph also provides a comparison between buyout and longevity swap business written since 2009.



The following chart shows an average cross section across the major players of the value of quotations requested during each quarter since the start of 2007.



The graph shows a clear reduction in quotation volumes from the previous quarter, which we believe is mainly due to two factors:

- an absence of new £1bn cases during this period;
- a trend, as contract structures get more sophisticated, towards pre selecting one or two insurers rather than having a "whole of market" exercise.

Commentary

The high level of activity in the early part of the year resulted in a sizeable number of completed deals in Q2. Although average new quotation pipelines for each insurer have reduced significantly during the quarter, insurers continue to be very busy and a number of £1bn plus schemes continue to investigate a buyout / buy-in at this time.

After a high level of activity in 2009 and early 2010, there were no further longevity swap deals until the ITV deal announced during Q3 2011. We continue to expect a small number of large transactions in this space as these deals are mostly bespoke and cover very large schemes.

Even with economic uncertainty, the outlook for the rest of 2011 remains healthy. In an attempt to facilitate deals insurers are continuing to provide innovative tailor made solutions and are committed to offer whatever flexibility they can around contract and payment terms. There remains a strong desire by both trustees and sponsors to reduce their pension risk, or even liquidate their defined benefit pension scheme, if at all possible.

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