

Buyout Market Watch





AN UPDATE REPORT FROM JLT EMPLOYEE BENEFITS AS AT 30 SEPTEMBER 2013

JLT Buyout Market Watch Update 30 September 2013

EXECUTIVE SUMMARY

2013 is shaping up to be a big year for the UK bulk annuity market, with business volumes of £5.7bn to 30 September already topping annual totals for the previous four years. We anticipate that business levels could reach £7-8bn by year end. Deals transacted in the third quarter exceeded expectations, with £3.9bn of new business written; the highest quarterly result on record.

Pension Insurance Corporation (PIC) made the biggest contribution this quarter, writing £1.9bn of business including the largest buyout to date for EMI at £1.5bn. They followed this up with another big announcement in mid November: a £670m buy-in for NCR.

Another big contributor was Rothesay Life. Uncertainty regarding its future ownership following an announcement in August 2013 did little to dissuade investors, with the insurer closing deals for InterContinental Hotels (£440m), Phillips (£484m) and Cobham (£280m). Three stakeholders took a combined 64% stake in Rothesay Life in October 2013, leaving Goldman Sachs as the majority stakeholder.

NEWS FROM THE MARKET

The big deals

Following their record-breaking £1.5bn deal for the EMI Group Pension Fund in July 2013, PIC announced in November 2013 a further £670m buy-in for the NCR pension plan; their 34th deal of the year.

Large deals struck by Rothesay Life over recent months have included a £440m buyout for InterContinental Hotels, a £484m buy-in with the Phillips Pension Fund and a £280m buy-in for the Cobham Pension Plan. Significantly, the InterContinental Hotels deal secured some discretionary pension increases as well as missing beneficiaries' risk.

These two insurers have dominated the larger deals over the last year, with the exception of a £347m partial buy-in written by L&G for Tate & Lyle in Q4 2012 and the more recent £120m pensioner buy-in that JLT brokered with Prudential for their own pension scheme. The JLT deal used a trigger-based mechanism to achieve demanding price targets.

The largest bulk annuity deals struck over the year ended 30 September 2013 are illustrated in the table below (with deals completed in the last quarter highlighted in blue):

Scheme	Date	Value	Insurer
EMI	Jul-13	£1,500m	PIC
Merchant Navy Officers	Dec-12	£680m	Rothesay Life
Philips	Oct-13*	£484m	Rothesay Life
InterContinental Hotels	Sep-13	£440m	Rothesay Life
Tate & Lyle	Q4-12	£347m	Legal & General
Cobham	Jul-13**	£280m	Rothesay Life
General Motors	Oct-12	£230m	Rothesay Life
Smith & Nephew	Q1-13	£190m	Rothesay Life
First Quench	Apr-13	£176m	PIC
Smiths Group	Sep-13	£170m	PIC
JLT	Sep-13	£122m	Prudential
Undisclosed	Nov-12	£122m	PIC

^{*}Transacted in Q3 2013, but announced in October 2013

Longevity solutions

H1 2013 saw two longevity swaps written, worth a combined £3.6bn, but there were no further deals struck in the third quarter. There is the possibility of another deal before year end, although these swaps are complex and deals can take some time to reach completion.

Although longevity swap transactions for pension schemes have been few and far between over 2012 and 2013, these types of transaction remain more common place amongst insurers as a tool to reinsure mortality risk for their own annuity books.

PIC announced in late November 2013 that it had reinsured the longevity risk relating to £1.4bn of the liabilities in its bulk annuity portfolio with a range of reinsurance houses, with Reinsurance Group of America reinsuring the biggest share (£1.1bn).

The top 10 longevity swap deals struck since 2009 are illustrated in the following table:

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Scheme	Date	Value	Counterparty
BAE Systems	Feb-13	£3.2bn	Legal & General
Rolls Royce	Nov-11	£3.0bn	Deutsche Bank / Abbey Life
BMW	Feb-10	£3.0bn	Deutsche Bank / Abbey Life
RSA	Jul-09	£1.9bn	Rothesay Life
ITV	Aug-11	£1.7bn	Credit Suisse
Akzo Nobel	May-12	£1.4bn	Swiss Re
BA	Q3 2011	£1.3bn	Rothesay Life
Babcock International	May-09	£1.2bn	Credit Suisse
Pilkington Superannuation	Dec-11	£1.0bn	Legal & General
Royal County of Berkshire	Dec-09	£1.0bn	Swiss Re

^{**}Transacted in Q2 2013 but announced in July 2013

Underwritten bulk annuities

A market in medically underwritten bulk annuities is fast developing. Partnership Assurance are leading the way, having written eight deals to date after entering the bulk annuity market in 2012. Just Retirement, another enhanced specialist from the individual annuity market, announced their first bulk deal in early November: a £3.2m pensioneronly underwritten buy-in for a firm in the legal sector. Legal & General and Aviva are also actively participating in this market.

The challenge to date for both trustees and their advisors has been the lack of consensus amongst insurers on a preferred underwriting process. JLT have worked hard with all four market players above to broker a common process allowing trustees and sponsors to run whole-of-market exercises. The four page explanatory leaflet entitled Medically Underwritten Bulk Annuities available from our website provides more information. The first whole-of-market underwritten broking exercises are now underway and we expect the first transactions later this year or early in 2014.

Schemes that may benefit from an underwritten approach are typically those with a high concentration of mortality risk (i.e. a few members who make up a disproportionately high percentage of total pensioner liabilities) or memberships expected to be in worse than average health. Careful consideration should be given, however, before pursuing an underwritten as opposed to a conventional broking process. Trustees are obliged to disclose that they have obtained medical data and this will preclude them from obtaining quotations from some bulk annuity providers who cannot offer a medically underwritten quotation.

Whilst underwritten bulk annuities are typically available for up to around 300 lives this does not preclude larger schemes from taking advantage of them. In a recent £22m underwritten transaction (the largest to date) the top 20 lives only (by pension size) were insured. The individuals insured accounted for 50% of the liabilities.

Innovative solutions

Providers continue to innovate in order to meet the demands of pension schemes.

Legal & General completed a buyout for the Kenwood Pension Scheme in June 2013 using a deferred premium mechanism to spread the premium payments over a number of years. Despite being underfunded, this allowed the sponsor to fully insure its pension liabilities on day one, with the certainty that once it had paid the agreed recovery contributions to the insurer it would have completely eliminated its pension debt. Legal & General retained the comfort that if the company were unable to meet their commitments, they could restructure the benefits payable under the policy. Some sponsors are exploring an alternative to this, which is to take out a fixed-term loan to fund a buyout. Depending on the corporate borrowing rates available, this may be more efficient.

The JLT UK Group Pension Scheme completed a pensioner buy-in to insure £120m of its defined benefit liabilities with Prudential in early October 2013, brokered by JLT's dedicated buyout team. The deal used an innovative structure to achieve demanding price targets. Trigger prices were set for tranches of the scheme's liabilities and Prudential were able to meet a number of these triggers and complete the transaction for over half of the liabilities.

Deutsche Bank launched a range of longevity indices aimed at enabling schemes to hedge longevity risk more quickly and cheaply. It will track the survival rates of five-year cohorts in England and Wales and the Netherlands and construct indices based on publically available data to allow insurance companies, pension funds and investors to transfer longevity risk based on standardised terms and documentation. Demand for options based on these indices remains to be seen.

Insurer news

The market learned in early August 2013 that Goldman Sachs was putting its majority stake in Rothesay Life up for sale. This was followed by an announcement in late October that, subject to regulatory approval, three funds (Blackstone, GIC and MassMutual) would acquire a combined 64% stake, leaving Goldman Sachs as the largest shareholder. We see this as good news as it demonstrates further interest in and support for the bulk annuity markets.

This followed further positive news in mid October that enhanced annuity specialist Just Retirement intends to float on the London Stock Exchange. Fellow enhanced annuity specialist Partnership Assurance, who also entered the bulk annuity market in 2012, was listed on the London Stock Exchange in June 2013.

Future capacity

2013 has already seen demand for bulk annuities increase to the type of levels not seen since 2008. Insurers have indicated they have capital to write significantly more new business in 2014 and expect current trends to continue.

We expect the year to finish strongly, with one or two more large deals still possible, although it is unlikely that business levels will exceed those seen in the third quarter.

Buyout ready

If demand continues to increase, in particular if scheme funding levels continue to improve and the economic outlook for employers picks up, we could see insurers becoming increasingly selective over which deals they will quote for in 2014. Preparing quotations costs insurers time and money; according to some estimates between £5,000 and £10,000 per quote. In times of extreme demand, insurers will focus resources on those cases that are most likely to transact and which represent the best allocation of capital. Any reductions in supply such as an insurer exit, particularly at the smaller end of the market, could exacerbate the situation.

Schemes considering a transaction should start preparing now. There is a lot of work that can be undertaken in advance to get a scheme buy-in/buyout ready, such as preparing a definitive benefit specification and collecting missing data, in particular postcodes and spouses' details. Whilst these factors may not prevent a transaction going ahead, they will often adversely affect the price and lead to a more painful implementation process. We are preparing a guide for trustees on this important subject, to be released in early December.

To get to the front of the queue it also pays to work with an advisor with well-established and efficient processes and a proven track record for getting deals done. JLT's conversion rate, i.e. the number of deals we take to market that ultimately transact, was measured at over 60% by one insurer for a period up to July 2013; significantly ahead of the average, which regular market speculation and commentary put at around 20%. We have also developed a robust pensioner buy-in solution aimed at schemes with between £5m and £60m of pensioner liabilities, which aims to maximise the chances of these schemes securing a competitive deal. Further details can be found in the BuyinSure Brochure available from our website.

JIT BUYOUT AFFORDABILITY INDEX

Some of the most recent developments affecting the price and attractiveness of a bulk annuity solution or longevity swap are considered below and overleaf.

Regulations

Late on 13 November 2013, after months of debate, European policy makers agreed the contents of the Omnibus II directive, a key package of changes to the planned Solvency II insurance capital regime. There is still a lot of work required to finalise the technical details before the proposed new Solvency II implementation date of 1 January 2016. It is expected that most insurers have made sufficient allowances for these changes in their pricing bases and, as such, we do not anticipate a material impact on pricing when Solvency II is implemented.

The Department for Work and Pensions has published a public consultation outlining the Government's proposals for a new regulatory framework for future pension provision. The consultation, Reshaping workplace pensions for future generations, contains a number of proposals for defined ambition pensions, where risk is shared between employers and employees. It seems likely that if some form of defined ambition pension provision does turn into reality, this may serve to fuel even more demand for insurance solutions, through either individual or bulk annuities. Benefits offered are likely to be simpler, for example non-increasing pensions without spouses' provisions, and hence easier and more cost effective to insure, and sponsors are less likely to retain the post-retirement risks associated with current defined benefit provision.

The Institute of Chartered Accountants in England and Wales, in conjunction with the Pensions Regulator, has published a consultation document on a new assurance framework for master trusts. The assurance framework is not mandatory, but the Regulator has said that it will monitor its effectiveness once the framework goes live. Master trusts are likely to play an increasingly important role in the efficient management of smaller defined benefit pension schemes and allow them to benefit from economies of scale both in terms of scheme administration and access to de-risking solutions.

The Financial Services (Banking Reform) Bill, due to come into force in early 2014, will require large banks to restructure their defined benefit pension schemes to ensure that the scheme assets and liabilities of a ring-fenced bank are completely separate from other banks in the group. Deadlines for compliance are still some time away: banks have until 2019 to comply with ring-fencing and until 2026 to restructure their pension schemes. There are likely to be significant legal, actuarial and administrative costs involved in the restructuring and, as such, this exercise may serve to accelerate banks' moves to fully buyout and wind-up their schemes. More stringent rules for banks under Basel III are also encouraging them to de-risk their pension schemes. Banks are required to hold capital on their balance sheets against the risks that exist in their pension schemes.

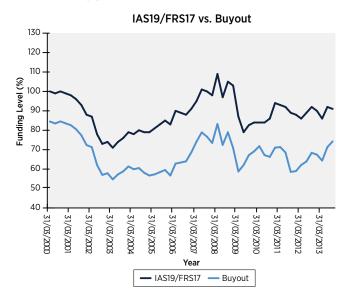
The Marriage (Same Sex Couples) Act 2013 received Royal Assent in July 2013, although many of its provisions are not yet in force. The Act will make it lawful for same sex couples in England and Wales to marry and enable civil partners to convert their civil partnership into a marriage. Trustees and sponsors will need to decide how they treat the surviving spouse of a same sex marriage; i.e. provide only the minimum legal benefits, or be more generous and provide survivor benefits based on all service as for opposite sex marriages. Decisions on this issue will ultimately affect the benefits insured in any bulk annuity transaction and hence the cost of this insurance. In some cases, where a buy-in policy has already been purchased, additional benefits for same sex partners may need to be secured before a scheme can proceed to fully buyout and wind-up.

In late October 2013, the Pensions Regulator published, under section 89 of the 2004 Pensions Act, a formal report detailing its regulatory action in relation to the MF Global UK Pension Fund. The scheme

entered a Pension Protection Fund assessment period in October 2011 when its sponsoring employer went into administration. The buyout deficit of the scheme was estimated at £35 million. The trustees announced in October 2013 that they had reached a settlement whereby a significant payment was made into the scheme and this allowed them to buyout the scheme's liabilities with an insurer. The scheme will now wind up outside the PPF.

Financial health

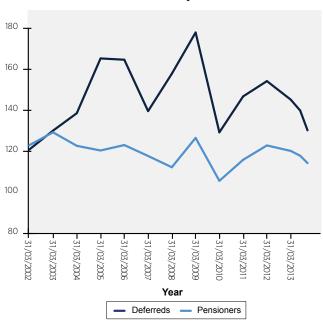
We regularly track the funding position of UK private sector pension schemes under standard accounting measures (IAS19/FRS17) used in company accounts. We compare this against indicative market-based buyout costs to monitor how relative prices are moving with changing financial conditions and to assess how attractive a buyout-type solution is at any given time.



Over the three months to 30 September 2013, long-dated AA-rated corporate bond yields fell by around 0.2% p.a. whilst long-dated Gilt yields and expectations for long-term inflation rose slightly. We estimate that the relationship between accounting values and buyout premiums has narrowed over the quarter, which could in turn reduce the accounting strain from transacting a buy-in.

Affordability index

Affordability Index



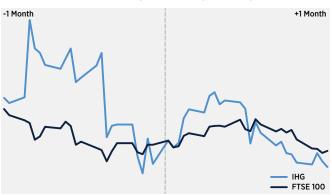
Our affordability index tracks prices in the buyout market against IAS19/FRS17 liability values and shows the relationship between average buyout premiums and accounting liabilities separately for deferred and pensioner members.

Our results show an improvement in affordability for both deferred and pensioner members, with the effect being more pronounced for deferred members.

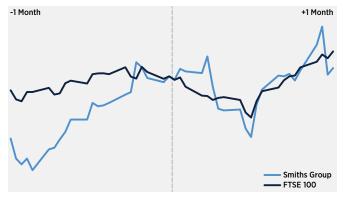
Share price analysis

Sponsors cite various reasons for undertaking de-risking transactions: common aims include reducing volatility and hence increasing control over funding costs; and reducing balance sheet and/or P&L volatility. The latter is of particular importance to listed companies, whose share prices may be adversely affected by the negative outcomes of taking excessive risk in their pension schemes. We ask whether the reverse is true, i.e. do significant de-risking transactions such as buy-ins/buyouts positively affect sponsors' share prices? We have analysed share price movements for three of the companies who have undertaken large buy-in/buyout transactions over the last few months.

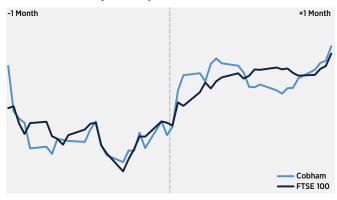
InterContinental Hotels Group: £440m buyout in September 2013



Smiths Group: £170m buy-in in September 2013



Cobham: £280m buy-in in July 2013



Whilst care must be exercised in interpreting these results, the evidence from these examples (and our previous analysis of company share prices following a bulk annuity or longevity swap transaction) is that de-risking transactions would appear to have a neutral or slightly positive effect on the companies' share prices. This suggests that the market recognises that any balance sheet hit is more than justified by the shareholder value delivered by the de-risking transaction.

Market sentiment

Market sentiment towards bulk annuity deals continues to improve, driven in part by general improvements in scheme funding positions and the UK's economic outlook. We are seeing increased interest from sponsors in assessing the feasibility of a buy-in/buyout transaction and designing trigger frameworks aimed at achieving the keenest possible transaction premium, quickly capturing advantageous market pricing.

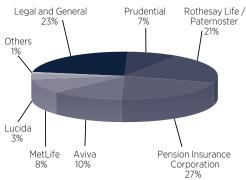
Two recent surveys confirm the long-term trend amongst UK defined benefit schemes to closure, first to new entrants and then to future benefit accrual. The annual Occupational Pension Scheme Survey published by the Office for National Statistics in September 2013 recorded a decline in the number of members still building up defined benefits from 4.6 million in 2000 to 1.7 million in 2012. The Purple Book 2013, released in early November, told a similar story: only 14% of defined benefit schemes are still open to new joiners, down from 31% in 2008. Closed schemes are on the rise, with 30% allowing no further build-up of pensions, up from 17% in 2008.

With an increasing number of schemes closed and in run-off, sponsors are considering all options for managing the costs and risks associated with their legacy defined benefit liabilities. Often, buy-ins are being considered as part of a suite of de-risking measures including Enhanced Transfer Value, Flexibility at Retirement and Pension Increase Exchange exercises.

MARKET STATISTICS

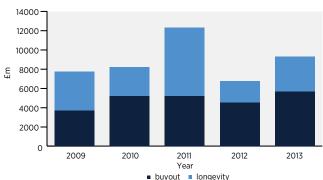
The chart below illustrates insurers' relative buyout market shares based on deals completed since 2009.

Bulk Buyout Business Written 2009 - Q3 2013 (£23.8bn)



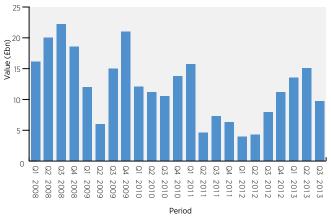
A comparison of longevity swaps and buyout deals transacted since 2009 is illustrated in the graph below.

Buyout and Longevity Swap Market Since 2009



The following chart shows an average cross section across all major players of the value of quotations requested by sponsors/trustees during each quarter since 2008.

Value of Buy-in / Buyout Quotations from 2008



COMMENTARY

The appetite for de-risking solutions remains strong amongst both sponsors and trustees, as evidenced by the high volume of deals announced to date in 2013. Insurers remain keen to transact, and are gearing up for an even stronger 2014, with speculation that next year could deliver in excess of £10bn of completed deals. Trustees and sponsors are increasingly aware of the risks and uncertainties associated with defined benefit pension scheme liabilities and continue to see the economic value of those liabilities as the true price that must be paid.

JLT has a dedicated buyout team with a long and well-established reputation for guiding clients with defined benefit pension schemes through de-risking transactions. We have completed 18 transactions so far this year, with premiums totalling more than £400m, with more due to close before year end. Our reputation with insurers remains strong: we have transacted with five of the eight major market players so far this year and are in final negotiations with others.

JLT currently has a conversion rate of circa 60% (as measured by one insurer for a period up to July 2013), i.e. six out of ten schemes we take to market transact. This compares favourably with industry averages, with regular market speculation and commentary suggesting that only one in five schemes that come to market actually transact. One factor driving JLT's statistic is the feasibility studies we undertake for clients before they approach the market place for indicative quotations. These short reports allow clients to assess quickly and cost-effectively, based on sample rates supplied by a panel of insurers, whether a buy-in could currently be affordable. We are seeing a lot of interest currently from sponsors and trustees already planning ahead for 2014.

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Sources: The data on which the analysis in this report is based is provided by insurers on a quarterly basis. Market data is sourced guidance and the JLT monthly deficit reports, published at

If you have questions about any of the subjects raised in this issue of Buyout Market Watch, please contact Martyn Phillips, Director, Head of Buyouts (Martyn Phillips@iltgroup.com, 07796 998140) or Tiziana Perrella, Principal (Tiziana Perrella@iltgroup.com, 07737 603050).

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