



PENSION CAPITAL STRATEGIES
Innovative Alternatives

Buyout Market Watch

An Update Report From Pension Capital Strategies
as at 30 June 2010



A JLT Group Company

Executive Summary

Market activity continued to remain healthy during Q2 2010. Total deals worth approximately £2.2bn were written by a variety of insurers. This includes the Rothesay Life pensioner buy-in with BA, worth £1.3bn, which was announced at the end of the quarter.

Key recent developments

- During the past quarter bulk annuity prices have remained stable, continuing to reflect a more settled regulatory and financial environment.
- Insurers continue to carry out detailed due diligence on prospective cases to identify the deals which are of particular interest to them in terms of membership profile and likelihood to proceed.
- Although it has become more affordable to insure deferred members, for most schemes deferred pricing will continue to be unattractive, and in common with most of the deals struck over the past 2 years the majority of the deals being currently sought are pensioner buy-ins.
- There remain a healthy number of providers able to offer competitive terms despite the exit of a few providers from the bulk market over the past couple of years. As such, many schemes have moved from a “full market” approach to approaching only a select group of insurers.
- For larger schemes, insurers are increasingly providing tailor made transactions designed to suit clients’ specific needs.
- For smaller schemes, plain “vanilla” buyout policies are still the norm. There continues to be an active market for smaller schemes with competitive pricing available even though most insurers operate a minimum quotation size.

Updates on various providers

- Aegon has withdrawn from the buyout market. This is part of a restructure of their life and pensions business. Aegon were a relatively small participant in the bulk buyout market writing just 1 case in 2010.
- The various deals completed during Q2 2010 have been shared around a number of insurers with Legal & General, MetLife, Pension Insurance Corporation and Aviva all writing a number of cases during this quarter.
- Rothesay Life confirmed the completion of a £1.3bn buy-in of pension liabilities of the BA Pension Scheme. This deal has been structured differently from previous buy-ins as the Scheme has retained ownership of the assets. This is the largest buy-in deal completed during 2010.

Longevity hedging

After we saw the largest pure longevity deal completed in the UK during the first quarter of 2010 no new longevity swap deals were announced during Q2 2010. The longevity swap market is still in its infancy with four deals being completed in the last 12 months. However there is significant interest from both trustees and sponsoring employers with one insurer quoting on a pipeline of £5.5bn during Q2.

Our view of the market for the remainder of 2010

- We expect interest in insured solutions to remain high throughout 2010. For most sponsors there is a large desire to de-risk their defined benefit scheme. With full buyout an option for very few schemes, most will consider a strategy of de-risking in stages with partial buyouts or buy-ins being desirable.
- We have not seen any longevity swap deals during the second quarter of 2010, which is not unexpected. These deals can be complex with a significant time lag between discussions and actual transaction. This option is also currently restricted to larger schemes due to the cost and complexity of the process. Hence we expect to see a few large and occasional transactions rather than the steady stream of transactions that we see in the buyout market.
- We believe that the market will remain active throughout 2010, with deals around the £1.5bn mark for buyout transactions each quarter, together with a few large longevity deals transacted through the year. Overall we may see total deals in 2010 exceeding £10bn.

PCS Affordability Index

The attraction of a bulk annuity solution is linked to four key factors:

Regulations

There have been no substantial regulatory changes in 2010.

On 8 July the Pensions Minister, Steve Webb, announced the Government's intention for the Consumer Prices Index (CPI) to replace the Retail Prices Index (RPI). Over the long term the average increase in CPI is expected to be 0.5%-0.75% per annum less than the increase in the RPI. If implemented this change could have an impact both for existing and future buyout transactions. There is uncertainty as to how insurers will price for CPI increases, and what effect this will have on the overall cost of a buyout. There may also be an impact on existing buyouts and buy-ins where revaluation and statutory increases apply.

The EU has launched a further paper with regards to the introduction of the Solvency II regime (an EU Directive) to harmonise funding and reserving requirements for insurance companies). There is still uncertainty as to what the actual impact of this will be; but it is likely to affect insurers' reserving requirements and as a consequence impact on future buyout prices. Although some insurers have previously suggested they have already included margins in their current pricing basis, as the debate continues it seems likely that this may not be the case, and that Solvency II will increase prices in the future.

Financial health

We regularly track the funding position of a typical pension scheme on the accounting RS17/IAS19) basis and 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 analysis shows that over the quarter funding deficits have remained stable. This is because while credit spreads have tightened, with a corresponding increase in liabilities, the recovery in financial markets has meant that assets have correspondingly increased. As there is evidence that buyout prices have increased over Q2 (deferred prices in particular), the buyout gap has also increased to a small extent over the period.

Affordability index

Our affordability index tracks prices in the buyout market against FRS17/IAS19 values.

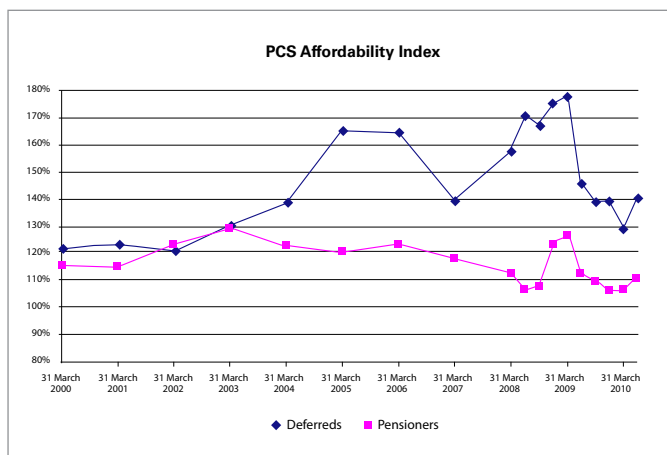
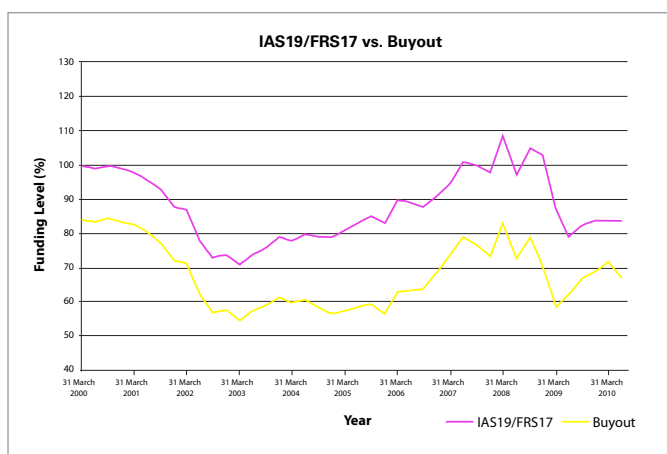
Our analysis shows that buyout prices have increased over the quarter, with deferred prices increasing significantly more than pensioner prices. A number of insurers have admitted that the allowance made to date for Solvency II may prove inadequate to deal with the final requirements. This may be part of the reason why prices seem to have increased to an extent.

It is unclear at this stage what effect the proposed change from RPI to CPI to calculate deferred and pension in payment increases will have on buyout prices. As CPI hedging instruments are not available at the current time it seems likely that insurers would not be able to change their investment strategy for a while, which suggests that price reductions in the near future are unlikely. Market activity may also reduce while sponsors and trustees wait for additional clarity from the Government but there is no evidence of this at the current time.

Market sentiment

Our analysis of the share prices of companies involved in the recent buyout and other derisking deals suggests that there appears to be a positive correlation between a derisking deal and a company's share price. This would confirm our view that analysts generally have a positive view, or a neutral view at least, of such deals - even when liabilities are settled at an amount which is greater than the accounting liability.

Final salary schemes continue to create a significant problem for companies, particularly when their size is disproportionately large compared to the size of the company. The general view from analysts is that any solution which reduces the impact of the pension scheme on the company's balance sheet must be good news.



PCS Market Analysis

£3.2bn of buyout business, (which includes Rothesay Life's BA deal) has been transacted so far during 2010. This is an excellent start to the year and evidences a healthy market, building on a relatively successful 2009.

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

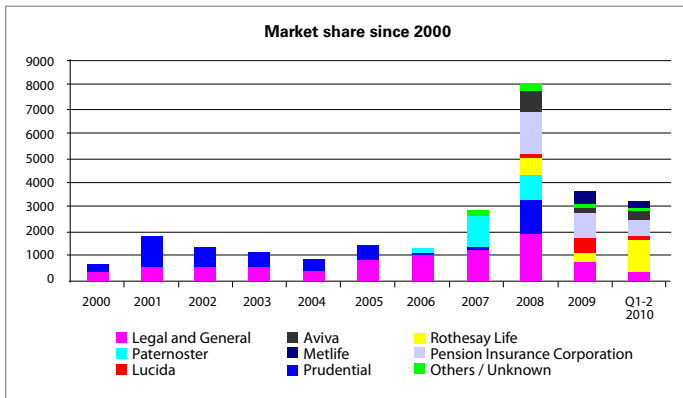
Scheme	Date	Value	Insurer
BA	Jul-10	£1,300m	Rothesay Life
Cadbury Pension Fund	Dec-09	£500m	Pension Corporation
MNOPF	Sep-09	£500m	Lucida
CDC Pension Scheme	Nov-09	£370m	Rothesay Life
Unknown scheme	Q2 2010	£230m	Legal & General
Aggregate Industries	Mar-10	£210m	Pension Corporation
Dairy Crest	Jun-09	£160m	Legal & General
Unknown scheme	Q1 10	£150m	MetLife
Unknown scheme	Q1 2010	£105m	Aviva
Denso Pension Scheme	Sep-09	£100m+	Pension Corporation

The major longevity swap deals struck over the last 12 months are illustrated in the table below.

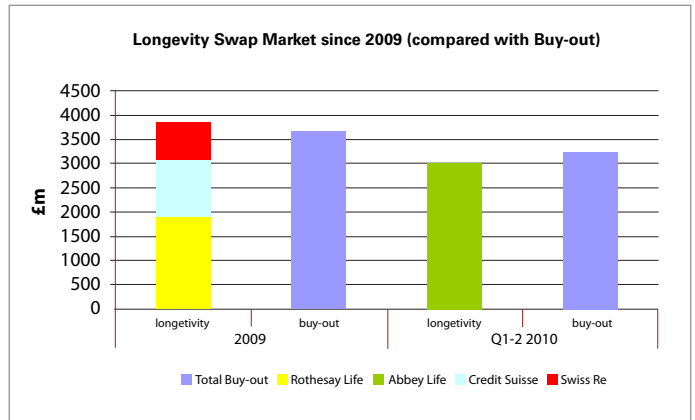
Scheme	Date	Value	Counterparty
BMW	Feb-10	£3bn	Abbey Life
RSA	Jul-09	£1.9bn	Rothesay Life
Babcock International*	May-09	£1.2bn	Credit Suisse
Royal County of Berkshire	Dec-09	£0.75bn	Swiss Re

* Completed longevity swaps for three of its schemes during 2009.

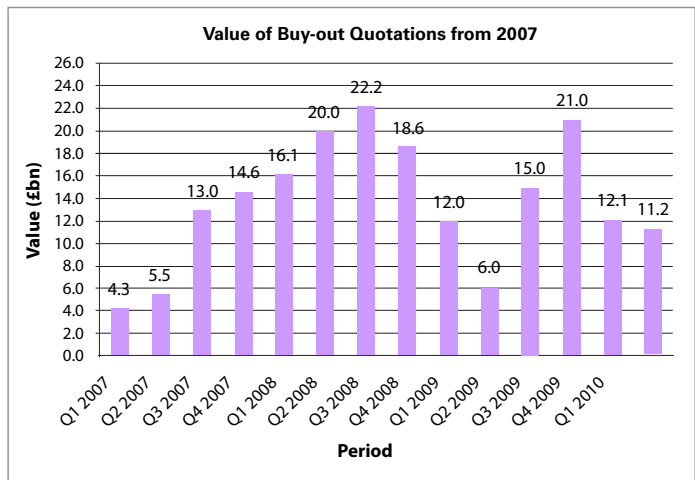
A breakdown of the various insurers' buyout market share since 2000 is illustrated in the graph below.



A breakdown of the various insurers' longevity swap market share since 2009 is illustrated in the graph below. This graph also provides a comparison between buyout and longevity swap business written during 2009 and 2010.



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.



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