

Buyout Market Watch

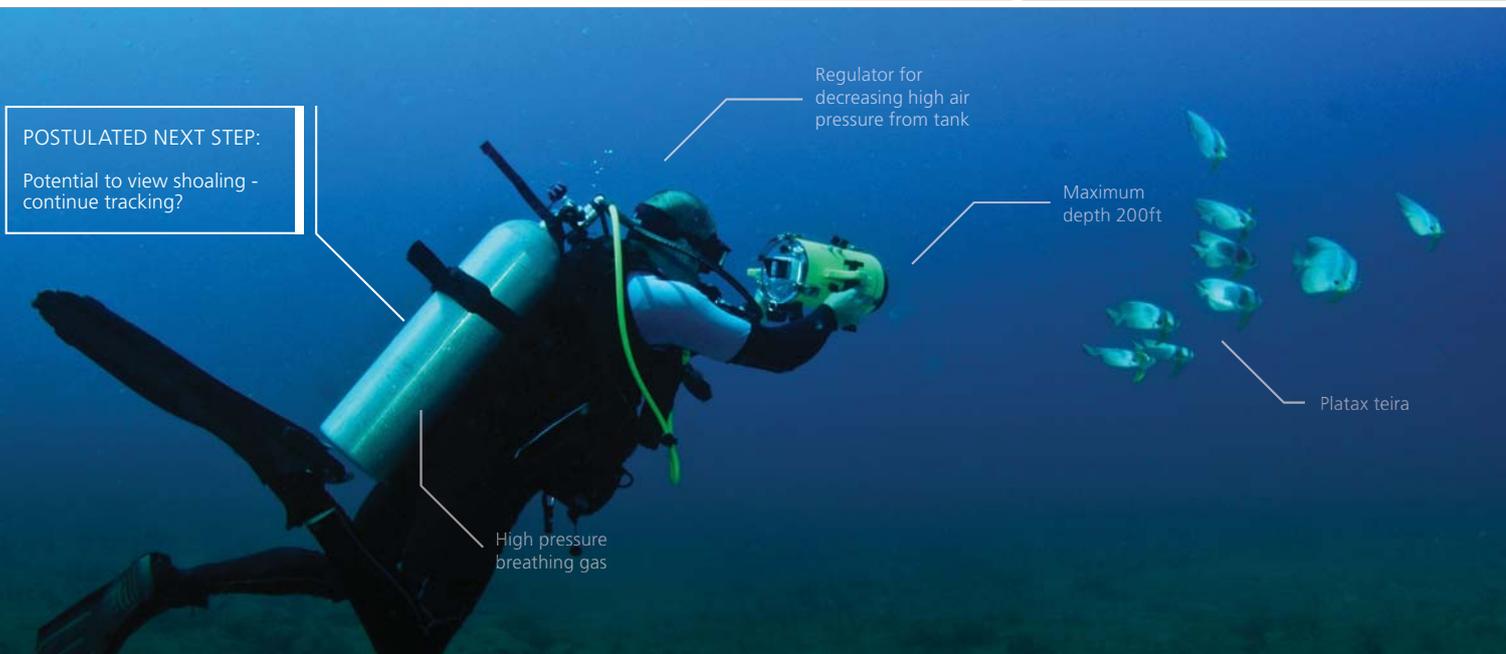
An Update Report From JLT Pension Capital Strategies
as at 31 December 2010

Strategies to Solutions



JLT PENSION CAPITAL STRATEGIES

Buyout Market Watch



The PCS Buyout Market Watch

Update – March 2011

Executive Summary

With the economy stabilising to some extent during 2010 the buyout market saw an increase in deals compared with 2009. The first half of the year was particularly encouraging, with total business written not far below that of the whole of 2009. The majority of buyout deals were for smaller schemes, potentially aligned to a small capital strain.

Although only one longevity swap deal was completed during 2010, pipelines remain very healthy and this is still clearly an area with great potential for larger schemes, especially given that deals can be entered into without a cash strain.

Buyout prices in 2010 and outlook for 2011

Buyout prices were generally stable throughout 2010, a reflection of a more settled economic outlook. There was a slight slowdown in business during the third quarter, reflecting capital market volatility, which caused uncertainty in the annuity market. During the last quarter there was evidence that some insurers have improved their pricing basis, carrying optimism of high business levels being written in early 2011. This evidence of improvement has carried through into the beginning of 2011.

During the year business was shared between a number of providers, which is evidence of a convergence in prices between the leading insurers and a healthy market.

We do not expect there to be any significant changes to prices in the short term, unless external influences dictate this. Insurers have indicated that the impact of Solvency II (the strengthening of insurers' reserving requirements) has already been reflected in their prices. There are differences in the mortality assumptions used by insurers, in some instances these can be substantial and prices could be increased by "weaker" insurers if mortality is strengthened. Prices are also affected by the insurers' required return on capital together with the default assumptions implicit in their pricing basis.

There is a continuing trend for insurers not to guarantee their pricing basis other than in the very short term. Even where a scheme has a LDI strategy in place they will not be immunised against changes in external market conditions as no strategy will provide an exact match to an insurer's pricing basis. We therefore recommend schemes be able to act fast in transacting when the time and the price is right for them by having appropriate asset transition support. A clear transaction plan is paramount to be ready for when the timing is favourable.

Our view of the buyout market in 2011

There remains a strong desire from sponsors for schemes to reduce risk, with buyout being the ultimate aim, albeit full buyout being unaffordable for most schemes at the present time due to the cost of insuring members yet to be at or near to retirement age. Insurers are continuing to adapt to the requirements of schemes, developing intermediate solutions which will enable full buyout to become attainable over time.

Most schemes should consider a buy-in where a buyout is not realistically affordable. For a buy-in the pension scheme is effectively undertaking an alteration to investment strategy replacing whatever assets it held in relation to the annuity liabilities by a bulk annuity policy. In effect the Scheme replaces an inexact investment policy match with an exact match with longevity insurance added on. This has a strong rationale as insurers are ideally placed to run annuity portfolios.

Some insurers offer contracts where the bulk of the payment is made upfront with the remainder being paid over a period of five years or so. One insurer offers a solution where a future premium is agreed at outset, payable in 10 years, allowing schemes to implement a recovery plan and investment strategy leading to a guaranteed buyout cost.

A number of insurers have reduced their minimum quotation price which has led to a competitive market for smaller schemes (£10m and under). We anticipate a large number of smaller transactions will take place during 2011.

We expect the market to continue to innovate, providing a solution for all but a few very poorly funded schemes. Very few schemes will be in a position to complete a full buyout, but many could realistically buy out pensioner liabilities or even a tranche of liabilities, for example older pensioners, for whom the buyout cost is likely to be close to the scheme's funding basis.

The quotation pipelines reported by insurers in quarter four 2010 were very healthy, leading to a bullish view for the market in the early part of 2011. Unless changes in the economic situation dictate otherwise we expect total buyout activity to exceed £10bn during 2011.

PCS Affordability Index

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

Regulations

The Government has recently published a consultation paper setting out its assessment of the impact of its decision to use CPI instead of RPI as the measure of price increases on private sector schemes. The change should lead to a reduction in liabilities to the extent that the CPI is expected to be below RPI. Most commentators believe that over the long term the average increase in CPI will be 0.5% – 0.75% per annum less than the increase in RPI. However, the impact of this legislation will depend on the rules of the pension scheme. In general terms, if the scheme rules make specific reference to RPI then increases and revaluation will be linked to RPI, if not then increases and revaluation will be linked to CPI. Even if a switch to CPI is achievable the saving available on a bulk annuity policy may be limited as there is no market for CPI linked assets for insurers to use to back such annuities, and a market is not likely to develop for some time. Any mismatching of assets on an insurer's part means that they have to hold additional reserves in order to demonstrate their solvency position to the FSA. Most insurers are willing to include some flexibility in their contracts to allow for a change to CPI whilst the bulk annuity policy is held in the Trustees' name (i.e. a buy in). For buy ins previously undertaken, if a scheme is liable for CPI and the insurer liable for RPI there could be a windfall for the scheme assuming RPI is higher than CPI.

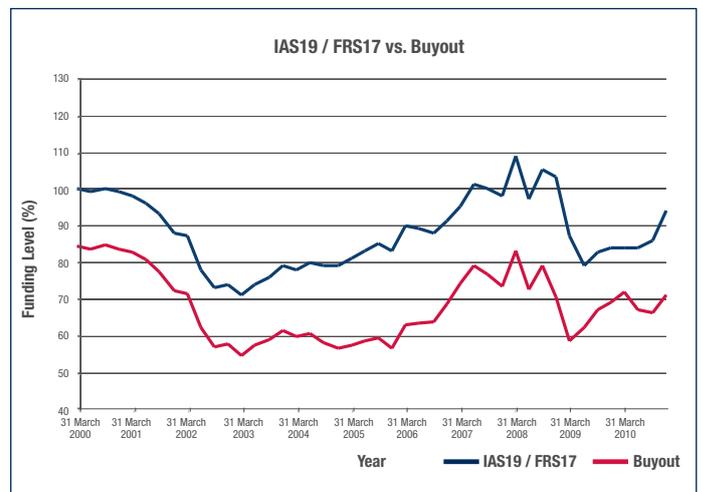
The issue of the Solvency II EEC insurer reserving requirement and its effect on bulk annuity pricing is ongoing. The Solvency II, which should be implemented in November 2012, aims to establish a revised set of EU wide capital requirements and risk management standards for the insurance industry. The full implications are still unknown as the requirements and standards have yet to be finalised. Most insurers are comfortable that their current prices reflect their expectations of future requirements; however, should there be adverse changes to the draft position, it could have an adverse affect on bulk annuity prices. Most insurers consider further adverse changes unlikely.

For schemes considering bulk annuity purchases there is a real issue in respect of equalisation of Guaranteed Minimum Pensions (GMPs). Most schemes are making some allowance when securing bulk annuity policies on a buyout basis; however there is no specific guidance on the method to be followed. Should legislation be passed, and this is not inevitable, we do not expect this to have a major impact on buyout deals; however there could be an impact on schemes with buy in contracts where no action has been taken to equalise GMPs, and also on schemes where a specific method to equalise is set out which results in additional liabilities.

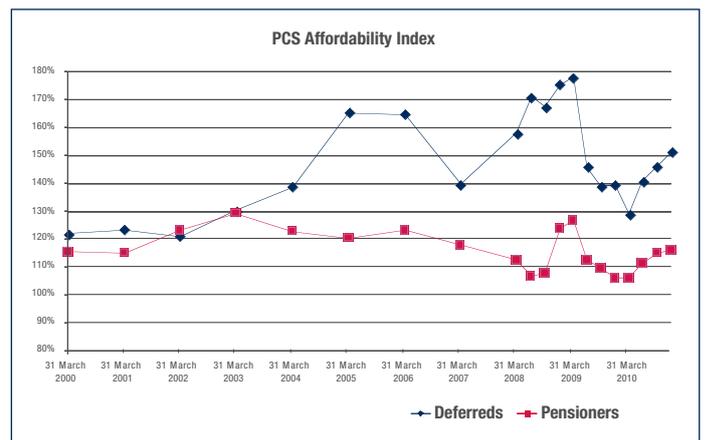
Financial health

We regularly track the funding position of a typical pension scheme on the accounting (FRS17/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 figures show that during 2010 accounting liabilities remained relatively stable before a noticeable decrease during the final quarter due to an increase in UK AA rated corporate bond yields. After an initial decrease during the first quarter of 2010 the buyout gap has risen slightly throughout the year.



Affordability Index



Our affordability index tracks prices in the buyout market against FRS17/IAS19 values. The index shows the relationship between the buyout price and the approximate balance sheet accounting liabilities, and illustrates that for deferred members this has increased significantly during the year.

For pensioners, the increase early in 2010, was possibly due to a further allowance made by insurers for Solvency II requirements. Although an increase in gilt yields would have reduced buyout prices during the final quarter, there was still a small increase in the relative buy-out cost over the last quarter due a greater proportionate decrease in FRS17/IAS values.

It should be noted that this analysis is based on generic information and a “typical” calculation basis for buyouts and accounting liabilities, and in many instances it may be possible to achieve a price of between 105% and 110% of accounting liabilities for pensioners. This can be achieved by providing clean data, sufficient demographic information, and in some instances finding investment transition opportunities. It is therefore becoming more common for schemes to engage with a small number of insurers to obtain suitable terms.

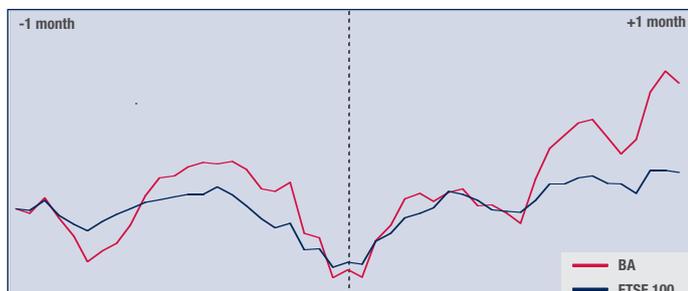
“It should be noted that a buyout clearly provides a reduction in risk and covers administration costs not usually included in FRS17 / IAS19 values and so a small premium over accounting values is to be expected in all but unusual circumstances.”

Market Sentiment

We have analysed share prices of a number of companies involved in recent buyout and risk reduction deals, which suggest that in most instances there is either a positive correlation between a risk reduction deal and a company’s share price or as a minimum the deals have no detrimental effect on the share price. This can be evidenced from the graphs below, which show the share price movement for two deals completed in 2010 against the movement of the FTSE100.



Inchcape deal – April 2010



BA deal – July 2010

The BA deal is a good illustration of this. BA’s equity market value on 30 June 2010 was £2.25bn. The £1.3bn buy in deal was announced on 3 July 2010, with their share price barely moving from tracking the FTSE 100 index.

In their October 2010 “Strategy Matters” document, Goldman Sachs’ research estimated there has been a large increase in pension deficits for STOXX Europe 600 companies due to low bond yields and flat equity returns during most of 2010. Their research also provided evidence that companies with large pension obligations tend to underperform the market.

For many sponsors, final salary schemes continue to create a significant problem, especially when their size is disproportionately large compared with the size of the company. It can only be positive for a sponsor if a risk reduction solution can reduce the impact of a pension scheme on the company’s balance sheet.

Equity market analysts are paying increasing attention to defined benefit pension volatility and a deal which reduces scheme size and pension risk is viewed positively if communicated effectively.

News from the market

Longevity Solutions

Although the market mood for pure longevity swap solutions was very positive during 2010 only one deal was actually completed, which was a £3bn transaction between BMW and Abbey Life. There remains a healthy pipeline of potential deals; however these are complex transactions which take time to reach their conclusion.

Throughout 2010 the deals continued to be open for only the larger schemes (£200m plus), and the market is yet to evolve enough to lower this threshold for scheme specific swaps. The number of providers offering longevity solutions in this area has expanded, with UBS Deutsche Bank and Legal & General entering the market during 2010.

The Life and Longevity Markets Association (LLMA), who continue to promote the development of this market, announced in December 2010 that Aviva has now joined the Association. There are now eleven members including, Legal & General, Prudential, Swiss Re and UBS.

The major longevity swap deals struck over the last 18 months are illustrated in the table below.

Scheme	Date	Value	Counterparty
BMW	Feb-10	£3bn	Abbey Life
RSA	Jul-09	£1.9bn	Rothsay 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.

On 1 February 2011 Pall (UK) Pension Fund announced that they completed a longevity hedge for their non-retired members with JP Morgan. This deal is significant for a number of reasons. It is the first index hedge for a pension plan's non-retired members; it was for just £70m of liabilities, which was made possible by referring to an index; and was also for a ten-year term, during which the scheme's trustees can choose to adjust the size and composition of the swap.

Synthetic Buy ins

There has been a move for insurers to offer bespoke solutions tailored to the needs and circumstance of a specific scheme. Rothsay Life's £1.3bn transaction with BA, is an example of such a solution, and has been referred to as a "synthetic buy in" due to its characteristics. In this instance the liabilities have been covered by an insurance arrangement issued by Rothsay Life with the Trustees retaining ownership of the assets backing the transaction. Such transactions are continuing to evolve and their potential at any time is linked to the relative levels of financial yields and swap yields.

Indicative quotations

Trustees and sponsors often wish to investigate the possibility of buyout but don't want to face the cost and expense necessary to obtain a formal quotation. A number of insurers are happy to provide indicative quotations, which assists schemes in overcoming this dilemma. These quotes often take between 2-3 weeks and are either based on summarised data or recent valuation data.

Deferred Premiums

Risk reduction "or "de-risking" is on the agenda for most schemes trustees and employers with many currently unable to afford buy in or buyout. Some insurers are offering deferred premium options. These range from a lower starting premium (i.e. less than the usual 95% required to secure buyout) to Prudential's "future premium" product, which guarantees a fixed price in 10 years, and locks in longevity, inflation and interest rate risk from the outset. These can be used in conjunction with a recovery plan and a provide schemes with a clear roadmap to buyout.

Data Cleansing

Many schemes undertake data cleansing exercises prior to commencing their buyout exercise. These can be time consuming held up by GMP reconciliations and also GMP equalisation calculations. Clean data, and also an accurate benefit specification, will lead to more accurate pricing, and therefore less surprises when the final price is calculated once the scheme is implemented. However, it can also delay obtaining a quotation, which in turn could lead to a scheme missing out on competitive terms and ultimately being unable to transact. There is some merit therefore in commencing a buyout exercise as soon as possible, with a data cleansing exercise running along side this. If terms look desirable, the Trustees can lock into these by paying an initial premium, whilst finalising the data. The flip side however can be if poor data is sent to insurers they may have less of a desire to quote. Cleaning data during a process can also mean insurers have to make less data assumptions if data becomes more complete and this can improve insurance premium terms.

Insurer News

Paternoster is now 100% owned by Goldman Sachs. New capital has been injected into Paternoster and full FSA authorisation has been obtained for future business. Although Rothsay Life is also owned by Goldman Sachs, the two insurance companies will currently be run separately, albeit with one group of staff. All new business will be written by Rothsay Life, with Paternoster's asset management reverting to Goldman Sachs.

During 2010 MetLife acquired ALICO from AIG, MetLife will write all new bulk annuity business. Earlier in the year Aegon Scottish Equitable withdrew from the market as part of their restructure of their life and pensions business.

Despite these changes, there remain a healthy number of providers able to offer competitive terms in the market. As

such, some schemes have moved from the “whole of market” approach to selecting a few core providers they would be willing to transact with.

The big deals

It was anticipated that a number of large deals would be completed in the final quarter of year. Prudential completed a combined £900m buy in of two GlaxoSmithKline schemes, covering approximately 15% of the sponsor’s pension liabilities. The total for the quarter was an estimated £1.6bn, meaning total business written during 2010 was circa £5.1bn with circa. This compares well with £3.7bn during 2009.

These figures are exclusive of the £3bn BMW longevity swap deal, which would increase the total to £8bn again comparing well with 2009.

These are excellent figures overall, particularly while the economic outlook for the UK remains unclear.

The main characteristics of the deals struck in 2010 are as follows:

- They continue to be, in the main, in respect of pensioners rather than deferred members.
- The majority of transactions have been buyouts or buy ins for smaller schemes.
- The larger transactions have had some bespoke element included to tailor this to the requirement of the particular scheme.
- Most insurers have written some business during the year with a large number writing at least one £100m plus transaction.

The total volume of quotations outstanding in the market also remains very high at around £13.8bn with a number of potential deals being carried over into 2011.

The top 11 largest bulk annuity deals struck during 2010 are illustrated in the table below.

Scheme	Date	Value	Counterparty
BA	Jul-10	£1,300m	Rothesay Life
GlaxoSmithKline	Nov-10	£900m	Prudential
Alliance UniChem	Q3 2010	£310m	PIC
Unknown Deal	Q2 2010	£230m	Legal & General
Aggregate Industries	Mar-10	£210m	PIC
Unknown Aviva deal	Q4-10	£200m	Aviva
Unknown MetLife Deal	Q1 10	£150m	MetLife
Next	Aug-10	£124m	Unknown
Unknown Aviva deal	Q1 2010	£105m	Aviva
MNOPF (2)	May-10	£100m	Lucida
Unknown Aviva deal	Q2/3	£100m +	Aviva

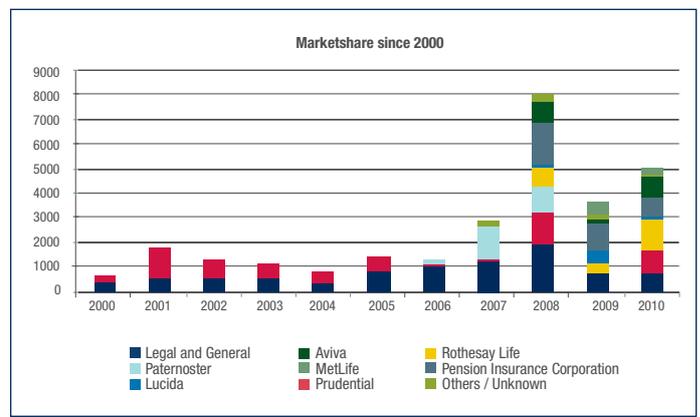
Smaller deals

2010 saw the return of a large number of smaller deals, this being the result of the contraction of the market, leading to a greater capacity for insurers to quote. The majority of deals struck during the year could be classed as smaller deals. Generally these are “plain vanilla” buyouts or buy ins, and therefore the transactions are much more straightforward to complete, compared with the larger deals that include bespoke solutions.

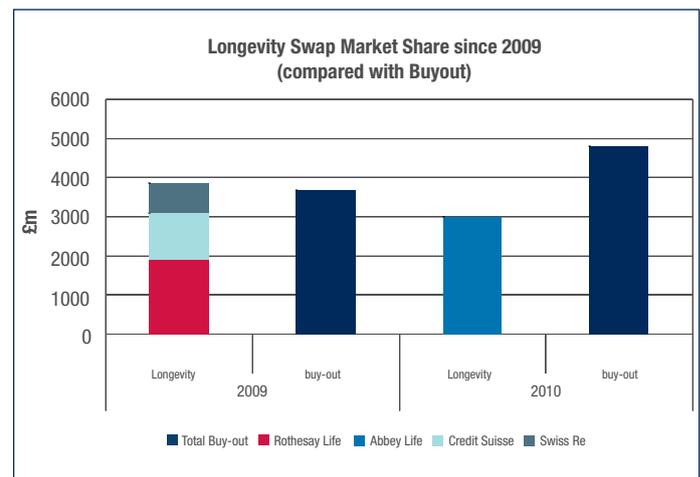
At the current time Legal & General will normally quote for any size scheme, with MetLife quoting for schemes greater than £2m. Aviva have no set minimum, whereas PIC will generally quote for schemes above £20m.

Market Stats

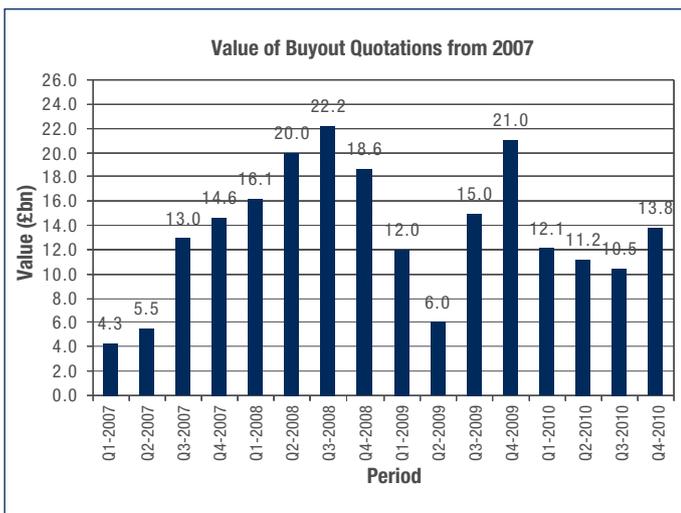
A breakdown of the various insurers’ buyout market share since 2000 is illustrated in the graph below.



A breakdown of the various insurers’ longevity swap market share since 2009 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.



Commentary

The amount of traditional bulk annuity business written during 2010 was in excess of that written in 2009, albeit still short of the record 2008 levels. After a strong start to the year the final figures were lower than some commentators had imagined; however a significant amount of business was written during another year of economic uncertainty. Insurers are keen to transact on the right terms and they remain open to innovation. Trustees and sponsors are aware of the risks and uncertainties associated with pension schemes and continue to see the economic price of a scheme as the real price that must be paid.

Pipeline remains healthy for most insurers, and through our discussions there seems to be optimism for 2011.

While there were no completed longevity swap deals during the second half of 2010, we believe negotiations, in some cases at an advanced stage, are ongoing for a number of schemes.

In our opinion, buyouts will remain desirable due to:

- Stronger funding requirements, which should result in the buyout funding gap reducing with time.
- Positive investment returns, although this may be offset by an increase in liabilities due to falling yields.
- A strong desire from some sponsors prepared to pay a top-up premium in order to remove pension schemes from their balance sheet.
- Insurers continuing to offer bespoke solutions to enable schemes who cannot afford a deal at the current time to effect a transaction over a longer period.
- Realistic, and therefore attractive, mortality pricing within bulk annuity quotations.
- Greater appreciation that insurers are best placed to run annuity portfolios.

Buyouts will be less desirable due to:

- Uncertain economic conditions leading to companies being unable to raise the necessary capital to finance a bulk annuity policy even if it has been assessed to be desirable.
- Prices remain higher than the peak years of late 2007 through to early 2009 (although those prices were artificial discounted and not normal insurance market conditions) leading to a buyout being unaffordable for many schemes - especially for deferred liabilities.
- Market conditions remaining relatively volatile leading to Trustees finding it harder to perfect the timing for implementing a buyout. This together with inefficient decision making can lead to deals being abandoned often with an element of regret later on.

Set against this, some of the difficulties of buyouts are avoided under a buy in. We further expect that:

- Smaller schemes will continue to transact, mainly on plain vanilla terms.
- Larger schemes will be the subject of bespoke solutions, with a significant time lag from an initial broking exercise through to a transaction. Furthermore larger schemes will engage with a small number of providers throughout the process rather than considering a full market approach.
- There will be a relatively small number of longevity only deals; due to their complexity and being limited to larger schemes.

Unless there are significant changes in the economic situation we expect buyout activity to grow significantly during 2011, leading to another busy and interesting year for those involved in this market.

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