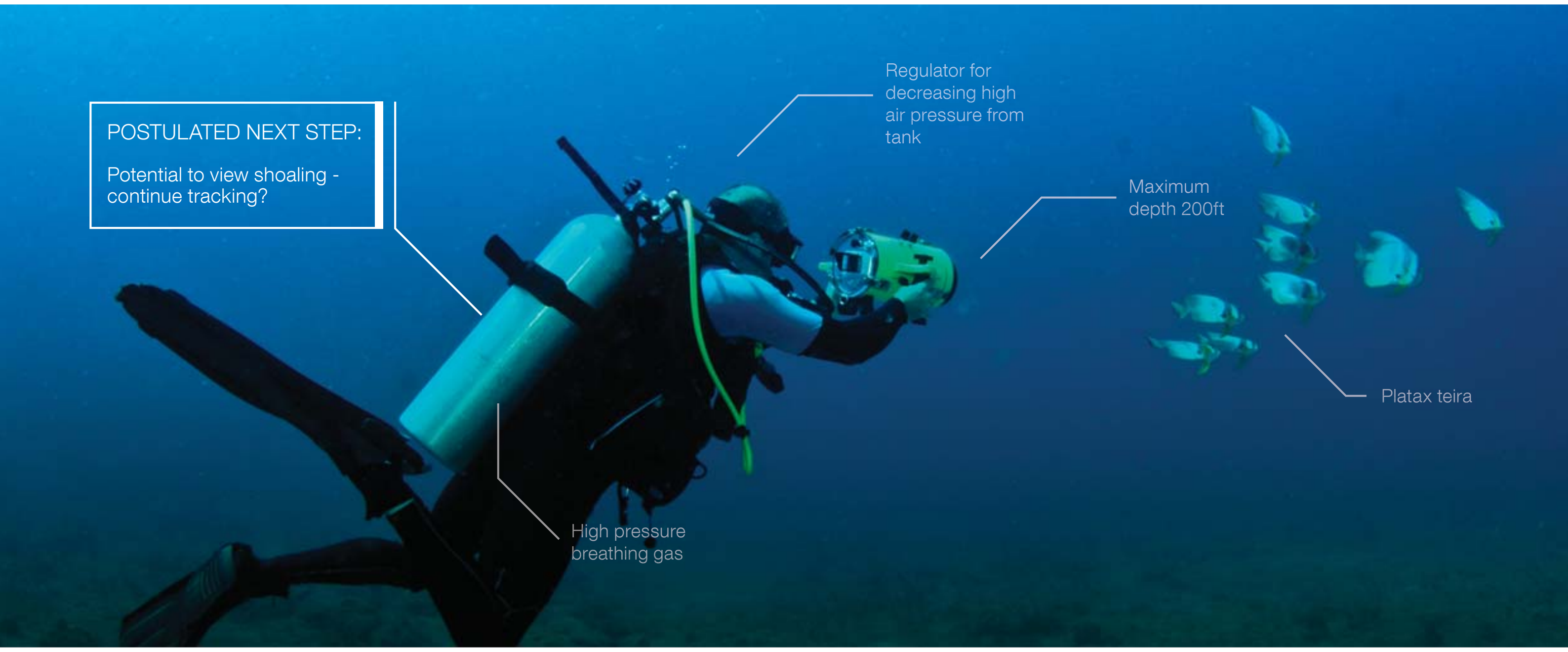
Buyout Market Watch

An Update Report From JLT Pension Capital Strategies as at 31 December 2011

Strategies to Solutions

JLT PENSION CAPITAL STRATEGIES

Buyout Market Watch



Executive Summary

What happened in 2011

- During the latter half of 2011 the financial markets were dominated by the developments of the Eurozone crisis, as a result of which UK Gilt yields reached record lows. Pension schemes continued to search for solutions to de-risk - after a substantial number of transactions were completed in Q4, 2011 ended as a record year, with total buyout and longevity swap transactions adding up to £12bn for the year, a phenomenal 50% increase on 2010.
- Insurers kept their pricing bases relatively stable throughout the year; however in monetary terms buyout prices increased significantly in the last few months of the year, predominantly as a result of falling Gilt yields.
- The majority of deals during 2011 were for pensioner buy-ins.
- Three insurers entered the bulk annuity / de-risking market. These were Partnership Assurance, who offer an impaired life solution, CNP Europe Life Limited, and Long Acre Life, who were established to offer solutions for companies with liabilities in excess of £500m, three of which transacted in Q4.
- Five large longevity swap deals were completed during the year, three of which transacting in Q4. Further deals are expected in the coming months - these contracts remain popular as they can be entered into without causing a cash strain on the Scheme.
- Insurers have sought to gain a market edge by providing innovative solutions, such as deferred premium options, monitoring services, vesting options, an “all risks” approach, liability management and performance sharing.

Outlook for 2012

- Our view for 2012 is bullish. The high business levels written during Q4 2011 show that the buyout market can thrive in difficult economic circumstances. Unless some fundamental changes take place in the economy, we expect total buyout activity once again to exceed £10bn during 2012.
- We expect pensioner buy-ins to remain the most popular form of contract in 2012. Low Gilt yields mean that schemes with the right investment profile are able to exchange their Gilt holdings for a pensioner buy-in contract with little or no additional cost.
- We anticipate further entrants to the market and fewer “whole of market” exercises; more trustees will consider “best fit” solutions for their schemes.
- As a result of this, we expect more innovation in the types of contract available for all segments of the market.
- Our expectation is further longevity only deals during 2012, including solutions for schemes with liabilities of £50m and over.
- With volatile markets, preparation for buyout is paramount as it is important that trustees are ready to act fast when the price is right, monitoring markets and having an agreed trigger point in place. Advance preparation will be crucial for successful deals.

The PCS Buyout Market Watch Update – December 2011

Buyout prices in 2011 and outlook for 2012

Insurers kept their pricing bases quite stable throughout 2011; however in monetary terms buyout prices increased significantly in the last few months of the year, predominantly a result of falling Gilt yields. This led to a slow down in business during Q3 as schemes struggled with the price volatility caused by changing financial conditions. High business levels during Q4 (which saw some insurers improving their pricing basis) more than compensated for this.

Falling Gilt yields meant that schemes with the right investment profile were able to exchange their Gilt holdings for a pensioner buy-in contract with little or no additional cost. As Gilt yields remain low, expectations are that other schemes will take advantage of this opportunity during the early part of 2012.

The biggest number of deals continued to be for pensioner buy-ins, as affordability remained an issue for most schemes when considering whether to also place their deferred population. Most insurers were able to complete a healthy number of deals, which is evidence of a convergence in prices for standard contracts between the leading insurers and, therefore, of a healthy market.

We do not expect any significant changes to prices in the short term, unless this is a result of external influences. While some insurers have indicated that further adjustments may still be required to comply with the requirements of Solvency II, the majority of insurers are confident that any changes will have a trivial impact on their pricing. Adjustments may be made to insurers' longevity assumptions if monitoring of business in force should reveal that past assumptions have underestimated improvements in longevity. We do not believe that the analysis carried out to date has thrown up any big surprises.

Due to the volatility in the market, insurers are very reluctant to guarantee their pricing basis for any significant length of time, and will usually only provide guarantees when a deal is imminent. Some insurers will put hedges in place and give price guarantees on request, but typically for no longer than a couple of days.

In order to maximise the likelihood of a transaction, we recommend that schemes get ready to act fast when the price is right. Each scheme should agree a trigger point and get its assets in order. Most insurers will assist trustees in monitoring prices on a regular basis, particularly in exchange for exclusivity over a period of time.

Our view of the buyout market in 2012

For most schemes, the sponsors' and trustees' appetite for reducing risk remains very strong. A full buyout is normally the ultimate aim, although this may well be unaffordable for most schemes, particularly if they include a substantial proportion of non pensioner members. Insurers are continuing to adapt their contracts and terms to the requirements of pension schemes, developing intermediate solutions which should enable a full buyout to become attainable over time.

Schemes should consider a buy-in where a buyout is not realistically affordable. Securing a buy-in is effectively an investment decision, through which the assets underlying the relevant liabilities are swapped for a perfectly matching bulk annuity policy. For schemes with significant Gilt holdings current market conditions make this an ideal time to consider a transaction, as the yields underlying the quotation premiums can sometimes be in excess of Gilt yields, so that longevity risk can be passed to an insurer with no cost to the scheme.

Viewing a bulk annuity as an asset class in itself also strengthens the argument for securing the liabilities in tranches, as and when it becomes affordable. Too often, securing a bulk annuity is seen as an "all or nothing" decision, so that any doubts about whether the "best" terms have been squeezed from an insurer result in a transaction not going through.

Although larger schemes are still able to get more bespoke contracts, there is still a significant market for smaller schemes, with a number of insurers willing to quote for smaller schemes (£10m and under). Most insurers are willing to quote for schemes of £50m and above.

Whilst quote pipelines remain healthy, insurers are most likely to quote for cases where a transaction has a good chance of proceeding, so any evidence that can be provided in this sense will help schemes maximise the number of quotes they are able to obtain. However, if a specific type of contract is required, or for a population which is likely to be of more interest to one or two insurers, early exclusivity may produce a suitable price and structure more quickly.

There is an indication that new insurers will join the market in 2012, providing an even more competitive market for schemes. However, we anticipate fewer "whole of market" exercises as trustees and insurers look for a "best fit" solution, based on scheme demographics, circumstances (including assets held) and what each insurer is willing to offer.

A number of innovative contract structures such as flexible premium options, tranched buyouts, "all risk solutions", performance sharing options and deferred premium contracts are now available to most schemes. We expect the market to continue to innovate, providing a solution for all but a few very poorly funded schemes. While few schemes will be in a position to complete a full buyout, many could realistically buyout pensioner liabilities, or even just a tranche of liabilities such as older pensioners (as the buyout cost for them is likely to be close to the liabilities calculated using the scheme's funding basis).

We expect further longevity swap deals to be completed during 2012. These deals will generally be struck by larger schemes due to their complexity, although one insurer has indicated they will write contracts to cover as little as £50m of liabilities.

Healthy quotation pipelines were reported by all insurers in Q4 2011. The market view for 2012 is quite bullish and reinforced by the high business levels written towards the end of last year. The experience of last year shows that the buyout market can continue to thrive even in difficult economic circumstances. Unless some fundamental changes take place in the economy (such as a disorderly break up of the Euro), we expect total buyout activity once again to exceed £10bn during 2012.

PCS Affordability Index

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

Regulations

It has now been confirmed that the implementation of Solvency II will be delayed until 2014. Bulk annuity insurers are still undertaking a consultation process over the methodology for calculating the discount rate for long term guaranteed contracts (such as bulk annuity policies). The delay in implementation, and the likelihood that some of the insurer arguments will be accepted, means that we do not expect any further loading to be incorporated in the insurers' bases to comply with the new regulations once they become effective.

The European Insurance and Occupational Pensions Authority (EIOPA) has proposed the extension of the Solvency II regime to occupational pensions. While it is not expected that this will result in any changes in the short term, it is likely that some of the principles will eventually be incorporated in the regulatory regime for occupational pensions. This would result in higher funding requirements and, by comparison, cheaper bulk annuity premiums.

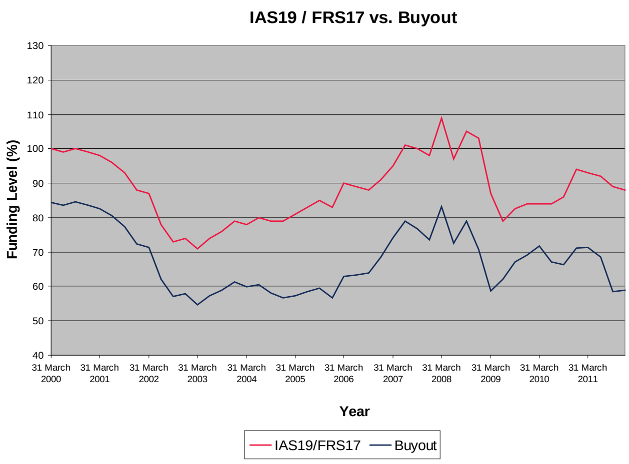
As part of its revised framework for the levy, the PPF will start to reflect each individual scheme's investment strategy in the levy calculations. A more "matched", less risky strategy should reduce the levy, and will make bulk annuities more desirable.

The Department for Work and Pensions has released a consultation document on the possible regulations and method to deal with GMP equalisation. Some allowance for GMP equalisation is normally made once a scheme completes a buyout or on wind up. To the extent that the regulations are no more onerous than anticipated, any formal regulations are not likely to impact the buyout market in any significant way. In fact, to the extent that the requirements are clarified once and for all, the impact on the market may turn out to be positive.

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.

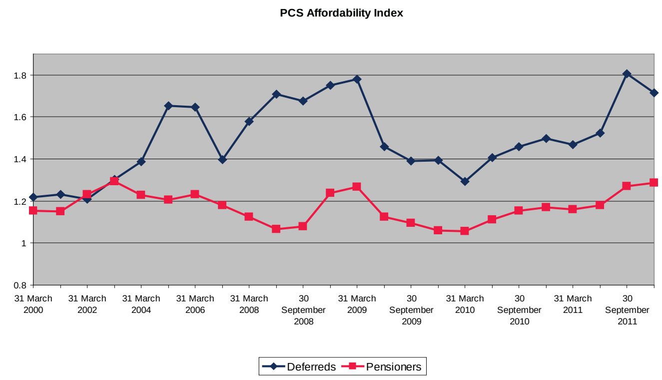
As corporate bond yields and Gilt yields fell by similar amounts over the period, the relationship between accounting values and buyout premiums remained broadly stable. Buyout prices remained attractive when compared to Gilt yields, so that schemes with large Gilt holdings had the opportunity to secure a bulk annuity contract with little or no financial strain on the scheme.



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.

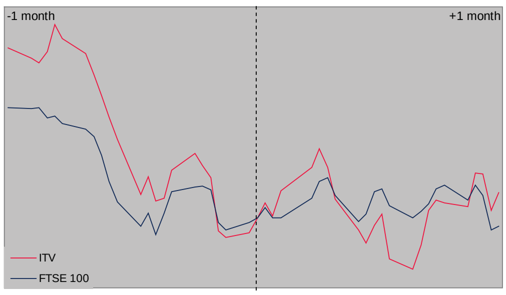
Our figures show that pensioner prices remained broadly stable over the quarter, while deferred prices improved slightly, although this only partially offset the sharp increase seen over the previous quarter.

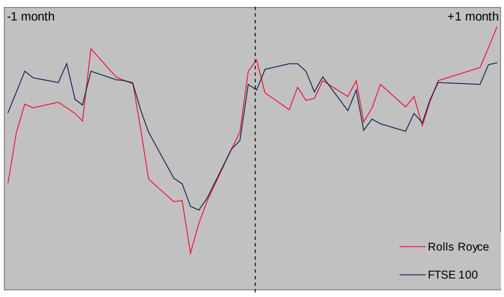


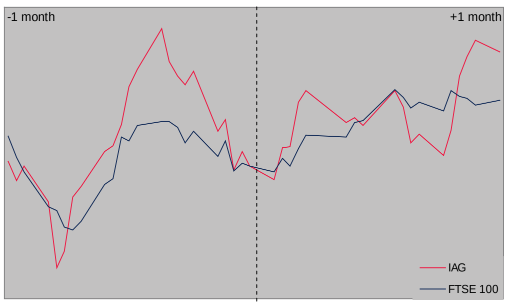
Market Sentiment

Our analysis of the share prices of companies following a buyout/buy-in deal or a longevity swap suggest a positive or neutral link between share prices and market activity.

The graphs below show the share price movement against the movement of the FTSE100 for BA (now International Airlines Group following the merger with Iberia), ITV and Rolls Royce, all of which completed longevity swap transactions for their pension schemes in 2012.







News from the Market

Longevity Solutions

After a quiet 2010 (in terms of completed transactions rather than market activity) 2011 has been the most successful year to date for pure longevity swap deals, with five transactions occurring, three of which were in the last quarter of the year.

To date scheme specific longevity swap deals have been open for large schemes only (£200m plus). It is expected that during 2012 this market will evolve enough to lower the threshold, allowing schemes as small as £50m to participate in the market.

The longevity swap market has expanded significantly with a number of providers actively seeking business. During 2011 scheme specific deals were agreed with Deutsche Bank, Rothesay Life, Credit Suisse and Legal & General. The Life and Longevity Markets Association (LLMA), who continue to promote the development of this market now has twelve members including Prudential, Aviva, Swiss Re and UBS.

The first index hedge for a pension scheme's non-retired members was completed in early 2011 between the Pall (UK) Pension Fund and JP Morgan. The hedge used JP Morgan's LifeMetrics index and is for a term of 10 years.

The longevity swap deals struck since 2009 are illustrated in the table below.

Scheme	Date	Value	Counterparty
Rolls Royce	Nov-11	£3bn	Deutsche Bank
BMW	Feb-10	£3bn	Abbey Life
RSA	Jul-09	£1.9bn	Rothesay Life
ITV	Aug-11	£1.7bn	Credit Suisse
BA	Q 3 2011	£1.3bn	Rothesay Life
Babcock International	May-09	£1.2bn	Credit Suisse
Pilkington Superannuation	Dec-11	£1bn	Legal & General
Royal County of Berkshire	Dec-09	£0.75bn	Swiss Re
Pall (UK) Scheme*	Q1 2011	£0.07bn	JP Morgan

*based on JP Morgan's LifeMetrics index

Insurers are reporting a healthy pipeline of potential deals, some of them at the very large end, which means that expectations are high for 2012 in this segment of the market. However, as these transactions can be complex, concluding a contract normally takes a number of months.

Indicative quotations

Trustees and sponsors often wish to investigate the possibility of buyout without embarking on a full blown broking exercise over a number of months, which may be speculative at best. Some insurers are happy to provide indicative quotations to assist schemes in overcoming this dilemma. Approximate quotes often take between 2-3 weeks to produce and are either based on summarised data or recent valuation data.

Innovative Solutions

Over the past 12 months insurers have sought to gain a market edge by providing innovative solutions to schemes considering buyout transactions. Solutions considered include:

Deferred Premiums

Contracts are available with deferred premium options, ranging from a simple "low start" premium with balancing payments to follow, to contracts with a guaranteed future premium locking into longevity, inflation and interest rate risks from the outset. For most scheme trustees and employers, risk reduction is high up the agenda; however the desire to avoid a capital strain if a standard contract is implemented can result in a lack of action. This type of contract enables schemes to transact in those circumstances.

Monitoring and triggers

Insurers are generally willing to assist pension schemes with monitoring the buyout price against a scheme's asset value, although they may require an exclusivity agreement in exchange. For cases where a trigger based execution mechanism has been agreed, work to finalise the contract would be carried out upfront so that when the trigger is hit the transaction can take place immediately.

Vesting Option

Some insurers are willing to offer guaranteed, or partly guaranteed, terms for future retirees as an additional option under a pensioner only buy-in.

"All Risks" approach

Some insurers are happy to consider an "all risks" approach; where in addition to the usual risks taken on under a buyout contact (mortality risk, investment risk etc.), the insurer would also cover further risks such as those relating to incorrect data and benefit specification. This type of contract does carry an additional cost but this may well be worth paying for schemes wishing to complete buyout and wind up in a short period of time.

Liability management

Many schemes considering a buyout contract are also looking at other methods of de-risking, such as ETV exercises and Pension Increase Exchanges (PIE). For pensioners a PIE exercise often will take place prior to a buyout; however some insurers will consider both exercises in conjunction with each other so that the risk associated with the delay in implementing a bulk annuity contract is eliminated.

Performance Sharing

In this type of contract part of the surplus originated by excess investment returns or higher mortality rates is passed back to the scheme or used to secure additional benefits (such as pension increases in payment).

As new entrants join the market in 2012, we expect innovation to continue so that more schemes can afford tailor-made solutions to fit their circumstances.

Data Cleansing

Many schemes undertake data cleansing prior to commencing a bulk annuity broking exercise. Data cleansing can be time consuming and can take a long time to complete if GMP reconciliation is also undertaken in advance. Clean data, and also an accurate benefit specification, will lead to more accurate pricing and no surprises when the final price is calculated once the scheme is implemented. However, the process can also delay a scheme from coming to market, which can result in the 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 alongside. If terms look attractive, the trustees can lock into these by paying an initial premium, whilst finalising the data. The flip side is that very poor data can see the scheme turned down by the insurer, particularly if market activity is quite high. Trustees should discuss the need for data cleanse, and the timescale for an exercise, with their adviser, so that the best option can be pursued for their scheme.

Insurer News

The transfer of the long term business assets and liabilities of Paternoster UK Limited to Rothesay Life became effective on 14 December 2011; therefore all business for both insurers is now under Rothesay Life.

Partnership Assurance entered the bulk annuity market in 2011. 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. Legal & General also provide an underwritten solution for members with higher liabilities through their "LIDBA" (Large Individual Defined Benefit Annuity) structure.

CNP Europe Life Limited also entered the UK bulk annuity market in 2011. CNP Europe are an Irish insurer fully owned by a French parent (CNP Group).

Long Acre Life has recently been established to deliver buy-in and buyout solutions to companies with liabilities in excess of £500m. They expect to receive authorisation from the FSA in early 2012.

There is an expectation that other insurers will enter the market in 2012, as buyout opportunities expand.

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 big deals

2011 was a record year for buyout and longevity business, with two large buyout and three longevity swap transactions being written in Q4 alone. These were as follows:

- Legal & General completed a £1.1bn buy-in of the T&N Retirement Benefit Scheme. This is the largest deal to date for a scheme which had exited the PPF Assessment period, and guarantees at least PPF level benefits for all 30,000 members.
- Rothesay Life completed a similar style deal for the Uniq plc Pension Scheme. In this instance all 20,000 members were provided with benefits at least equal to PPF compensation levels.
- Rothesay Life also completed a £1.3bn longevity swap for BA, increasing the longevity insurance for the Scheme to 40% of the total liabilities.
- Deutsche Bank completed a £3bn longevity swap covering 37,000 pensioners of the Rolls-Royce Scheme.
- Legal & General completed their first pure longevity swap deal insuring £1bn of liabilities for the Pilkington Group Superannuation Scheme. Legal & General have reinsured this arrangement with Hannover Re.

Total buyout and longevity swap business written during Q4 was over £8bn, approximately two thirds of the business written for the year. These are exceptional figures, particularly while the economic outlook for the UK remains unclear.

The main characteristics of the buyout deals struck in 2011 were as follows:

- They continued to be in the main in respect of pensioner rather than deferred members, although many transactions at the smaller end did include deferred members.
- All the larger transactions had bespoke elements to fit the requirement of the particular scheme; without these it is unlikely the transactions would have proceeded.
- All insurers did write 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 £10bn with a number of potential deals being carried over into 2012.

The largest bulk annuity deals struck during 2011 are illustrated in the table below.

Scheme	Date	Value	Insurer
T&N	Oct-11	£1,100m	Legal & General
Uniq plc	Dec-11	£830m	Rothesay Life
Home Retail Group	Q2 2011	£280m	Prudential
Law Society	Jun-11	£240m	MetLife
LSE	May-11	£203m	PIC
ITB	Q2 2011	£170m	PIC
TI	Q 3 2011	£150m	Rothesay Life
Unnamed Deal	Mar-11	£120m	Legal & General

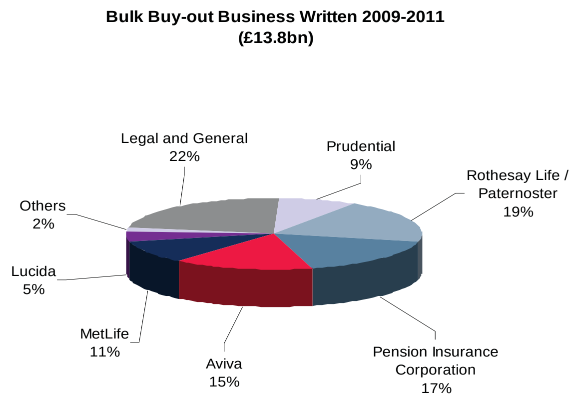
Smaller deals

By number, the vast majority of deals struck during the year can be classed as smaller deals (£30m or less). Generally these are "plain vanilla" buyouts or buy-ins, so that the transactions are much more straightforward to complete compared with the larger deals.

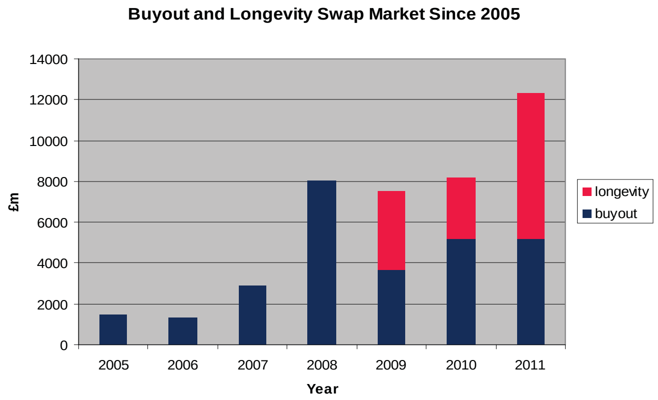
At the current time Legal & General will normally quote for any size scheme, with MetLife quoting for schemes greater than £2m. Aviva have no set minimum, whereas PIC will generally quote for schemes above £10-15m.

Market Stats

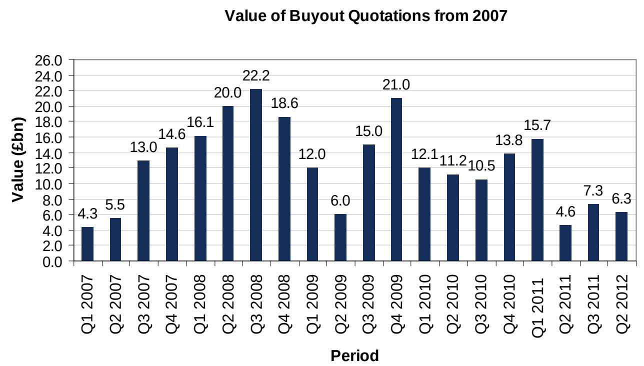
A breakdown of the various insurers' buyout market share since 2009 is illustrated in the graph below.



A comparison of longevity swap and buyout business transacted since 2005 is illustrated in the graph below.



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 2011 was similar to that written in 2010 and, while very good, still fell short of the record 2008 levels. If we also consider longevity swap deals, however, 2011 was a record year. After a slow start, the final figures were better than some commentators may have expected, illustrating that in these uncertain economic times opportunities are still available. 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.

Insurer pipelines remain healthy and our discussions with the insurers evidences continuing optimism for 2012.

In our opinion:

Buyouts will remain desirable due to:

- A strong desire from some sponsors to remove pension schemes from their balance sheet, backed up by their willingness to pay a top-up premium in order to achieve this.
- The opportunity, while yields remain at record lows, to switch Gilt holdings to a buyout policy at a low / no cost.
- Stronger funding requirements, which should result in the buyout funding gap reducing with time.
- The availability of flexible, bespoke solutions enabling schemes to effect a transaction over an extended period if a full buyout cannot be afforded from outset.
- Realistic, and therefore attractive, mortality pricing within bulk annuity quotations.
- Increasing running and advisory costs, resulting in a greater appreciation that insurers are best placed to run annuity portfolios.

Buyouts will be less desirable due to:

- Uncertain economic conditions, with cash constraints leaving companies unable to finance a bulk annuity policy even when one may be desirable for both sponsors and trustees.
- Increased prices in money terms because of low bond yields for schemes that are mismatched on the asset side. This could lead to a buyout being unaffordable for many schemes - especially for deferred liabilities.
- Market conditions remaining relatively volatile so that trustees find it harder to select the right timing for implementing a transaction. Inefficient decision making can lead to deals being abandoned with an element of regret later on.

We further expect that:

- Smaller schemes will continue to transact, mainly on plain vanilla terms.
- Larger schemes will increasingly engage with a small number of providers, looking for bespoke solutions rather than taking a full market approach.
- Longevity deals will remain large in size but small in volumes, due to their complexity, although we may see smaller deals as the market develops during the year.

Once again, unless there is a significant worsening in the economy as a whole, or some unprecedented shocks, our expectation for 2012 is that with an attractive buyout market, activity will continue to grow, with a busy year ahead for trustees, insurers and advisers alike.

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