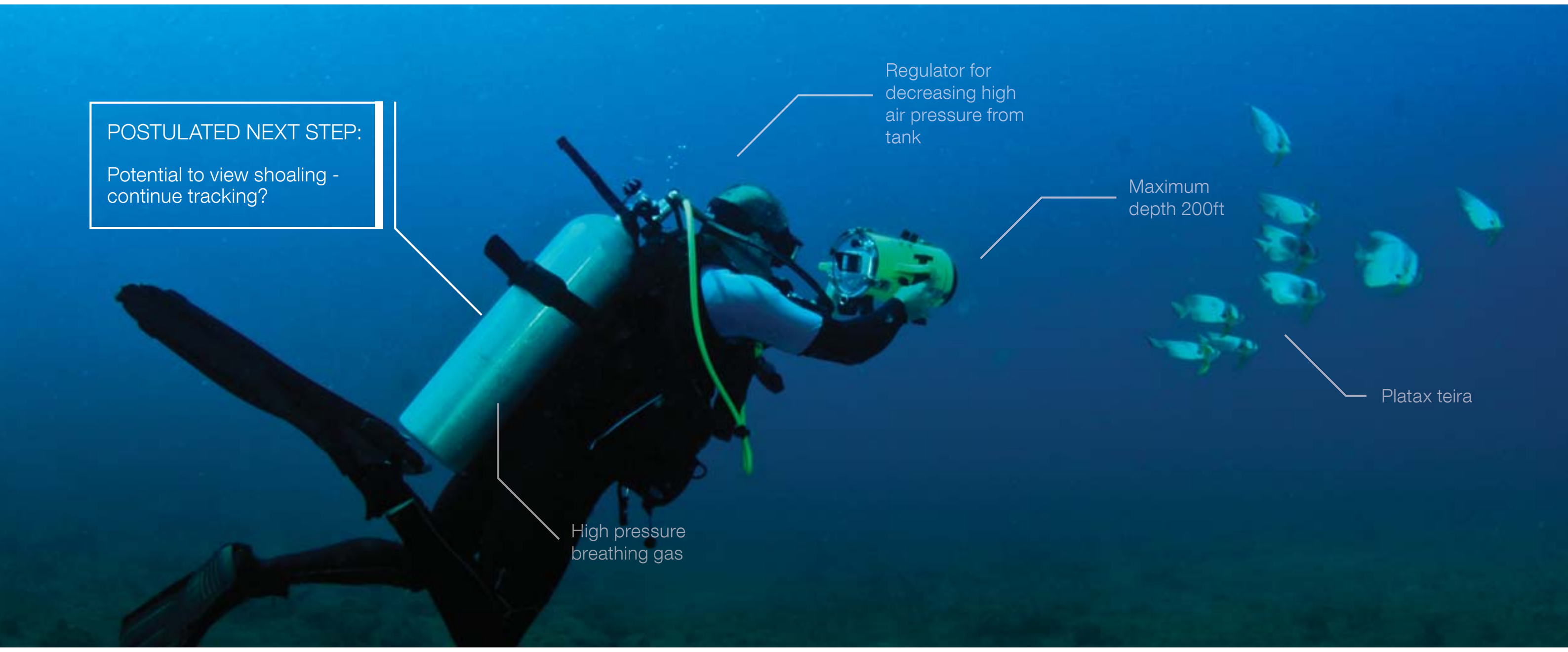
Buyout Market Watch

An Update Report From JLT Pension Capital Strategies as at 31 March 2012

Strategies to Solutions

JLT PENSION CAPITAL STRATEGIES

Buyout Market Watch



The PCS Buyout Market Watch Update – March 2012

Executive Summary

After a record breaking 2011, with an exceptional number of deals being completed particularly during Q4, it is not surprising that business levels during the first quarter of 2012 were relatively low, with only around £500m being transacted over the period. The insurers' outlook for the year remains optimistic and two deals in excess of £150m have already been announced during Q2.

News from the market

- Evidence suggests that some insurers tightened their prices early in the new year; subsequent to this, prices have remained stable during the early months of 2012, despite the continued economic uncertainty caused by the Eurozone debt crisis. In monetary terms, bulk annuity prices remain higher than 12 months ago, predominantly due to the continuation of low bond yields, however they compare favourably against most scheme's assessments of their Technical Provisions.

- Pensioner buy-ins remain the most desirable contracts. This is due to affordability, as pensioners are "cheaper" than deferred members, and strained funding levels, as a buy-in can be completed with less need for immediate additional funding than a buyout.

- The decision to invest in a pensioner buy-in is an investment decision, and bulk annuities are increasingly seen as a separate asset class. Most trustees are as a consequence looking to secure liabilities in tranches, when terms are deemed appropriate, and this is reflected in the number of "tranched" deals reported by the various insurers.

- Low Gilt yields have led to schemes with the right investment profile being able to exchange their Gilt holdings for a pensioner buy-in contract with little or no additional cost. Trustees of pension schemes with Gilt holdings should consider exchanging these for a pensioner buy-in contract while terms are beneficial.

- PIC announced the completion of the first ever buyout to include active members (the deal involved two schemes sponsored by Denso). The transaction requires the sponsoring employer pay an annual premium to PIC in respect of each year's accrual of benefits, to be calculated on a pre agreed formula linked to the number of active members over the year and their pensionable salaries. As all non active liabilities have also been passed to PIC using an "all risks" structure, the risk connected with running the scheme has been removed from the sponsoring employers' balance sheet with no loss to the active members in terms of their future benefit accrual.

- The ultimate cost implications of Solvency II continue to be unclear as Solvency II has been delayed until 2014. However most insurers remain comfortable with their pricing. The European Insurance and Occupational Pensions Authority (EIOPA) has proposed the extension of the Solvency II regime to occupational pensions, which, if and when implemented, would result in higher funding requirements and, by comparison, cheaper bulk annuity premiums.

- CPI benefits are still not being priced efficiently and consistently by insurers, predominantly due to the lack of issue of CPI-linked debt from the government. As such many buy-ins are being secured on a RPI basis, with flexibility to change to CPI when the time is right.

- Insurers are increasingly willing to be flexible around the structure of bulk annuity contracts, so that trustees are able to secure cover for those risks which are assessed to be better value for money. An example would be to retain the risk attaching to the 0% floor underpinning LPI increases in payment within the scheme, which could result in a significantly lower bulk annuity price.

Longevity Hedging

- There were no new longevity only deals announced during Q1 2012. This is not unexpected given the extended lead times for these contracts and given that three large deals were completed during Q4 2011. A longevity swap deal between Akzo Nobel and Swiss Re, worth £1.4bn, was completed in May 2012.

- Legal & General have confirmed they will be offering bespoke longevity swaps for schemes with pensioner liabilities between £50-250m, opening up the market to smaller scheme (to date bespoke transactions have been restricted to larger schemes due to contracts' complexity and associated costs.) Other insurers may follow suit if the contract proves popular.

- Three longevity only providers (UBS, Nomura and Credit Suisse) have pulled out of the market, citing overly onerous capital and regulatory requirements. However there is still significant competition in the market, with a number of new re-insurers poised to offer quotations for both vanilla and more innovative structures, including longevity only contracts.

Our view of the market for 2012

- It remains to be seen what effect the persistent crisis in the Eurozone sovereign market will have on the bulk annuity market. The market has been buoyant during testing conditions, with record volumes being completed last year, particularly during Q4. In recent months Gilt yields have remained volatile, and whilst lower yields normally result in higher premiums it is important to note that for schemes with significant Gilt holdings affordability may actually have increased over the period. Some insurers have also seen a bigger impact than others, depending on their pricing basis. We expect well matched schemes to continue to strongly consider opportunities to de-risk via the purchase of a bulk annuity.

- Our expectation is that a number of deals, predominantly pensioner buy-ins, will complete during 2012. As insurers continue to offer flexibility in their terms, interest in de-risking solutions will remain high and more schemes of all sizes will approach the market during 2012.

- Market volatility means that it is extremely important for schemes to prepare in advance if they are serious about transacting. Even if current market conditions may be seen as prohibitive, advance preparation will enable a scheme to transact swiftly once conditions allow. Preparation includes testing the market, assessing any changes required in a scheme's investment strategy, determining suitable triggers and having the right Governance in place. Triennial valuations would be an opportune time to consider strategies which include market based solutions.

- Advance preparation is 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.

PCS Affordability Index

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

Regulations

The European Insurance and Occupational Pensions Authority has published advice to the European Commission on proposals to extend a Solvency II type regime to occupational pension schemes. While no change is imminent, it is likely that a solvency level requirement of some kind will be introduced at some point. Depending on how tough the requirements turn out to be, this could well be the final death knell for DB provisions in the UK. Demand for bulk annuities would then proportionally increase as bulk annuity prices would look much cheaper by comparison.

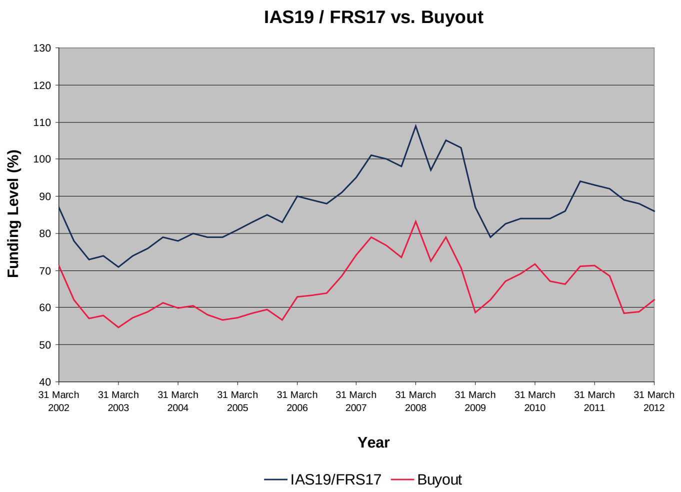
There is an expectation that amendments to IAS19 regulations will be agreed over the next few months. These amendments will mean that schemes with a riskier investment profile will not be able to justify a higher discount rate. This will make bulk annuity prices more attractive by comparison.

The FSA has tightened the rules for IFAs providing advice on transfers from DB schemes to personal pension arrangements, which could result in fewer enhanced transfer value exercises going forward. This could impact deferred buyouts in two ways - on one hand bulk annuity prices are more attractive by comparison if transfer values increase as a result; on the other, it means that schemes can no longer gain by discharging some of their deferred liabilities at a price lower than buyout.

Financial health

We regularly track the funding position of all UK 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.

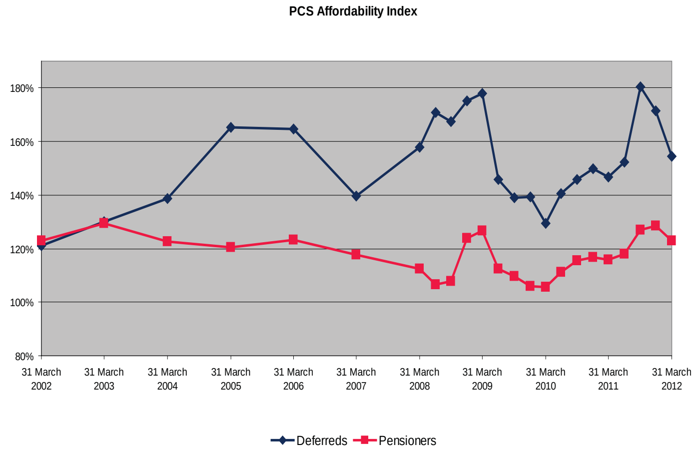
Our figures show a small drop in the buyout gap over the period, as accounting liabilities over the period have seen a small increase.



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 an increase in affordability for both pensioner and deferred members. This is consistent with the slight improvement in Gilt yields and small decrease in corporate bond yields experienced over the period.



Market Sentiment

Market sentiment towards bulk annuity deals continues to be favourable as it is increasingly acknowledged that pension liabilities calculated on the accounting basis are not a realistic estimate of a sponsor's exposure. Companies remain very keen to de-risk and continue to see a buyout as their longer term objective. This is confirmed by the fact that the majority of the larger deals completed over the recent past have been sponsor driven, rather than driven by the trustees of the scheme.

PCS Market Analysis

During the first quarter of 2012 just under £500m was transacted, consisting of a mixture of buyout and buy-in deals. The largest transaction was for £201m and was struck by PIC to insure two schemes sponsored by Denso.

The top 10 largest bulk annuity deals completed over the last 12 months 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	Q2-11	£280m	Prudential
West Mildands Transport	Q2-12*	£272m	Prudential
Law Society	Jun-11	£240m	MetLife
Unknown Deal	Dec-11	£227m	Aviva
LSE	May-11	£203m	PIC
Denso (2 schemes)	Mar-12	£201m	PIC
ITB	Q2-11	£170m	PIC
Gartmore	Q2-12*	£160m	PIC

*Recently announced in Q2

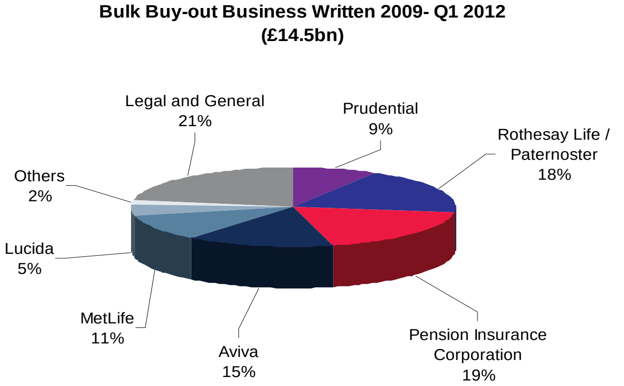
The major longevity swap deals completed to date are illustrated in the table below:

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
Akzo Nobel	Q2 -12*	£1.4bn	Swiss Re
BA	Q3 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 Scheme	Q1 2011	£0.07bn	J P Morgan

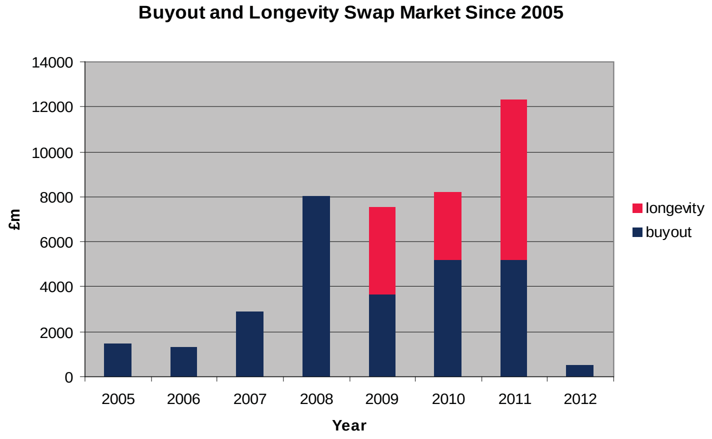
*Recently announced in Q2

Market Stats

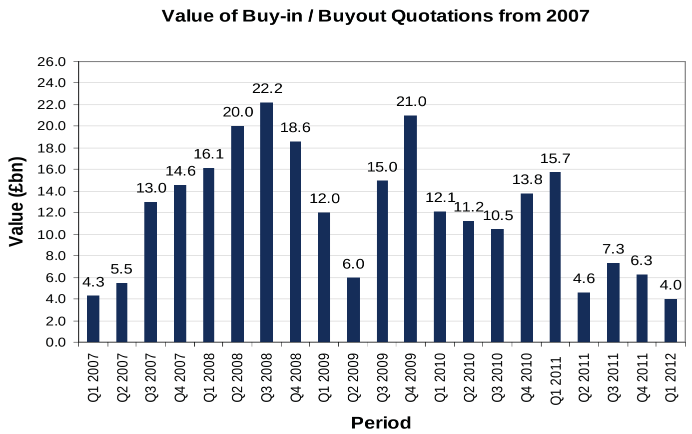
A breakdown of the various insurers' buyout market share since 2009 is illustrated in the graph below.



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



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 appetite for de-risking solutions remains strong both for sponsors and trustees, as uncertain economic and financial conditions result in pension schemes being seen ever more as an uncontrolled, unaffordable risk. As insurers continue to offer flexible contract structures and payment terms we expect a healthy number of transactions to be completed in 2012, particularly at the small and medium end of the market.

However, given the continued concerns over the debt crisis in the Eurozone, and the increased possibility of Greece breaking away, we expect conditions will remain difficult and cannot anticipate a softening of prices any time soon. This means that, for many schemes, a transaction may remain unaffordable, especially if additional cash is required from sponsors, who may be unwilling to release capital in the current economic climate.

Schemes should look to get themselves "transaction ready", to ensure they can take advantage of opportunities that may arise in the short term. This includes establishing the specific buyout terms available, considering possible investment strategies to fill the gap or reduce volatility, and setting formal trigger points for a transaction. Undertaking a liability management activity, such as a Pension Increase Exchange or an Enhanced Transfer Value exercise, in advance of approaching the market, can also help schemes obtain more convenient and affordable terms.

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