

Buyout Market Watch

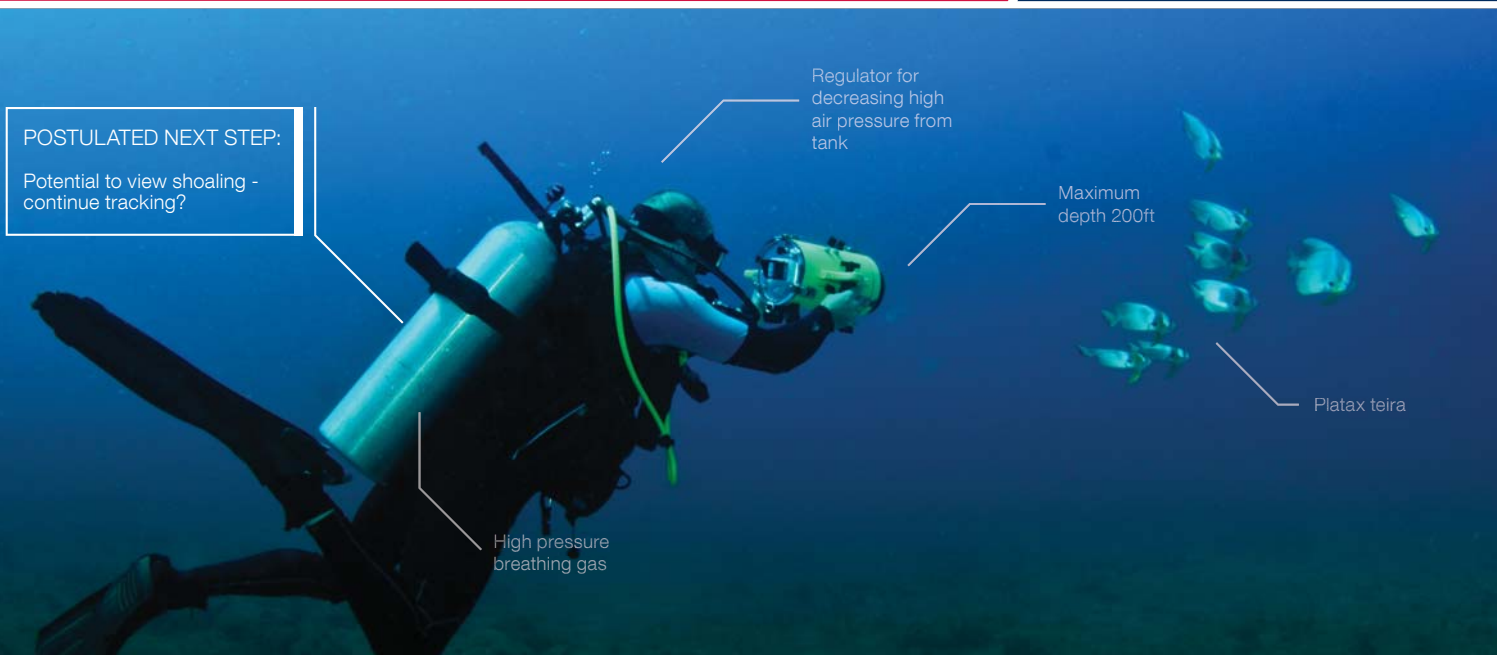
An Update Report From JLT Pension Capital Strategies
as at 30 September 2011

Strategies to Solutions



JLT PENSION CAPITAL STRATEGIES

Buyout Market Watch



The PCS Buyout Market Watch Update – November 2011

Executive Summary

After a very busy Q2, activity levels remained high in Q3, with approximately £2.1bn worth of deals written over the quarter (ITV's longevity swap of £1.7bn plus £390m worth of bulk annuities). Pricing bases have remained stable in an environment of falling gilt yields, so that expectations for Q4 remain high. A further £1bn plus deal was already secured by Legal & General in October.

News from the market

- Despite economic uncertainty due to the Eurozone debt crisis our evidence suggests that prices have been quite resilient throughout Q3, and have remained so during the early part of Q4. Although in pure monetary terms prices have increased, this is due to market movements rather than changes in insurer pricing bases.
- Pensioner buy-ins remain the most popular contracts. This is due to affordability, as pensioners remain "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 ultimate cost implications of Solvency II remain uncertain, although there is a growing belief that these may be no more onerous than insurers are currently allowing for.
- Legal & General have announced 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. The deal guarantees at least PPF level benefits for all 30,000 members of the Scheme. In the last 15 months PIC have also taken on two Schemes from PPF assessment and this is an area of the market which could see significant growth over the next few years.
- Insurers are offering flexible contract and payment structures to differentiate themselves from their competitors. It is increasingly the case that the selected insurer for a transaction is identified based on a mixture of price and structure offered.
- Legal & General have launched a new product called LIDBA (Large Individual Defined Benefit Annuity). The contract is a partial buy-in intended to cover the benefits of the of the scheme members with the higher liabilities. The lives to be covered would be underwritten in order to take advantage of any savings from health conditions. This structure would best fit schemes where a small number of individuals hold a significant proportion of the liabilities, as underestimating longevity for this group lives may prove to be disastrous for an uninsured scheme.
- CNP Europe Life Ltd have entered the UK bulk annuity market. CNP Europe are an Irish insurer fully owned by a French parent (the CNP Group) and have already written a deal worth Euro 450m.

Longevity Hedging

- During August Credit Suisse announced a £1.7bn longevity swap transaction with ITV for 12,000 of its members. This is the first bespoke longevity deal announced during 2011.
- We understand that negotiations continue on several large schemes. The expectation is for a relatively small number of large schemes to transact during each year as longevity swaps remain limited to larger schemes (typically with liabilities in excess of £250m), due to their complexity and completion time.

Our view of the market for the remainder of 2011 and early 2012

- The effect that the persistent crisis in the Eurozone sovereign market will have on the bulk annuity market remains to be seen. In recent months, gilt yields have been very volatile. While lower yields generally result in higher premiums (although some insurers will see a bigger impact than others, depending on their pricing basis), it is important to note that for schemes with significant gilt holdings affordability may actually have increased over the period. As such we expect schemes holding a proportion of gilts may consider this opportunity to de-risk.
- Some insurers offer more aggressive pricing during Q4, which may also lead to an increase in business levels. Conversely this could lead to a change in basis and hardening of prices (for those insurers) in the early part of 2012.
- Our expectation is that a number of deals, predominantly pensioner buy-ins will complete during the last quarter, and as the interest in de-risking solutions remains high more schemes will consider buyout solutions during 2012.
- The current volatility in market conditions continues to make it extremely important for schemes to prepare in advance. Even if current market conditions may be seen as prohibitive, advance preparation will enable a scheme to transact once conditions allow. Preparation includes obtaining initial quotations, assessing any changes required in a scheme's investment strategy, determining triggers and monitoring external market conditions.
- Advance preparation is also 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

It is now looking likely that the implementation of Solvency II will be delayed until 2014 (Solvency II is the EU backed Directive reviewing the capital adequacy regime for the European insurance industry). Bulk annuity insurers are involved in a consultation process over the methodology for calculating the discount rate for long term guaranteed contracts (such as bulk annuity policies). If successful, the current proposal will reduce the requirement for additional reserves, so that no extra loading will need to be made to buyout premiums.

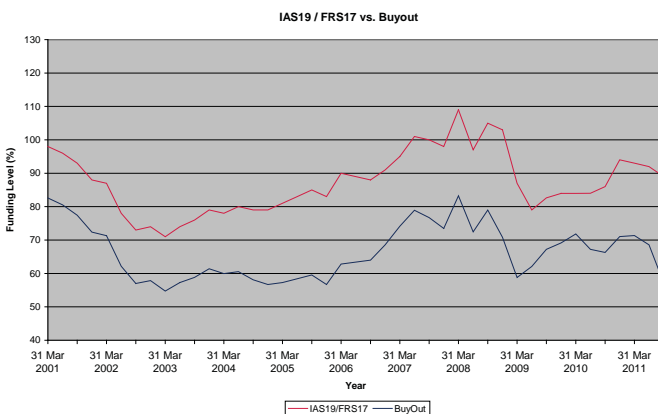
The European Insurance and Occupational Pensions Authority (EIOPA) has also proposed the extension of the Solvency II regime to occupational pensions. It remains to be seen whether this principle will be accepted, and to what extent, however any change in regulations would result in an increased appetite for de-risking, and may result in supply side pressures later on.

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.

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.

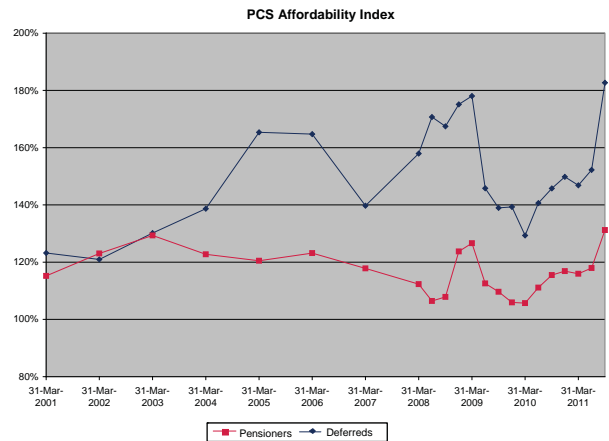
It should be noted that, whilst prices currently look poor when compared to the accounting costs, they probably look better than they have done in the past when compared to gilts (and we have evidence of prices coming in at "gilts plus something" for a number of schemes). This may therefore be a good time for schemes with significant gilt holdings to approach the market with a view to securing a bulk annuity policy.



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 a substantial fall in affordability over the quarter if measured against a scheme's accounting basis. This is mostly due to the impact of falling gilt yields, at a time when corporate bond yields have remained stable. It is important to note that prices for different insurers have increased at different rates, depending on their pricing portfolio (with prices for some insurers increasing very little, if at all).



Market Sentiment

Our regular "round table" conversations with a number Financial Directors confirm that the various stakeholders are fully aware of the accounting risk not being a realistic measure of the economic risk attaching to running a defined benefit pension scheme. The key obstacle with implementing a bulk annuity purchase, or any other de-risking activity, is the price associated with it, or more specifically, the need for liquidity, which may not always be available. For this reason we advise schemes to engage with their advisors and the market as early as possible, so that opportunities which may arise are not lost because of insufficient preparation.

PCS Market Analysis

During the third quarter approximately £390m in buyout and buy-in deals was transacted, with only one transaction of significant size, a £150m deal written by Rothesay.

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

Scheme	Date	Value	Insurer
BA	Q3 2010	£1,300m	Rothesay Life
T&N*	Oct-11	£1,100m	Legal & General
GlaxoSmithKline	Nov-10	£900m	Prudential
Alliance UniChem	Q3 2010	£310m	PIC
Home Retail Group	Q2 2011	£280m	Prudential
Law Society	Jun-11	£240m	MetLife
LSE	May-11	£203m	PIC
Unknown PIC Deal	Q2 2011	£170m	PIC
Unknown Rothesay Life Deal	Q3 2011	150m	Rothesay Life
Next	Aug-10	£124m	Unknown

*Announced in Q4

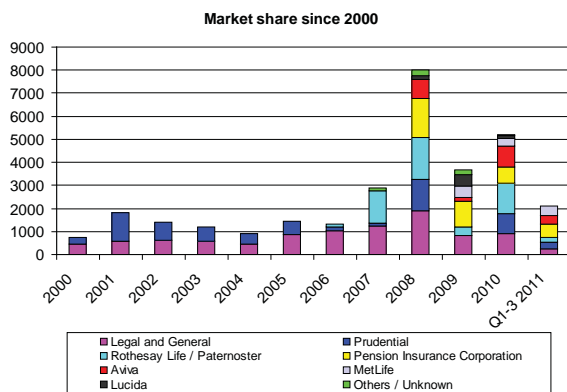
The only longevity swap deal completed during Q2, was the £1.7bn longevity swap with Credit Suisse.

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

Scheme	Date	Value	Counterparty
BMW	Feb-10	£3bn	Abbey Life
RSA	Jul-09	£1.9bn	Rothesay Life
ITV	Aug-11	£1.7bn	Credit Suisse
Babcock International	May-09	£1.2bn	Credit Suisse
Royal County of Berkshire	Dec-09	£0.75bn	Swiss Re

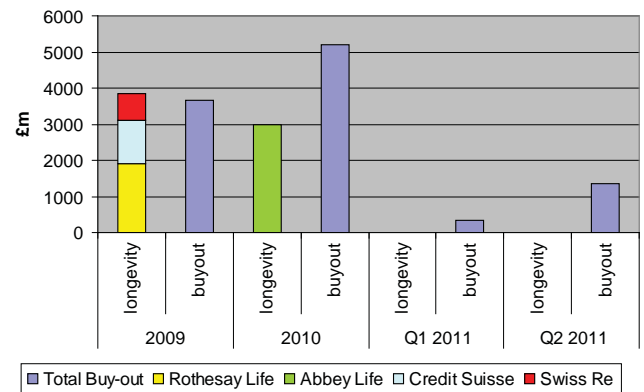
Market Stats

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



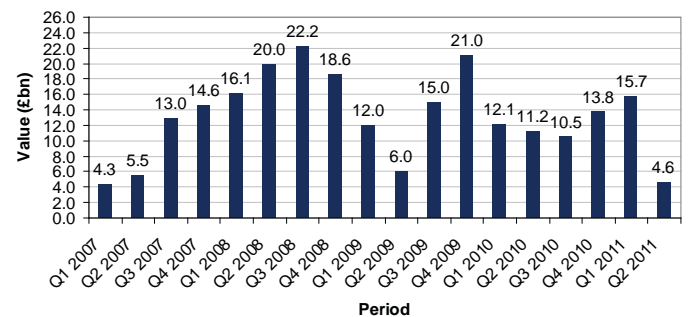
A breakdown of the various insurers' longevity swap market share since 2009 (up to end of Q3 2011) is illustrated in the following graph. The graph also provides a comparison between buy-out and longevity swap business written since 2009.

Longevity Swap Market Share since 2009 (compared with Buyout)



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.

Value of Buyout Quotations from 2007



The graph shows a significant increase in quotation volumes from the previous quarter. We are aware of at least £1bn plus case approaching the market over the last few weeks.

Commentary

The emerging picture for the buyout market is mixed - the appetite for de-risking remains strong and the continued flexibility offered by insurers both in terms of contract structures and payment facilities should ensure a steady number of transactions even in adverse financial conditions. However, continuing concerns about the Eurozone and historically low gilt yields may in practice make transactions unaffordable for all but the best funded (or best matched) of pension schemes.

The above compounds an environment of low UK growth in the short to medium term or possibly even a double dip recession. In the circumstances, schemes should aim to make themselves "transaction ready" if they wish to take advantage of any opportunities which may arise. This would mean:

- implement a full data cleanse;
- carry out any other de-risking activity which may be seen as desirable (such as an ETV or PIE);
- switch their assets to a more matched position;
- agree a formal trigger taking into account the scheme's funding level and the sponsor support which may be available;
- engage with the market, on a formal or informal basis;
- set up a monitoring system and governance structure so that a deal can be pursued quickly once the time is right.

JLT Pension Capital Strategies

6 Crutched Friars
 London EC3N 2PH
 Tel 020 7528 4892
 Fax 020 7309 8330
 Email solutions@pensionstrategies.co.uk
 Web www.jltpcs.com

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