Buyout Market Watch

An Update Report from JLT Pension Capital Strategies as at 30 September 2012

Strategies to Solutions

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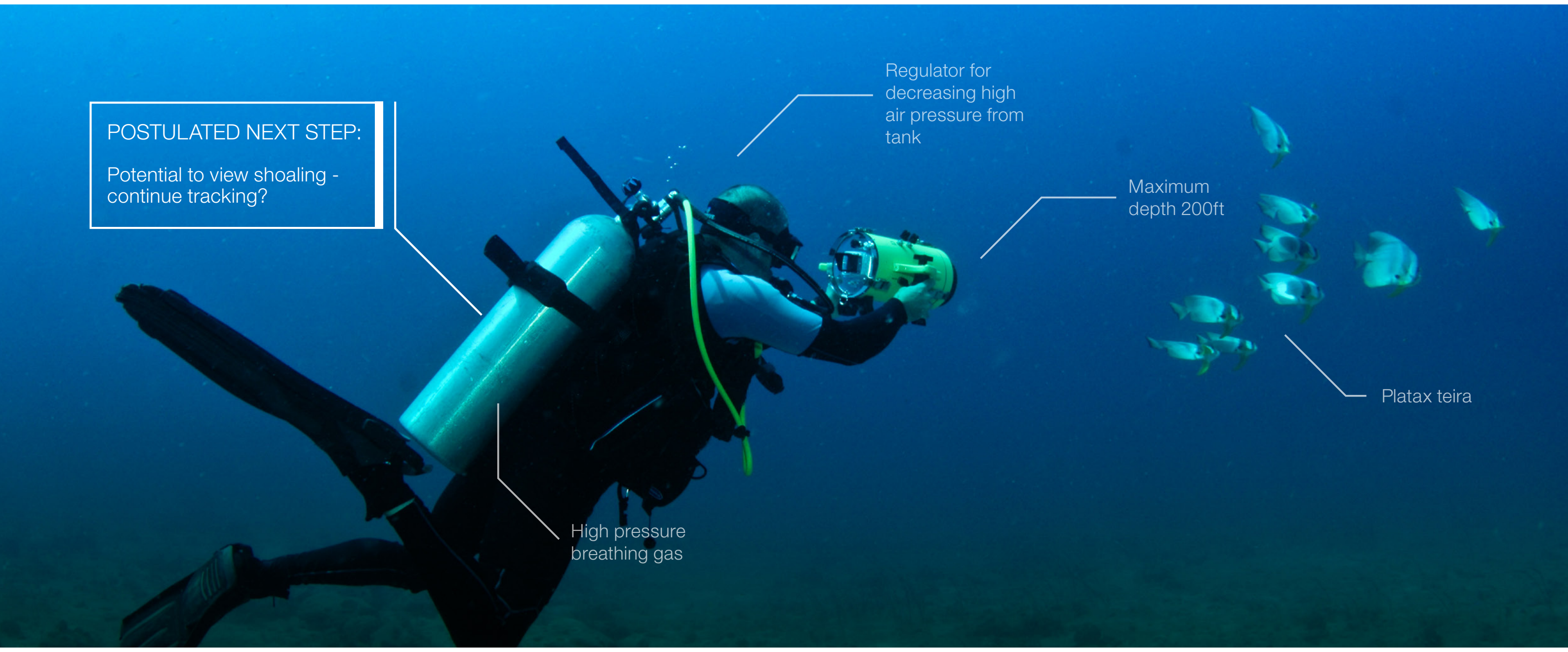
JLT PENSION CAPITAL STRATEGIES

Buyout Market Watch



The PCS Buyout Market Watch Update – September 2012

Executive Summary

After a slow start to the year, business levels picked up during the second and third quarters of 2012. Insurers continue to report healthy quotation pipelines, and with significant insurer appetite to write business, the mood remains optimistic for a successful last quarter.

News from the market

- Despite the continued economic uncertainty caused by the Eurozone debt crisis, pricing bases have remained relatively stable throughout 2012. In monetary terms, bulk annuity prices are higher than 12 months ago, mainly due to falling bond yields.

- For the majority of schemes, buyout is the ultimate aim, but with affordability an issue, predominantly due to the cost of the longer duration deferred members, pensioner buy-ins have been more common. Pensioner buy-ins, which are increasingly being seen as a mainstream asset category, often require no additional funding upfront; in fact, due to the low bond yields environment, prices compare favourably against most scheme's assessments of their Technical Provisions.

- Buy-ins can be arranged to allow for future changes in the structure of the benefits, enabling Trustees to choose what risks they want to insure at any given time. An example would be to omit the deflationary floor protection whilst the cost of insuring this risk is relatively high, with the Trustees retaining this deflationary risk until such a time as it is deemed more affordable. The result is a significantly lower cost for the buy-in (up to c8% reduction for each tranche for which the deflationary floor protection applies).This potentially means it is possible to secure a buy-in for a premium below Technical Provisions if the scheme retains the deflationary floor risk.

- This flexibility around contract structure could also enable Trustees to secure terms now based on RPI increases, with the option for a later switch from RPI to CPI increases when a liquid CPI hedging market develops (with an associated release of value from the policy).

- With gilt yields remaining near record lows, schemes with the right investment profile are potentially able to exchange their gilt holdings for a pensioner buy-in contract with little or no additional cost. Trustees of pension schemes with material gilt holdings should strongly consider exchanging these for a pensioner buy-in contract while terms are beneficial.

- PIC have been successful in raising further capital to support writing new business, following a £100m capital injection made by Reinet (with the possibility of a further £300m to follow later on). PIC have again been very successful in 2012, in no small part due to the innovative contract structures they are able to offer (such as the Denso deal, which included cover for members with continuing accrual, and a deal with the Graham & Brown Retirement Benefits Scheme, which was struck on the basis of a partially deferred premium and the deflation risk being retained within the Scheme).

- Aviva, who announced the results of a strategic review of their whole business earlier in the year, will focus their resources on smaller buy-outs or buy-ins, typically under £50m in size, rather than the bespoke larger cases. Although Aviva are not actively seeking new business for the remainder of 2012, they are keen to write business from January 2013, and as such they are currently able to provide quotations for terms available in the new year.

- Insurers continue to focus on business that is conducted through well run, efficient and streamlined processes, as this leads to a greater likelihood of transactions being completed. Trustees who follow such processes are also more likely to get greater traction in the market, particularly for schemes looking to secure up to £10m of pensioner liabilities.

- The ultimate cost implications of Solvency II continue to be unclear as Solvency II has been delayed until 2014. Most insurers remain, however, comfortable with their pricing for the time being. 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 target funding levels and, by comparison, more affordable bulk annuity premiums.

Longevity Hedging

- There has only been one new longevity only deal announced during 2012, the £1.4bn Akzo Nobel swap with Swiss Re. The lack of transactions so far during 2012 is not unexpected, given the extended lead-in times for these contracts and given that three large deals were completed during Q4 2011. Interest remains high, and it is possible that one or two deals will be completed in the latter part of the year.

- Although the market has now been opened up to the smaller schemes, with Legal & General offering longevity swaps for schemes with pensioner liabilities between £50m and £250m, in the short term we would expect the market to be predominantly made up of the larger bespoke transactions whilst the market at the smaller end gets established. As smaller schemes are normally more easily able to complete a buy-in or a buyout (the "gold standard" of de-risking) we only expect a limited number of smaller longevity deals in any case.

Our view of the market for 2012

- Based on business written during the first three quarters of the year, our expectation is that business levels during 2012 will be lower than previous years. It should be noted that the market has remained relatively buoyant during extremely testing conditions in the financial markets. Whilst the low yields we are experiencing have led to higher absolute prices compared to 12 months ago, schemes with significant gilt holdings will have seen significant growth in assets, so that affordability may actually have increased over the period. We expect well matched schemes to continue to consider opportunities to de-risk via the purchase of a bulk annuity.

- The persistent crisis in the Eurozone sovereign market may lead to a further weakening of the economic conditions both in Europe and the UK (the threat of a disorderly break up of the Euro has certainly not gone away), in which case activity will slow. However, our view for 2012 is still quite bullish as the experience of the last 18 months shows that the buyout market can continue to thrive even in difficult economic circumstances.

- Market volatility means that it is extremely important for schemes to be in a position to transact in a timely manner. Running efficient processes, determining suitable triggers, and having the right governance in place, all assist in enabling transactions to proceed. If the timing is not quite right, the ability to monitor the buyout position is becoming increasingly important.

- Understanding the market is also key, as a larger number of innovative structures becoming available to schemes of all sizes as the market develops. Trustees and sponsors need to be aware of what is happening 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

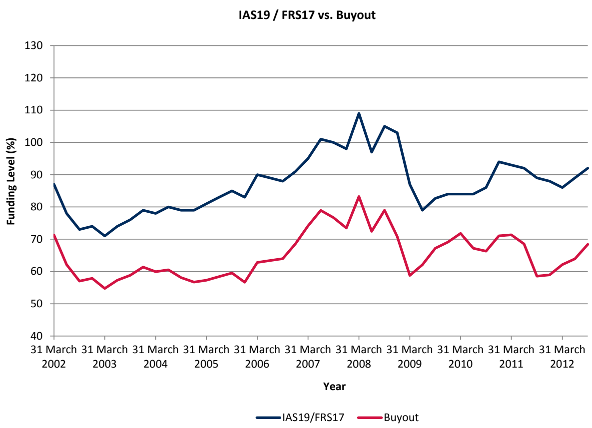
The Office for National Statistics has launched its promised consultation on the way the RPI is calculated, including options to reduce differences between RPI and CPI. RPI usually rises faster than CPI, with an average gap of 1.2 percentage points each year since CPI was first used in 1996. Any recommendations for change will be published in January 2013 and any change will be introduced with the annual update of RPI when it is published on 19 March 2013.

The European Commission (EC) has launched a Quantitative Impact Study (QIS) on its plans to revise the Institutions for Occupational Retirement Provision (IORP) (pension fund) directive. The QIS, which is expected to include Solvency II capital requirements for UK pension schemes, ends on 17 December and will provide results to the EC by spring 2013. Depending on how harsh 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 proportionally increase as bulk annuity prices would look much cheaper by comparison.

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.

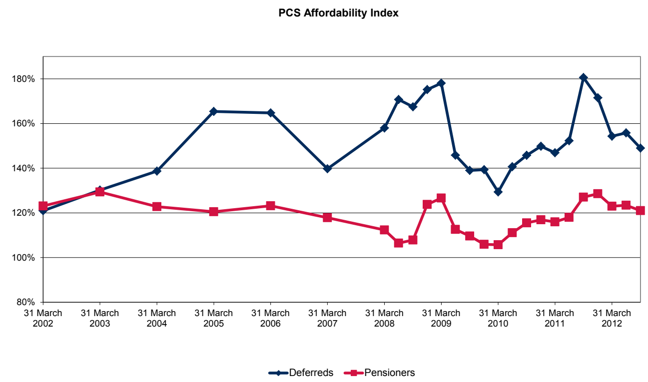
As the gap between corporate bond yields and Gilt yields was similar over the period, the relationship between accounting values and buyout premiums remained broadly stable.



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 mostly due to recent falls in bond yields.



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 third quarter of 2012 over £900m of buyout business was transacted, leading to total business written during the year of £2.5bn. The larger deals were predominantly pensioner buy-ins, with the largest struck the £320m Cookson deal with Pension Insurance Corporation.

In addition there was a £1.4bn longevity swap completed in the second quarter of 2012, taking total buyout and longevity business to a little under £4bn for 2012 so far.

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

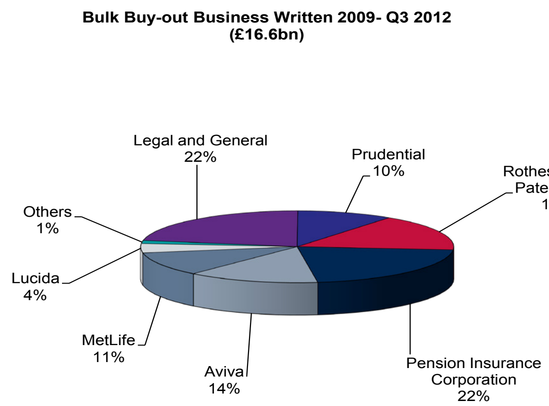
Scheme	Date	Value	Insurer
T&N	Oct-11	£1,100m	Legal & General
Uniq plc	Dec-11	£830m	Rothesay Life
Cookson	Jul-12	£320m	PIC
West Mildands Transport	Q2-12	£272m	Prudential
Undisclosed	Q3-12	£250m	Legal & General
Undisclosed	Dec-11	£227m	Aviva
Denso (2 schemes)	Mar-12	£201m	PIC
Undisclosed	Apr-12	£198m	PIC
Gartmore	Mar-12	£162m	PIC
Undisclosed	Q3-12	£140m	Prudential

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

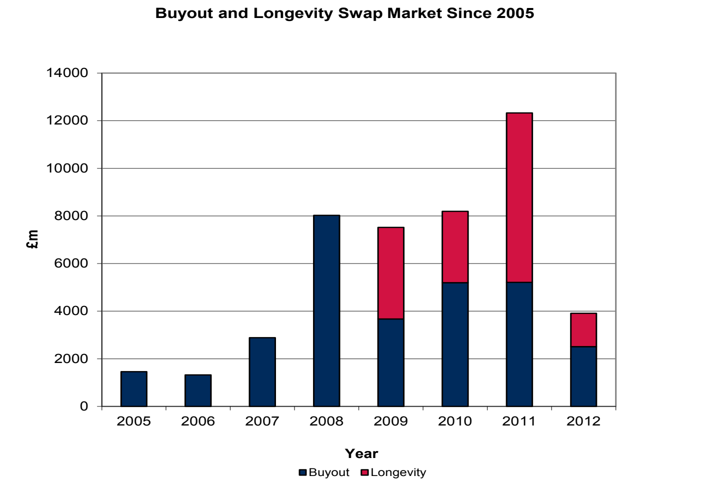
Scheme	Date	Value	Counterparty
Rolls Royce	Nov-11	£3bn	Deutsche Bank
BMW	Feb-10	£3bn	Abbey Life
RSA	Jul-09	£1.9bn	Rothesay Life
ITV	Aug-11	£1.7bn	Credit Suisse
Akzo Nobel	May-12	£1.4bn	Swiss Re
BA	Q3 2011	£1.3bn	Rothesay Life
Babcock International	May-09	£1.2bn	Credit Suisse
Pilkington Superannuation	Dec-11	£1bn	Legal & General
Royal County of Berkshire	Dec-09	£0.75bn	Swiss Re
Pall Scheme	Q1 2011	£0.07bn	J P Morgan

Market Stats

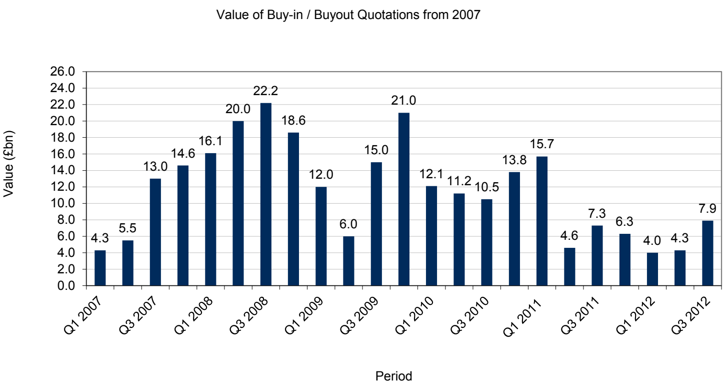
A breakdown of the various insurers' buyout market share since 2009 is illustrated in the graph below.



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, 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, Early Retirement exercise or an Enhanced Transfer Value exercise, in advance of approaching the market, can also help schemes obtain more convenient and affordable terms.

JLT Pension Capital Strategies
6 Crutched Friars
London EC3N 2PH
Tel 020 7528 4892
Fax 020 7309 8330
Email solutions@jltpcs.com
Web www.jltpcs.com