

Buyout Market Watch

An Update Report From Pension Capital Strategies

October 2008



PENSION CAPITAL STRATEGIES

Innovative Alternatives

Executive Summary

Despite the recent turmoil in financial markets and some slowing down in buyout activity, 2008 is still expected to be a bumper year for pension buyouts. Indeed, transactions in the first half of 2008 exceeded the record business volumes seen for the whole of 2007.

Key recent developments

- Prudential shattered the previous record for insured buyouts when it completed the £1bn buy-in of the Cable & Wireless Superannuation Fund. This was the Pru's first significant deal in 18 months and represented its predicted re-emergence as a major force in the market.
- Competition is still intense in the market, which is keeping prices down, particularly for pensioner liabilities. The PCS Affordability Index suggests that prices may still be as attractive as they have been at any time in the last decade.
- Synesis Life became the first victim of our predicted consolidation of providers when it was taken over by Pension Corporation. Synesis had failed to write any new business during its 27 month life.
- Lehman Brothers entered the market and were believed to be one of the providers to pitch for the Delta Pension Scheme. Their participation was short-lived however due to their well publicised collapse.
- The head of Citigroup's pensions structured solutions group, Wiltrud Heiss, left her position at the bank in July.
- PensionsRisk Insurance, a specialist provider of related insurance solutions for Defined Benefit (DB) schemes has withdrawn from the market. Another corporate-transfer vehicle pulled out of the market in July, when Aleva Group de-registered itself from the Financial Services Authority's (FSA) list of regulated firms.
- The continued participation of AIG in the buyout market is cast in doubt, following the US government's £48bn bail-out. It is being reported that AIG are looking to sell parts of its UK operations.

Our view on the market for the remainder of 2008

- The total amount of bulk annuity business written by the year end will fall just short of the £10bn predicted earlier in the year;
- Prices will continue to be low. However with the widening spreads on AA bonds, meaning that IAS19 liabilities are falling, we expect the gap between IAS19 and buyout liabilities to be maintained.
- As predicted, we have already seen the first billion pound buyout deal (Cable & Wireless). There are several other multi-billion pound deals being negotiated and it is still possible that another billion pound deal will be completed before the year end.
- Recent problems in financial markets have led to some constraints on the supply of the capital required to secure of new buy-out business. This is becoming a significant constraint for providers and is likely to lead to a stagnant 4th quarter of 2008. The non-listed insurers, which largely rely on banks and private equity vehicles for their capital (e.g. Paternoster, Pension Corporation, Lucida) are likely to be impacted to a greater extent than the larger FTSE 100 insurers such as L&G, Prudential and Norwich Union.
- Early signs are emerging of the need for, and the willingness of insurers to facilitate syndicated deals for larger schemes. We are yet to see a multi-insurer transaction, but we feel that this will become an important feature of the market in 2009. It will be driven by two main factors - the Trustees' and/or Companies' need for diversification of insurer's default risk, and the insurers' need for significant amounts of capital.
- It is becoming increasingly difficult for schemes with less than £25m of liabilities to obtain a range of quotations and this has inevitably lead to uncompetitive rates for such schemes.
- There is growing interest in longevity hedging and there are now a number of providers offering such products. In particular, it is now possible to get bespoke longevity hedging for pension schemes below £100million.

PCS Affordability Index

The attraction of a buyout solution is crucially linked to four key factors.

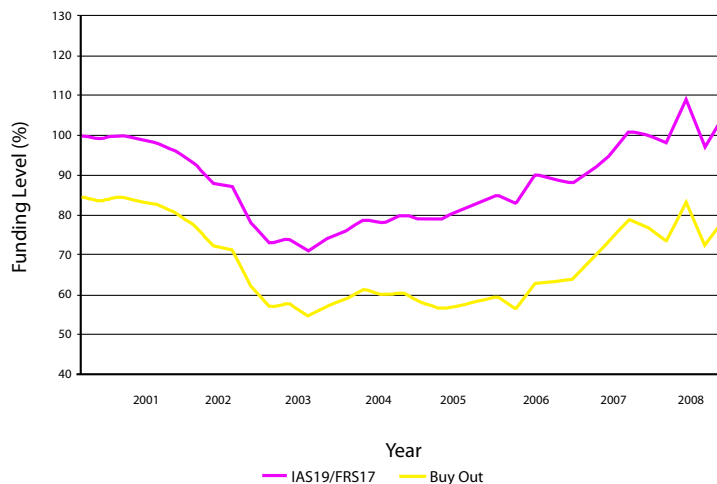
Regulations

The growing weight of regulatory change continues to increase the attractions of a buyout solution. However, the last few months have seen some slight easing of the pressure. Firstly, the Regulator has backed down from its stance on prescribing mortality assumptions. Also in the last couple of weeks, following consultation on the Pensions Bill earlier in the year, the DWP announced that the Regulator is not going to have its powers to issue Contribution Notices and Financial Support Directions increased as much as had been feared. The recently announced changes which relate to employer actions or failures which "have a materially detrimental effect" on the likelihood of members receiving their benefits, are unlikely now to have much impact on the large majority of pension schemes.

Financial health

PCS is tracking the funding position of a typical pension scheme, both on the accounting (FRS17 / IAS19) basis and on the buyout basis. This shows that (at least up to the end of September) both IAS19 and solvency funding levels have generally been improving. The last few weeks though will have badly affected many schemes. However, one slightly bizarre impact of the turmoil in financial markets is that under the IAS19 valuation rules (which are linked to AA corporate bonds) pension liabilities have appeared to be falling. This has offset much of the fall in asset values, but there is a risk that this could reverse if credit spreads on AA bonds return to more normal levels.

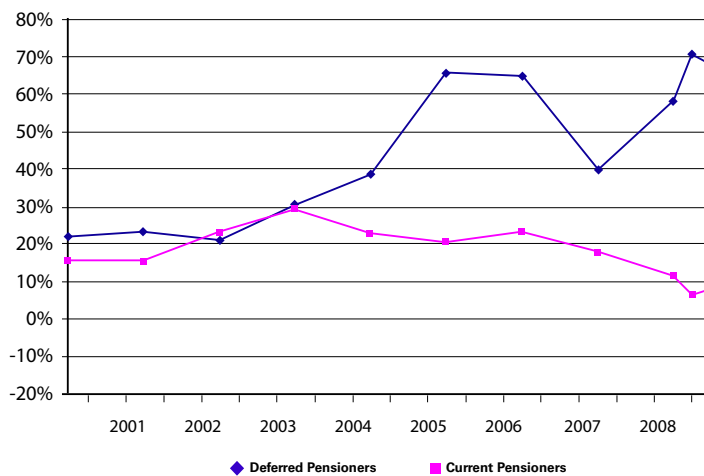
IAS19 / FRS17 vs Buyout



Affordability index

We also track prices in the buyout market against IAS19 values to create the PCS Affordability Index. Although we have seen some slight hardening of prices in Q3, it is clear that insurance companies are passing on a part of widening credit spreads to customers. This has meant that buyout values, particularly for pensioners, continue to look very attractive against historic levels.

PCS Affordability Index



Market sentiment

Markets continue to look favourably on buyout deals. PCS research shows that whilst buyout deals do usually result in a hit to the balance sheet, they rarely have much if any detrimental impact on the company's share price. Markets would therefore seem to accept that the buyout price is a fair price to pay to offload a risk which analysts find hard to quantify.

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The Big Deals

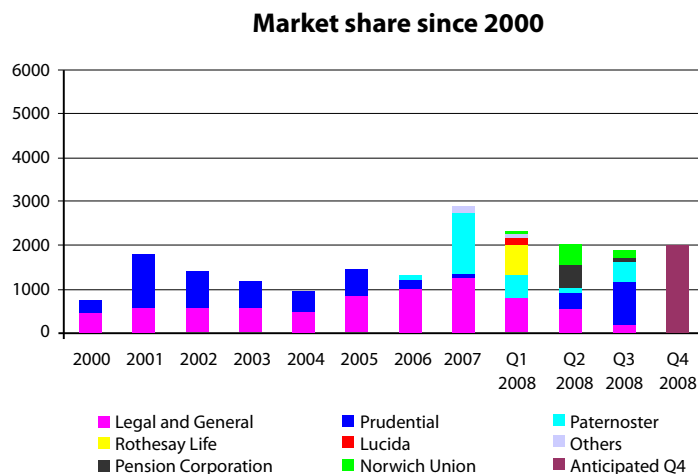
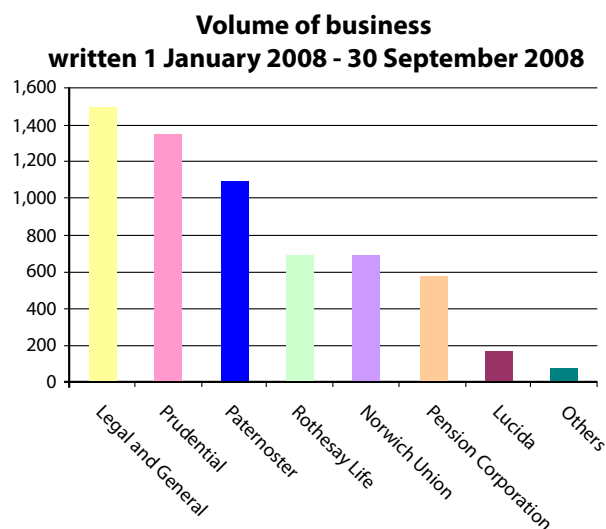
July and August were quiet months in terms of deal completions (but certainly not in quotation volumes) but business certainly picked up in September.

- Prudential shattered the previous record for insured buyouts when it completed the £1bn buy-in of the **Cable & Wireless Superannuation Fund**. The Pru will pay over £57m of annual annuities into the Cable & Wireless fund in respect of 5,000 pensioners. This was the Pru's first significant deal in 18 months.
- Following on from their £250m buy-in with Legal & General in March, **TI Group** purchased a further block of £250m of annuities with Paternoster in September.
- Paternoster also clinched the buy-out of the **Pensions Trust Growth Plan** pensioners in a £225m deal.

We have updated our table of the largest bulk annuity deals in the last 12 months which is now opposite.

Scheme	Date	Value	Successful Insurer
Cable and Wireless	Sep-08	£1bn	Prudential
P&O	Dec-07	£800m	Paternoster
Rank	Feb-08	£700m	Rothesay Life
Delta	June-08	£451m	Pension Corporation
Powell Duffryn	Mar-08	£400m	Paternoster
Friends Provident	May-08	£350m	Norwich Union
BBA Aviation	Mar-08	£270m	L&G
TI Group (2nd)	Sep-08	£250m	Paternoster
TI Group (1st)	Mar-08	£250m	L&G
Weir Group	Dec-07	£240m	L&G
Pensions Trust	Sep-08	£225m	Paternoster
M-Real	Mar-08	£180m	L&G
Electricity Association Services	Nov-07	£170m	L&G
Emap	Nov-07	£170m	Paternoster
Morgan Crucible	Mar-08	£160m	Lucida
Lasmo	Dec-07	£150m	Paternoster

These new deals mean that we can also update our analysis of the market as a whole. The graphs below show the breakdown of the business written by each provider during the first 3 quarters of 2008, and the share of the buyout market since 2000.



The value of deals completed to date totals just over £6bn. This is a long way short of the pre-credit crunch predictions for the year. We still expect more significant deals to be completed before the year end, but we now expect the total for 2008 to fall short of £10bn.

For further information on the services PCS can offer you, please email us at solutions@pensionstrategies.co.uk or visit our website at www.pensionstrategies.co.uk to register your interest. Alternatively call Charles Cowling on 0161 242 5388, Tiziana Perrella on 0161 242 5332 or Aled Edwards on 0117 968 9628.