

Buyout Market Watch

An Update Report From Pension Capital Strategies

February 2009



JARDINE LLOYD THOMPSON
Benefit Solutions



PENSION CAPITAL STRATEGIES
Innovative Alternatives

Executive Summary

Business levels in 2008 were very high, as expected, although the number of transactions reduced significantly towards the end of the year as the credit crunch continued to bite and the expectation of a recession became increasingly realistic.

Over the last 12 months, we have seen the following developments:

- It is believed that the deals struck over 2008 totalled in excess of £8bn. This was below the £10bn that had been anticipated at the beginning of the year, however it was well in excess of the level of business written in 2007.
- The first £1bn plus buyout deal was struck by Prudential when they agreed to insure the pensioner liabilities for the Cable & Wireless pension scheme. This confirmed that they remain a major player in the buyout market.
- MetLife secured their first major deal in respect of the liabilities of the Vivendi 2008 Pensioners' Scheme. This deal, which was worth in excess of £130m, was significantly larger than the previous buyouts secured with MetLife. Of particular relevance is the fact that the deal was based on MetLife's same-day transaction model, where a scheme prepares to buy out in the weeks prior to the transaction with the valuation of the scheme assets and the quotation price being agreed on the day of the transaction. This model requires significant advance work but enables trustees to enter into a contract minimising their exposure to volatile markets. The advice to the Trustees of the Vivendi Scheme was provided by Jardine Lloyd Thompson.
- Credit Suisse launched a longevity hedging product where fixed payments, payable from the scheme to the insurer, are swapped for "floating" payments reflecting the scheme's actual liabilities. This product enables smaller schemes to obtain bespoke mortality hedging, where previously this was only an opportunity for the very largest schemes. A similar product is also available from Paternoster.
- No other major players joined the market in 2008. Lehman Brothers were rumoured to have pitched for some business over the summer, however their presence in the market was short lived.
- The market saw some consolidation, with Pension Corporation taking over Synesis. In addition, Aleva withdrew from the market.
- As prices for pensioner liabilities remained competitive, pensioner-only deals became more popular.

Our view on the market for the 2009 is that:

- We expect insurers to have another busy year as more and more pension schemes explore the possibility of a buyout, even if just for a sub-category of members.
- Following a quiet start to the year, we expect that business will pick up and that a comparable level of business to 2008 will be written in 2009. We therefore expect overall deals for the year to total between £8bn and £10bn.
- In order to make an efficient use of their resources, we expect insurers to carry out a due diligence investigation on each case before agreeing to provide a quotation. Insurers will also tend to concentrate on the type of business for which they feel they are more competitive or which is more desirable to them.
- We expect prices to increase to a certain extent as insurers alter their pricing bases to reflect a higher liquidity premium and a higher default risk in respect of corporate debt. However, prices are still likely to be good value for money for a lot of schemes when considered in the context of the risk being given up.
- Deferred pensioner prices are likely to increase more than pensioner prices. We also expect to see a widening range of prices quoted by the various insurers as their pricing bases diverge.
- Because of the insurers' heavy workloads, we expect they will concentrate on medium and large schemes. Buying out smaller schemes (£10m and less) will remain quite difficult, with limited competition for this segment of the market.
- More consolidation is possible in the market as insurers may struggle to raise the necessary capital to write additional business.

In the longer term, our expectations are that:

- The buyout market will pick up significantly once the economic recovery is under way and pension scheme sponsors will have the means to follow up on their desire to reduce their DB liabilities exposure.
- Prices will tend to increase. We do not believe that the very competitive terms offered early last year will be available again.
- A detailed due diligence analysis of the data and procedures used on the scheme, carried out in advance of the bulk quotation process, will become essential to obtain the largest number of quotations and the best prices.
- The market for hedging longevity is likely to develop once some initial deals are struck.
- The secondary market will develop as the main players wish to reinsure their books to diversify risk.

PCS Affordability Index

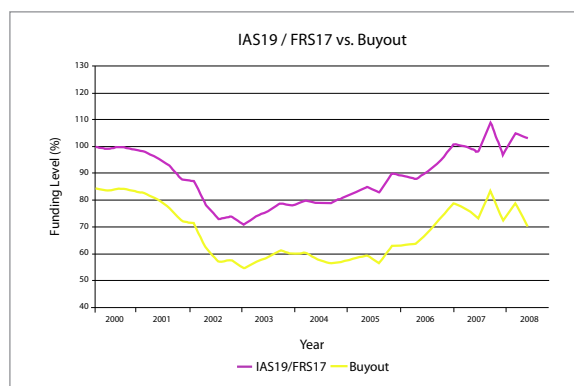
The attraction of a buyout solution depends on the four key factors below.

Regulations

In general, the regulatory environment is not becoming any less tough, which means that buyout solutions are as attractive as ever. Whilst the Regulator has confirmed that it will not be prescribing the mortality assumptions to be used in the funding plan for a scheme, it has also confirmed that there is no plan to amend current guidance and extend the length of a recovery period. It remains to be seen whether regulations will be relaxed to assist sponsors in dealing with their pension liabilities during the downturn. However, we believe any changes would in any case have limited scope.

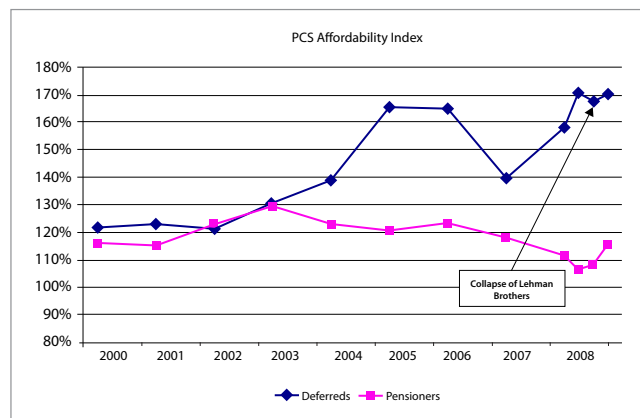
Financial health

PCS is tracking the funding position of a typical pension scheme, both on the accounting (FRS17/IAS19) basis and on the buyout basis to show how the relative attractiveness of a buyout is changing as financial conditions change. Our figures show that, as at the end of 2008, the spread between the accounting basis and the buyout basis had widened. This was due to credit spreads remaining at very high levels, which has resulted in accounting liabilities being artificially low. A reduction in spreads (or a change in the basis used to produce accounting figures) could lead to significant increases to the calculated liabilities and a subsequent reduction in the gap to buyout.



Affordability index

We also track the prices in the buyout market against FRS17/IAS19 values to create the PCS Affordability Index. Regardless of the turmoil in the market, there is no evidence that insurers have altered their pricing bases to any significant extent. Prices are moving slightly upwards but we would still consider a buyout good value for money, especially as far as pensioner members are concerned.



Market sentiment

Our research confirms that news of buyout deals are received favourably by markets. There is no evidence that companies' share prices experience any significant changes following a buyout deal being struck. It seems that markets believe that any hit to the balance sheet to implement the deal is a fair price for the risk being passed across.

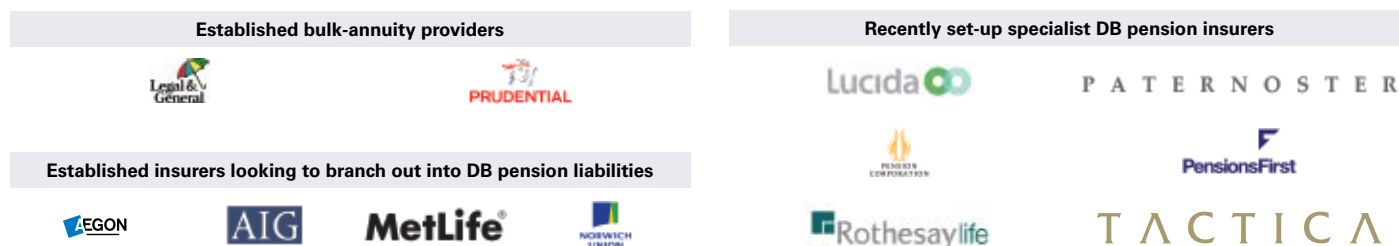
Commentary

It was confirmed in January 2009 that the UK economy is in recession, having experienced two consecutive terms during which the GDP has contracted. Even the most optimistic commentators do not expect any sort of meaningful recovery until the end of the year. In addition, the credit crunch is continuing to affect companies, as the level of toxic debt held by most banks, and the exposure associated with it, remains unclear. The uncertain environment has led to some sponsors being unwilling or unable to commit to buying out scheme benefits, in some cases even when negotiations had been underway.

This outlook is not likely to change in the short term, and a buyout may indeed not be feasible for some companies until the economy improves. Even if this is the case, it can be worthwhile to keep the market under review and to carry out some of the necessary background work (such as a full data cleanse) that will simplify the process later on.

What's On Offer In The Market

The main players in the buyout market can be grouped into three categories, as follows:



Some points to note are as follows:

- Synesis Life was taken over by Pension Corporation. Synesis did not write any business over the 27 months it was open for business.
- It is unlikely that any new entrants will come to the market in the short and medium term due to the significant capital required. In the current economic environment, capital is in short supply and likely to be very expensive.
- The issue of capital also raises questions for mono-line insurers, who are not able to raise funds from other business lines – it remains to be seen whether they are going to stick around for the longer term.
- A number of insurers introduced new products intended as pure longevity hedges, to enable schemes of all sizes to obtain a bespoke cover against the risk that their pensioner members will live longer than expected. Longevity hedges can be used in conjunction with interest rate and inflation-hedging products (which are widely available) to achieve a synthetic buyout. The success of synthetic buyouts will depend on the price, as there is no incentive in pursuing this route unless the cost of a traditional buyout is significantly more expensive.
- The mortality swap product available from Paternoster is particularly interesting, as Paternoster are offering the option for pension schemes entering this contract to switch to buyout on the basis of the mortality underlying the swap. As the swap does not require an initial outlay of capital from the scheme (other than collateral if required) this would be an opportunity for a scheme to fix their buyout mortality at the current time, even if a full buyout cannot be afforded.
- Aegon Scottish Equitable have made available a new form of insurance whereby a pension scheme can pay a premium to fix the mortality assumptions underlying the price of buying out a scheme's liabilities for a period of up to 7 years. The buyout can then be implemented in stages as the funds become available. This product, however, is only available to schemes that sign up for Aegon's Staged Trustee Exit Plan.
- The TI Group scheme buyout has been the first substantial example of a "tranching" deal, where the liabilities are split and secured in different tranches and each is bought out (not necessarily with the same insurer) following a formal broking exercise. This approach should help with getting optimum terms overall, and it can also fit with a funding plan aiming to complete a buyout over a number of years.
- There have been no further deals where an insurer has replaced the current employer as principal employer for a pension scheme. This was mostly in response to governance-related issues that became apparent following these type of deals and a toughening stance from the Pensions Regulator.

The Big Deals

Buyout activity continued to be very high over the year, although the number of completed deals is a small proportion of the quotations produced. In particular, the summer months were fairly quiet and very few deals were struck in October and November 2008 following the collapse of Lehman Brothers and the consequent panic in financial markets. The year did, however, end on a positive note as the Thorn buyout was finalised.

The top 10 largest bulk annuity buyout deals of 2008 are set out below.

Scheme	Date	Value	Successful Insurer
Thorn*	Dec-08	£1.17bn	Pension Corporation
Cable and Wireless	Sep-08	£1bn	Prudential
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 (2 nd)	Sep-08	£250m	Paternoster
TI Group (1 st)	Mar-08	£250m	L&G
Pensions Trust	Sep-08	£225m	Paternoster

Shortly after the year-end, Pension Corporation underlined their position among the current market leaders for larger Schemes by securing a full buyout of the Leyland DAF Scheme for £230m.

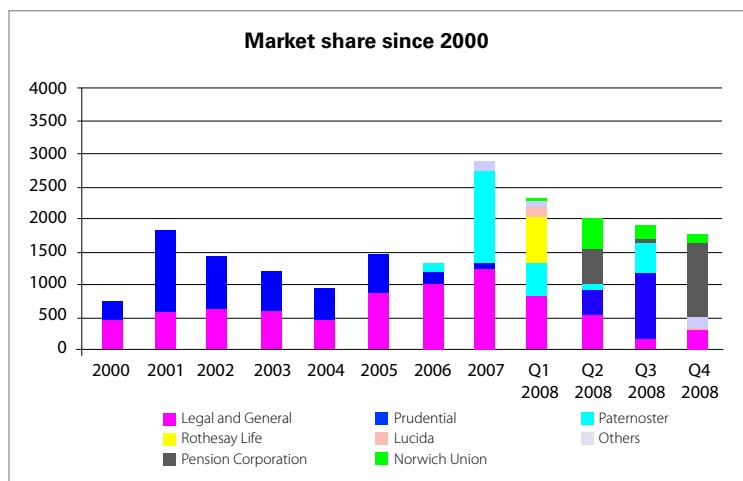
*The Thorn Pension Scheme was originally taken over by PIC in June 2007 in a corporate transfer of the sponsoring employer.

PCS Market Analysis

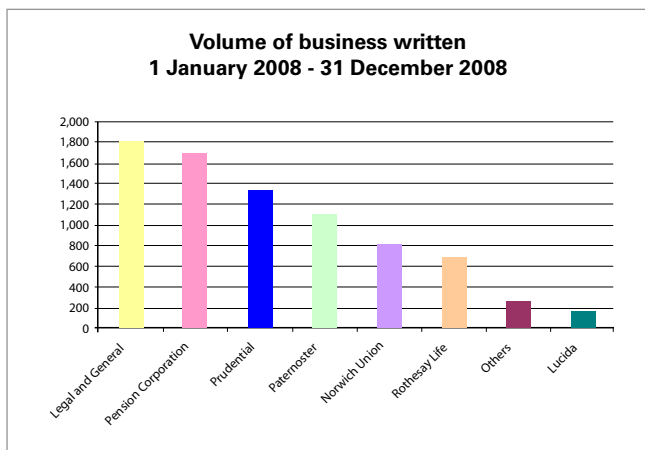
The various providers have been particularly active in the market at various times. The table below shows how the market share for each insurer has evolved over time.

The following points can be noted:

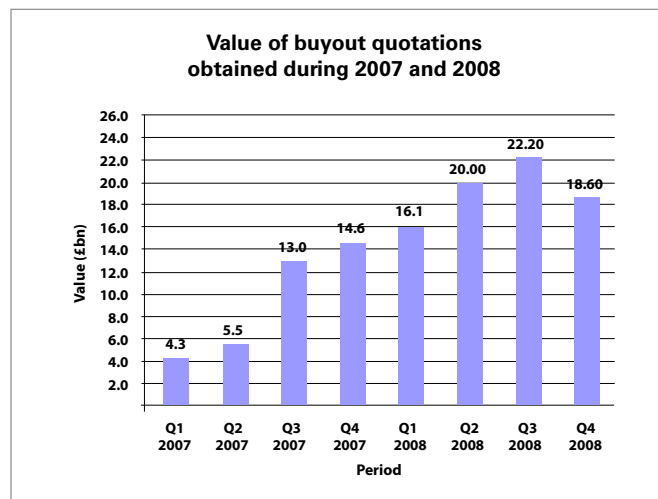
- Legal & General have been consistently present in the market since 2000.
- Prudential's share of the market contracted over 2007 but they managed to take a large share of the market by securing the Cable & Wireless deal in September 2008.
- Paternoster were very successful in 2007 and the beginning of 2008 but they lost some ground later in 2008.
- Pension Corporation have struck only a few deals but they have generally been very large.
- The other market participants have had a more marginal role.



The breakdown of the market share over 2008 is better 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

Following the collapse of Lehman Brothers in September 2008 and the increased press attention to the impending recession, the resulting market volatility and uncertainty led to many of the main providers being reluctant to provide guaranteed quotations. As a result, many quotations were issued by insurers on a provisional basis. The providers are hoping that these initial quotes will lead to further enquiries later in 2009 once confidence is restored in the economy.

Popular Buyout Myths

1. "Annuity buyouts aren't a feasible option for schemes as they are far too expensive."

This statement was very much true some years ago when the market consisted of only two insurers - L&G and Prudential. However, as we have seen, the last few years have seen a dramatic influx of new players into the market - a mixture of established insurers (AIG, Norwich Union, MetLife) and new specialist pension buyout ventures (such as Lucida and Paternoster).

This increased competition has shattered the duopoly that previously existed and has forced prices down - excellent news for sponsoring employers. The last few years have also seen corporate bond yields (which are used by insurers to price their annuities) surge. Higher yields lead to lower prices. The increased "popularity" of buyouts is perhaps best summarised by the result of an industry poll which showed that 62% of over 100 senior corporate delegates stated that they were intending to buyout their pension scheme liabilities within 10 years.

2. "Buyouts are only relevant to companies that are in financial difficulty and need to wind-up their pension scheme."

Large and volatile pension deficits are a significant burden for all companies regardless of whether or not the company's immediate future is bleak. More and more household names are taking direct action to remove or reduce their pension scheme liabilities - Cable & Wireless, P&O, Texaco, EMAP and Rank Group have all transacted with insurance companies over the last 2 years.

3. "Reducing pension scheme risks is an issue for the Trustees and their advisers to consider, not for the company itself."

The company is the ultimate sponsor and owner of the pension scheme. As at 31 December 2008, the disclosed pension surpluses in the company accounts of FTSE-100 companies totalled approximately £12bn. The corresponding figure as at 31 December 2007 was a deficit of £8bn. This amount of volatility can significantly distort year-on-year comparisons of financial performance and can hence lead to a very shaky share price.

The debate continues on whether a risk-free government bond-yield discount rate (as opposed to a high-quality corporate bond yield) should be adopted to value pension scheme liabilities for accounting purposes. Any changes to the accounting basis along these lines would lead to a significant increase in the liabilities and consequently in the deficits shown by the various companies.

4. "OK, perhaps we can secure the pensioners and deferred pensioners, but we want the actives to continue accruing benefits - insurers wouldn't be willing to take on this liability."

DB pension schemes are still a vital cog of a company's overall HR strategy and represent an issue that goes beyond company accounting deficits and surpluses. The attractiveness of a well-run, generous DB pension scheme can often be a key distinguishing recruitment tool in certain industries. However, companies that fit in this bracket should not rule out the options available to help reduce the risks in respect of both the past and future accrual of benefits.

Whilst insurers have traditionally focussed on securing pensions in payment and, to a lesser extent, deferred paid-up pensions, there is an emerging market in the UK for offloading risks in respect of active members also. This allows companies to retain the paternal control of a DB pension scheme without the uncertainty regarding future economic and demographic factors.

5. "Apart from buying-out, there are no other effective tools for reducing or removing pension scheme risks."

The purchasing of immediate and deferred annuities to guarantee DB pension benefits is the comprehensive total de-risking solution. It is also the most traditional and widely known method of removing risk - however it is also the most expensive and least flexible option. Whilst full buyout removes all the demographic and financial risks as a one-stop solution, it may not represent the ideal solution for each and every scheme.

With the emergence of new and innovative de-risking products it is possible to break down the buyout process into several sub-processes and eliminate specific risks without necessarily removing all the risks. In such a fervent marketplace, we believe that a number of solutions are available to fit the different circumstances of the various schemes - and this can only be good news for sponsors of DB pension schemes.

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.



JARDINE LLOYD THOMPSON
Benefit Solutions

JLT Benefit Solutions Ltd
6 Crutched Friars, London, EC3N 2PH
Telephone: 020 7528 4444
Fax: 020 7528 4500
www.jltgroup.com/EB



PENSION CAPITAL STRATEGIES
Innovative Alternatives

Pension Capital Strategies Ltd
6 Crutched Friars, London, EC3N 2PH
Telephone: 020 7528 4892
Fax: 020 7528 4983
solutions@pensionstrategies.co.uk
www.pensionstrategies.co.uk

Whilst all reasonable care has been taken in the preparation of this publication no liability is accepted under any circumstances by Jardine Lloyd Thompson for any loss or damage occurring as a result of reliance on any statement, opinion, or any error or omission contained herein. Any statement or opinion unless otherwise stated should not be construed as independent research and reflects our understanding of current or proposed legislation and regulation, which may change without notice. The content of this document should not be regarded as specific advice in relation to the matters addressed.

Pension Capital Strategies Ltd. Authorised and regulated by the Financial Services Authority. A member of the Jardine Lloyd Thompson Group.
Registered Office: 6 Crutched Friars, London EC3N 2PH. Registered in England No 5651461. VAT No. 244 2321 96

JLT Benefit Solutions Limited. Authorised and regulated by the Financial Services Authority. A member of the Jardine Lloyd Thompson Group.
Registered Office: 6 Crutched Friars, London EC3N 2PH. Registered in England No. 02240496. VAT No. 244 2321 96.