

# Buyout Market Watch

An Update Report From Pension Capital Strategies

June 2009



**PENSION CAPITAL STRATEGIES**

Innovative Alternatives

Market activity in Q1 2009 was subdued. Deals worth just under £1bn were written by a variety of insurers (Q1 2008: £2.3bn). However the majority of these are cases that had been ongoing since 2008.

## Key recent developments

- There is evidence to show that bulk annuity prices are increasing. Pensioner prices, which previously were particularly low, are increasing at a faster rate than deferred prices. Price increases are a result of stronger pricing and reserving bases being used by the insurers as a reaction to a changing financial and regulatory environment.
- The price increases come at the wrong time for most schemes, which are struggling to maintain their funding levels in a challenging economic climate. This has led to a smaller number of deals being concluded than had previously been anticipated.
- The change in market conditions is particularly bad news for sponsors and trustees of schemes for which quotations were obtained and found to be affordable or close to affordable, but where deals were not concluded due to uncertainties around the scheme or because decisions could not be made in a sufficiently timely manner. This demonstrates the importance of clear objectives and a sound decision-making process for any buyout exercise which is undertaken.
- As market uncertainty persists, many insurers have stopped providing guaranteed quotations. Some of the insurers still providing guaranteed quotations warn schemes that substantial changes in yields may lead to changes in the pricing basis, which would invalidate the guarantee.
- Insurers are continuing to carry out detailed due diligence on prospective cases to try and identify the deals which are of particular interest to them in terms of membership profile and likelihood to proceed. However, as the insurers' capacity to quote is less stretched, insurers are becoming less likely to turn down quotation requests purely on grounds of size.
- In common with most of the larger deals struck in 2008, the majority of the deals being sought in 2009 are partial buy-ins, normally in respect of pensioner members only.
- The first longevity swap deal is in the process of being completed by Babcock International, covering £500M of the £800M pensioner liabilities held within its pension scheme. The remaining pensioner liabilities are expected to be part of a separate deal to be negotiated later in the year. It is possible that deal will kick start the longevity swap market, as a few other large schemes are also expected to be investigating similar deals.
- In response to the increasing demand for collateralised arrangements, where trustees would have a claim on a separately identifiable pool of assets in the case of an insurer's insolvency, Legal & General have set up a formal framework to deal with such arrangements.
- Tactica have withdrawn from the buyout solutions market. A combination of market turbulence and some trustee advisers dragging out the due diligence process and not willing to advise trustees in a timely fashion meant that opportunities to secure deals were missed.
- Swiss Re have scaled down their pension department, although they are keeping their longevity and buyout offerings unchanged.
- In recent weeks, Pension Corporation have been involved in negotiations to take over Paternoster. However, it appears that the two insurers could not come to an agreement on the price of the deal, and the discussions have now collapsed.

## Our view on the market for the remainder of 2009 is:

- De-risking their defined benefit schemes remains a priority for most sponsors. We expect the interest in insured products to remain high, even though a full buyout may only be affordable for a minority of schemes at the current time.
- Sponsors and trustees contemplating buyouts in the short and medium term may wish to implement steps which will simplify the buyout process, such as cleansing the data and finalising the benefit specification for the scheme.
- Buyout prices are expected to remain high when compared to the prices available in 2007 and 2008. If market uncertainty and uncertainty about the insurers' reserving bases persists, prices may also be quite volatile.
- As more companies become insolvent, a significant number of quotations may be in respect of schemes going through an assessment period with the Pension Protection Fund.
- As insurers have more capacity as a result of fewer deals being struck, it is likely that smaller schemes will be better placed to obtain competitive quotes. It may therefore be a good time to undertake a broking exercise for smaller schemes which are reasonably well funded.
- In order to obtain the most quotations and the best prices it will remain important that trustees have adequate support in getting the scheme ready to buying out, including having a robust broking process.
- Some consolidation may be possible in the market if there is a significant contraction in business which leaves some insurers in a particularly vulnerable position.

## Preparing for buyout

Buyout prices are hardening at a time when the importance of de-risking pension schemes is more relevant than ever. Trustees and sponsors who feel they have missed out on the particularly low prices available in the recent past will want to make sure that they do not miss any such opportunities arising in the future.

As fewer schemes are likely to be able to buy out their benefits, some emphasis is likely to shift on preparing for buyout. This will include:

- Data cleanse (spouses' pensions, existence and address check)
- Start working on GMP reconciliation
- Dealing with historical insured pensions
- Rationalising AVC arrangements
- Tidying up the adjustments carried out to comply with equalisation legislation

# PCS Affordability Index

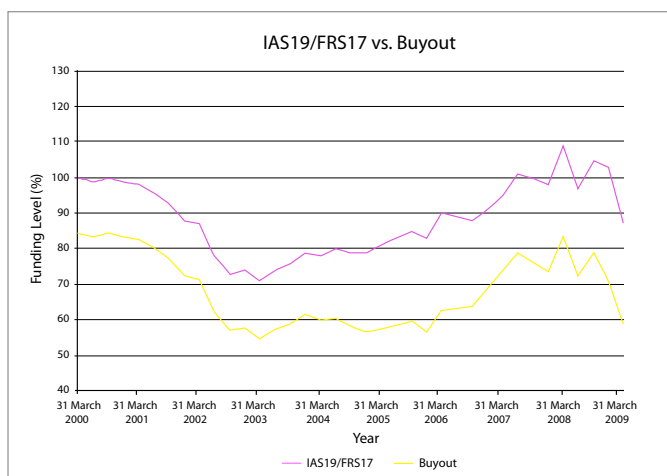
The attraction of a buyout solution depends on the four key factors below.

## Regulations

There have not been any regulatory changes of note over the last few months. The Pension Regulator has stressed that it believes current regulations are sufficiently flexible and do not require any specific amendments to fit with the current economic environment. They will however monitor any developments and issue revised guidance if required. However there is increasing evidence that the Regulator is taking a much closer interest in actuarial valuation assumptions and encouraging trustees to take a more cautious position, particularly if discount rates linked to corporate bonds are proposed.

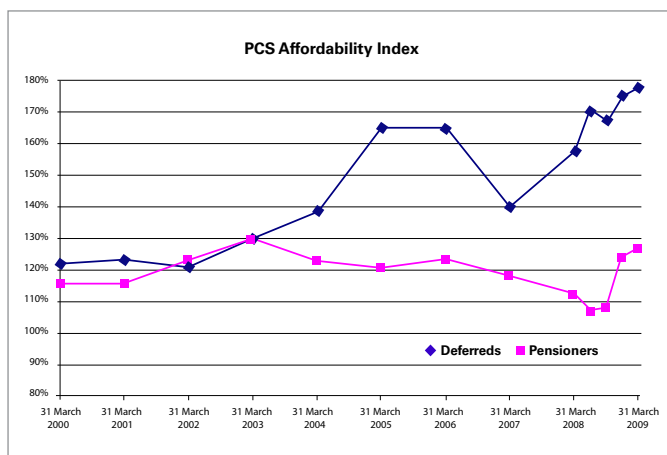
## Financial health

PCS tracks 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 changes as financial conditions change. Our figures show that, as at the end of Q1 2009, the spread between the accounting basis and the buyout basis had widened further. This is due to high credit spreads and correspondingly low accounting liabilities. While insurers generally price buyouts with reference to credit spreads, their liquidity and default premium assumptions have tended to become more conservative, leading to a higher estimated value for the liabilities to be placed.



## Affordability index

We also track the prices in the buyout market against FRS17/IAS19 values to create the PCS Affordability Index. Looking at quotations received over Q1 2009 there is evidence that, following the changes in the pricing bases referred to above, prices are generally increasing for of both deferred and pensioner members. As different insurers amend their pricing and reserving bases in different ways, significant volatility in the different quotations can also be observed. However it should be noted that this picture is distorted by the fact that current AA bond spreads are unusually wide. This means that the FRS17/IAS19 liabilities are artificially reduced at present. Buyout prices relative to gilt yields still look attractive.



## Market sentiment

Markets continue to look favourably on buyout deals. Pension risks and costs are increasingly seen as being greater than the simple accounting disclosures would suggest. Hence the general view is that given the uncertainties around pensions, companies are getting good value for any additional funds paid to implement a buyout once the corresponding risk given up is considered. It remains to be seen whether the current trend for higher prices will affect market sentiment. We believe markets will continue to welcome pension risks being taken off the corporate balance sheet.

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## PCS Market Analysis

Buyout activity has been slow over Q1 2009 when compared to the same quarter in 2008 - however we estimate that a healthy £1bn worth of business was written over the period.

The only major deal which has been made public in 2009 is that in respect of the liabilities of the Leyland DAF scheme, worth £230m, which was struck by Pension Corporation.

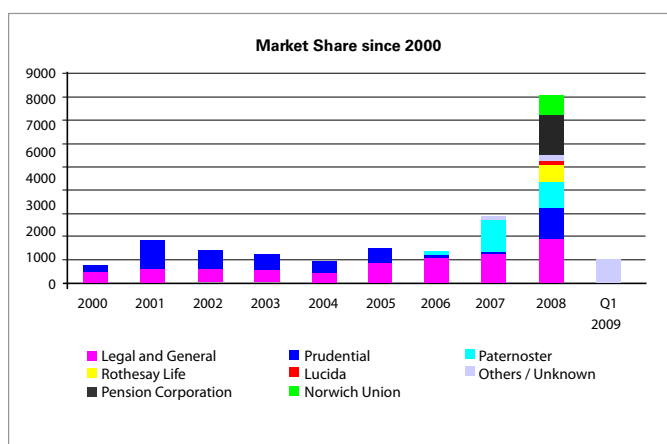
Other large deals have been written in 2009 by Norwich Union and Legal & General, however the names of the pension schemes have not yet been made public.

The top 10 largest known bulk annuity buyout deals over the last 12 months are set out opposite.

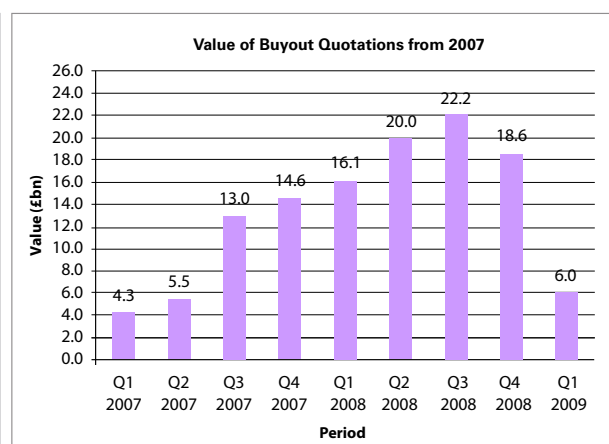
Scheme	Date	Value	Successful Insurer
Thorn*	Dec-08	£1.17bn	Pension Corporation
Cable and Wireless	Sep-08	£1bn	Prudential
Delta	June-08	£451m	Pension Corporation
Friends Provident	May-08	£350m	Norwich Union
BBA Aviation	Apr-08	£270m	L&G
TI Group (2nd)	Sep-08	£250m	Paternoster
Leyland DAF	Jan-09	£230m	Pension Corporation
The Pensions Trust	Jul-08	£225m	Paternoster
Diary Crest	Dec-08	£150m	L&G
West Ferry Printers	Sep-08	£130m	Norwich Union

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

The breakdown of the various insurers' market share since 2000 is 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

The market for buyout type solutions remains tough. This is due to a variety of reasons:

- Pension scheme funding levels have generally weakened as investment markets have deteriorated
- Sponsors are less able to fill the buyout funding gap due to difficult trading conditions in a sharply contracting economy
- Buyout prices have generally increased as insurers have strengthened their reserving and pricing bases.

However, the issues which make a buyout type solution desirable (essentially, the reduction or elimination of the risks associated with running a defined benefit scheme) have not gone away, and in fact are more pressing than ever.

The above charts illustrate the contraction experienced by the buyout market in the first 3 months of 2009. We expect that Q2 and Q3 will also be relatively quiet. Business may pick up by the end of the year, particularly if the economic situation starts to improve and indications can be seen that the recession is easing.

On the other hand, it is believed that two or three very large schemes (£1bn plus) are interested in a market related solution - a buyout or a longevity swap. If all these deals were to go ahead then this may yet be another bumper year for pension buyouts in the UK.

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