

# Buyout Market Watch

An Update Report From Pension Capital Strategies

as at 31 December 2009



**PENSION CAPITAL STRATEGIES**

Innovative Alternatives

The serious recession suffered by the UK has meant that 2009 was a very difficult year. Traditional buyout deals have suffered a contraction compared to 2008, although the position is less clear cut if we take into account the longevity swap deals written during the year. This is clearly an area with great potential for growth, particularly as longevity deals can be entered into without the large injection of capital from the sponsor which is often required for bulk annuity purchases.

### **Buyout prices in 2009 and outlook for 2010**

Buyout prices increased early in 2009 in response to the difficult economic conditions as it became apparent that a substantial contraction of the economy was on the way and that significant government bail outs would be required to prop up a number of financial institutions.

Prices have since stabilised and they are starting to converge more. There is some indication that prices have been decreasing slightly over the past month or so. This could be of particular interest to schemes which have been monitoring their buyout funding level with a view to securing a policy as soon as funding allows.

We do not expect significant changes in the pricing bases over the short term unless there are external influences (such as a strengthening of the insurers' reserving requirements. If liquidity remains scarce, this is likely to have a bigger impact on the mono line providers. It may be the case that the most successful insurers are less able to write business going forward. There are differences, sometimes substantial, in the mortality assumptions used by the various insurers. "Weaker" insurers may therefore end up increasing their prices if their mortality is strengthened. The other key factors in pricing are the default assumptions implicit in the bases and each insurer's required return on capital.

Insurers are generally not willing to guarantee their prices other than in the very short term. We therefore recommend that, once a set of quotations is received, trustees decide whether to act and, if required, implement a transaction as quickly as possible. There is sometimes an expectation that a scheme is broadly protected against changes in buyout prices just because they are invested in bonds. In practice, even with a LDI strategy in place, a scheme will not be immunised on a specific insurer's pricing basis. Schemes should therefore act fast and ensure that they have appropriate asset transition support.

### **Our view of the buyout market in 2010**

Insurers have recognised the changing conditions in the markets and are adapting to them. Apart from agreeing to quote for smaller schemes, insurers are developing alternative solutions with scope for full payment of a bulk annuity policy over an extended period of time. The aim is that of enabling immediate transactions where the funding level of the scheme would not normally allow.

Some insurers offer contracts where the bulk of the payment (70% or more) is made upfront and the remainder is paid over a period of up to five years. Other insurers prefer a solution where they agree to take a scheme on from an agreed date in the future, consistent with the amount that the scheme can pay at outset. The scheme, with support from the sponsor, is then responsible for the pensioner payroll and other cashflows until the date the insurer has agreed to take over responsibility for the scheme.

As these solutions are tested following implementation for a few initial cases, they will become more generally available to smaller schemes. It is therefore very important for schemes to rely on specialist advisers in this field with a comprehensive knowledge of the market, so that the best solution for each scheme can be identified.

There are now market related solutions to fit all but the most badly funded of schemes, especially if the intention is to "chip away" at the liabilities, in a realistic way, rather than buying out the whole scheme at once. This could, for example, be achieved by buying out tranches of older pensioners for whom the buyout cost is likely to be very close to the liability calculated on the scheme's funding basis.

Insurers are currently very busy with quotation work and remain bullish about the prospects for the buyout market in 2010 and their own position within it. Clearly, the continued success of the market depends on some economic recovery being achieved and no further shocks being in store for financial institutions. Our expectation is that, excluding any pure longevity deals, about £5bn worth of business will be written in 2010. This figure could be substantially higher if a proportion of the schemes which have obtained a quotation, but not transacted, over the past couple of years, decide that the time has come to execute a deal.

## PCS Affordability Index

Some of the most recent developments affecting the prices and attractiveness of a bulk annuity solution are considered below:

### Regulations

There have been no substantial regulatory changes in 2009.

The Pensions Regulator has been sending an even clearer message about the level of prudence they require in respect of the valuation and recovery plan assumptions. The message is that trustees should be trying to get schemes to a fully funded position as quickly as possible. tPR may be looking closely at a company's covenant to assess whether the trustees have been sufficiently robust in their funding plans. If low post retirement discount rates and stronger mortality assumptions mean that the funding liability for older members is very close to the buyout cost, trustees and sponsors may be encouraged to assess whether a market related solution may be desirable to cap the scheme liabilities once and for all.

Insurance companies have been concerned about how the introduction of the Solvency II will impact buyout prices if much stronger reserves are required. Lobbying is ongoing by insurers to relax the requirements to avoid some potentially damaging impact. Our conversations with the various insurers suggest that they have already included margins in their current pricing basis to cover for the additional requirements stemming from Solvency II, as they expect it to be implemented.

In December 2009 the Pensions Regulator has also issued a strongly worded message to warn trustees against enhanced transfer value exercises for deferred members. These are normally undertaken to reduce the scheme's liabilities in advance of a scheme buying out. We believe that it is reasonable for the Regulator to warn trustees about the dangers of carrying out an exercise which is not robust and compliant. However, if this kind of exercise is prohibited, member choice will be more limited and buyout will become harder for some schemes. We therefore auspicate that tPR will relax its stance on this issue.

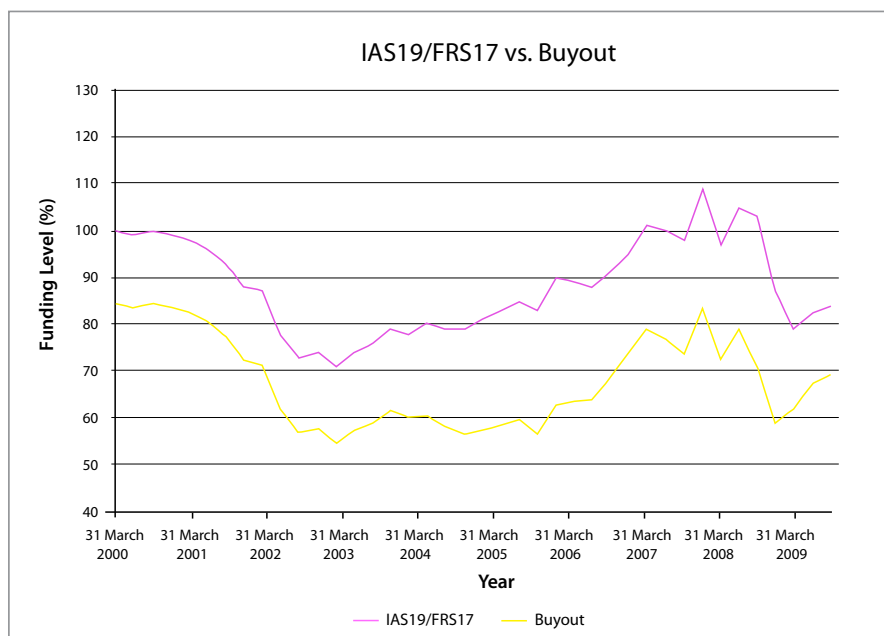
Recently it has also transpired that formal legislation may be passed to require schemes to act to equalise Guaranteed Minimum Pensions. We do not expect specific guidance to be given on the method to be followed, and some allowance for GMP equalisation is already generally made when schemes secure a bulk annuity policy on a buyout basis. We therefore do not expect the changes to have a major impact on buyout deals. However there will be an impact on schemes with buy-in contracts where no action has been taken to equalise GMPs and also on all schemes where a specific method to equalise is set out which results in additional liabilities to those already secured.

### Financial health

We regularly track the funding position of a typical pension scheme on the accounting (FRS17/IAS19) basis and 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.

Bond spreads have generally decreased in 2009, which has led to higher liabilities for pension schemes if assessed on an accounting basis. Pension schemes have moved from a small accounting surplus at the end of 2008 to a substantial deficit at the end of 2009, although the year end position is still better than at the mid year.

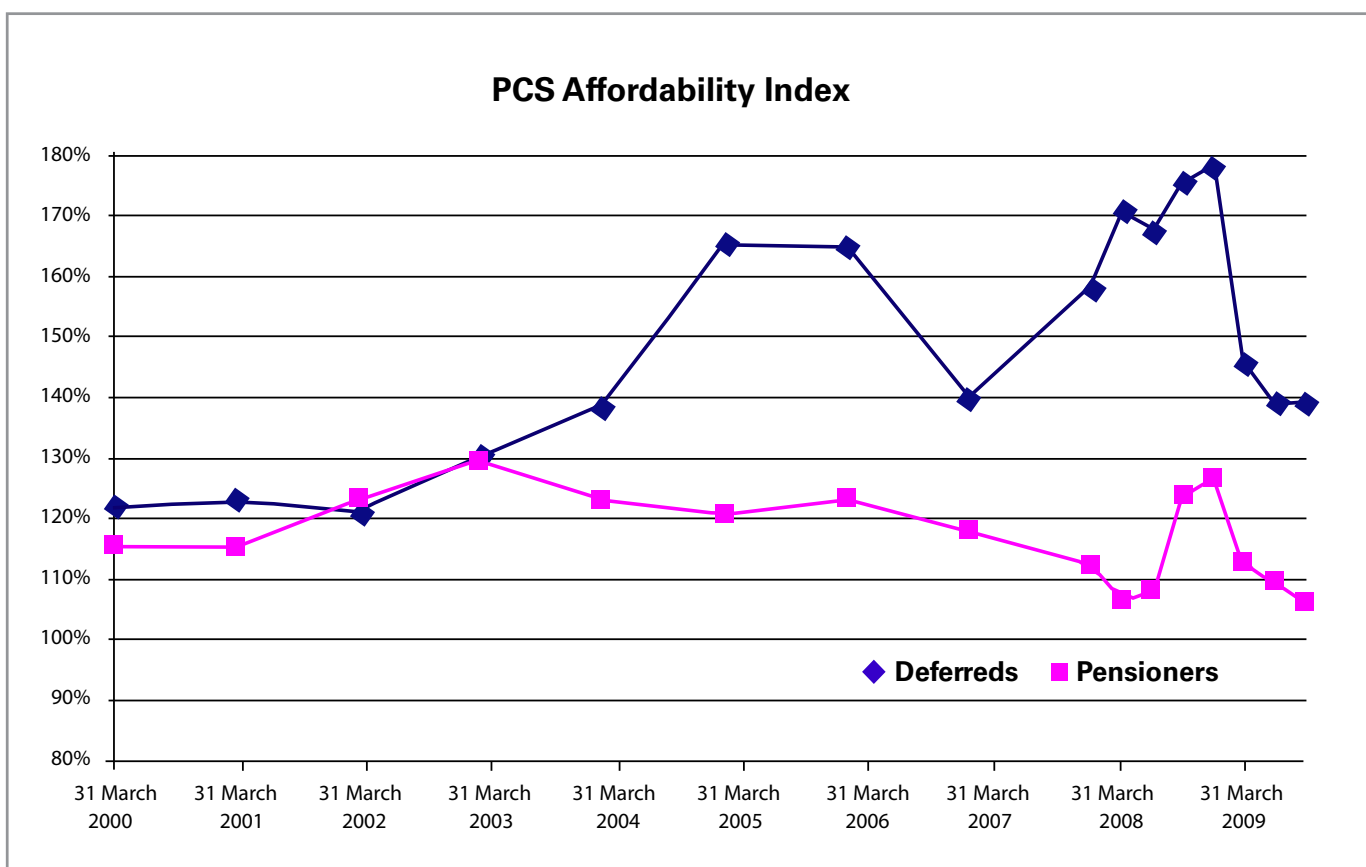
Market conditions in Q4 have been relatively stable. Scheme liabilities at the end of December 2009 are only marginally higher than those at the end of September. The increase has also been partly offset by corresponding increases in asset values. As buyout prices over the period have been quite stable, we believe that the buyout gap has also remained stable and has possibly reduced just at the year end.



## PCS Affordability Index (Continued)

### Affordability index

Our affordability index tracks prices in the buyout market against FRS17/IAS19 values. Our figures show that buyout prices at the end of 2009 are generally lower than they were at the end of 2008, following price increases in late 2008 and early 2009. Prices also seem to have stabilised as the insurers' underlying bases have become more durable. This is also evidenced by the fact that quotations now appear to be closer together. Our conversations with insurers suggest that they have already incorporated some margins to reflect any tightening in reserving regulations.



It remains unclear at the current time how gilt yields will move in the short and medium term and the impact this may have on buyout prices. The Government's Quantitative Easing policy is currently providing £200bn of support to the economy. It is uncertain whether this support will expand or contract over 2010. Increasing inflationary pressures are also likely to impact the interest rates' strategy followed by the Bank of England. We expect very little change this side of the General Election.

## News from the market

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### **Longevity hedging**

Although a pure longevity transfer agreement had been rumoured to be “imminent” for some time, the first deals took place in 2009 - the successful insurers were Credit Suisse (Babcock International), Rothesay Life (Royal & SunAlliance) and Swiss Re (Royal Country of Berkshire Pension Fund). The overall value of the deals was in excess of £4bn.

Longevity deals can be written as swaps or insured contracts. Derivative contracts have some “residual risk” at the end of the contract as they cannot be written on a “whole of life” basis. There is also “counterparty risk” if the majority (or all) the longevity risk is transferred to another party.

The big advantage of a longevity deal is that no transfer of capital is required at outset (other than in respect of collateral).

The market mood for longevity deals is very positive - UBS, Deutsche Bank and Legal & General have confirmed that they will be entering the market to provide longevity hedging contracts. Deutsche Bank have also teamed up with AXA, J P Morgan, Legal & General, PIC, Prudential and Swiss Re to set up an association to promote standardisation and a liquid longevity market. The group is called the Life and Longevity Markets Association.

For the time being, these deals only remain open to the larger schemes (£200M plus). It remains to be seen how easy they are to unwind, if required, which may undermine their popularity. On the other hand, as the market expands, the products offered should evolve to be a better fit for a larger number of schemes. There could also be significant growth in investments relating to mortality indices. Such investments only provide partial hedging compared to a bespoke longevity contract, however they are available to schemes of any size and are potentially easily tradeable.

A couple of very large deals have already been announced as in 2010. One deal, worth £3bn, involves the BMW pensions and Paternoster, although the deal has been written by Abbey Life (Abbey Life's parent is Deutsche Bank, one of Paternoster's main backers). The second deal, which has not yet been completed, involves Premier Foods (or, more specifically, the Rank Hovis McDougall Pension Scheme) and an unnamed insurer and is said to be worth around £2bn.

Paternoster have suggested that they will reapply for the required FSA licence to write business later in the year. Paternoster's main issue has been access to capital. Longevity swap deals have lower capital requirements than traditional bulk annuity deals and so they can theoretically be written by an insurer with a less strong capital base.

We expect that other large deals of this kind will follow. Given the size of the schemes involved, it could easily be the case that £10bn plus of longevity swap business is written in 2010.

### **The importance of governance**

Better funded pensions schemes that are not quite able to afford to buyout, can enter into a formal or informal agreement to monitor assets and liabilities on a regular basis, with a view to triggering a bulk annuity deal as soon as terms allow. This is the process followed by the CDC scheme prior to finalising a deal with Rothesay Life.

It may be the case that schemes are not in a position to commit to a deal with a given insurer, but they still wish to be able to act when the time is right. In order to achieve this, we recommend that the right infrastructure is put in place (for example by setting up an investment sub committee to which decisional powers are fully delegated) so that a contract can be executed quickly.

We are in a different environment of relatively volatile, non guaranteed prices. Failure to act at the right time can lead to schemes missing out and a corresponding financial loss for the sponsor. A thorough understanding of the market, including types of deals and terms available, is essential so that optimal choices can be made.

### **Due Diligence**

It has been extremely encouraging to see that, despite the unprecedented difficulties for a number of major financial institutions, there has been no need for any UK based insurance companies to be bailed out by the Government. This reflects the relative strength of the statutory reserving basis and should be of comfort to trustees who have implemented buyout type solutions and those considering them.

One important point to note is that, as buyout deals become increasingly bespoke, it is going to be the case that schemes will have to engage with one or two insurers from outset. In the absence of whole of market quotations, and collation of information relating to a large number of insurers, trustees and sponsors will have to be convinced that the insurer(s) they have selected are suitable. We therefore expect increasing due diligence research to be undertaken earlier in the process, and also increasing engagement with the insurers at an early stage. This should lead to better informed, more efficient choices.

## News from the market (Continued)

### Indicative quotations

It is often the case that trustees and sponsors wish to investigate the possibility of a buyout but do not want to face the cost and expense necessary to obtain a formal quotation. Some insurers have been willing to provide indicative quotations to assist schemes in overcoming this dilemma. At the current time, the only insurer willing to provide a “quick and dirty” figure on the back of summarised data is Aviva, although we understand that MetLife are also considering making this option available.

We believe there is a lot of merit in obtaining indicative quotations prior to a formal broking exercise, as this can give a clear steer on whether a buyout is affordable or not. We would therefore encourage insurers to continue to provide, or introduce, this kind of service, on the understanding that schemes should not take advantage to obtain a cheap solvency valuation estimate at the expense of an insurer.

### The big deals

As anticipated, the end of the year saw a considerable number of contracts being closed off. Buyout deals written in Q4 2009 added up to a healthy £1.2bn, which means that the total amount of business written over 2009 was almost £3.7bn.

These above figures are exclusive of the longevity swap deals referred to earlier in this report. If we include the longevity swap deals in the overall amount of business written over the year is in the excess of £7.5bn, which is an excellent figure given the economic backdrop.

The beginning of 2010 has seen a sustained level of demand for quotations and a few deals have already been struck (such as the £61M deal between Liberty and Pension Insurance Corporation).

The main characteristics of the deals struck in 2009 are as follows:

- they have continued to be in respect of pensioner members rather than deferreds
- the average size has been smaller than in the previous 18 months
- they have had some bespoke element to fit the requirements and the characteristics of each scheme – plain vanilla buyouts being generally struck only by the smallest scheme
- most insurers have written some business during the year.

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

Scheme	Date	Value	Successful Insurer
Cadbury Pension Fund	Dec-09	£500m	Pension Corporation
MNOFF	Sep-09	£500m	Lucida
CDC Pension Scheme	Nov-09	£370m	Rothsay Life
Leyland DAF	Jan-09	£230m	Pension Corporation
Unknown Legal & General deal	Q1 09	£215m	Legal & General
Dairy Crest	Jun-09	£160m	Legal & General
Unknown MetLife deal	Jun-09	£150m	MetLife
Unknown Legal & General deal	Q1 09	£145m	Legal & General
Denso Pension Scheme	Sep-09	£100m+	Pension Corporation
Unknown MetLife deal	Q2/3	~£100m	MetLife

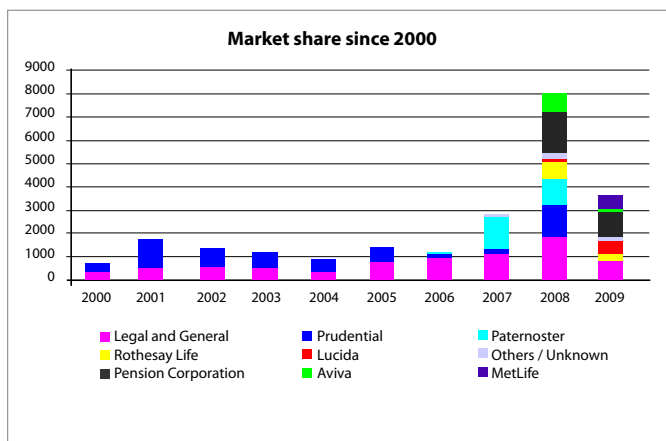
### The smaller deals are back

As the market contracted, insurance companies had the capacity to provide more quotations for smaller schemes. While it is true that smaller deals have always played an important part in the market, which means they never actually did go away, it is equally true that competitiveness in this segment increased during 2009.

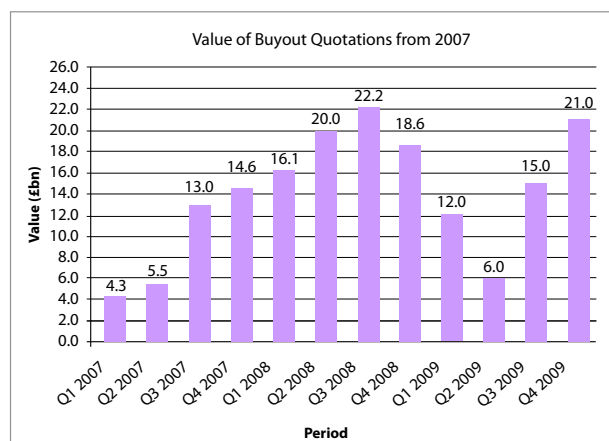
At the current time Aviva and Legal & General are willing to quote for any size of business. MetLife quote for schemes greater than £2m. Alico and Aegon have a stated minimum size of £5m. Other insurers are normally only interested in much larger schemes.

## News from the market (Continued)

A 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 amount of traditional bulk annuity business written in 2009 has been substantially smaller than that written in 2008, and certainly much smaller than what was anticipated at the end of last year, when the severity of the recession in the UK and on a global scale was still unclear. However, calling 2009 a "bad" year would give a misleading impression. A significant amount of business has been written, even on the back of an unprecedented economic background. The appetite of the insurers for innovation, and for providing desirable and useful products for their clients, remains strong. Trustees and sponsors are ever more aware of the risks and uncertainties associated with pension schemes, and generally more willing to see the economic price of a scheme as the real price that, in some way, must be paid. In our opinion:

#### Buyouts will remain desirable due to:

- Stronger funding requirements, which should result in the buyout funding gap being reduced and possibly closed off with time.
- Positive investment returns, although it remains doubtful whether they can offset higher liabilities resulting from falling yields.
- Bespoke solutions becoming more widely available, enabling schemes which cannot afford to complete a deal at the current time to effect a transaction over a longer period or at a time which has been assessed to be right for them.

#### Buyouts will be less desirable due to:

- Economic conditions remain uncertain, so that it may be hard for companies to raise the necessary finance to fund a bulk annuity policy, even when a buyout solution has been assessed to be desirable.
- Prices remain higher than has been the case over the past few years, although it now seems clear that those prices were a result of artificial discounts implemented in an attempt to kick start the market and were not sustainable in the longer term.
- Market conditions remain volatile, and trustees are finding it harder to perfect the timing for implementing a deal. This, together with inefficient decision making, can mean (and as meant in the past) that deals close to being finalised are eventually abandoned, sometimes resulting in an element of regret later on.

We further expect that:

- more smaller schemes will be able to transact in response to the increased competitiveness at the smaller end of the market
- for larger schemes, solutions will be usually bespoke and will involve significant preliminary work to identify which providers are a best fit in the circumstances
- more longevity only deals will be finalised as those products come to be seen as a mainstream tool to manage a scheme's liabilities

We therefore predict another very busy and interesting year for all those involved in this still growing area of the market.

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