Buyout Market Watch

An Update Report From Pension Capital Strategies as at 30 September 2009

PENSION CAPITAL STRATEGIES

Innovative Alternatives

Executive Summary

November 2009

Due to the difficult economic and financial conditions, the buyout market has been rather subdued in 2009. Buyout prices have increased and companies are less likely to be willing and/or able to fund pension schemes to buyout level.

1. Updates on the various providers

A short update on what is happening with the various insurers is given below:

- After an extremely successful couple of years Paternoster announced that they were exiting the market due to a lack of capital. Lack of fresh capital meant that Paternoster did not have sufficient funds to support new business, although they remain sufficiently well capitalised in respect of the business they have already written. They have since rationalised their organisation, losing about 20% of staff in the process, and raised a further £5m worth of capital.
- MetLife have written a small number of reasonable size deals and are the third most successful insurer in 2009 to date. They are not yet active in the market for longevity swaps but are willing to provide other bespoke products.
- Pension Insurance Corporation were one of the most successful players in 2008, particularly after the competition from Paternoster started to fall away. The largest deals secured over 2009 were in respect of the Denso Pension scheme (worth over £100m), also the second tranche of the Thomson Regional Newspapers deal, worth about £35m. PIC offer a full range of de-risking deals, including longevity swaps.
- Alico (ex AIG Life) are a smaller player but competitive at the smaller end of the market. They may have suffered by association following the well publicised difficulties experienced by their US parent. However, the UK operations are independent from the parent as far as their assets are concerned and, as such, their solvency has not been questioned.
- Aegon are one of the smallest players in the buyout market, although their parent company is one of the largest insurers in the world. They have written a few policies in 2009.
- Aviva (previously Norwich Union) are particularly active (and successful) at the smaller end of the market. They write a large number of small deals and have been relatively successful in 2009. Aviva are a traditional insurer and concentrate on standard contracts, although they are willing to offer collateralised arrangements to larger schemes. They are not active in the market for longevity swap contracts.
- Legal & General have been the most successful insurer to date in 2009, although they were quieter in Q3 compared to Q1 and Q2. They have also written the largest number of deals. Legal & General's largest deals have included Dairy Crest, a pensioner buy-in in June 2009. Legal & General have recently stated that they may enter the longevity swap market in 2010.
- Lucida secured their second major deal and one of the largest deals of 2009 when they entered into a contract with the Merchant Navy Officers Pension Fund in respect of a bulk annuity contract (secured on a buy-in basis) covering around 22,000 pensioner members. Lucida are active in the reinsurance market and offer a full range of bespoke products, including longevity swaps.
- Prudential have not been particularly active in the market over the past 18 months, although the one deal they did write (Cable & Wireless in September 2008) was the first bulk annuity deal in excess of £1bn. Prudential are however keen to re-enter the market, at the right price, and have been providing quotations for a number of schemes over the last few months. Prudential do not offer longevity swap solutions at the current time but are willing to revisit their position should the need arise.
- Rothesay Life were the counterparty to a longevity swap with Royal & SunAlliance (RSA) in June 2009. RSA achieved a synthetic buyout, as, at the same time as the longevity swap, they agreed an interest rate and inflation swap with Goldman Sachs (Rothesay Life's parent company). This is the first deal of its kind for this type of scheme and reinforces Rothesay Life's stated position as a player outside the mainstream market, providing bespoke solutions only. Rothesay Life also struck a £370M buy-in deal with the CDC Group Pension Scheme in November 2009.

2. Longevity hedging

The year to date has seen the first two pure longevity deals undertaken in the primary market. The RSA deals have been mentioned in the previous section. The other deal has been implemented by Babcock International with Credit Suisse. It is to be structured in three tranches, two of which have already been completed, with an overall value of £800m. The big advantage of a longevity deal is that no transfer of capital is required at outset (other than in respect of collateral) and therefore these contracts can be implemented by underfunded schemes.

3. Smaller schemes

A quieter market can be advantageous for smaller schemes, as more insurers have the capacity to quote and so it is more likely that they are successful in obtaining a competitive price.

4. Pricing basis and guarantees

Buyout prices in Q2 and Q3 2009 have remained relatively stable, following the changes in the insurers' pricing bases implemented early in the year. Such changes were a reaction to the worsening economic environment (and consequent higher perceived default risk on the insurers' bond portfolios) and reserving requirements. Based on the quotes we have received over the past few months it seems that insurers are "tinkering" with their bases rather than making substantial one-off adjustments. It certainly seems the case that insurers are aware of the size and type of business they have a preference for, and also the areas where they are most competitive, and they will use this information to decide which schemes to quote for.

5. Our view of the market for the remainder of 2009 and early 2010

Q4 tends to be a busy time of the year as far as buyouts are concerned, as insurers try to complete deals in time for the end of their accounting year. We understand that there are a number of pension schemes in quite advanced negotiations to complete deals prior to the end of 2009 and so we believe the year will end on a positive note. Provided that the encouraging signs seen in the markets are not a false dawn and that the economy continues to pick up in the medium term we believe that the market will remain quite active in early 2010, with deals around the £1bn mark for each quarter. Figures could be skewed if any major deals (£0.5bn to £1bn or more), some of which are under negotiations, come to fruition at any point

PCS Affordability Index

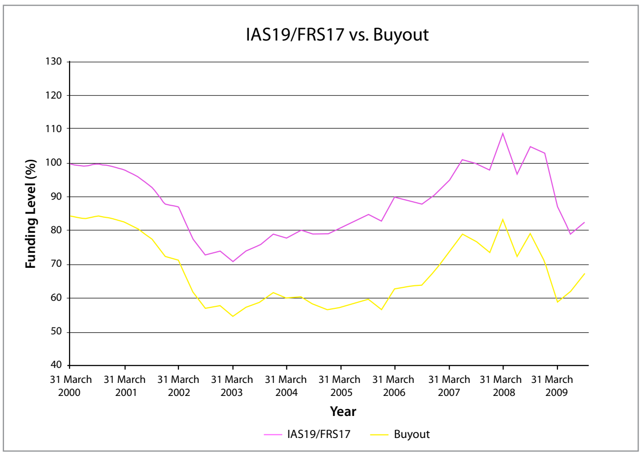
The attractiveness of a buyout solution essentially depends on the four factors below.

Regulations

The current big issue in connection with regulatory changes relates to insurance companies rather than pension schemes. Specifically, this is how the introduction of the Solvency II regime is likely to affect insures' reserving requirements and the consequent impact on buyout prices. Solvency II is an EU Directive to harmonise funding and reserving requirements for insurance companies. One key requirement of Solvency II is that insurers would have to reserve with reference to liabilities calculated with reference with a risk free rate of return – this would mean that the amount of capital required to underwrite bulk annuity policies would increase, with a consequent increase in bulk annuity prices (figures of as much as 20% have been suggested, although in practice the impact could be much lower). Clearly this would have a disastrous impact on the UK bulk annuity market. Intense lobbying is being carried out by the insurance companies so that the requirements are relaxed as far as buyout business is concerned. It has been noted that, if the insurers did not feel confident that their lobbying is going to be successful, they would have already amended their pricing basis to reflect the stricter reserving requirements. However this seems not to be the case based on the quotations we have received over the past few weeks and months

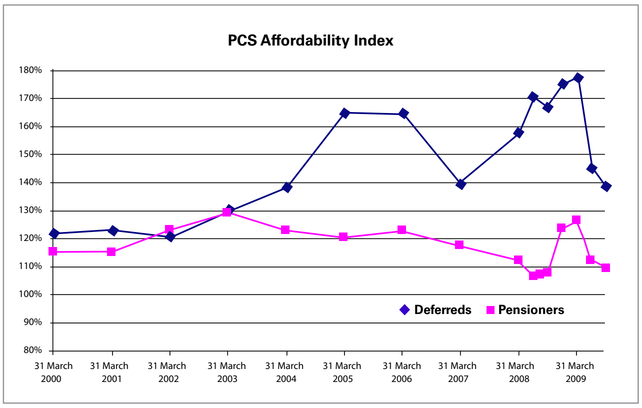
Financial health

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. Our figures show that, as credit spreads have decreased over the period, accounting liabilities have increased and accounting deficits have increased, although the position as at 30 September 2009 has improved slightly when compared to the position as at 30 June 2009. This has been partly offset by increasing buyout prices over the period. Overall, we believe that the buyout funding gap has slightly decreased over the period.



Affordability Index

The affordability index below tracks prices in the buyout market against FRS17/IAS19 values. The early part of the year saw some significant price increases for both pensioner and deferred quotations. In addition, as different insurers changed their pricing bases in different ways, more variability could be seen in the quotations received by the various insurers. Over the last few months it would appear that insurers have kept their pricing bases stable and changes in prices have been mostly due to changes in market conditions, which have remained volatile to some extent. Prices for pensioner members, in particular, seem to have stabilised. As bond spreads have decreased over the period, with a consequent increase in pension liabilities calculated on a scheme's accounting basis, buyout prices, especially for pensioner members, continue to remain attractive. One significant unknown in the medium term is how gilt yields will move once the quantitative easing policy followed by the Bank of England is terminated. The general expectation, however, is that yields will continue to be low so that, other things being equal, there will not be any serious impact on the perceived attractiveness of buyout prices in comparison with gilt yields.



Market Sentiment

Some consultants have argued that, while there is no doubt that accounting prices are not generally considered by Finance Directors to provide a realistic picture of the funding level of a pension scheme at any given time, corporate deals rarely price pensions as expensively as the buyout cost. If this were the case, it may not make sense for a sponsor to choose to buyout to help future corporate activity. Our experience, however, contradicts this view – increasingly, Finance Directors are looking at buyout prices to decide what cost to factor into corporate deals in respect of the pension element. This has been due to both the increased publicity over pension schemes' funding levels and also a higher level of awareness around the volatility of pension schemes' funding levels assessed on an accounting basis. Our analysis of how company share prices have moved following the announcement of a buyout deals, bears this out, even though in most cases the deal has meant an additional one off payment to the scheme. Therefore, we continue to believe that the market sentiment in respect of buyout deals is still overwhelmingly positive.

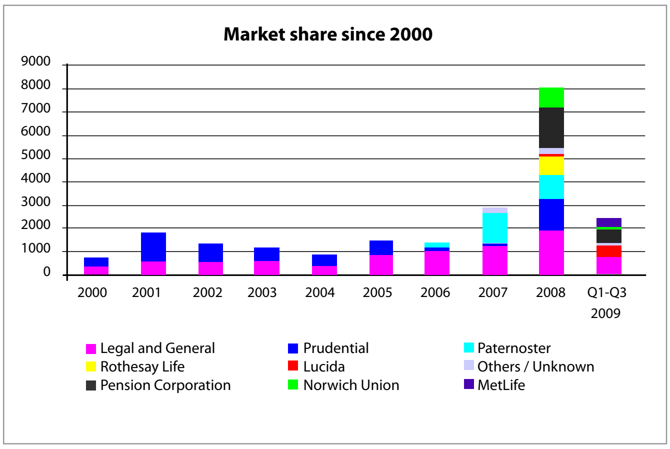
PCS Market Analysis

Buyout deals over the first three quarters of 2009 have totalled around £2.4bn, with around £0.9bn worth of business being written in Q1 and Q3 and £0.6bn being written in Q2, which was particularly quiet. These figures ignore the longevity swap deals referred to earlier in this report. The figures compare unfavourably with business written over the same period in 2008, however they are still in excess of the deals written over the same period in 2007, when economic conditions were far more benign.

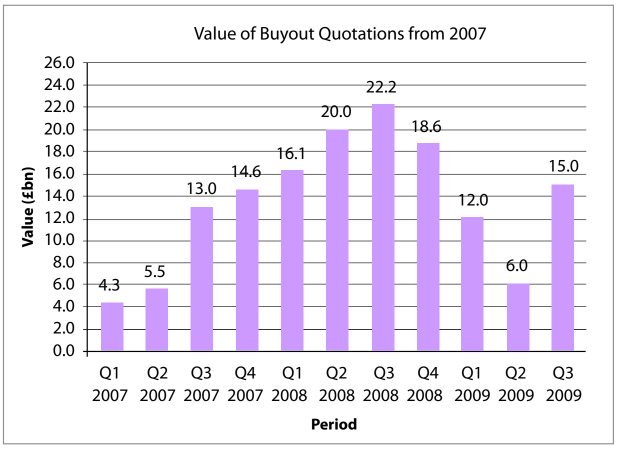
The top 10 largest bulk annuity deals struck over the last 12 months are illustrated in the table below.

Scheme	Date	Value	Successful Insurer
Thorn	Dec-08	£1.17bn	Pension Corporation
MNOPF	Sep-09	£500m	Lucida
CDC Pension Scheme	November 2009	£370m	Rothesay Life
Leyland DAF	Jan-09	£230m	Pension Corporation
Unknown Legal & General deal	Q1 09	£215m	Legal & General
Dairy Crest	Jun-09	£160m	Legal & General
Dairy Crest	Dec-08	£150m	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

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

This has been a difficult year for buyout deals compared to expectations, although the above graph shows that interest in market related solutions remains strong. Insurers also remain bullish about their pipeline deals, both in terms of numbers and average size of deal. The contraction in the buyout market has had a positive impact as far as the smallest schemes (£20M and under) are concerned, in that it is much easier for them to obtain quotations that has been the case for a number of years. We have seen some evidence of pent up demand in this section of the market, although it remains to be seen whether this results in significant market activity.

The market for longevity swaps remains no more than promising at the current time. These contracts, as stated earlier, remain for the time being available to the larger schemes only and so do not provide a feasible solution for the majority of schemes in the UK. We expect that the level of activity will pick up in Q4 2009 and that the year will end up positively for most insurers compared with what has happened to date. The outlook for 2010 will crucially depend on whether the limited economic recovery will be sustained, or grow stronger, or whether, as some predict, we will see a "double dip" recession. In any case, the need and urgency for de-risking pension schemes is not going away, therefore we would expect that business levels would remain historically pretty high.