



PENSION CAPITAL STRATEGIES  
Innovative Alternatives

## Buyout Market Watch

An Update Report From Pension Capital Strategies  
as at 30 September 2010



A JLT Group Company

## Executive Summary

Market activity was very slow during quarter 3, with deals worth just over £600m being completed. However, insurers continue to report a healthy pipeline and expectations are for a strong final quarter. Also, following high levels of activity in Q1 and Q2, the amount of business written up to 30 September 2010 has already equalled that written in the whole of 2009.

## Key recent developments

- Bulk annuity prices have been quite volatile during the last quarter; predominantly a result of Gilt yield volatility. The insurers' underlying bases, i.e. non-financial assumptions have remained fairly stable, however, continuing to reflect a settled regulatory and financial environment.
- A number of insurers are willing to provide indicative quotations for schemes **whg** are unsure whether **buy** out would be affordable. These quotations are generally based on valuation data, and are less onerous to produce; therefore they are usually available in shorter timescales.
- Insurers are reporting large pipelines of business, as such they continue to carry out detailed due diligence on prospective cases to identify the deals which are of particular interest to them. In particular, the emphasis for the remainder of the year is on those cases which may transact, or at least agree terms, before 31 December.
- The impending change from CPI to RPI in respect of pension increases (both in deferment and payment) has caused insurers to consider the terms of their bulk annuity contracts. Most insurers are happy to allow a restructuring clause to be included in the contract; thus enabling schemes to complete bulk annuity deals now rather than delaying until there has been full clarification of the CPI / RPI issue. In the absence of a developed market for CPI linked assets it remains to be seen whether there are any savings to be made by securing CPI increases rather than increases linked to the RPI.
- Pensioner buy-ins remain the most popular type of deal being sought by schemes. Most of the deals completed over the past 2 years have followed this structure.
- Insurers continue to provide tailor made transactions designed to suit clients' specific needs. Innovative structures are predominantly limited to larger schemes, however there is evidence that once insurers become comfortable with a deal structure and terms they are willing to cascade this to smaller schemes.
- There continues to be an active market for smaller schemes with competitive pricing available, even though most insurers operate a minimum quotation size. The majority of deals completed in 2010 have been at the smaller end (schemes of £10m or under).

## Updates on various providers

- MetLife have formally announced the acquisition of Alico from AIG, completed on 1 November 2010. MetLife will underwrite all new quotations and will write all new bulk annuity business.
- It has been reported that Paternoster has been put up for sale, with interest from a couple of major players in the market (at the right price). Paternoster remains closed for new business for the time being.
- Prudential have recently announced two major pensioner buy-in deals, worth £900m in total, with the GlaxoSmithKline Pension Scheme and the GlaxoSmithKline Pension Fund. The deal covers around 15% of the sponsor's pensioner liabilities.
- Two other large deals (Alliance UniChem and Next, worth £300m and £124m respectively) were struck with PIC and an unnamed insurer. Prudential are said to be very close to completing a very large (£1bn **u** deal).

## Longevity hedging

- No new longevity swap deals were announced during Q3 2010, although we believe that some large schemes have gone through a number of quotation rounds. It would appear that most insurers are working on schemes which approached the market some time ago rather than having a large number of new enquiries.
- The expectation of the market is not for a large number of deals, rather a relatively small **amount** of large deals to be transacted each year, as longevity swaps are generally limited to larger schemes (typically with liabilities in excess of £250m), can be complex and take time to complete.
- It is also important to note that deals are subject to the capacity of the reinsurance market. Even a small number of large cases, where most providers are approached for a quotation, can result in potential market capacity being exhausted relatively quickly.

## Our view of the market for the remainder of 2010

- We expect a number of transactions to take place during the final quarter of 2010, so that the level of activity in Q4 is closer to that seen in the early part of the year. Where the opportunity exists it may be prudent for schemes to transact prior to the year end as some insurers will offer attractive prices to complete deals in 2010.

## PCS Affordability Index

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

### Regulations

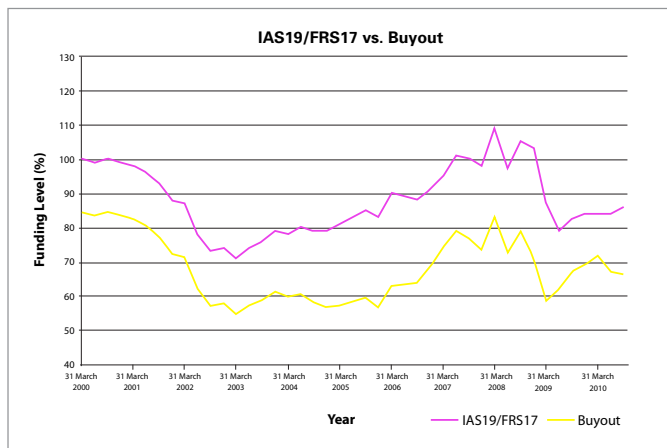
There have not been any substantial regulatory changes likely to affect the bulk annuity market over the past few months.

It remains unclear at this stage the impact that the switch from RPI to CPI will have on each scheme. In particular, it is unclear whether schemes retaining the CPI link will have to provide a CPI underpin, and also the extent to which schemes with the RPI link hard coded in their governing documents will be able to take advantage of the change in legislation. In addition, the Office of National Statistics has now suggested that housing costs will be taken into account in calculating the CPI in the future. This is likely to substantially reduce the difference between CPI and RPI and as a consequence, the potential gains from a switch.

The full implications of the Dodd-Frank Act (signed as law in the US in July 2010) on some of the bulk annuity providers operating in the UK also remain unclear. The Act places some restrictions on banks in respect of their ownership of insurance companies.

### Financial health

We regularly track the funding position of a typical pension scheme on the accounting RS17/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 over the quarter accounting liabilities have increased to some extent, due to a reduction in yields only partly balanced by a reduction in the expected level of inflation. Buyout prices have generally been stable, which has result in a small increase in the buyout gap.

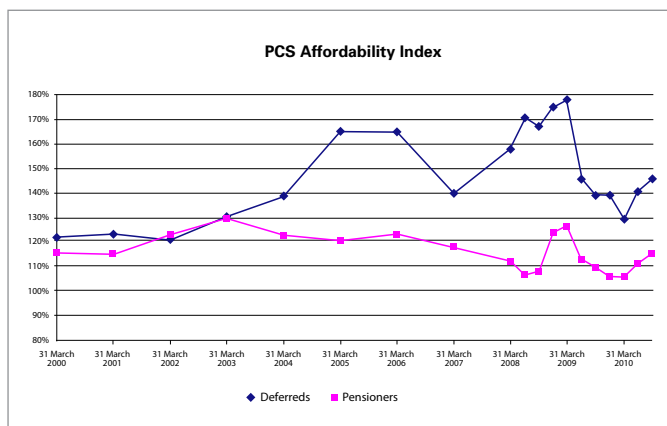
### Affordability index

Our affordability index tracks prices in the buyout market against FRS17/IAS19 values.

Our figures show a small increase in buyout prices for both pensioner and deferred members, very likely a consequence of the small decrease in Gilt yields over the quarter.

It should be noted that insurers are increasingly willing to engage with pension schemes and carry out a demographic analysis of the scheme data in order to home in on the best price they are able to offer. In order to do this pension schemes need to be willing to choose a shortlist of potential providers relatively early on in the selection process. Schemes with clean data and sufficient demographic information may be able to achieve a price of between 105 and 110% of their accounting liabilities.

The understanding that significant engagement with a small number of insurers is the most likely avenue for a scheme to complete a deal is also leading to more insurers being increasingly selective about the number and types of quotations they wish to provide.



### Market sentiment

Goldman Sachs have recently produced a fascinating research note (29 October 2010), "Strategy matters," in which they recommend selling a basket of stocks with pension risk on a sector-neutral basis. This note highlights underperformance in share prices of companies with large pension obligations. We see this note as yet more clear indication that market sentiment favours companies that seek to offload pension liabilities through annuity buyouts.

## PCS Market Analysis

£3.5bn of buyout business has been transacted up to and including Q3 2010. This is an excellent figure overall, particularly while the economic outlook for the UK remains unclear. The total volume of quotations outstanding in the market also remains very high at around £11bn.

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

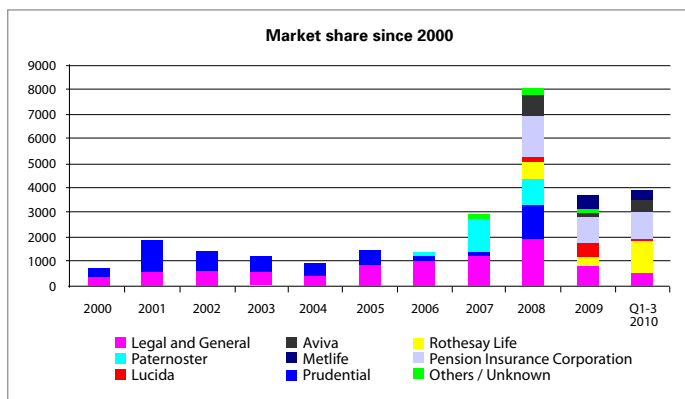
Scheme	Date	Value	Insurer
BA	Jul-10	£1,300m	Rothsay Life
GlaxoSmithKline	Nov-10	£900m	Prudential
Cadbury Pension Fund	Dec-09	£500m	Pension Corporation
Alliance UniChem	Q3 2010	£300m	PIC
Unknown Deal	Q2 2010	£230m	Legal & General
Aggregate Industries	Mar-10	£210m	Pension Corporation
Unknown MetLife Deal	Q1 10	£150m	MetLife
Next	Aug-10	£124m	Unknown
Unknown Aviva deal	Q1 2010	£105m	Aviva
MNOFF (2)	May-10	£100m	Lucida

The major longevity swap deals struck over the last 18 months are illustrated in the table below.

Scheme	Date	Value	Counterparty
BMW	Feb-10	£3bn	Abbey Life
RSA	Jul-09	£1.9bn	Rothsay Life
Babcock International*	May-09	£1.2bn	Credit Suisse
Royal County of Berkshire	Dec-09	£0.75bn	Swiss Re

\* Completed longevity swaps for three of its schemes during 2009.

A breakdown of the various insurers' buyout market share since 2000 is illustrated in the graph below.



### Commentary

After a strong start to 2010 buy out transactions during Q3 slowed significantly, with a couple of insurers winning the lion's share of the business. Pipeline however remains healthy for most insurers, and through our discussions there seems to be optimism for the remainder of 2010. Most insurers are also very positive about the expected workloads well into Q1 2011.

While there have not been any longevity swap deals during the Q3 2010 we believe negotiations, in some cases at an advanced stage, are ongoing for a number of schemes.

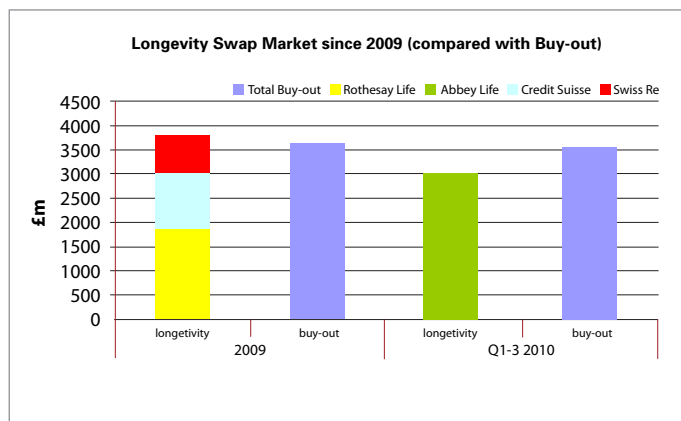
The outlook for the market in the short and medium term remains in our view positive for both buyout and longevity swap solutions. The desire for pension schemes to de-risk is as strong as ever; therefore unless changes in the economic situation dictate otherwise, we would expect that business levels will remain historically high.

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A breakdown of the various insurers' longevity swap market share since 2009 is illustrated in the graph below. This graph also provides a comparison between buyout and longevity swap business written during 2009 and 2010.



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.

