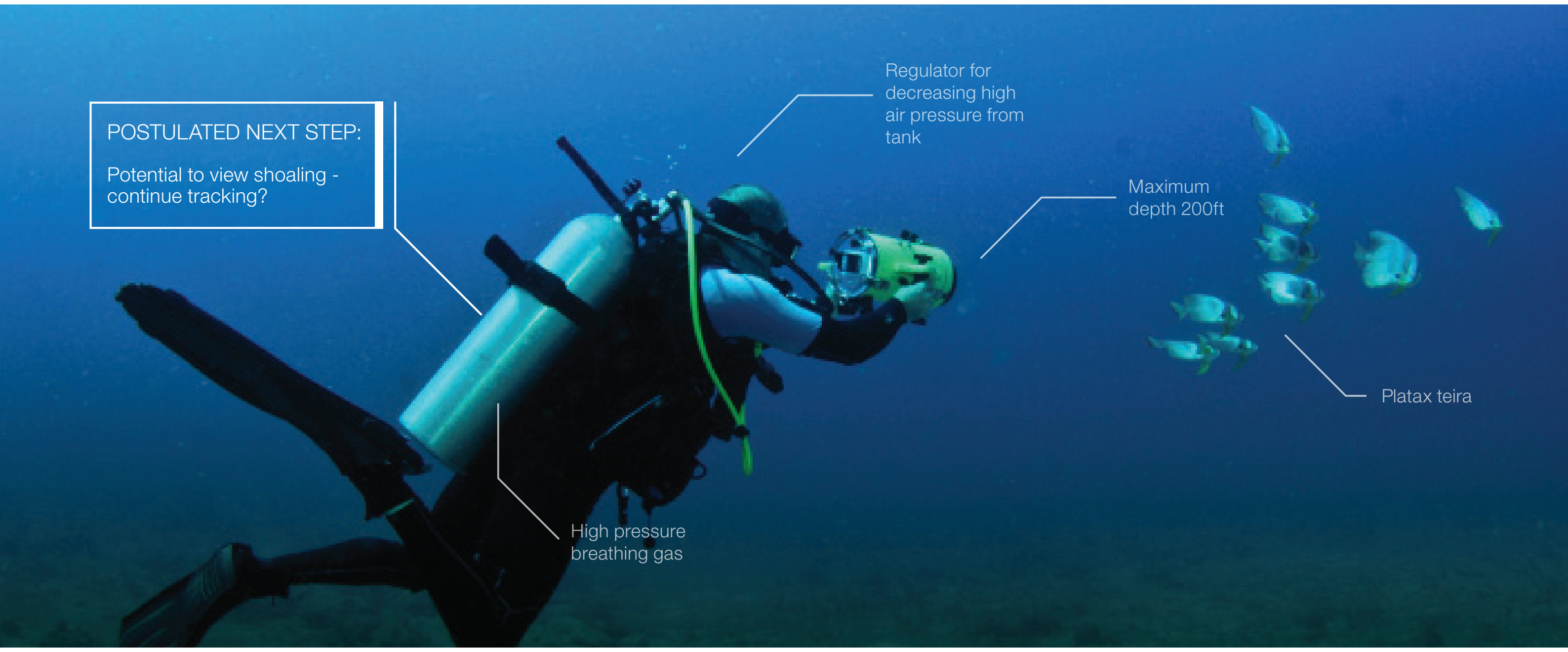
Buyout Market Watch

An Update Report From JLT Pension Capital Strategies as at 31 March 2011

Strategies to Solutions

JLT PENSION CAPITAL STRATEGIES

Buyout Market Watch



The PCS Buyout Market Watch Update – June 2011

Executive Summary

All insurers continued to be very busy during Q1, although the business eventually written over the quarter was a disappointing £350M. Nevertheless, insurers remain confident about their prospects, their confidence looking justified as deals completed in Q2 to date are already in excess of £1bn.

News from the market

- Bulk annuity prices have remained stable in Q1. The amount of business transacted over the quarter was low, possibly as some deals were delayed because of uncertainty around the RPI to CPI switch.
- Insurers are offering a number of payment options in an effort to make deals more affordable to underfunded schemes. These structures, initially developed for larger schemes, are now being made available to smaller schemes. The main types of contracts are as follows:
  - › partly deferred payment, where the excess funds required over the insured members' share of funds are paid over an extended period;
  - › deferred insurance, where a scheme retains the liabilities to be insured for a period to amortise the difference between the full premium and the amount that can be afforded at the current time;
  - › tranched solutions, where the liabilities are offset in tranches over a set period on partly guaranteed terms (similar to the deal between London Stock Exchange and Pension Insurance Corporation (PIC)).
- In addition to the above, Prudential continue to offer their "Future Premium Product", quoting a cash price payable in 10 years' time (while all risks, other than short term investment risk, are transferred on day 1).
- The most popular contracts are still pensioner buy-ins. This is mostly in recognition of affordability (pensioners remain "cheaper" than deferred members) and strained funding levels (as a buy-in can be completed with less need for immediate additional funding than a buyout).
- The most popular de-risking contracts era pensioner buy-ins. Insurers are also increasingly willing to insure GMP equalisation risk and quoting more reasonable prices than was previously the case.

Longevity Hedging

- No bespoke longevity transactions were finalised in Q1. We believe that negotiations continue on a number of very large schemes, some of which are also investigating a more traditional bulk annuity product.
- The first longevity hedge deal based on a change in a mortality index (the LifeMetrics index, set up by JP Morgan) was completed by the Pall (UK) Pension Fund. The contract, which has a term of 10 years, covers non pensioner members and provides an efficient way to mitigate the mortality risk for non pensioner members. It hedges against changes in overall population mortality rather than against the experience of the specific scheme - but, given that a major component of the risk depends on medical developments and other national trends, this is potentially a useful de-risking tool for schemes to adopt.

Our view of the market for the remainder of 2011

- The interest in de-risking solutions remains high as more schemes enter "end game" territory. We believe that trustees need to understand the market and prepare in advance so that a transaction can be undertaken as soon as conditions allow. The advance preparation will include obtaining an initial quotation, assessing their investment strategy and setting up the required Governance infrastructure, possibly even appointing an Independent Trustee to supply any missing expertise.
- Advance preparation is particularly important, as the number of contract structures available grows. Trustees and sponsors need to be aware of developments in the market and understand the implications for their own scheme, if they want to maximise their chances of striking an optimal solution at the right time.
- Provided that no major shocks hit the economy in the short and medium term, we believe that prospects for the industry remain excellent and any low periods of activity will simply result in more pent up demand.
- One element of uncertainty in the market is the final impact of the Solvency II requirements on bulk insurers. While most insurers are confident that the changes already made to their reserving basis are sufficient for them to comply with the new framework, we are aware that a number of insurers will be looking to make further changes, which will have an impact on their pricing models.
- A further element of uncertainty is the persistent crisis in the eurozone sovereign market. Any default could have a severe impact on the UK and European economies.

PCS Affordability Index

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

Regulations

The Government has now confirmed that it will not issue legislation to override pension scheme rules where the scheme is switching from CPI to RPI. This will reduce the impact of the legislative changes for all schemes which specifically refer to a revaluation and increase rate linked to the RPI in their governing documents. There is some evidence that insurers have started to take into account the lower expected CPI assumption in their pricing basis, even though a market in CPI linked assets is still in its infancy.

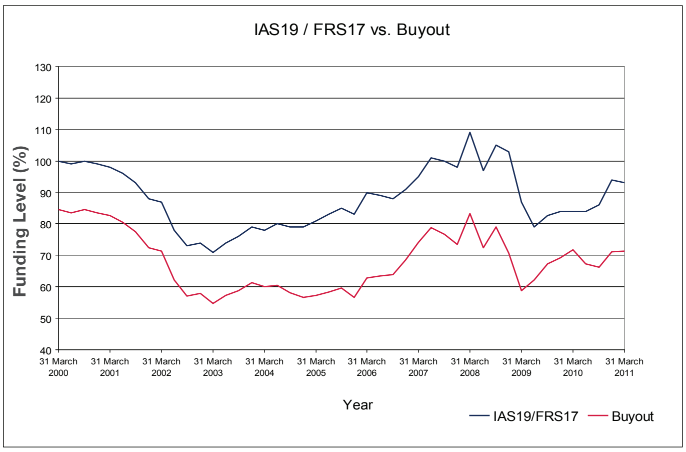
The Pensions Minister, Steve Webb, has highlighted again the dangers of poor practice in how Enhanced Transfer Values exercises are carried out (the Pension Regulator has already provided guidance on this issue). At this stage there is no suggestion that these exercises will be prohibited (and it is hard to see how a prohibition can be justified while individual transfer values remain a statutory right), however any restrictions may impact on the ability to improve the funding position in relation to deferred pensioners and may prove detrimental to buyout activity for deferred pensioners as a consequence.

Following a recent ruling by the European Court of Justice, charging different rates on insurance products depending on gender will be classed as a breach of sex equality legislation with effect from 2012. At the current time we do not believe this will have an impact on bulk annuity terms, which are priced taking into account the characteristics of the aggregate population, however the position may change as the implications of the judgement are further considered.

Changes to the accounting standard, IAS19, will mean that the option to smooth returns via the "corridor spreading" method is removed. The changes also see the introduction of a return on assets calculation based on AA discount rates. The consequent impact on a company's profit and loss (P&L) will make the option of a buyout more desirable.

Financial health

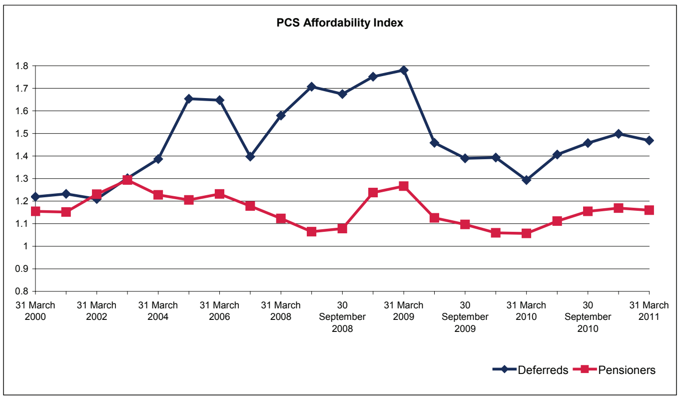
We regularly track the funding position of a typical pension scheme on the accounting (FRS17/IAS19) basis and the buyout basis to monitor how relative prices move with changing financial conditions and assess how attractive a buyout type solution is at a given time.



Our figures show that over the last quarter accounting liabilities and deficits were stable as there was little movement in bond yields over the period. The buyout gap also remained stable as there was little evidence of a change in prices.

Affordability Index

Our affordability index tracks prices in the buyout market against FRS17/IAS19 values and shows the relationship between the buyout price and the "average" accounting liability for pensioner and deferred members.

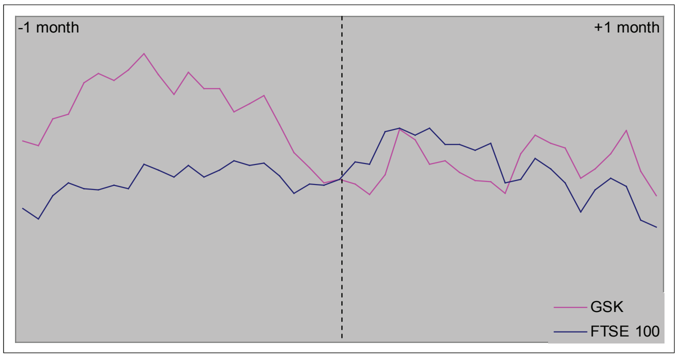


Our figures show that buyout prices for pensioner members were broadly stable. This is a reflection of stable yields and also the desire from insurers to complete business on current terms. There is some evidence that deferred prices decreased over the period, although the position could be reversed following a review of each insurer's Solvency II position.

The lack of vigour in the economic recovery (UK and European wide), plus concerns about the level of underlying inflation, mean that future prospects are uncertain at the current time.

Market Sentiment

Our analysis of the share price of companies following a buy-in/buyout deal suggests a positive or neutral link between share prices and market activity. The graph below illustrates the position for GSK, who completed a large deal with Prudential at the end of 2010. There is no evidence of any adverse effects on GSK's share price following the deal.



PCS Market Analysis

Longevity Solutions

Only £325M of buyout business was transacted in Q1 2011. However this was not a fair reflection of the level of activity in the market, which remained high, as evidenced by the number of deals which have been finalised since.

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	Rothesay Life
GlaxoSmithKline	Nov-10	£900m	Prudential
Alliance UniChem	Q3 2010	£310m	PIC
Unknown Deal	Q2 2010	£230m	Legal & General
Aggregate Industries	Mar-10	£210m	PIC
Unknown Aviva deal	Q4 2010	£190	Aviva
Unknown MetLife Deal	Q1 10	£150m	MetLife
Next	Aug-10	£124m	Unknown
Unknown Aviva deal	Q1 2010	£105m	Aviva
MNOPF (2nd tranche)	May-10	£100m	Lucida

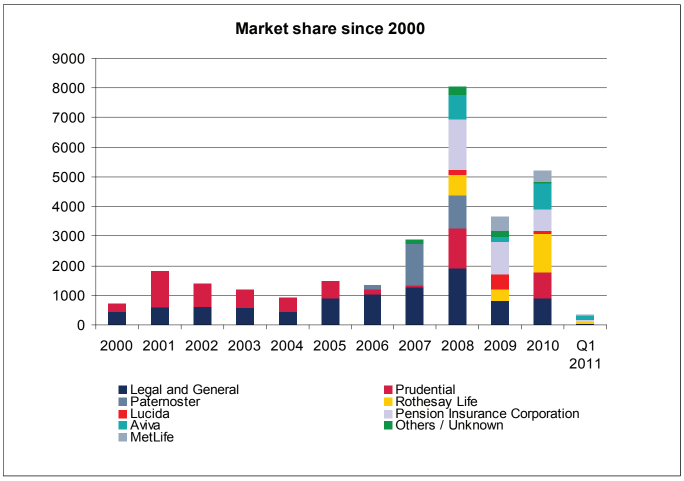
The major longevity swap deals completed in the market are illustrated in the table below.

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

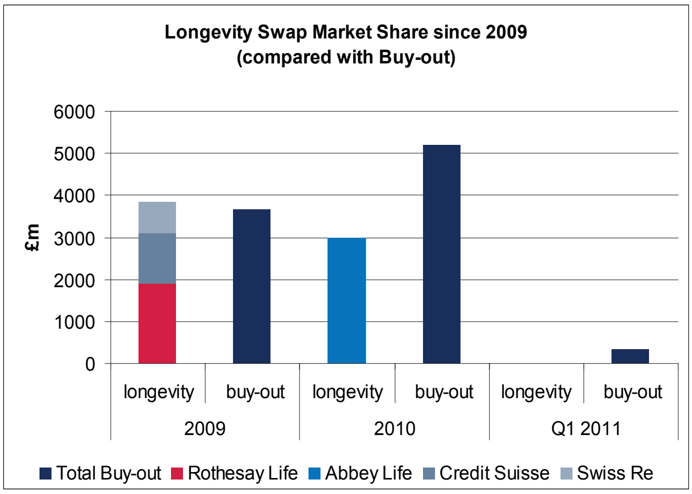
* Completed longevity swaps for three of its schemes during 2009.

Market Statistics

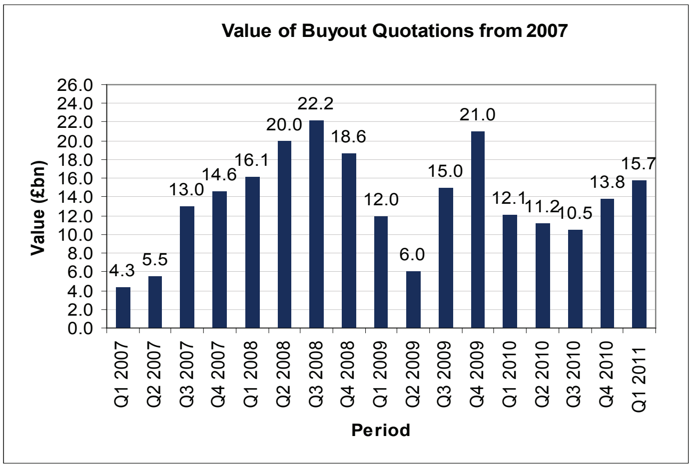
A breakdown of the various insurers' buyout market share since 2000 is illustrated in the graph below.



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



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 high level of activity in the early part of the year was not reflected in the number of completed deals in Q1, although a number of larger cases have subsequently transacted in Q2. All insurers are still very busy with quotation work and we understand that there are at least 10 £1bn plus schemes investigating a buy in/buyout at the current time.

After a flurry of activity in 2009 and early 2010, there have been no further longevity swap deals since the second quarter of 2010. As these deals are mostly bespoke and cover very large schemes, this is not completely surprising. We continue to expect a small number of large transactions in this space.

The first indexed longevity deal for non pensioners is very interesting. This is an area with significant potential, although unlikely to be of interest to the majority of schemes.

The outlook for the rest of 2011 remains healthy, with no sign of supply side restrictions as yet. The desire to innovate on the part of the insurers is strong and we believe they are committed to offer whatever flexibility they can around contract and payment terms, in an attempt to make deals happen. This is balanced by a strong desire by both trustees and sponsors to reduce their pension risk, or even liquidate their defined benefit pension scheme, if at all possible.

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