Lane Clark & Peacock
Actuaries & Consultants

Pension buyout market

January 2009 update

This briefing note provides company management and trustees with an update on activity in the UK pension buyout market. In particular, we review how the global financial crisis has impacted the prices at which pension liabilities can be transferred to insurance companies and look at which insurers have been successful in winning business over 2008.

Headlines

Many insurers took a step back from the buyout market in the immediate aftermath of Lehman Brothers' insolvency in September 2008, but we saw renewed confidence from insurers in the run-up to the year end, evidenced by some competitive pricing and a number of transactions completing.

Prices are currently above the historically low levels seen in the first half of 2008, but they will still be attractive to many schemes. A typical scheme could now expect to complete a buy-in of their current pensioners at broadly the same cost as their funding reserve.

Total business volumes for 2008 are likely to have been around £8bn, compared to £2.9bn in 2007. Lane Clark & Peacock ("LCP") expects 2009 volumes to be similar to 2008, with depressed equity values meaning activity is likely to be focused on pensioner-only transactions.

Interest in longevity swaps is starting to grow as pricing becomes more competitive, potentially offering an alternative to buy-in for schemes keen to maintain direct control of their assets but wishing to reduce exposure to the risk of improving life expectancy.

These issues will be covered in more depth in Lane Clark & Peacock's annual "Pension Buyouts" report later in 2009.

www.lcp.uk.com/buyouts

Pricing

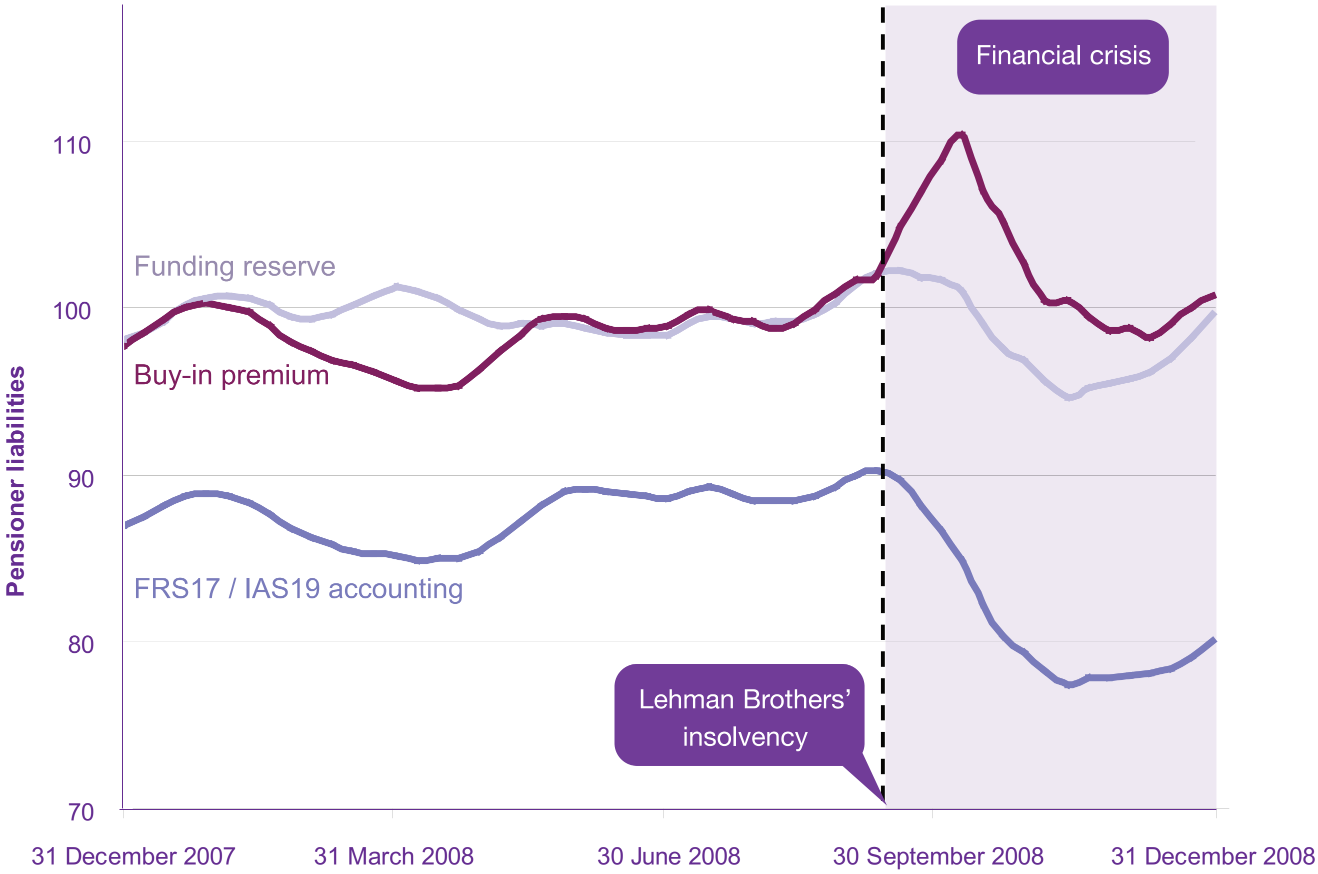
The buyout market in 2008 was dominated by a number of significant "pensioner buy-ins". A pensioner buy-in transaction involves the trustees of a scheme purchasing an insurance policy to fully match the future pension payments to some or all of the current pensioners.

In the first half of 2008, buy-in prices for pensioners were frequently lower than the funding reserves being agreed between trustees and companies in their actuarial funding valuations. This provided an opportunity for schemes to transfer investment and longevity risk to an insurance company without increasing their funding deficits or requiring accelerated cash contributions to be paid to the scheme.

Following the collapse of Lehman Brothers in September 2008, there was a sharp increase in buy-in prices, both in absolute terms and relative to both funding and accounting valuations. In addition, many insurers were not prepared to guarantee their quotations during this period. After this initial spike in September, pensioner buy-in prices started to converge once again with a typical funding basis, as can be seen from the chart below. A typical scheme could currently expect to complete a buy-in of their pensioners at broadly the same cost as their funding reserve.

Whilst pensioner buy-in pricing and typical funding reserves have converged again, the gap to accounting values has widened significantly. This reflects the rapid increase in corporate bonds yields following Lehman Brothers' collapse which has pushed down accounting values to historically low levels.

Funding measure for pensioner liabilities (UK)



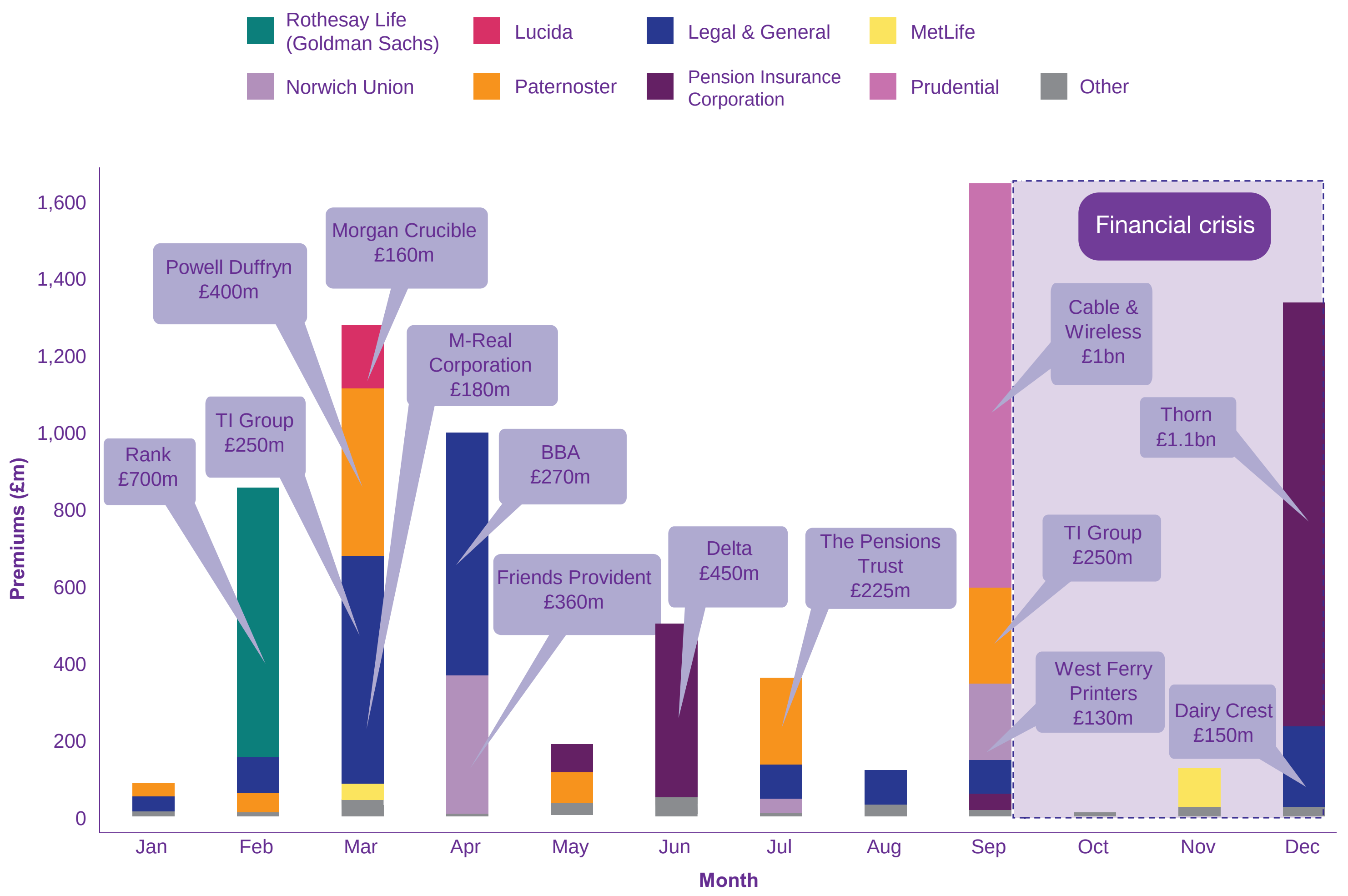
Source: LCP analysis

Deal activity

The chart below shows all significant buyout and buy-in transactions announced during 2008. The two month "shutdown" of the market during October and November can be clearly seen; during this period many schemes who were close to completing deals decided to defer completion until insurers could price with more certainty, and liquidity in investment markets improved. In fact, December then proved to be one of the highest months to date for business written, driven by the £1,100m buyout of the Thorn Pension Scheme by Pension Insurance Corporation – just eclipsing Prudential's £1,050m pensioner buy-in by the Cable & Wireless Pension Fund in September. Pension Insurance Corporation's success in closing deals has followed on into 2009 with their recent announcement of the £230m full buyout of the Leyland DAF Pension Scheme.

Total business volumes for the year, based on publically announced deals in the fourth quarter and information provided to us by insurance companies, are expected to be around £8bn. Final figures will be included in our "Pension Buyouts 2009" report.

Publicly announced buyout and buy-in transactions over 2008 (UK)



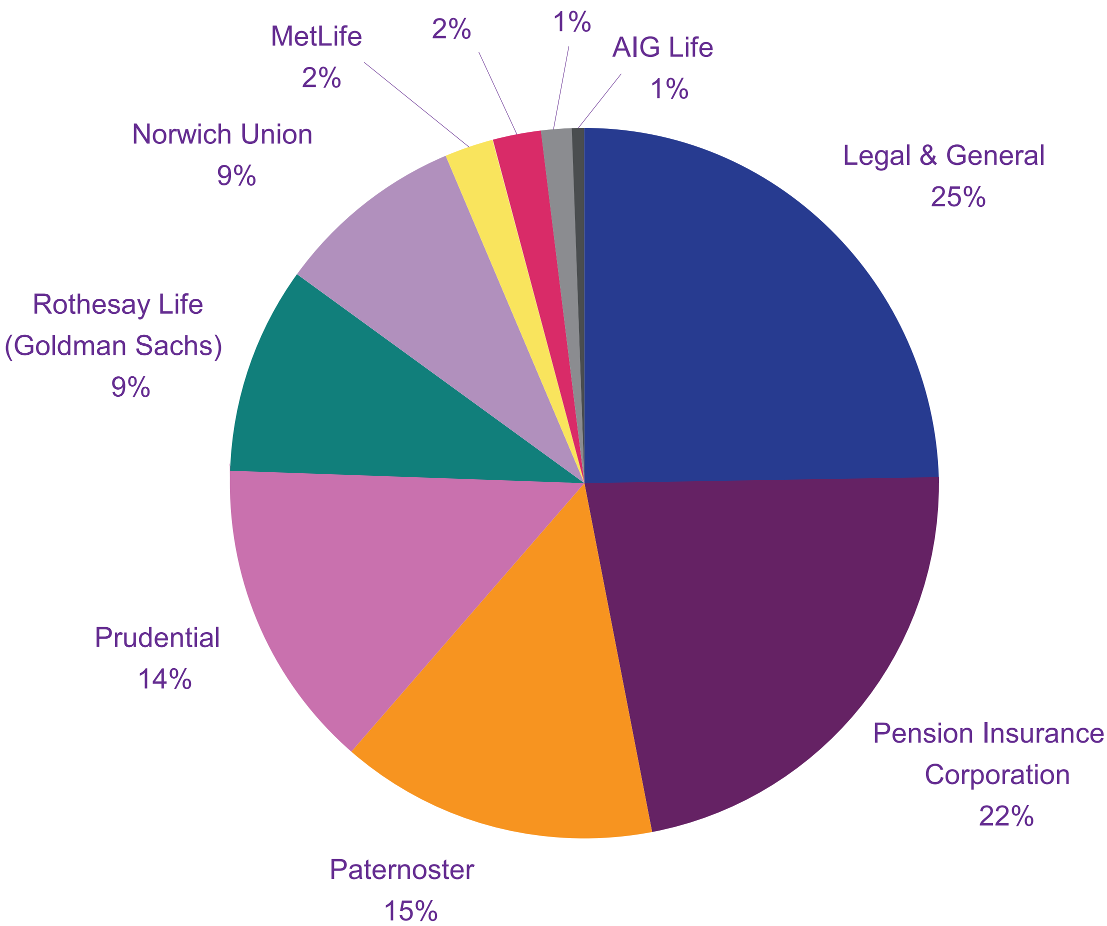
Source: Insurer data for Q1 to Q3 2008. Publicly announced deals for Q4 2008.

Deal activity (cont.)

A noticeable feature of the market in 2008 was the absence of any further non-insured buyout transactions (typified by the £3bn telent acquisition by Pensions Corporation in November 2007). The fact that the Thorn Pension Scheme moved from a non-insured transaction to a full insurance based buyout gives further evidence of the change in focus towards insured buyouts.

The chart below shows insurance company market shares during 2008. As the buyout market matures, business is being spread more evenly across the different providers – for example, during 2007 over 90% of business was written by Legal & General and Paternoster. This year it is split between six insurance companies with Pension Insurance Corporation leap-frogging the pack and joining Legal & General and Paternoster at the top.

Provisional 2008 market share by value of transactions written (UK)



Source: Insurer data for Q1 to Q3 2008. Publicly announced deals for Q4 2008.

2009 UK outlook

We see a continued bright outlook for pensioner buy-in transactions in 2009, driven by renewed confidence in the ability of insurance companies to weather current market conditions and by continued competitive pressure on insurance company pricing. The spread of business between several insurers is a positive sign of the competition that currently exists within the buyout market. Full buyouts over 2009 are likely to be limited to schemes, such as the Leyland DAF Pension Scheme, that had completed investment de-risking programmes before the equity market falls in 2008.

Overall we expect that pension buyout business volumes for 2009 will be similar to 2008 levels at around £8 billion.

Practical steps for companies and trustees

The implementation of a pension buyout or buy-in is a significant exercise and there are a number of steps that companies and trustees can take now to ensure they can act quickly to take advantage of attractive pricing when market conditions are right.

Steps that can be taken include:

Set up a trigger-based approach

A buy-in is essentially an investment decision. Therefore it is helpful to set up a framework for assessing whether a buy-in price represents an attractive investment. By monitoring pricing closely schemes can identify when the price is within their target zone and work quickly to execute and achieve the desired risk reduction.

Review your data

Few schemes go through a buyout or buy-in process without a number of data issues arising. A data audit in advance of the process can speed up negotiation and implementation, as well as providing increased certainty over price. The recent guidance on record keeping from the Pensions Regulator serves as a timely reminder of the importance of ensuring that schemes' data is in order.

Review your investments

Transitioning significant amounts of assets can be challenging in volatile financial markets and this has been a significant hurdle in recent transactions. By reviewing the marketability and liquidity of the scheme's investments in advance of any deal, work can be undertaken to prepare asset portfolios to allow a buyout transaction to be executed more rapidly. Some schemes may also wish to adjust their investment strategies to better match their position against buyout or buy-in pricing.

Review the insurers

One of the most difficult decisions for trustees is selecting which insurer to place the business with. This decision can be made easier by spending time now understanding who the insurers are and what they can offer. Assessing the insurers' strengths and weaknesses and considering potential selection criteria will allow the final decision on insurer selection to be made much more quickly when the time comes. The importance of this stage of the process had been emphasised by the recent high profile difficulties that AIG Life's US parent company has experienced.

Longevity hedging - is now the time?

Alongside buyout and buy-in, interest is continuing to grow in market tools that allow longevity risk to be managed whilst the trustees retain direct control of the scheme assets. These tools are offered by a range of insurance companies and investment banks.

Whilst there is considerable innovation taking place, the market is still early in its development and parallels can be drawn to where the buyout market was several years ago. Indeed, at the time of writing, the only known longevity hedges to have transacted have been between financial institutions and none yet by a UK pension scheme.

Longevity hedging is available in a number of different forms. One common form provides a full longevity hedge for pensions in payments. We see this as being a potentially attractive alternative to buy-in for schemes and corporate sponsors in a number of scenarios, including where:

- there is an appetite to retain investment control in an attempt to enhance future scheme investment returns through investing in reward-seeking assets;
- there is a desire to avoid counterparty risk (for example with a single insurance company); and
- a buy-in or buyout is difficult to execute (for example due to a shortfall in scheme funding, uncertain market conditions, or where pension liabilities are very large).

We expect increased interest in longevity hedging during 2009. In many ways the market for hedging longevity risk is in a very similar position to the buyout market at the start of 2007 with the potential for rapid growth if the pricing is seen as attractive.

LCP and the pension buyout market

LCP designed and implemented the first of the new-style pensioner buy-in deals for Hunting in early 2007 and has since advised on many more including pensioner buy-ins over 2008 for Cable & Wireless Plc, West Ferry Printers and Morgan Crucible.

In an article by Financial News in January 2009, LCP was recognised as one of the two leading buyout advisers over 2008 having advised on more medium or large buyout deals than any other adviser. This followed LCP's market leading position in 2007, where LCP advised on 50% of all medium or large buyout deals.

For further information about pension buyouts and LCP's specialist services in this area please contact **Clive Wellsteed**, **Charlie Finch** or **Jill Ampleford** in our London office, **David Stewart** in our Winchester office, or the partner who normally advises you. For further copies of this briefing note or the full LCP Pension Buyouts 2008 report, please download a copy from our website **www.lcp.uk.com/buyouts** or contact **Mark Roberts** on **+44 (0) 20 7439 2266** or email **enquiries@lcp.uk.com.**

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