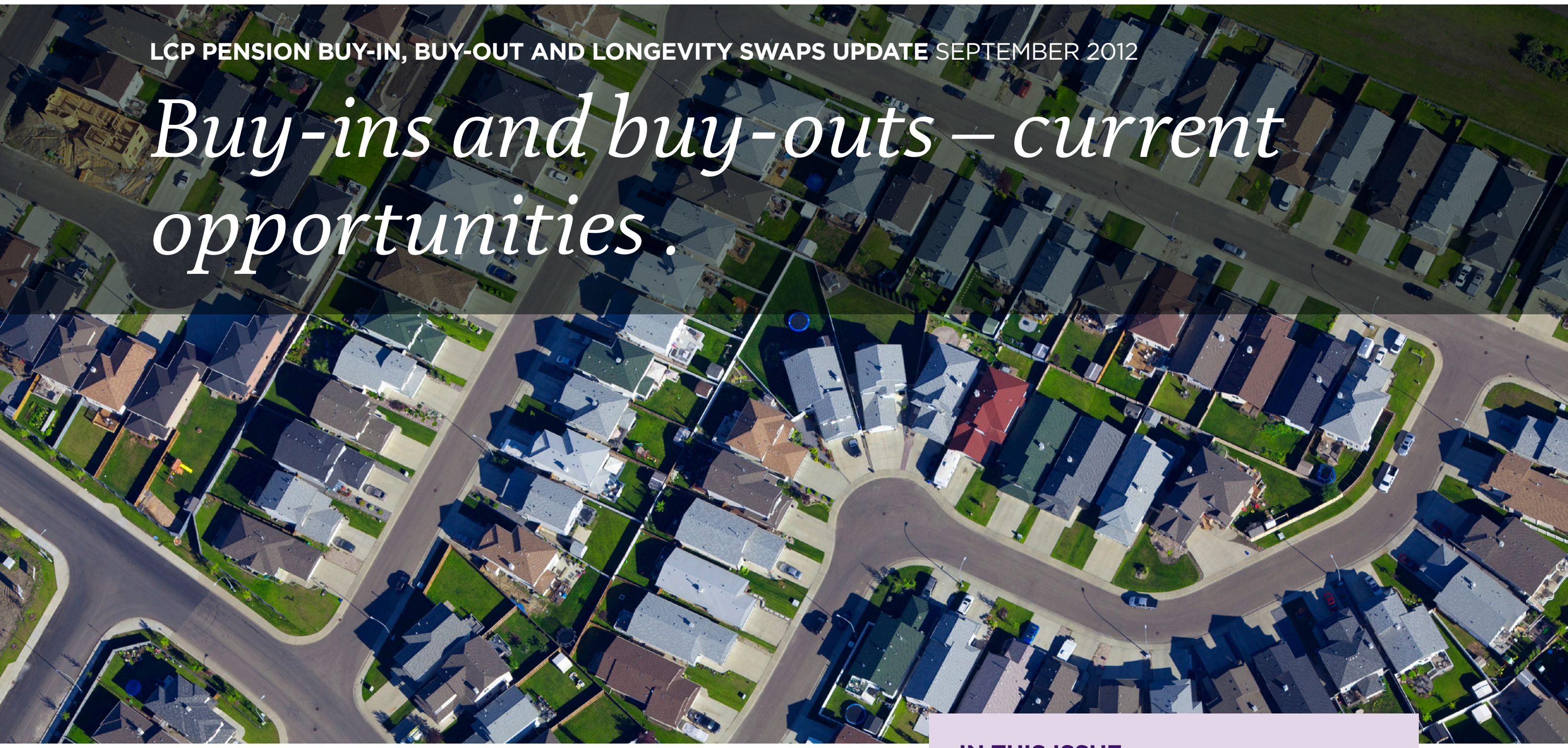
LCP PENSION BUY-IN, BUY-OUT AND LONGEVITY SWAPS UPDATE SEPTEMBER 2012

Buy-ins and buy-outs – current opportunities

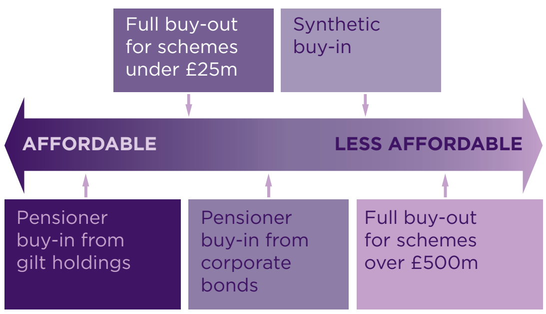


IN THIS ISSUE

Many trustees have already planned their de-risking journey, while others are currently considering what their end game is and how they might get there.

Along the way market opportunities will arise and for many the real skill will be identifying these and acting quickly. As market conditions change, so does the relative affordability of the various insurance driven solutions available to pension funds (the diagram opposite illustrates the current position).

This update sets out what we believe are currently the most attractive insurance solutions and some of the latest developments and innovations.



What de-risking solutions might work for my scheme?

We comment below on the three transaction structures that we believe are currently most cost-effective for a typical pension scheme.

1. Schemes holding gilts MORE AFFORDABLE
For schemes holding gilts the past 12 months have offered the most favourable buy-in pricing since 2008. Currently most schemes can exchange their gilt holdings for a buy-in policy covering some or all of their pensioners, with little or no funding strain.

2. Schemes holding corporate bonds AFFORDABLE
Corporate bonds have seen significant gains in value in recent months. These gains can be sufficient to offset any funding impact to exchange them for a buy-in policy. Most insurers invest in corporate bonds so will offer a price discount to receive corporate bonds as payment for the buy-in.

3. Full buy-out of small schemes AFFORDABLE
Current low yields mean buy-out is unaffordable for most large pension schemes. However, for smaller schemes (up to perhaps £25 million) ever increasing compliance and governance costs mean that once the capitalised value of on-going running costs have been taken into consideration, a buy-out will often be more economic than continuing the scheme in its current form.

For a £12m scheme with a funding deficit of £2m, a £5m buy-out deficit may initially look unattractive. However, if the capitalised value of future expenses and management time is included (c£3m), the ongoing position looks similar to buy-out, but with considerable uncertainty over the future deficit.

Innovations in the marketplace over 2012
The buy-in and buy-out market is constantly evolving. We set out below three innovations that have come to prominence over the past six months.

1. Premium payment solutions
Recently, an insurance company completed its first transaction using an innovative product, which, in this case, insured all pension payments after 10 years; the first 10 years of payments being met by the trustees. By not insuring the first 10 years of payments the premium for the buy-in was reduced by nearly 50%, while continuing to close off the key long term risks. This can fit in well with a recovery plan over a similar period.

2. Use of property
Companies now have the opportunity to use property assets they may hold to fill the scheme's buy-out deficit. In simple terms this can involve the transfer of property in part or in full to the insurance company to meet any short-fall in the buy-out cost; the company then makes lease payments to the insurer over the period of the arrangement (typically a number of years), after which ownership of the property reverts to the company. One such transaction has already completed with an insurer.

3. Medically underwritten bulk annuities
Following significant growth of enhanced individual annuities in recent years, four providers have developed medical underwriting solutions over 2012 for the buy-in and buy-out market. Our view is that while care is needed on the implementation, for smaller pension schemes medically underwritten buy-ins provide a useful alternative to conventional buy-in. They can also be effective at targeting the largest pensions in a scheme thereby removing a significant concentration of risk at a cost-effective price.

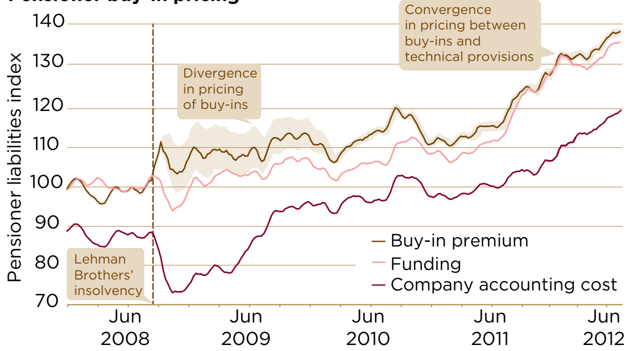
These innovations are creating opportunities for underfunded schemes to buy-out.

Schemes should move promptly to take advantage of current favourable buy-in pricing conditions.

A combination of quantitative easing and investors searching for a safe haven has contributed to current low UK gilt yields and, therefore higher liability values. However, the current unprecedented price of gilts also presents opportunities in terms of exchanging gilts for a buy-in policy with an insurer.

Over the past 12 months, insurer buy-in pricing relative to gilt valuations has been at its most favourable level since 2008.

Pensioner buy-in pricing



Source: LCP research

What is driving this current opportunity?

Buy-in pricing will usually reference swap yields and credit spreads. Over the last 12 months, widening credit spreads have allowed insurers to achieve better returns on their investments and so price more competitively. For pension schemes that have benefitted from the performance of UK gilts, the relative differential between technical provisions and buy-in looks very affordable.

LCP's streamlined service for pensioner buy-ins helps schemes transact quickly, maximising the chances of executing at a highly competitive price.

Where will buy-in pricing go?

The higher credit spreads are partly a result of the Eurozone crisis. There are three scenarios which could play out potentially affecting the buy-in opportunity:

Eurozone situation contained but continued uncertainty

This is the current situation. From a market opportunity perspective, this scenario is the most favourable and will encourage continued high credit spreads and favourable pricing compared to gilt prices.

Eurozone situation improves

In this scenario it's likely that gilt values and credit spreads would reduce, thus increasing pricing relative to gilts making the current opportunity less attractive.

Eurozone deterioration

Whilst this would appear to favour pricing, insurance companies looking to invest in high quality corporate bonds may find the market illiquid during a time of significant uncertainty. This could prevent a transaction completing or increase prices due to the risk premium an insurer would charge to protect against the market risk of purchasing suitable assets.

Pension schemes that initiate a buy-in process today can expect to be in a position to transact over the next 3-4 months if they move promptly using an experienced provider, allowing them to take advantage of current favourable conditions.

LCP INSIGHT CLARITY ADVICE

How LCP can help

Some useful next steps for trustees/companies looking to investigate insurance de-risking options further include:

- **Trustee training** – a useful way to ensure a good level of trustee understanding ahead of any proposal to explore buy-in, buy-out or longevity insurance options.
- **Feasibility exercise** – to help compare insurance options such as buy-ins to other de-risking options, focussing on the most suitable approaches for your scheme given its membership profile, benefit structure and investment strategy.
- **Seminars** – we run regular seminars on buy-in and buy-out options, both for larger and smaller pension schemes, often with guest speakers such as clients and lawyers who have hands-on experience.

A list of forthcoming seminars can be found at www.lcp.uk.com/events.

Emma Watkins
Principal
emma.watkins@lcp.uk.com
+44 (0)20 7432 7757

Any questions?

If you would like any assistance or further information on the issues raised, please contact Emma Watkins or the partner who normally advises you at LCP.

LCPs buy-out practice

LCP have one of the largest and most experienced pension buy-out advisory teams in the UK, with a clear focus on getting transactions across the line and a strong reputation for achieving a competitive price and commercial terms. We have led the way in de-risking pension schemes across the spectrum of transaction sizes, from ground-breaking solutions for some of the UK's largest pension schemes to our recent launch of a streamlined process to give smaller to medium sized pension schemes access to the market on a fixed fee basis.

LCP is a firm of financial, actuarial and business consultants, specialising in the areas of pensions, investment, insurance and business analytics.

Lane Clark & Peacock LLP
London, UK
Tel: +44 (0)20 7439 2266
enquiries@lcp.uk.com

Lane Clark & Peacock LLP
Winchester, UK
Tel: +44 (0)1962 870060
enquiries@lcp.uk.com

Lane Clark & Peacock Belgium CVBA
Brussels, Belgium
Tel: +32 (0)2 761 45 45
info@lcpbe.com

Lane Clark & Peacock Ireland Limited
Dublin, Ireland
Tel: +353 (0)1 614 43 93
enquiries@lcpireland.com

Lane Clark & Peacock Netherlands B.V.
Utrecht, Netherlands
Tel: +31 (0)30 256 76 30
info@lcpnl.com

LCP Libera AG
Zürich, Switzerland
Tel: +41 (0)43 817 73 00
info@libera.ch

LCP Libera AG
Basel, Switzerland
Tel: +41 (0)61 205 74 00
info@libera.ch

LCP Asalis AG
Zürich, Switzerland
Tel: +41 (0)43 344 42 10
info@asalis.ch

Lane Clark & Peacock UAE
Abu Dhabi, UAE
Tel: +971 (0)2 658 7671
info@lcpgcc.com