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The pension buyout and settlement market – a practical perspective

Haberdashers' Hall

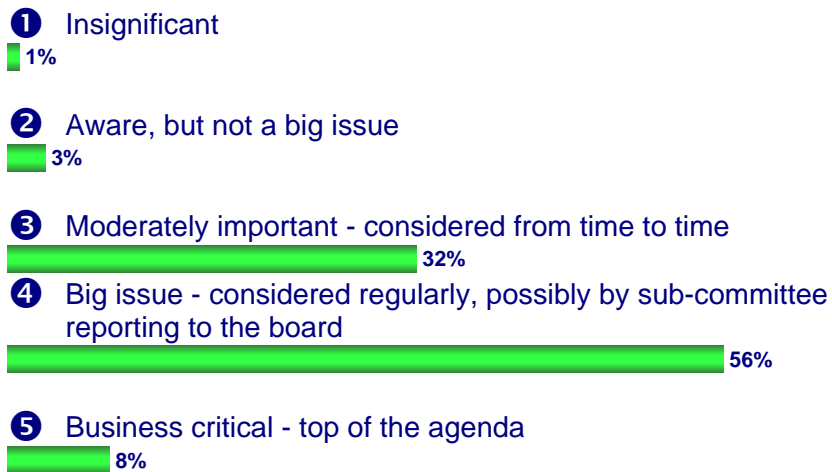
26 March 2008



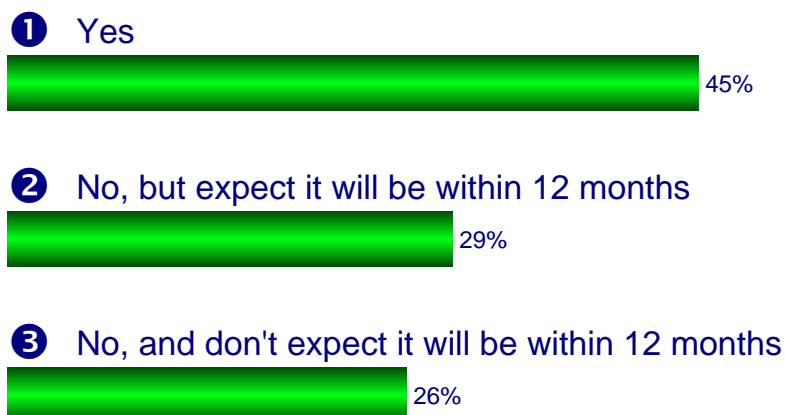
Agenda

- Welcome by the Chairman
Rash Bhabra
- The developing market
Robert Hall
- What employers are looking for
Graham Mitchell
- The provider's experience
Mark Wood
- Q&A

How high up the agenda is pensions for your board?



Has the possibility of buying out your company's pension liabilities been discussed at a board meeting?





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The developing market

Robert Hall



The current buy out landscape



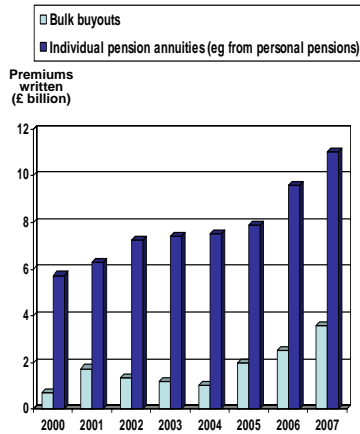
Where we have come from

- Traditionally only two main providers:
 - L&G
 - Prudential
- Solutions limited:
 - Insured buy out (annuities assigned to members)
 - Insured buy in (annuities held as assets of the scheme)

Current marketplace

- Many providers:
 - L&G
 - Prudential
 - Paternoster
 - Rothesay Life/GS
 - Synesis Life
 - Citigroup
 - Pension Corp
 - Lucida
 - UBS/Aegon
 - Other insurers (AIG, MetLife etc)
 - Brighton Rock
 - Pensions First
 - OPT
 - Various others
- Solutions varied:
 - Full or partial insured buy out or buy in
 - Separation from sponsoring employer
 - Bulk transfers
 - Credit insurance
 - Securitisation and longevity swaps

Volumes of insured buy outs & buy ins



Source: Association of British Insurers

Note: 2007 volumes still <0.5% of total DB scheme liabilities

Historic form of market:

- Mostly small (<£5m schemes)
- Some larger schemes forced into buy out by insolvency of sponsoring employer

Pattern from 2007:

- Still mostly small schemes, but
- Insolvent employer cases now largely taken on by PPF
- Emergence of new sector of voluntary buy outs/buy ins

Notable recent transactions

Vendor	Acquiror	Approx size (£bn)	Form
Telent	Pension Corporation	2.5	Acquire entire company, then private equity sale of business, retaining pension scheme
Thorn / Thresher		1.2	
P&O	Paternoster	0.8	Insured buy in
Rank Group	Rothesay Life	0.7	GN16 bulk transfer followed by insured buy out
Weir Group	Legal & General	0.2	Insured buy out
Thomson Regional Newspapers	Citigroup	0.2	Establishment of SPV as principal employer, followed by sale of SPV and employer covenant enhancement
Morgan Crucible	Lucida	0.2	Insured buy in

Recent transfers of non-profit annuity portfolios between insurers

Vendor	Acquiror	Approx size (£bn)
Resolution (SALAC)	Canada Life	2.2
Resolution (Phoenix)	Prudential	1.5
CIS	XL Re	1.0
Royal London	Prudential	1.1
Equitable Life	Canada Life	4.6
Friends Provident	Swiss Re	1.7
Zurich Assurance	Swiss Re	4.5
Standard Life	Canada Life	6.7
Bank of Ireland Life	Lucida	0.1 & flow

- Competitive process for sale of annuity portfolios of up to £6.7 bn
- Indicative of appetite for annuity risks
- Some acquirors also active in buy out market

Emergence of mortality derivative market

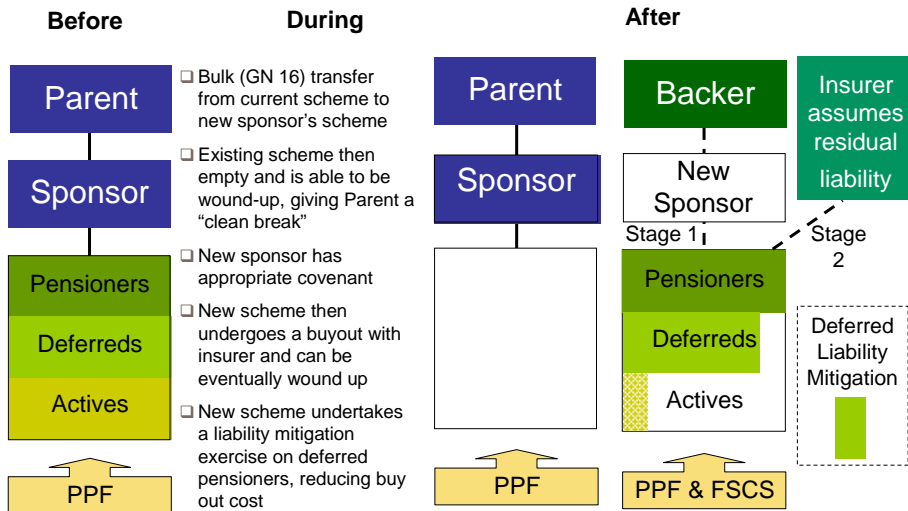
January 2008: first public longevity derivative:

- *Lucida entered into reported £100m 10yr longevity swap:*
- *Based on JP Morgan LifeMetrics indices*
- *Protects Lucida from systemic decreases in population mortality rates*
- *If mortality rates in 10yrs are lower than expected, Lucida receives cash from JP Morgan, if higher than expected, it pays cash to JP Morgan*

- Growing number of banks now prepared to trade in mortality derivatives:
 - Population, or
 - Portfolio specific
- Not a substitute for insurance buy outs, but:
 - Provides schemes with an alternative means of hedging longevity risk
 - Increases capacity of insurers to take on more annuities

Will they come to be regarded in the same way as RPI swaps?

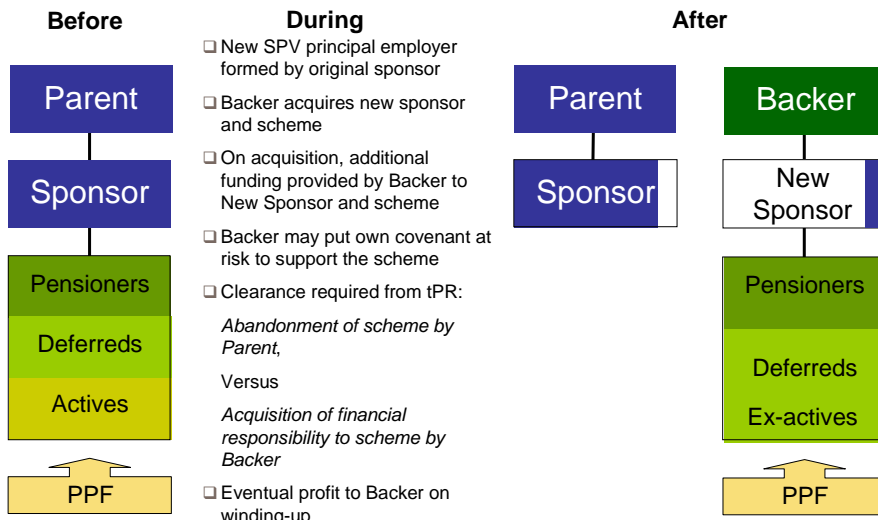
Quasi buy outs: “GN16 transfer” (from Rank Group to Rothesay Life)



Implications of the Rank/Rothesay Life transaction

- Another marker on the trend away from “broking” to corporate finance approach:
 - GN16 bulk transfer gives “clean break” and an easier wind up of existing scheme than traditional buy out
- A new low for buy out costs:
 - Cost <115% of IAS 19
 - c£700m scheme went from reporting a £100m deficit on buy out basis in 2006, to having surplus to pay £20m+ to sponsor, plus benefit improvements by Feb 2008

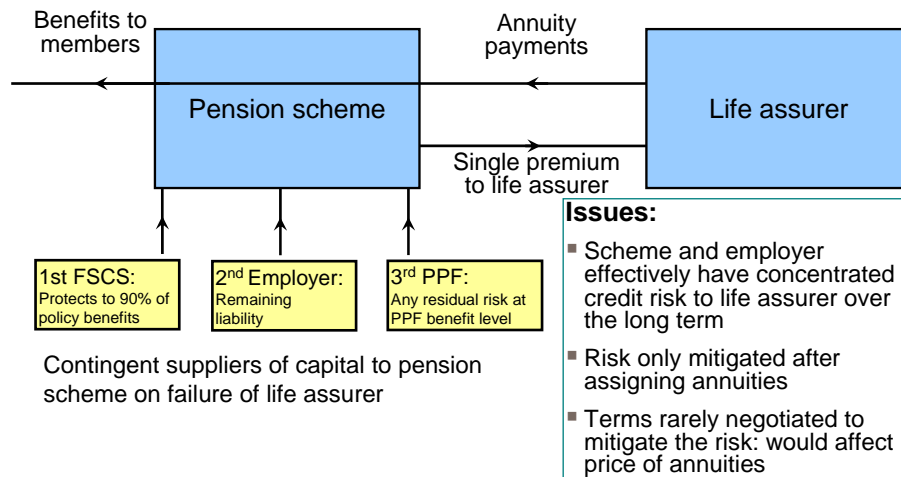
Quasi buy outs: “sponsor separation” (Thomson Regional Newspapers to Citigroup)



Buy out or buy in?

- In 2007; higher volumes of “buy ins” than “buy outs” – but is this in the interests of the scheme and employers?
- Buy in contracts rarely adequately structured for the eventual need for trustees to secure benefits in a wind-up:
 - Often even miss simple language to permit assignment
 - Rarely reflect consequences of annuity ceasing to be aligned with scheme liabilities
- Concentrated credit risks to life assurer

Credit risks on buy in



GMP equalisation

The (PPF) Board has sought advice on the legal and actuarial issues regarding GMP Equalisation. In line with prevailing legal opinion as applied to scheme trustees, the Board's position is that:

- it is subject to a legal obligation to provide equal compensation to men and women in comparable employment situations; and
- this legal obligation extends to equalising compensation to the extent that it is unequal as between such men and women by virtue of their entitlement to GMPs.

The Board is currently taking actuarial advice on the best approach to be adopted in relation to this and intends to consult in due course on the issue. (14/12/2007)

- Normally required to wind up – but few schemes yet recognise the liability
- How to deal with on buy ins?

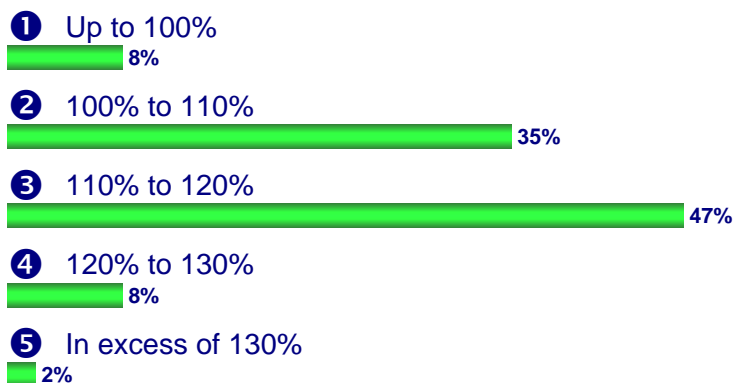
The future?

- Impact of credit crisis is mixed:
 - Wider credit spreads beneficial for some
 - Adverse impact on index-linked instrument availability and cost of equity capital
- Rising pressures on schemes and employers:
 - tPR guidance on mortality assumptions for funding
 - Possible changes to accounting standards
 - Rising PPF levies
- Possible rationalisation of players in the market
 - Impact of competition
 - Doubts about future accounting treatment

Is this as good as it will get for schemes and employers?

Views on pension liability

What is the maximum cheque you would write to see liabilities transfer to a third party (all expressed as % of IAS19)?





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What employers are looking for

Graham Mitchell



Likely corporate objectives

- Drive the business forward
 - Focus on core skills and activity
 - Be competitive in HR and employment marketplace
- Control costs
- Control risk
- Protect the corporate brand
- Manage message to analysts and investors

Removing legacy DB risk can be analysed from all of these perspectives

Differing perspectives on buyout

Can afford it → Do it asap?
→ Security already there

Can't afford it → Long haul?
→ Alternative approaches?

Transfers value from shareholders to beneficiaries?

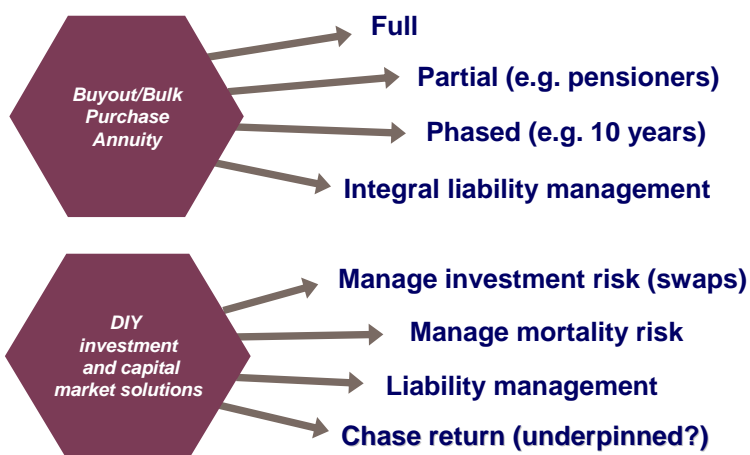
Extent of resources → Can do some in-house?

Early mover advantage ↔ More product sophistication to come

Not today's problem → tPR and ASB will make it so?

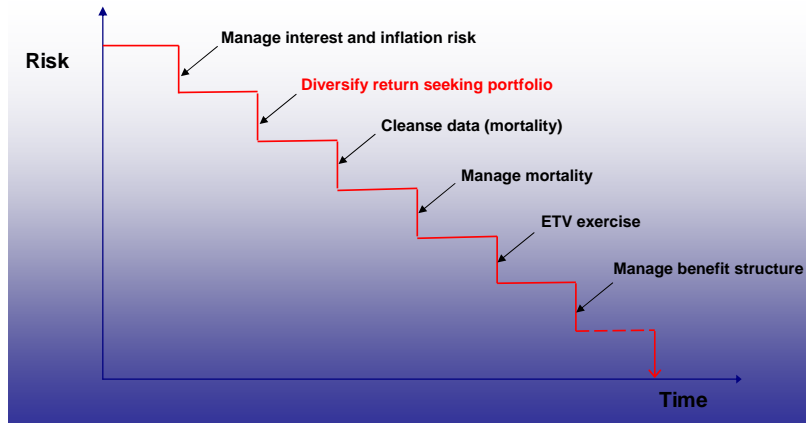
Degree of 'legacy', ownership structure and trustee relationship all key

Selecting approach

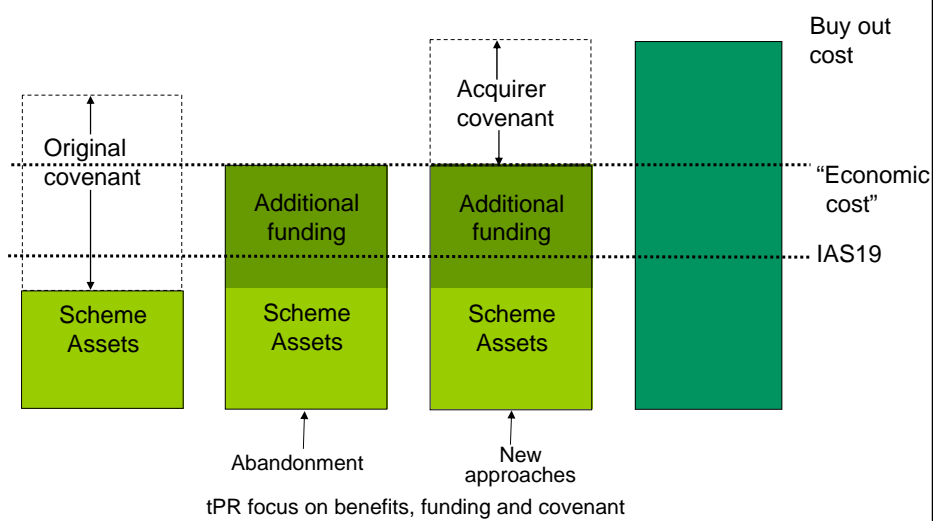


Another alternative is to "get bought"

DIY -steps along the way



Alternative approaches – get bought



Selection – Auction approach

- Where price is the key variable, various auction processes may be used, for example:
 - **A pure price auction:** This requires upfront due diligence of all possible providers to satisfy that they could be chosen if cheapest.
 - **A casting out auction:** A price auction but pre-announcing how many will be eliminated in each bidding round (eg 1 or 2 bidders) to encourage competitive bids from the outset
 - **Limited movement auction:** A price auction with pre-announced limits on the amount by which bids can be changed per bidding round, to encourage realistic bids at all stages
 - **Reverse auction:** Offer a price you are willing to pay and move it up until someone 'bites'

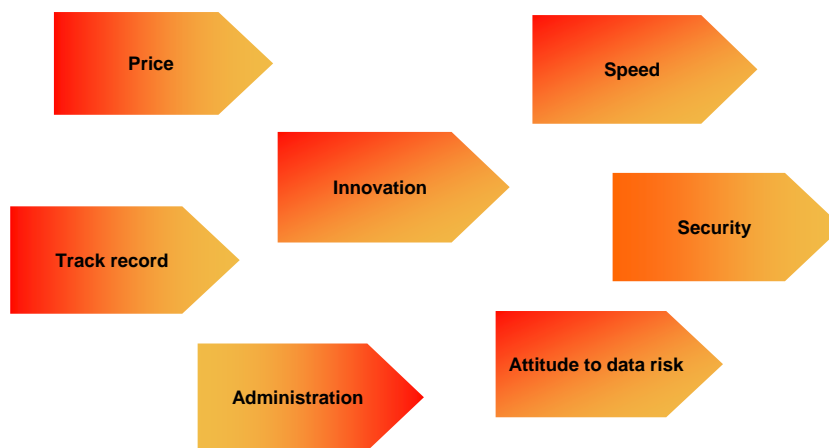
Selection – Auction approach

- Issues with any form of auction can include:
 - **Backtracking:** Bidders can discover errors/oversights in their calculations which mean they increase their price again – particularly difficult if this is after some bidders have been excluded
 - **Segmentation:** May want to place different tranches of members with different insurers, so need to bid each tranche separately
 - **Benefit issues:** Eg hard code existing factors versus letting insurers use their 'normal'
 - **Not accepting the lowest bid:** A particular source of frustration for providers is where a new insurer quotes the lowest price and an established one then quotes a little higher and wins (ie a premium for track record)

Selection – Transaction approach

- Transaction approaches focus on identifying a relatively small number of preferred bidders with whom a more detailed engagement can be made on all possible variables in the process:
 - This is more akin to an M&A transaction than insurance broking
 - It facilitates inclusion of alternative solutions in the process as well as fully insured buy outs
- Issues with transaction approaches can include:
 - An element of **'rough justice'** may be involved in reducing the number of bidders at an early stage; there are likely to be more potential providers than can reasonably be engaged in detailed negotiations – this also means the risk that a particularly competitive potential provider could be inadvertently excluded
 - **Confidentiality/non-disclosure** agreements may be required in order to get sufficiently close working with bidders to allow effective negotiation
 - Significant effort is required on detailed negotiation and to **ensure sufficient bidders remain engaged** with the process to provide competitive tension until the final stage

Selection criteria



Trustee and company weightings will differ

Selection criteria

Next to price, which of the following criteria would you rank as most important in assessing either a range of buyout solutions or individual providers?



What happens next

Product development on mortality?

Step changes in attitudes driven by ASB and tPR?

Economic downturn leading to more future accrual closures?

Regulatory clarity on alternative approaches?

Market will grow

The provider's experience



Mark Wood
26 March 2008


P A T E R N O S T E R

DB risk transfer - insurance market activity




c. £800 million P A T E R N O S T E R



c. £700 million 



c. £240 million 



c. £170 million P A T E R N O S T E R



c. £150 million P A T E R N O S T E R

P A T E R N O S T E R

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Trustee preoccupations

Our primary concern has been to ensure **long term security for our scheme members** and we agreed that transferring to an insurance company was the best way to manage this. Paternoster impressed us at every stage of the process."

Roger Lawson Trustee, Chartered Accountants; Employees Superannuation Scheme

"We are delighted to have been involved in advising the Trustee on the terms of the contract with Paternoster. The new approach that Paternoster is bringing to **securing benefits** is really helpful to trustees of schemes winding-up."

Vivien Cockerill, Partner, Wragge & Co LLP

"As trustees, ensuring the **long term security for the scheme members** was paramount. We are confident that the solution offered by Paternoster delivers the best possible outcome for our pensioners and the remaining members."

Graham Pitcher, Director, GP Noble Trustees

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What our clients say...

"Paternoster had an ability to work effectively towards an end-result within our required timeframe...Paternoster always met the deadlines, working with us to achieve our goals. We found they had a **willingness to consider a structure that addressed our corporate needs** rather than simply following the conventions of the pensions insurance market. This was very apparent when we compared them with the approach of all the traditional big players who we also invited to tender (and some new entrants to the market). Paternoster were both innovative and flexible in contract negotiations. Other providers agreed to match Paternoster's offer when questioned, but it was Paternoster who really led the process, working close to our pensions and legal advisers.

Ferrante Zileri Dal Verme, Finance Treasury Director, Iveco Group

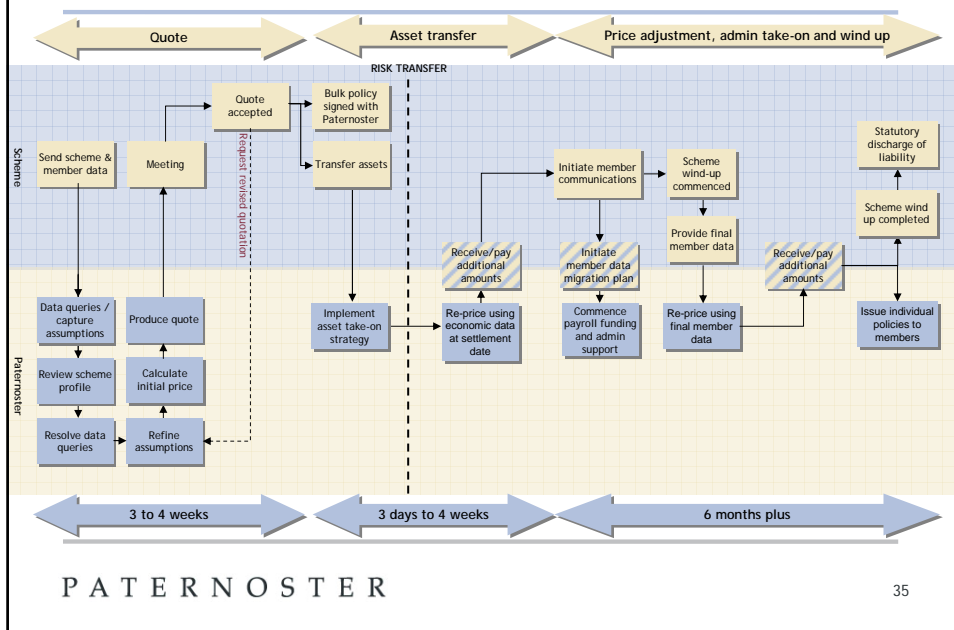
The transition over to Paternoster could not have been better. The payroll was set up without any delay, **communication to scheme members was spot on** and the dedicated Paternoster resource managing the process was excellent."

Ashley Sanders Pension Adviser, Texaco Overseas Tankship Seagoing Personnel & Widows Pension Plan

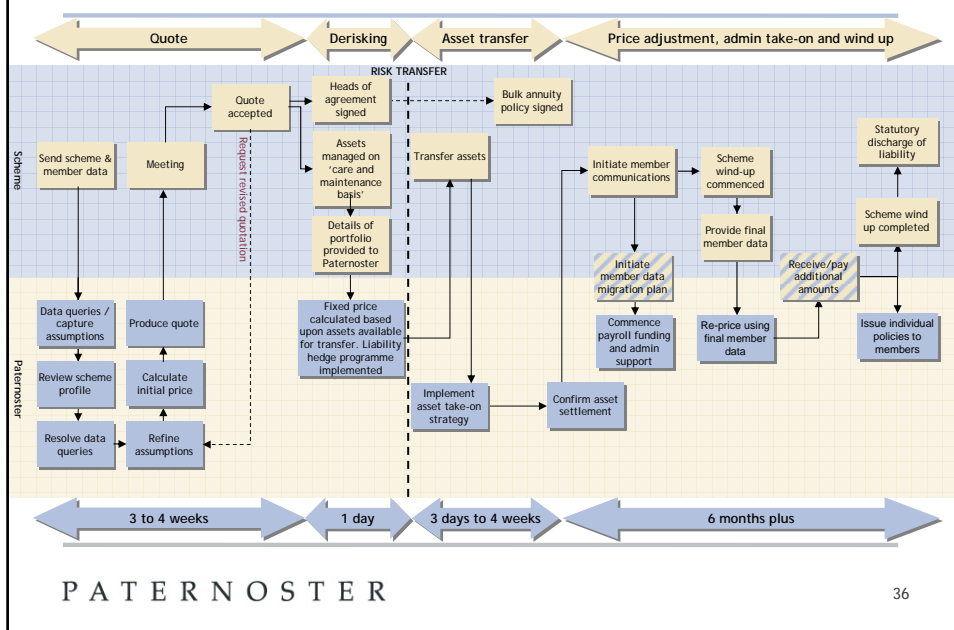
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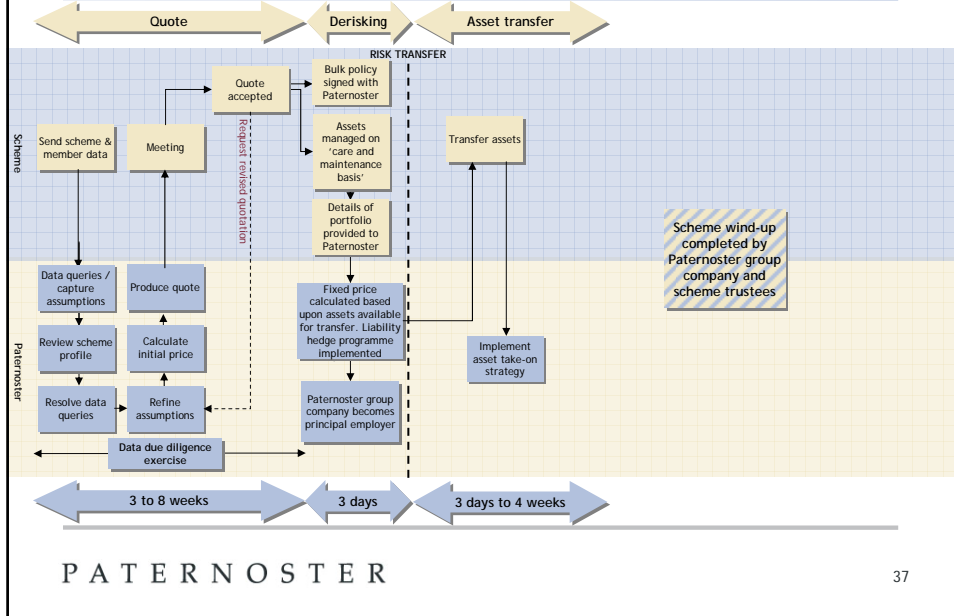
Overview of conventional buy-out process followed by wind up



Overview of fixed price buy-out process followed by wind up

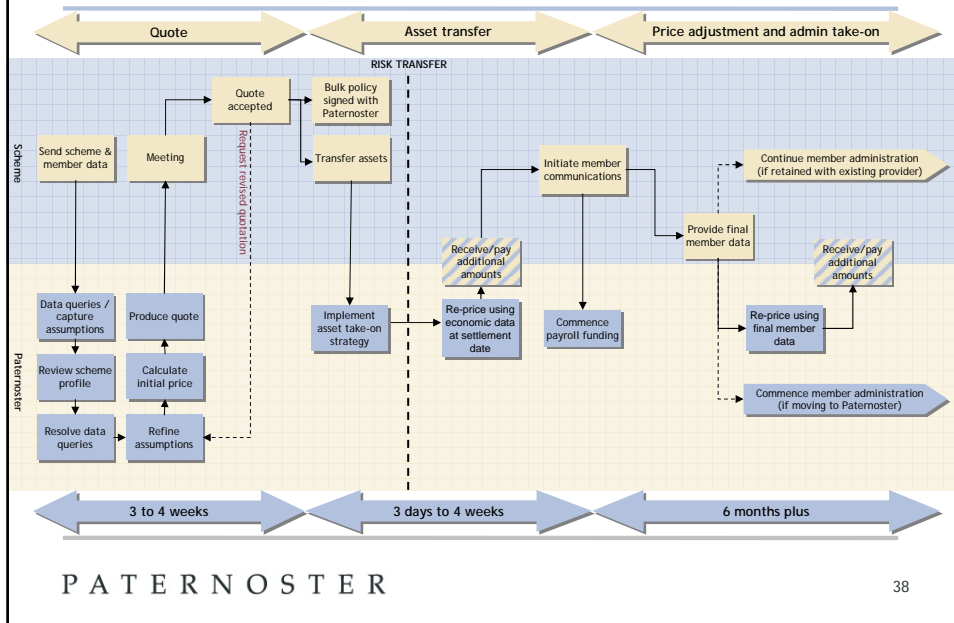


Overview of fixed price buy-out process with data risk removal followed by wind up



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Overview of partial buy-out process



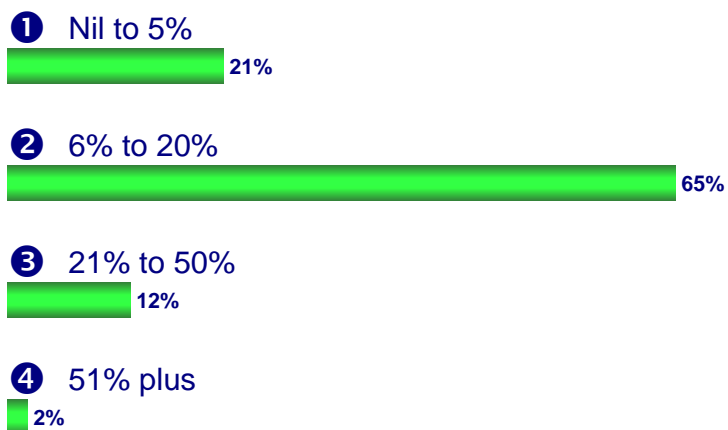
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P A T E R N O S T E R

How much of the current DB market will the expanding buy-out market absorb in the next 3 years?



Which will your scheme do in the next 3 years?

- ① Buy out with established insurer
8%
- ② Buy out with a new insurer
4%
- ③ Non-insured buy out
2%
- ④ LDI (and try to hedge mortality)
14%
- ⑤ Prepare for buyout in next 3-5 years
34%
- ⑥ Prepare for buyout in next 5-10 years
16%
- ⑦ Return seeking run off / DB forever
22%

Questions?