

# De-risking market quarterly update: Q1 2011

## Introduction and summary

Welcome to our quarterly update on the latest developments in the defined benefit (DB) pension plan de-risking market. We will be looking at all aspects of the market, including regulatory developments, product development, completed transactions, product pricing and market sentiments. We will also provide views on the future development and shape of the market.

This continues to be an extremely interesting and dynamic time in the de-risking market, with activity increasing as the UK economy slowly recovers in the aftermath of the global recession.

In this update, we look at the first three months of 2011, including providing a background to some pertinent regulatory issues, the drivers behind recent de-risking activities, some innovative de-risking solutions that we can advise on and a preview of how we think the market will develop in the next six to twelve months.

## Regulatory issues in the market

### The switch from RPI to CPI indexation

The impact of this change is dependent on what has been hard-coded into the scheme rules. If indexing against the Retail Price Index (RPI) is specified in the rules, revaluation will still be linked to RPI. However if RPI is not stipulated, revaluation can be linked to the Consumer Price Index (CPI).

Historically, CPI has been around 80bps lower than RPI. Any savings on bulk annuities might be limited as insurers do not currently have a market in which to purchase CPI-linked assets. Thus, a change to CPI is likely to lower the on-going valuation of liabilities, but this might not translate into lower de-risking costs.

### Solvency 2

The implications of Solvency 2 on insurance company reserving continue to be debated. The most likely result is higher capital requirements for bulk annuity writers.

Most insurers have indicated that their current pricing of buy-ins and buy-outs reflects their expectations of Solvency 2 reserving requirements.

### Guaranteed Minimum Pension (GMP) equalisation

As yet, there is no specific guidance on equalisation methodology. It is important that plans looking to buy in or buy out make an allowance for equalisation in their valuation of benefits, which they should then communicate to insurers. Some insurers are offering de-risking quotations that immunise the pension plan against inappropriate GMP equalisation methodology.

## Spin off from the budget

The government has hinted at cutting employer tax relief on asset-backed contributions to defined benefit pension plans. This could make these structures (alternative financing) less appealing to employers and less common.

## Appetite for de-risking

The global financial crisis of 2009 and early 2010 magnified the risks inherent within defined benefit pension plans. This has led to a sharp rise in the appetite of UK trustees and sponsors to de-risk their pension plans.

Good corporate and pension governance is often associated with having a clear and identifiable strategy for managing or de-risking the pension plan. A wealth of new and innovative de-risking solutions have come on to the market. These solutions look to address the underfunded nature of many plans by minimising requirements for large asset transfers. Solutions include longevity swaps, deferred premium buyouts and asset swap structures.

De-risking can be done in phases and the cost can therefore be spread over time. For example, deferred premium buyouts can be structured to fit in with an employer's schedule of contributions into the pension plan.

## De-risking benefits for Trustees and Members

**Protect members' benefits** - de-risking the pension fund is seen as part and parcel of protecting and securing members' benefits

**Negotiating tool** - de-risking can be a condition for trustees to grant an employer a longer recovery period to pay off a deficit

**Better informed** - trustees have a better understanding of the range of de-risking options, together with their associated values

## De-risking benefits for employers

**Removing volatility** - sponsoring employers are keen to cap or remove the cost of operating the pension plan

**Business restructuring** - de-risking is part of a longer-term strategy to restructure the sponsoring employer through a sale or merger

**Enterprise value protection** - sponsors wish to invest in growing the operating business and do not want the enterprise value of the business to be artificially depressed by the pension fund



### Market news

Pricing for pensioners remains attractive from most providers and the buy-out price will vary, depending on each provider's investment strategy and access to high yielding assets. The table below is for general guidance and it is possible to get prices from the market that are +/- 5% for buy-outs and buy-ins. As scheme funding positions generally improve (despite short term volatility) it is expected that buy-ins will continue to be the dominant de-risking transaction in terms of volume in the market. Recent research suggests that buy-ins and buy-outs are now more popular than longevity risk hedging.

Strategy	Indicative price (excluding adviser fees)
BPA* buy-out	40% to 60% above accounting liabilities
BPA buy-in	10% to 20% above accounting liabilities
Indemnity-based longevity swap	10% to 15% above actuarial Technical Provisions (using medium cohort with no underpin)
Index-based longevity swap	5% to 10% above actuarial Technical Provisions (using medium cohort with no underpin)
Deferred premium BPA	Initial price will be in line with BPA buy-out or buy-in pricing, but total premium payment (including lower initial premium) is likely to be higher than initial price due to longevity guarantee and/or interest on deferred premiums

\* Bulk Purchase Annuity

### Market sentiment

Investors and equity analysts are increasingly taking into account the risk management strategies of companies with DB pension funds. There is evidence to suggest that the market responds positively to companies that have implemented a materially significant risk reduction strategy on their pension plan. See the table below for some examples.

Company	Date	Type of de-risking	Transaction size	Share price		% change
				Before	After	
Babcock	May 2009	Longevity swap	£1.9bn	412	480	16.5%
Dairy Crest	June 2009	BPA	£310m	280	325	16.0%
Royal Sun Alliance	July 2009	Longevity swap	£1.2bn	113	130	15.0%
British Airways	July 2010	BPA	£1.3bn	188	207	10.0%
Denso	September 2009	BPA	£140m	1,900	2,020	6.0%
BMW	February 2010	Longevity swap	£3.0bn	2,870	3,040	6.0%
Cadbury	December 2009	BPA	£500m	791	837	6.0%

10.2% Average

### Quotations and stakeholder management

Providers report that quotation requests are up from this time last year, with a 60/40 split between BPA and longevity swap quotes respectively, against a 50/50 split in 2010. Amongst our clients, there is a split of 80/20 between BPA and longevity swap de-risking enquiries respectively. We are finding that there is increasing interest from clients about longevity hedging on an indexed basis. Buy-ins continue to be the most popular solution considered by clients.

If you are a stakeholder considering de-risking the pension fund, it might be useful to consider the following:

- Involve key stakeholders from the outset - a Joint Working Party or Committee - is key to ensuring that the process runs smoothly
- Resolve potential issues upfront – anticipate potential issues that might create a delay or increase the cost of the potential de-risking solution, such as guaranteed minimum pension equalisation
- Provide accurate data – whether you are undertaking a buy-in or any form of longevity swap, good quality data will be beneficial in terms of potentially lowering the cost of the de-risking solution
- Document benefits concisely – this will help to save time and ensure that the right levels of benefits are provided and secured
- Assess investment strategy – whether you are undertaking a buy-in or a longevity swap, it is important that the pension fund has the appropriate assets to transfer to an insurer or to use as collateral in any swap arrangement

### Outlook for the next 12 months

#### Bulk purchase annuities

The outlook for 2011 is highly encouraging. A combination of improvements in the investment market and stronger funding requirements will see a narrowing of the gap between buy-out and on-going funding costs. In some instances, a pensioner buy-in could lead to an improvement in the scheme's funding position.

We expect there to be more innovation around the products offered and that market capacity will rise as new players enter the market. This will in turn lead to competitive pricing and real opportunities for plans to de-risk. Our forecast is that the total Bulk Purchase Annuity transaction value will reach nearly £5 billion by year end 2011.

### Longevity swap market

Following the largest industry deal in February 2010 between Abbey Life and BMW UK for £3 billion, there have been no new publicly announced indemnity-based longevity swap deals transacted. We do, however, believe that one or possibly two indemnity-based longevity swap deals will be announced by year end 2011.

The first index-based longevity swap deal on non-retired members took place during Q1 this year and we expect this

structure, once basis risk has been understood, calculated and controlled, to become increasingly popular with most schemes with liabilities above £50 million. We also expect more plans to use a combination of solutions to tackle the different risks they face. Combining a pensioner buy-in and a non-retired index-based longevity swap with a liability-driven investment (LDI) overlay can lead to a de-risked position that is very close to a buy-out - a 'DIY buy-out', where the index-based longevity swap would have to be re-executed at the end of each contract term (usually every 15 years).

### De-risking transactions in the last year

The top 5 largest bulk purchase annuity deals struck in the last 12 months are listed below:

Date	Pension scheme	Counterparty	Value
July 2010	BA	Rothsay Life (Goldman Sachs)	£1,300m
November 2010	GlaxoSmithKline (GSK)	Prudential	£900m
August 2010	Alliance Unichem (Boots)	Pension Corporation (PIC)	£310m
May 2010	Unknown	Legal & General	£230m
Others	Others	Others	£989m
<b>Total</b>			<b>£3,729m</b>

Notes:

- BPA pensioner buy-ins continue to be the most popular de-risking solution
- Prudential completed their first major deal since Cable & Wireless, in 2008, by executing a pensioner buy-in with GSK for £900 million
- Goldman Sachs has completed its purchase of Paternoster which, for the time being, sees Goldman Sachs owning two separate UK Life insurance companies (Rothsay Life and Paternoster) offering pension risk transfer services
- There is an intention to combine Rothsay Life and Paternoster over time, subject to legal terms being agreed

### The major longevity swap deals struck over the past 18 months

Date	Pension scheme	Counterparty	Structure: (indemnity or index-based)	Value
February 2010	BMW UK	Abbey Life (Deutsche Bank)	Indemnity	£3,000m
December 2009	Royal County of Berkshire	Swiss Re	Indemnity	£750m
February 2011	Pall UK Pension Fund	JP Morgan	Index	£70m
<b>Total</b>				<b>£3,820m</b>

Notes:

- The first index-based longevity swap hedge for non-retired members was written in Q1 2011
- The deal between Pall UK Pension Fund was written for 10 years and it hedges the change in value of Pall's liabilities as a result of changes in longevity on active and deferred members, referenced to mortality changes in England Wales
- Despite plenty of interest from clients, no indemnity-based longevity swap has been written since February 2010
- Longevity swap transactions take some time to execute and we expect at least a couple of transactions to be completed before year end 2011

### Our innovative solutions

While a pension annuity buy-in remains the most popular insurance-based solution used to de-risk a defined benefit pension fund, Grant Thornton can advise on a wide range of new and creative de-risking solutions, which are tailored to the size, risks and requirements of an individual pension scheme.

A buy-in, while a good solution for dealing with nearly all risks associated with retired pension fund members, is not usually cost-effective for managing the risks associated with non-retired deferred and active members. An indemnity-based longevity swap, while protecting the specific longevity experience of a pension fund, does so only on a portion of the fund (usually the pensioners in payment). To hedge the longevity risk associated with active and deferred members, an index-based longevity swap is increasingly seen as the most practical solution.

A 'DIY buy-in' is now a commonly-used term describing how pension funds can replicate the risk-mitigating features of a pensioner buy-in, through combining a pensioner longevity swap with an LDI matching strategy. This principle can be extended to replicate the risk-mitigating features of a buy-out, by combining a pensioner buy-in and an index-based longevity swap on deferred member liabilities with an LDI strategy. While the solution does not allow a wind-up of the scheme, it can still be regarded as a 'DIY buy-out'.

We offer independent advice on structured solutions and transactions that will either transfer out or mitigate the risks faced by your pension scheme. Our work can help both privately-owned and listed corporate sponsors and trustees to reduce the risk of financial losses as a result of the pension scheme and concurrently give more protection for members' accrued benefits. We also play an important role in providing pensions advice in corporate Mergers & Acquisitions transactions.

### Key contacts

If you would like to discuss how these changes may impact on you, please contact any of our specialists below:



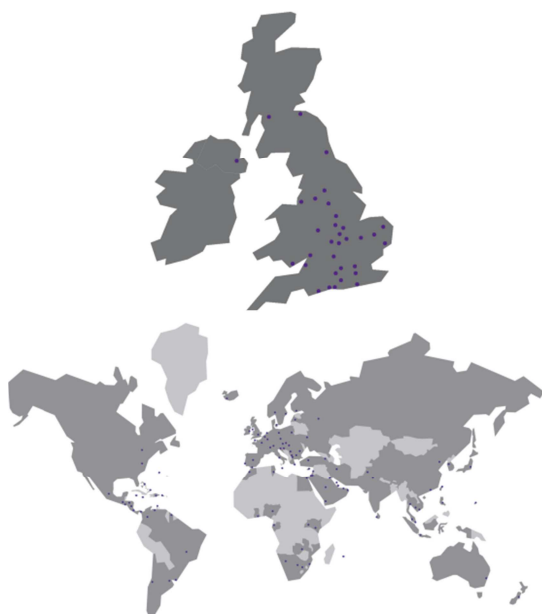
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