An Introduction to the Buy-Out Market

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P A T E R N O S T E R

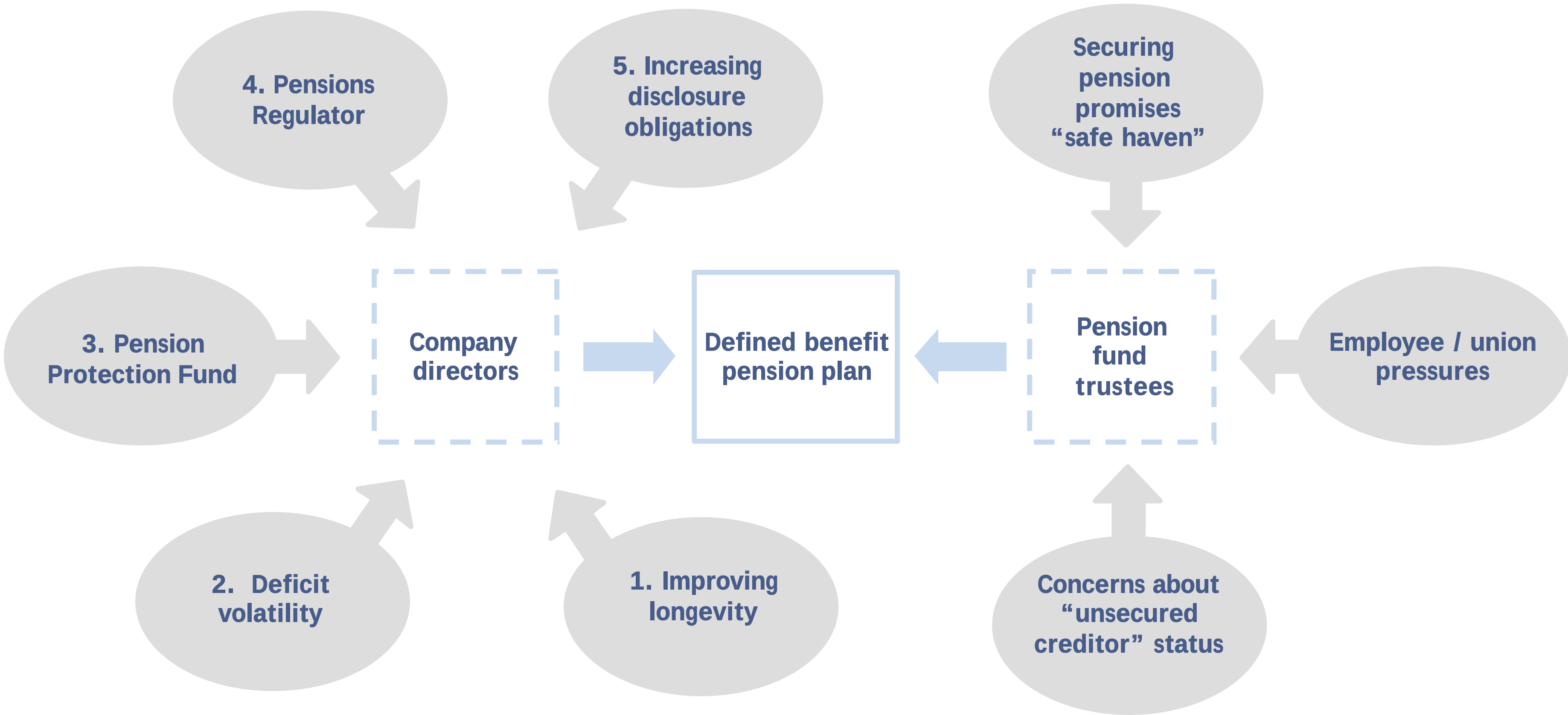
Development of a new market

The traditional buy-out market for schemes in wind-up is changing as a new DB scheme risk transfer market develops…

- When a DB scheme is bought-out with an insurance company, the costs of pension provision are fixed; the sponsoring employer has no further exposure to:
  - investment risks;
  - mortality risks;
  - operational risks; or
  - Regulatory risks
- Prior to the 2004 Pensions Act, the buy-out market existed for DB schemes in wind-up

Traditional buy-out market → **Key drivers** → **DB scheme risk transfer market**

Key drivers of growth in the DB scheme risk transfer market

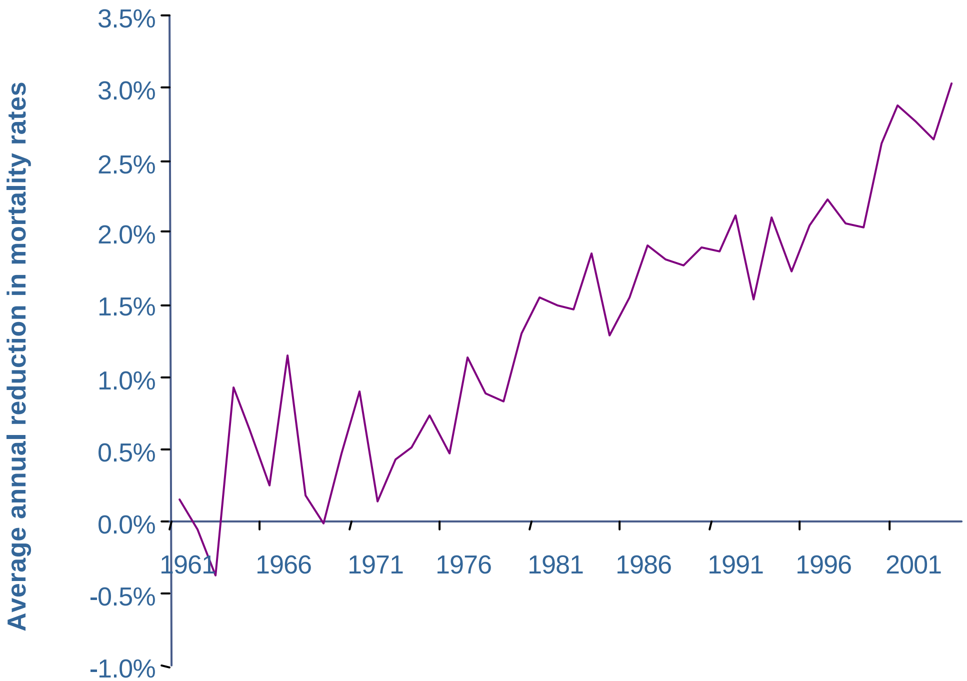


...for many companies the uncertain future cost of providing defined benefit pensions has become a major risk

1. Improving longevity

Are sponsoring employers and trustees content to manage mortality risk…?

PACE OF MORTALITY IMPROVEMENT



Source: Willets Consulting figures based on ONS data. Improvement rates are weighted by the number of deaths at each age and smoothed over time.

ASSESSING MORTALITY

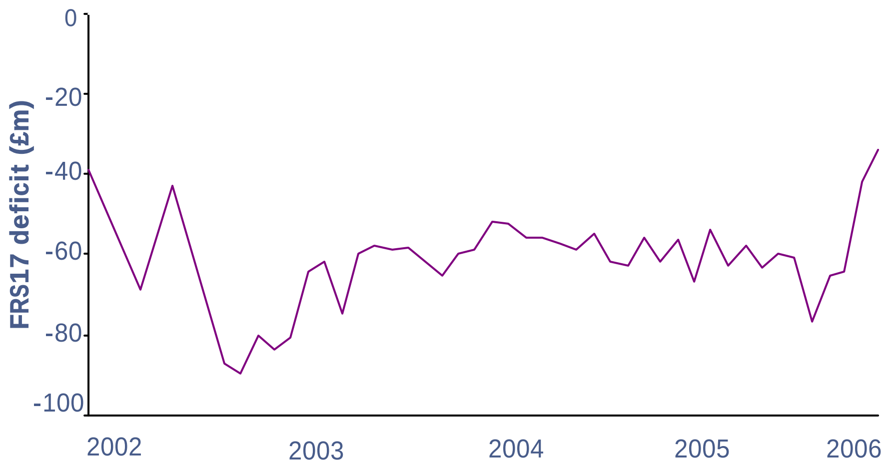
- Pricing of mortality risk has two components:
  - Base mortality assumptions
  - Future improvement assumptions
- Experience over past 40 years illustrates the difficulty in calling the peak in mortality improvement rates
- Life expectancy improvements are significant

2. Deficit volatility

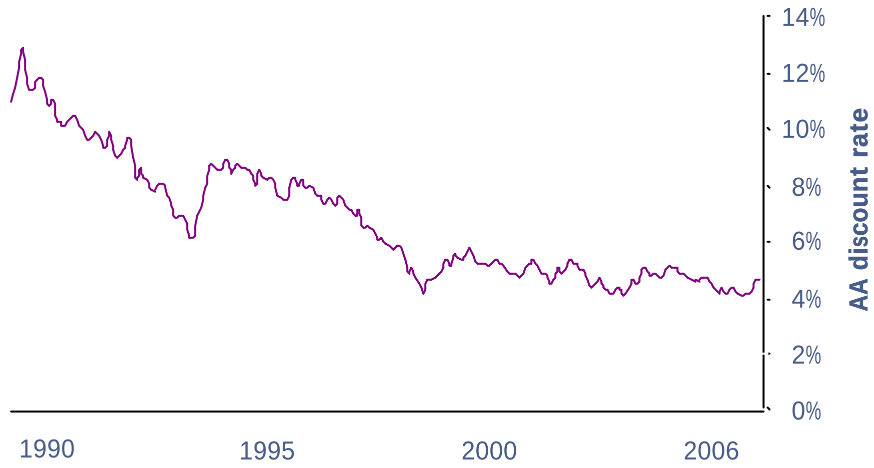
…or other sources of DB scheme deficit volatility?

- Asset portfolios, unmatched to liabilities, have driven deficit volatility
- Perceived volatility in FRS17 liabilities even if actual portfol io is unchanged due to full matching of assets

CHANGES IN FTSE100 PENSION DEFICIT



NOMINAL AA FRS17 DISCOUNT RATE



Source: Deutsche Bank

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3. The Pension Protection Fund

The Pensions Act 2004 established the Pension Protection Fund ("PPF") and the Pensions Regulator ("tPR")

- Statutory fund established to pay compensation to members of eligible DB pension schemes
  - Qualifying insolvency event
  - Insufficient pension assets to cover obligations
- Benefits of immediate annuitants fully protected
- Other scheme members to receive 90% of benefits, subject to £26,050 benefit cap

PPF LEVY

- Scheme-based levy (20%)
- Risk-based levy (80%)
- Calculated with reference to buy-out cost
- Total levy has risen from approximately £300 million in 2005 to £575 million in 2006

4. The Pensions Regulator

The Pensions Act 2004 established the Pension Protection Fund (“PPF”) and the Pensions Regulator

- New regulator established to:
  - Protect DB scheme benefits for all members
  - Improve confidence in DB schemes
  - Minimise claims on the PPF
- Key powers to issue:
  - Financial Support Directions
  - Contribution Notices
- Regulator has ability to intervene in corporate activity if a DB scheme is deemed to be under-funded
- Requirement to disclose funding status to scheme members from September 2006

KEY CHANGES TO REGULATION

- Scheme specific funding
- 10 year plan for funding deficits
- Buy-out funding disclosure
- Monitoring of buy-out funding below 60%

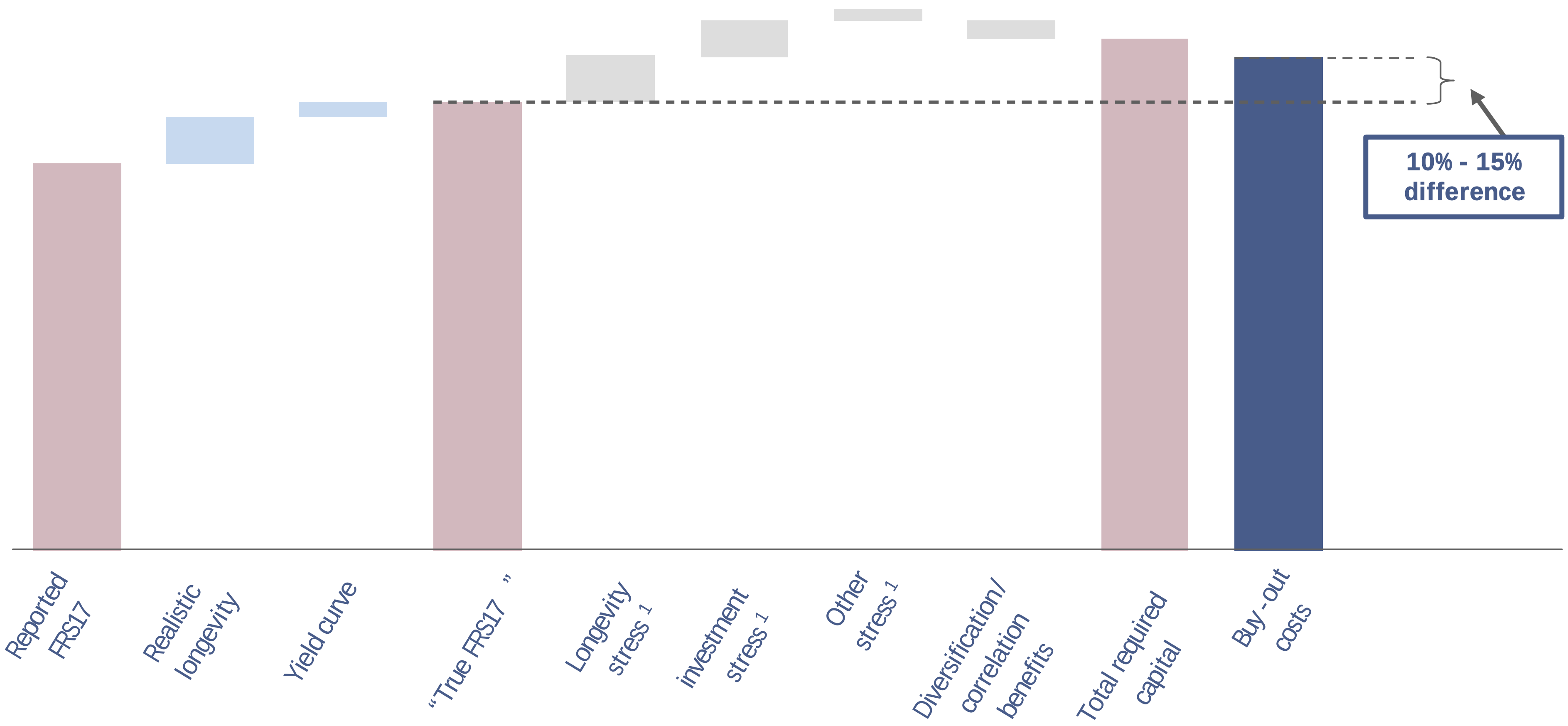
5. Disclosure requirements - tightening-up FRS17

- The Pensions Act 2004 introduced Scheme Specific Funding requiring sponsoring employers and DB scheme trustees to agree and disclose assumptions appropriately
- Accounting bodies and the investment community are applying pressure on companies also to provide full disclosure on company accounts
  - the ASB has suggested six recommendations for improving disclosure under FRS17:

Employer-trustee relationship	• Indication of degree of independence of scheme from sponsoring employer
Principal assumptions	• Disclosure of mortality assumptions as well as financial assumptions
Sensitivity analysis	• Illustration of how changes in assumptions could change management of scheme liabilities
Measurement of liabilities	• Disclosure of buy-out cost as well as FRS17 liabilities
Funding of DB scheme	• Details of regular and special contributions; to be compared with sponsoring employers' financial strength
Scheme assets	• Disclosure by class including expected rates of return

5. Disclosure requirements - true value of liabilities

Following the Pensions Act 2004, many businesses are reassessing their FRS17 liabilities, closing the gap with buy-out cost



Note 1: Based on a 1 in 200 year event

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DB scheme risk management strategies

A number of strategies are currently available to shrink deficits and reduce volatility of DB scheme liabilities

Increased employer and/or employee contributions	Reduction or reorganisation of scheme benefits	Transfers of contingent assets
Asset return optimisation	Full or partial risk transfer	Liability management

KEY

- Deficit reduction
- Volatility reduction/ removal

- Full or partial risk transfer is the only mechanism for delivering financial certainty to sponsoring employers and scheme members alike

- Other risk management strategies can be applied:
  - Before risk transfer, thereby potentially lowering cost;
  - As part of risk transfer structure; or
  - Following risk transfer with upside participation for scheme members and/or sponsoring employer

An inevitable structural shift

The risk transfer market will provide a mechanism for a shift in responsibility for pension provision from sponsoring employers and trustees to insurance companies…

SPONSORING EMPLOYERS & TRUSTEES

- High deferred employment costs
- Personal liabilities
- Regulatory intervention
- Shortage of expertise
- Volatile risks

Structural shift

INSURANCE COMPANIES

- DB scheme risk pricing expertise
- Capital backing
- Willingness to take on mortality risk
- Skills to manage investment risks
- Access to operational expertise

Is pension risk transfer the next stage in corporate reorganisation?

1980s	Business re-engineering
1990s	Value chain optimisation
2000s	Pension risk transfer?

Ignoring the DB scheme risk transfer option

If a DB scheme is not to be transferred to an insurance company, the sponsoring employer and/or trustees implicitly believe…

- FRS17 is an accurate and stable measure of pension liabilities
- Interest rates (and inflation) are currently unsustainably low
- There is certainty that equity markets can close any deficit over time
- Life expectancy can be fully understood
- The sponsoring employer will always be able to make further contributions if necessary
- Legislation will not change to disfavour sponsoring employers further

Paternoster – What, Who and Why?

- What?

A new insurance company, regulated by the FSA, to take on defined benefit pension assets and liabilities…

- Who?

An expert Board and Management team with over 250 years of relevant experience…

Mark Wood, Ron Sandler, Howard Davies, Lord Turner, Lord Leitch, Jeremy Goford.

- Why?

Paternoster represents the combination of senior industry expertise with the largest pool of capital committed to the defined benefit pension market…