HEALTH WEALTH CAREER

MERCER GLOBAL PENSION BUYOUT INDEX

AUGUST 2016

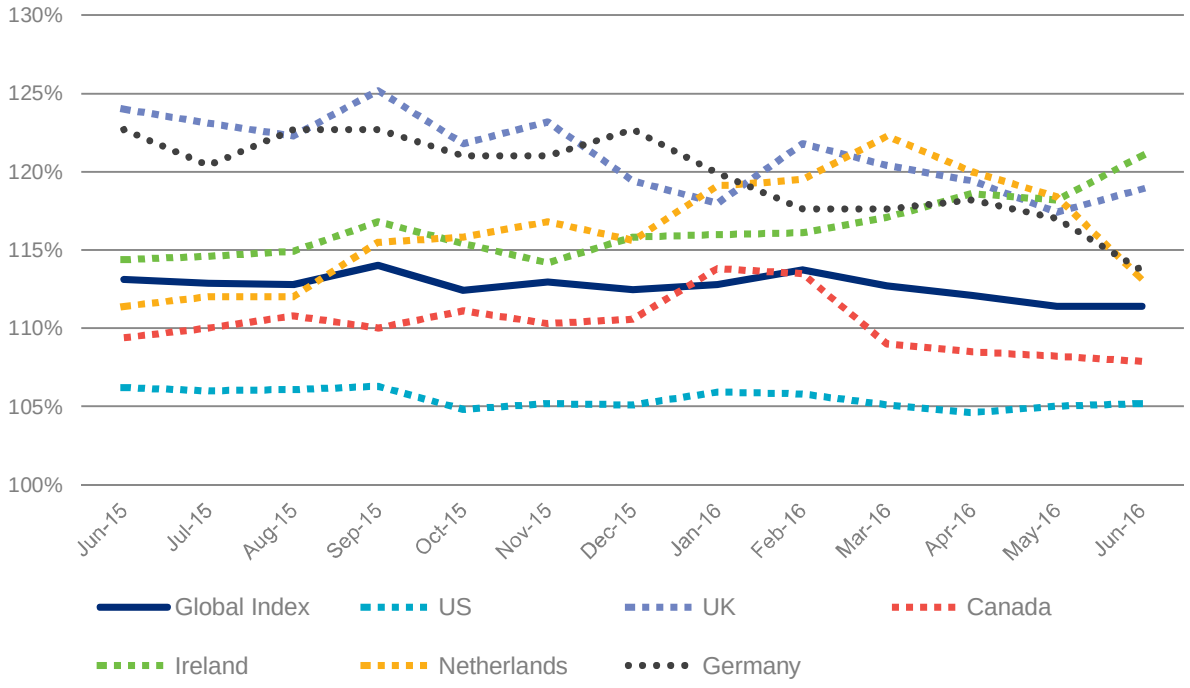
MAKE TOMORROW, TODAY MERCER

EXECUTIVE SUMMARY

Mercer Global Pension Buyout Index monitors the general trend in the pricing of bulk pension annuity transactions in the US, UK, Ireland, Canada, Germany and the Netherlands.

Pension risk transfer transactions increasingly involve an international element – for example, the sponsoring employer might be seeking to externalise pension risk in multiple countries. Pricing is subject to movements in global financial markets and domestic requirements for insurer reserving. However, country-specific pricing often trends in different directions due to domestic influences, leading to windows of opportunity in one country relative to another.

The chart shows estimated annuity prices from insurers as a percentage of accounting liability in the six countries monitored, for existing retirees in a sample defined benefit pension plan. This is based on up-to-date pricing information provided regularly by insurers in each country.



For example, where a line is at the 110% level, Mercer estimates the average price of a pension annuity transaction for current retirees to be broadly 10% higher than the equivalent accounting liabilities. The Global Index is represented by the solid line, showing the average price of pension annuity transactions as a percentage of accounting liability across the six countries and draws upon information such as country market size.

The Global Index has remained steady during June with rises in the UK and Ireland offset by a big drop in both Germany and the Netherlands. A period of market turbulence and high levels of uncertainty after the UK's vote to leave the European Union one week prior to the end June is likely to be the cause of much of the changes in the European regions. The US and Canada on the other hand both remained largely stable during this period.

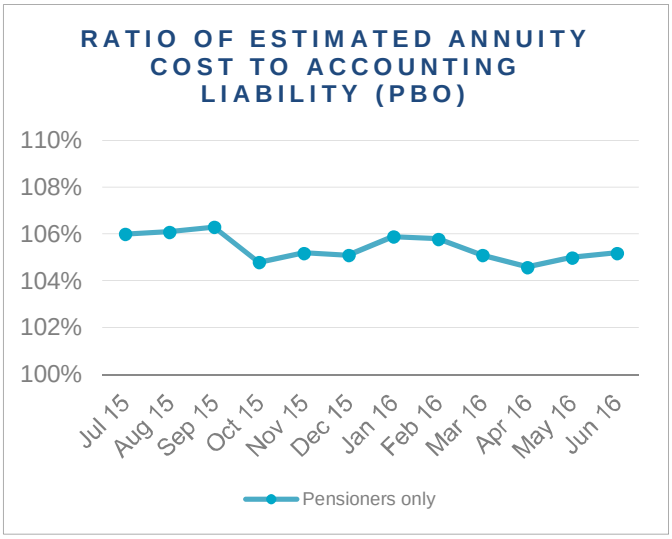
Pension liability has been measured according to local standards. As an example, the cost of insuring pension liabilities in the UK is higher than in the US (relative to accounting liabilities) because UK pension liabilities are normally indexed for inflation, which increases the liability durations, and because insurers charge an additional premium to take on inflation risk.

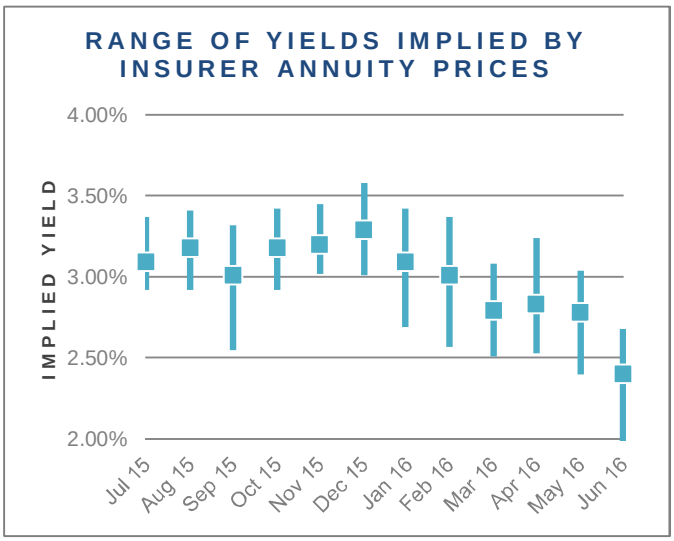
Mercer appreciates the assistance of more than 20 insurers, which provide pricing data every month to allow this report to provide a good indication of the trend in each country.

The information contained in this report is not based on information specific to your circumstances and approximations have been used. Past experience is no guarantee of future pricing and experience may vary for your plan.

UNITED STATES

The cost of a buyout has been decreasing in recent years relative to PBO accounting liabilities. Price transparency allows for greater information from which a plan sponsor can act. The chart on the left shows the relative price to PBO using average pricing received from insurers, and the chart on the right shows the range of sample pricing received. At a single point in time pricing between insurers varies materially which may lead to a difference in cost of up to 10%.





At the end of June 2016, if the accounting liability in respect of plan pensioners only was US$100 million, the buyout cost would be broadly US$5.2 million higher, as compared to May where the cost would have been US$5.0 million higher.

When insurer pricing rates increase relative to discount rates used to calculate PBO, the premium for an annuity buyout decreases.

It should be noted that the above implied yield has decreased more than corporate bond yields in June, resulting in the increase in the ratio shown in the chart to the left.

UNITED STATES MARKET NEWS

Mercer recently launched Mercer Pension Risk Exchange®, a groundbreaking solution that both increases annuity price transparency by enabling plan sponsors to continuously monitor pricing and helps plan sponsors execute group annuity buyouts in a shorter timeframe and in a more competitive pricing environment. Given the current level of volatility, it is not surprising that we already have over 50 clients in the US, representing approximately US$10 billion of assets, sign up to Mercer Pension Risk Exchange, since its launch, to execute an annuity placement. Please see the infographic at the end of this report for more information.

Financial markets continue to display volatility, which is likely to persist in the coming months. During these volatile times, opportunities may be available to plan sponsors who are ready to take advantage of momentary situations where annuity purchases may be particularly attractive.

Taking advantage of attractive pricing in the current market and with the intention of reducing expenses attributable to PBGC premiums, plan sponsors have recently been particularly keen on retiree-only buyouts, with a high number of cases in the US$200 to $500 million range. We have especially seen an increase in interest associated with small benefit pensioners.

Given this market activity, we expect to see unique transactions arise in 2016 and get very close to the circa US$14 billion of pension risk transfer sales we experienced in 2015.

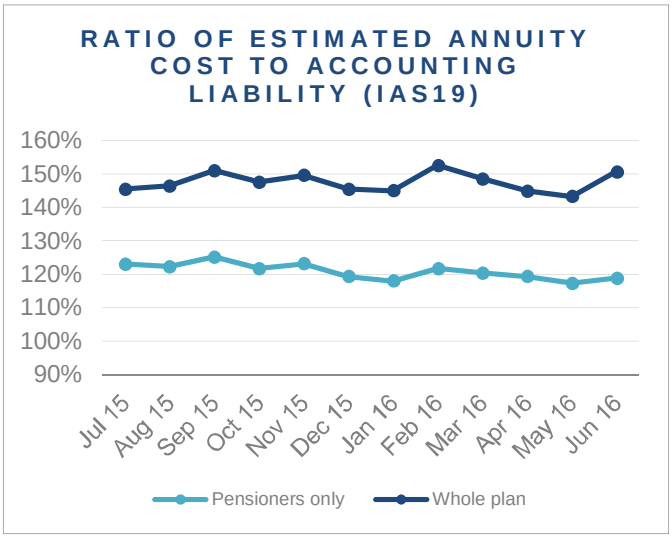
NOTES

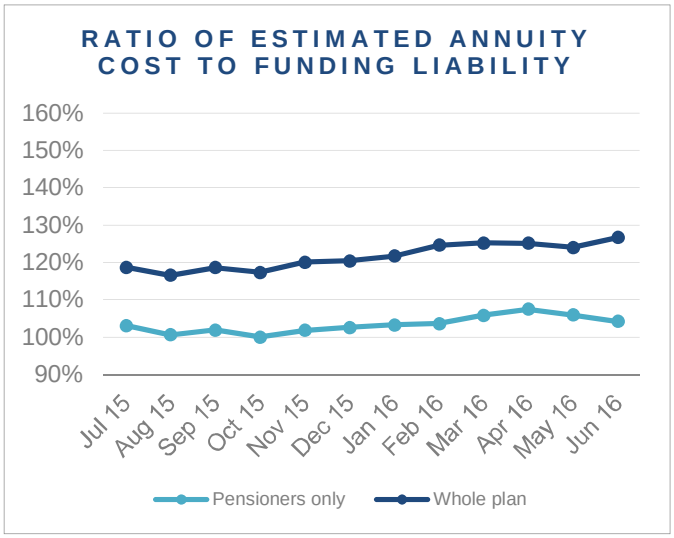
The chart on the left is based on a set of liabilities with pension benefit obligations of US$50 million, cash flow duration of 9 years, and discounted using the Mercer Yield Curve.

The figures in the charts should be used as an indication of the market pricing for annuity placements; actual pricing received will depend on plan-specific factors such as plan provisions, size, and age of the population. It is important to note that some of the insurers who provide pricing do not reflect mortality sensitivity in their illustrative rates, or benchmark to a standard table.

UNITED KINGDOM

The charts track the cost of a buyout and buy-in of a representative pension plan against accounting and typical funding liabilities. The plan has pensioner and non-pensioner liabilities, with a weighting towards pensioners. Pensioner and non-pensioner members receive a mixture of flat and increasing pensions in payment, commensurate with an "average" UK pension plan.





At the end of June 2016, if the plan had accounting liabilities in respect of all members of £100 million, the buyout cost would be broadly £51 million higher.

If the accounting liability in respect of plan pensioners only was £100 million, the buy-in cost of pensioners would be broadly £19 million higher.

At the end of June 2016, if the plan had typical funding liabilities (technical provisions) in respect of all members of £100 million, the buyout cost would be broadly £27 million higher.

If the typical funding liability in respect of plan pensioners only was £100 million, the buy-in cost of pensioners would be broadly £4 million higher.

UNITED KINGDOM MARKET NEWS

Since the UK population voted to leave the European Union on 23 June 2016, the yields on UK government and corporate bonds have continued to fall, resulting in a corresponding increase to prices. This yield reduction has been detrimental to the funding level of those UK pension schemes that were not similarly invested in bonds but corporate bond yields have not fallen to the same extent as government bonds, meaning that a pensioner buy-in, for example, may look more attractive for plans holding government bonds to hedge their pensioner liabilities.

The uncertainty and market volatility created by the vote on 23 June 2016 could generate valuable (and likely transient) opportunities to transact on advantageous terms. Further, for US and European sponsors, the changes in exchange rates mean that the cost in $ and € for funding a UK plan deficit has reduced significantly.

The introduction of the Solvency II European-wide standard for capital adequacy in January 2016 created a “pause” in the UK bulk annuity market during the first quarter of 2016. Nevertheless, looking at the first half of 2016 in aggregate, some £3 billion of reported bulk annuity purchases by pension schemes have taken place plus a further £9 billion of annuity back-books have transferred between insurers. The second half of 2016 has the potential to be busy as a result of the increasing number of new bulk annuity quotation requests that were made during quarter two of 2016. The UK bulk annuity insurers so far remain relatively unaffected by the vote on 23 June 2016, with 7 insurers continuing to compete hard for business.

Mercer’s UK DB Bulk Pensions Insurance - Market Review is available, providing detail on the UK market and what Mercer does to generate value for sponsoring employers and trustees investigating opportunities in this space.

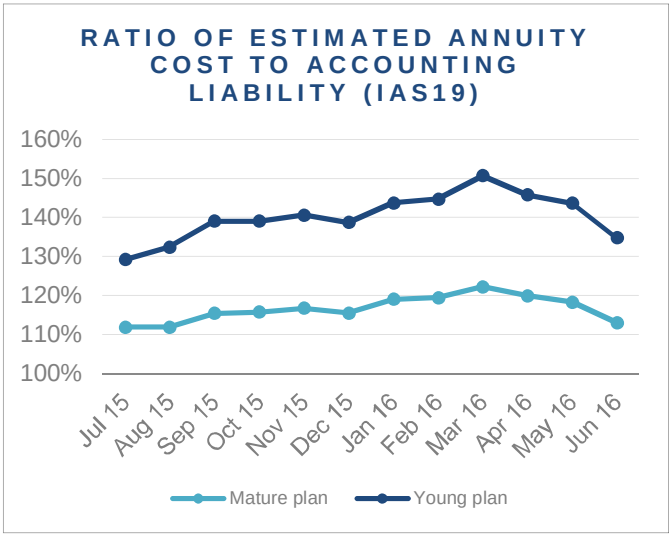
NOTES

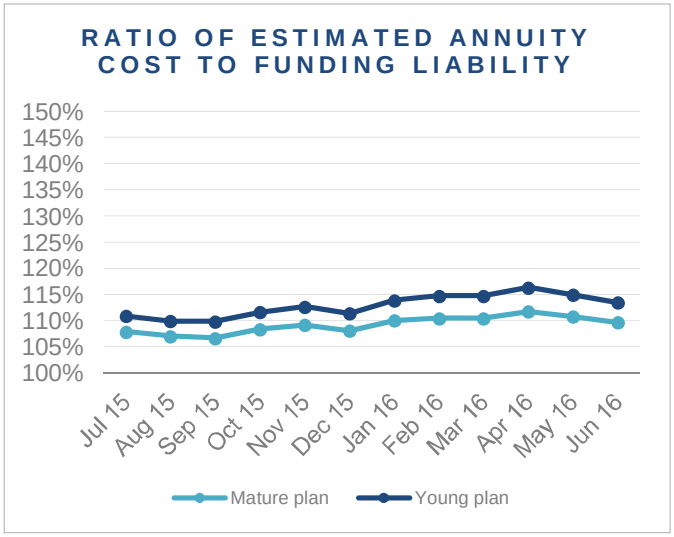
The buyout or buy-in costs could be up to 10% higher or lower depending on the prudence of the assumptions adopted by the plan trustee. The capital contribution needed to implement a transaction would be higher still if the plan assets were less than the funding liability.

The accounting liabilities are valued using the Mercer Yield Curve, which is used by leading UK and multinational companies to set their discount rate for accounting purposes.

NETHERLANDS

The charts track the cost of a buyout of two representative pension plans against accounting and funding liabilities. Mercer uses up-to-date pricing information sourced directly from a key insurer and one multi-employer pension fund[1] in order to compare these against the benefit liabilities based on current market conditions. The insurer price includes an estimate of the price of indexation at the same level as in the corresponding DB accounting liability, which reflects expected discretionary indexation.





At the end of June 2016, if the less mature, Young plan had accounting liabilities in respect of all members of € 100 million, the buyout cost would be broadly €35 million higher.

At the end of June 2016, if the Mature plan had accounting liabilities in respect of all members of €100 million, the buyout cost would be broadly €13 million higher.

At the end of June 2016, if the less mature, Young plan had funding liabilities (technical provisions) in respect of all members of €100 million, the buyout cost would be broadly €14 million higher.

At the end of June 2016, if the Mature plan had funding liabilities (technical provisions) in respect of all members of €100 million, the buyout cost would be broadly €10 million higher.

NETHERLANDS MARKET NEWS

The increase during 2015 and 2016 of the buyout cost compared to the accounting valuations is due to a slow but steady increase in credit spread between the risk free rate used by the insurers for the buyout price and the interest rate used for accounting valuations. This rise in credit spread peaked at the end of March 2016. It should be noted that for a different subset of bonds there was less of a peak that month. From April through to the end of June the credit spread has reduced resulting in a drop in the index. One of the likely

[1] Note that as of 30 June 2016, one of the parties previously providing quotes has withdrawn.

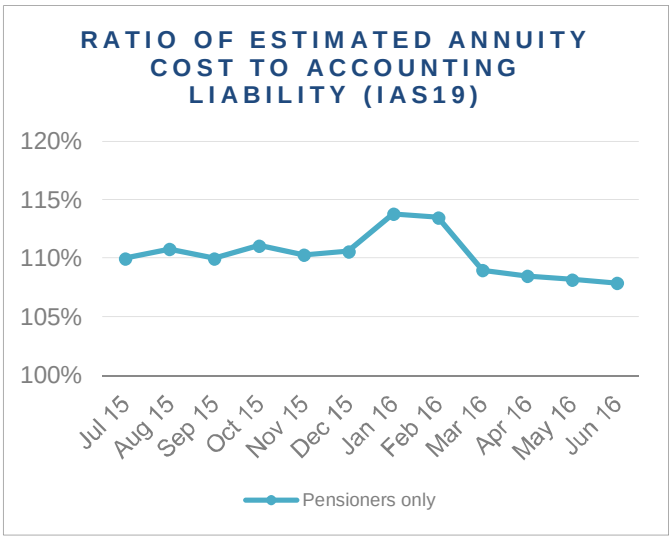
reasons for this decrease is the expanded Quantitative Easing program of the European Central Bank, which now also includes corporate bonds.

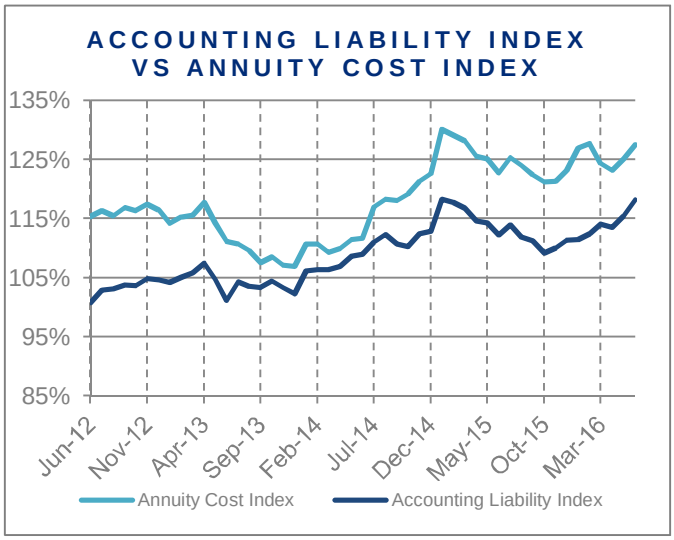
The buyout cost compared to the funding liabilities was relatively stable during 2015 and the first half of 2016. The only significant change was seen in July 2015 which was due to a change in the Ultimate Forward Rate (UFR) used to produce the yield curve (as published by the Dutch Central Bank) to be used by pension funds. Due to the decrease in discount rates in 2016, the UFR effect increases, hence the upward sloping ratio of annuity cost (based on mark-to market pricing) and funding liability (based on yield curve including UFR)

Within the Netherlands a new pension vehicle has been introduced, the so-called “Algemeen Pensioenfonds”, which could open up new possibilities to secure buyouts. One of these funds has now received its license to operate from the pensions regulator. A further 5 to 7 parties have applied for a license.

CANADA

The charts track the movement in the cost of a group annuity as a percentage of the associated accounting liabilities for a representative sample group of retirees.





During June 2016, the Index fell slightly from 108.2% as at the end of May 2016 to 107.9% by the end of June. This implies that, at the end of June 2016, the cost of settling obligations through the purchase of annuities was approximately 8% higher than the accounting liability.

It is also important to consider the absolute cost of settling plan obligations. This can be best accomplished by looking at the movement of each component of the index in isolation. To do so, we look at the yields of long -term government bonds, which drive annuity pricing, and compare them to the yields on AA corporate bonds, which are used to calculate accounting liabilities.

In the month of June, yields on corporate and long-term federal bonds decreased by approximately 20 bps, increasing both accounting liabilities and annuity costs, respectively. However, this rise in liabilities was slightly less pronounced on an accounting basis where the underlying yield was higher, resulting in a modest decrease in the Index of 0.3%.

Mercer Pension Risk Exchange®, now boasts over 80 clients across its three platforms in the US, UK and Canada. In fact, more than US$14 billion in annuity purchase premiums have already been secured using the Exchange with Canada having its first completed transaction executed in early July. Please see the infographic at the end of this report for more information.

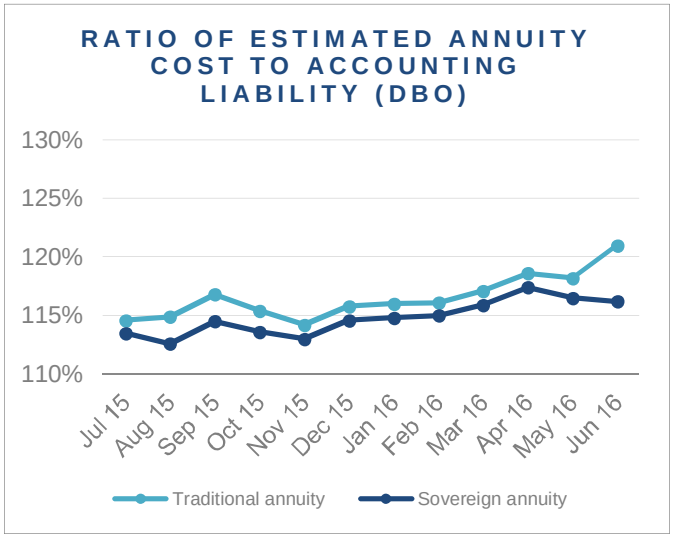
NOTES

The Index is based on an estimate of settling non-indexed pension obligations through the purchase of annuities and an accounting discount rate based on a proprietary model developed by Mercer to assist our clients with selection of the discount rates used for the purpose of corporate financial reporting. It is provided for a sample group of non-indexed retired members and is only intended to illustrate general trends. The actual premium can vary significantly for individual plans based on a number of factors that may include:

- The plan's benefit structure and timing of its anticipated benefit payments.
- The demographic profile of the plan's participants.
- Market conditions prevailing at the time benefits are distributed and annuities purchased.
- Insurer appetite and capacity for a transaction.
- Which employees, if any, receive and accept an offer to take a lump sum instead of an annuity.

IRELAND

The chart shows the relative cost of a buyout of pensioner liabilities of a sample defined benefit plan versus the equivalent liabilities on a company accounting basis.



At the end of June 2016, if the Plan had accounting liabilities in respect of pensioners only of €100 million, the cost of a traditional annuity would be broadly €21 million higher.

At the end of June 2016, if the Plan had accounting liabilities in respect of pensioners only of €100 million, the cost of a sovereign annuity would be broadly €16 million higher.

IRELAND MARKET NEWS

The UK's decision to leave the EU resulted in significant market volatility in June. Bond yields in core Eurozone countries decreased significantly over the month of June 2016; particularly post Brexit vote, leading to increases in the cost of buying out pensioner liabilities. Corporate bond yields which drive the equivalent accounting liabilities also increased over the month but not to the same extent. The discount available via the purchase of sovereign annuities (where payment terms are subject to the performance of the reference bonds underlying the contract), versus conventional annuities increased over the month reflecting the stressed market conditions at the end of June. Activity in the bulk buyout market in Ireland is driven by the winding up of pension plans which, under Irish legislation, requires the buyout of pensions in payment.

May 2016 proved to be a largely positive month for pension schemes on the asset side with positive returns on both equity portfolios and government bond portfolios given the increase in yields.

NOTES

The index is provided for a sample mature pensioner population and is indicative only. The benefits secured (and valued as an accounting liability) are flat pensions, with no increases in payment.

The price differential identified above will also be affected by the nature of the assumptions adopted for the accounting disclosures.

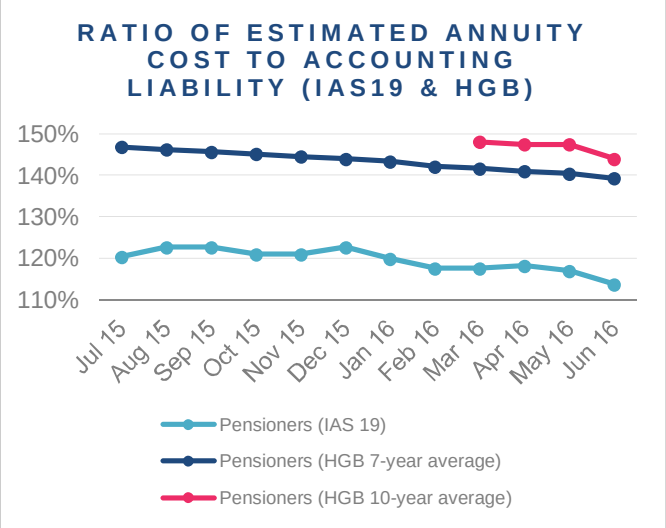
The accounting liabilities are valued using the Mercer Yield Curve, which is used by leading Irish and multinational companies to set their discount rate for accounting purposes.

The index does not make any allowance for buyout costs for active or deferred members.

A sovereign annuity differs from a traditional annuity in so far as it is linked directly to reference bonds that back the contract. Importantly, this means that pension payments will be reduced in the event of non-performance of some or all of the underlying reference bonds. This transfers the credit risk to the annuitant.

GERMANY

The chart focuses on transactions in which the underlying benefit payment is reinsured for a group of retirees, but does not include additional potential liabilities from inflation indexation. It is built on a sample retiree population and compares the accounting liabilities against the insurance premium in a buyout / buy-in transaction. The pricing for the insurance policies is based on a 1.25% p.a. guaranteed rate of return (1.75% p.a. dates prior to 01/01/2015) whereas the discount rate is based on a liability with a 10 year duration.



At the end of June 2016, if the plan had accounting liabilities under local German GAAP (HGB) in respect of all members of €100 million, the buyout cost would be broadly €44 million higher using the 10-year average rate and broadly € 39 million higher using the 7-year average rate..

If the plan had accounting liabilities under international accounting standards (IFRS) in respect of all members of €100 million, the buyout cost would be broadly €14 million higher.

GERMANY MARKET NEWS

- Benefit obligations of the 30 DAX companies reached a level of €350 billion at the end of 2015.
- The fair value of the corresponding plan assets was €230 billion at the end of 2015.
- There has been an improvement in the DAX funding position since the end of 2015.

A bill that includes a modification of the method for determining the discount rate used for pension valuations under German-GAAP (Generally Accepted Accounting Practice) recently passed parliament. The law took effect on 1 March and is binding for all balance sheet dates in 2016. Companies with a balance sheet date of 31 Jan 2016 will have already closed their books but their annual financial statement – which is usually finalized at a later date – will have to comply with the new rules. If the financial year begins and ends in 2015, the new legislation can be applied voluntarily.

The new rules require companies to use a rolling average period of 10 years that will result in a reduction of the reported pension liabilities at the time of the change – previously a seven year rolling average of market rates was used.

Generally, larger organisations prefer funding through so-called Contractual Trust Agreements (CTAs), but buy-in solutions for annuities are also becoming more common. However, there remain a large proportion of companies with unfunded pension arrangements – with pensions being paid from operating cash flow. Alternatives to funding are also being considered to reduce benefit obligations, for example by changing the plan design or by including lump sum options.

NOTES

The illustrations are based on values used by German life insurers, public information and a representative sample of a retiree population.

The performance of the Index reflects the changes in the valuation-related discount rates and the underlying rates used by German life insurers.

Due to the applied approximation method the Index is not suitable for any company - and plan-specific pricing.

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MERCER PENSION RISK EXCHANGE

A GROUNDBREAKING APPROACH TO PENSION RISK MANAGEMENT

The majority of defined benefit plans are closed to new employees, but these plans still represent significant obligations for the company to manage alongside its on-going business. In addition to the company specific situation, economic factors are also driving up the demand for annuity buyouts; however, the buyout marketplace can be hampered by long execution timelines and lack of price transparency. A plan sponsor requires robust information on the financial position of the company's pension plan, needs an understanding for how key financial metrics are developing over time, and values custom buy-out information. This information must be accurate, up-to-date, and easily accessible.

CURRENT PENSION BUYOUT CHALLENGES

UNPREDICTABLE MARKET

Each deal is unique and attracts different insurers.

Deal pricing can vary dramatically

PRICE VOLATILITY

Pricing fluctuates over time but is not visible to plan sponsors.

LACK OF PRICING TRANSPARENCY

Obtaining a price can be difficult and time consuming.

Plan sponsors often don't know the price at which they should execute a buyout

MERCER PENSION RISK EXCHANGE®

WHAT IT IS

- Online solution that supports pension plan sponsors through the complex annuity purchase process
- Helps sponsors execute a deal in a more competitive price environment and in a shorter time frame than is currently possible.
- Allows plan sponsors to prepare data and documents in advance, enabling them to proceed quickly when the time is right.
- Mobile-optimized to give sponsors access to valuable information anytime and anywhere.

WHAT IT'S FOR

- PLAN TERMINATIONS
- RETIREE BUYOUTS
- BUY-INS
- ACTIVE SPINOFF/ TERMINATIONS

HOW IT WORKS?

READINESS

Mercer's systematic and disciplined approach finalizes all data and documents well in advance of the transaction, enabling swift execution. We advise on target buyout price levels and plan metrics that should be monitored, and we establish triggers upon which to act.

DYNAMIC MONITORING

Our pricing platform allows insurers to submit regular bids for specific plans. This enables sponsors to continuously monitor their unique buyout price and specific plan metrics and to execute when market conditions are optimal.

EXECUTION SUPPORT

Provides fiduciary training and insurer due diligence to support the final auction, insurer selection, and transition of responsibilities to the insurer, all while enhancing participant security.

MERCER PENSION RISK EXCHANGE SUPPORTS YOU THROUGH EACH STEP OF THE ANNUITY PLACEMENT PROCESS

MERCER PENSION RISK EXCHANGE PROCESS

There are four components of the solution. We work with clients to understand the services that are most applicable to their current situation, and timeline to execute a transaction. Our approach provides increasing financial certainty as a client moves through the purchase process.

EXPLORE

- Provide insurer-informed annuity pricing
- Assess trends over time
- Determine timing / strategy to proceed with a transaction

DISCOVER

- Prepare insurer RFP and plan data
- Gather preliminary annuity quotes from insurers
- Establish financial metrics to monitor
- Start fiduciary education

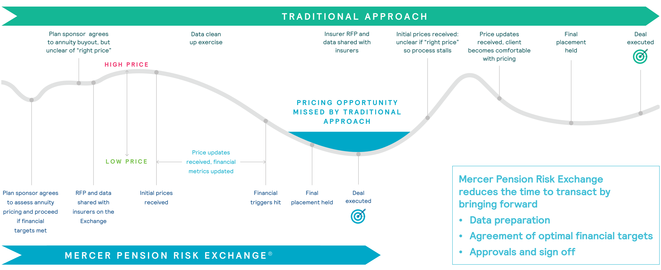
MONITOR

- Monitor annuity pricing against financial metrics
- Complete fiduciary education and insurer due diligence against DOL 95-1 guidelines

EXECUTE

- Hold final placement auction
- Select insurer and transfer premium
- Commence post deal transition

TIMELINE



Mercer Pension Risk Exchange reduces the time to transact by bringing forward

- Data preparation
- Agreement of optimal financial targets
- Approvals and sign off

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