

12

Risk Reduction

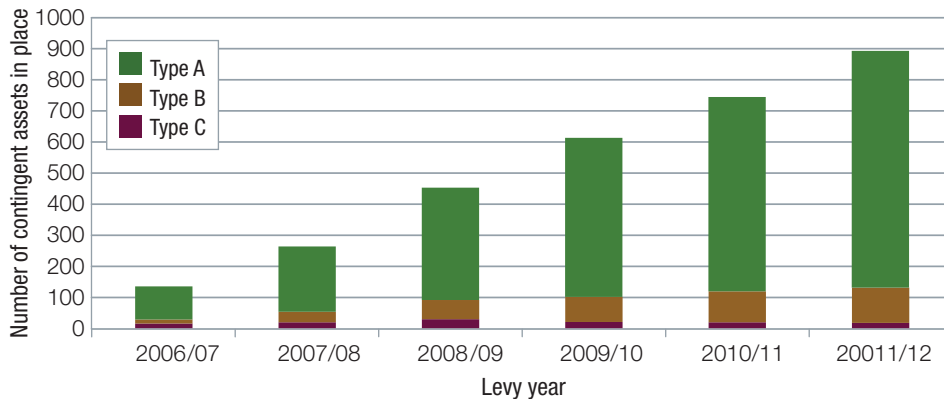
12.1 Summary

- The total number of recognised contingent assets (CAs) in place has risen by 20 per cent, from approximately 750 for the 2010/11 levy year to 900 for 2011/12.
- Schemes in the Purple 2011 dataset (excluding those schemes which were in a PPF assessment period as at 31 March 2011) had by 7 April 2011 certified approximately £28.0 billion of deficit reduction contributions (DRCs)⁴⁵ to reduce deficits for the 2011/12 levy year. This was similar to the £29.1 billion certified for the previous levy year.
- The DRCs were not only paid by companies sponsoring the largest schemes; around 44.1 per cent of the £28.0 billion was paid by employers sponsoring schemes with fewer than 10,000 members.
- MQ5 data from the Office for National Statistics (ONS) covering 350 large pension schemes, including 100 local authorities, show that employers' special contributions (i.e. those in excess of regular annual contributions) increased markedly in 2010 to £16.1 billion, a record level, up 60 per cent on the level in 2009. In the first quarter of 2011 they were running at an annual rate of £14.8 billion.
- Analysis of the Pension Regulator's latest technical provisions and recovery plan data shows that in Tranche 4, the average recovery plan length widened to 9.5 years, the average funding ratio as measured by assets divided by technical provisions fell to 71 per cent, and technical provisions as a percentage of s179 liabilities fell to 102 per cent. Tranche 4 covers schemes with valuation dates between 22 September 2008 and 21 September 2009 when equity markets were very weak and bond yields low.
- Changes in asset allocation were much less marked between Purple 2010 and Purple 2011 after a period of large falls in the equities share and large increases in the bond share (see chapter 7 Asset Allocation for more detail).
- Quarterly F&C surveys of volumes traded by investment banks suggest that £16.8 billion of liabilities were hedged using interest rate derivatives in the first half of 2011, the same as in the second half of 2010 and significantly above that in the first half of 2010 and second half of 2009.
- £13.7 billion of liabilities were hedged using inflation derivatives in the first half of 2011. Inflation-hedging activity peaked in the second and third quarters of 2009.
- Industry sources suggest that the total amount of hedging done using derivatives is around £200-250 billion, 15-18 per cent of total liabilities (on a full buy-out basis).
- Total risk transfer business covering buy-outs, buy-ins and longevity hedges amounted to £31 billion between the end of 2006 and the third quarter of 2011. Just under half of the total reflected buy-in activity, just over 30 per cent reflected buy-outs and just over 20 per cent longevity hedges (which started in 2009).

⁴⁵ The certificates cover deficit reduction contributions made since the last scheme valuation

12.2 Contingent assets

Chart 12.1 | Contingent assets by type*



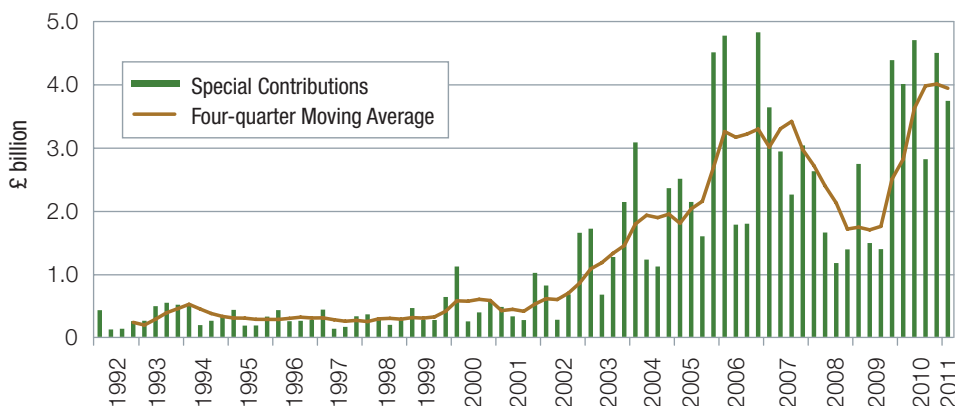
Source: PPF / The Pensions Regulator

*The numbers of recognised contingent assets for each year presented in Chart 12.1 may change as a result of, for example, successful appeals. This is likely to mainly affect the latest year. The figures for 2010/11 reported in Purple 2010 showed the total number of contingent assets in place as 722 whereas the latest estimate is 747. However, there was only a minor change for 2009/10.

Type A contingent assets are guarantees provided by the parent/group companies to fund the scheme, most commonly, to a pre-arranged percentage of liabilities. Type B contingent assets comprise security over holdings of cash, real estate and/or securities. Type C contingent assets consist of letters of credit and bank guarantees.

12.3 Special contributions

Chart 12.2 | Special contributions



Source: 'Investment by Insurance Companies, Pension Funds and Trusts', ONS

The total number of recognised contingent assets has risen by 20 per cent from approximately 750 for the 2010/11 levy year to 900 for 2011/12.

Special contributions have increased markedly in 2010 and first half of 2011 relative to the levels observed in 2008 and 2009.

In Tranche 4, recovery plan lengths rose while the ratio of technical provisions to s179 liabilities fell. Valuations for this tranche were at a time of financial distress.

12.4 The scheme funding regime

Table 12.1 | Technical Provision (TP) and Recovery Plan (RP) lengths (unweighted)*

Tranche	Valuation dates	Number of plans	Average recovery plan length years	Assets as a percentage of Technical Provisions	Technical provisions as a percentage of s179 liabilities
1	2005-06	1,928	7.8	79.80%	105.2%
2	2006-07	1,829	7.3	82.00%	114.2%
3	2007-08	1,787	8.4	80.90%	110.9%
4	2008-09	1,849	9.5	71.30%	102.0%

*Notes: (1) valuation dates run from 22 September to 21 September (2) the Tranche 4 number of plans includes 1455 schemes from Tranche 1.

Source: PPF / The Pensions Regulator

12.5 Liability Driven Investment

The average quarterly interest rate and inflation risk traded by investment banks over the latest year was £22 million and £14 million respectively.

Chart 12.3 | Inflation and interest risk traded for liability hedging purposes

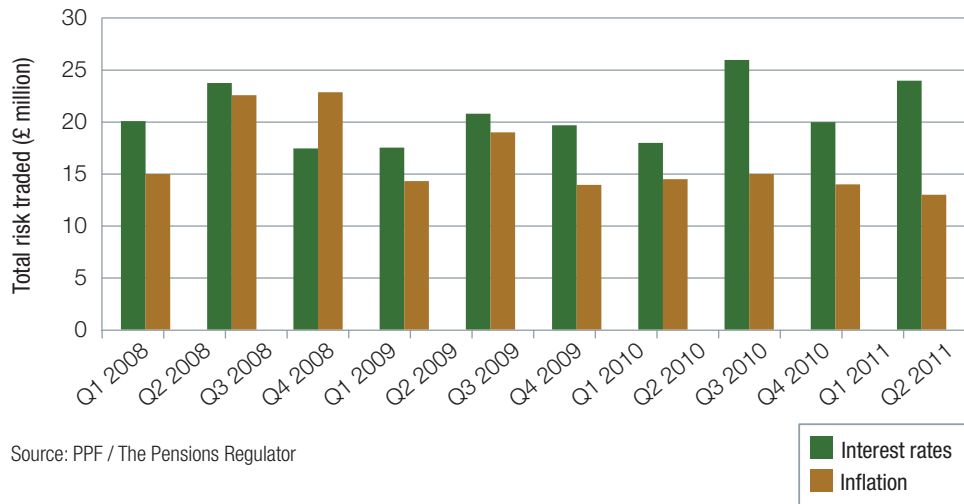
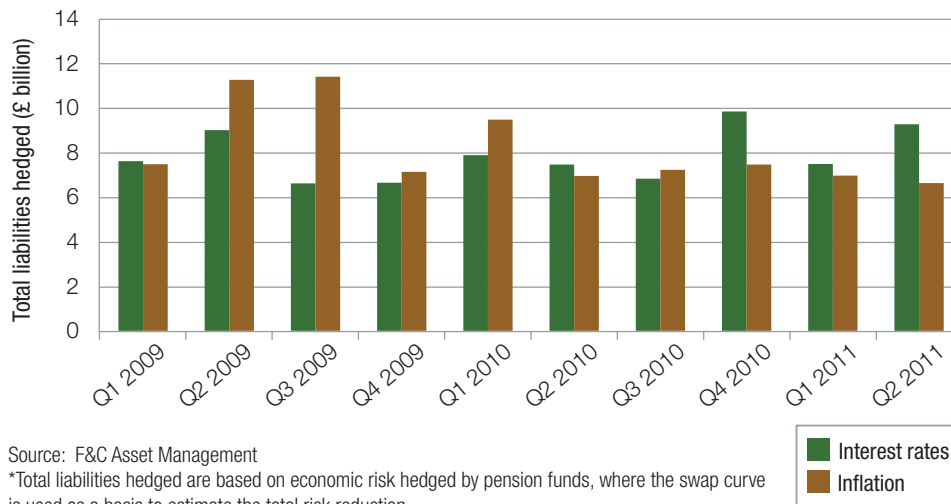


Chart 12.4 | Average quarterly flow of liabilities being hedged*



The average quarterly flow of liabilities being hedged against interest and inflation movements were £8.5 billion and £7.0 billion respectively. The flow of inflation-hedging business has fallen back compared with Q1 2009 to Q1 2010 while interest rate hedging has risen.

12.6 Buy-out, Buy-in and Longevity Hedging

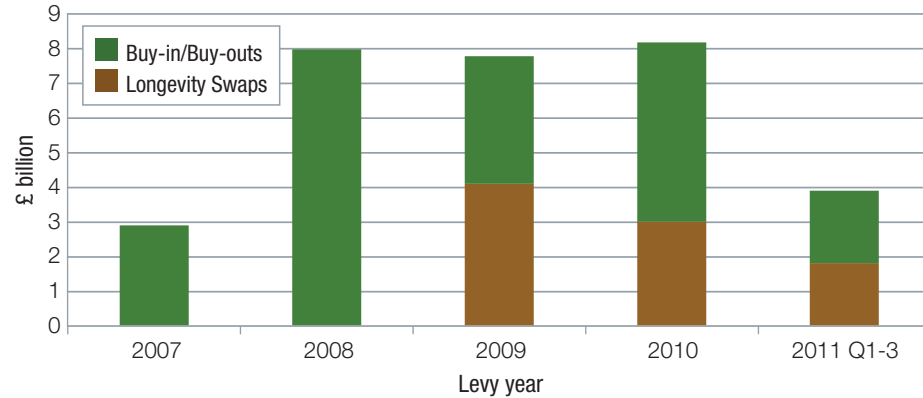
Buy-out and buy-in transactions provide schemes with the opportunity to remove risk relating to all or part of their liability. Under a buy-out deal, a scheme transfers its entire liability to an insurer in exchange for all scheme assets. Insurers tend to require assets significantly in excess of scheme liabilities to compensate for the risk transferred. Buy-in deals are effectively partial buy-outs where the insurance policy is a scheme investment.

While both longevity swaps and buy-in/buy-out can mitigate the risk of greater than expected life expectancy, under the former there is no transfer of the underlying scheme assets to a counterparty. Longevity swaps entail the pension scheme exchanging fixed payments for cashflows that vary in accordance with the longevity experience of a reference population (either the named scheme members or a wider sample).

The value of risk transfer deals since the end of 2006 has totalled £31 billion.

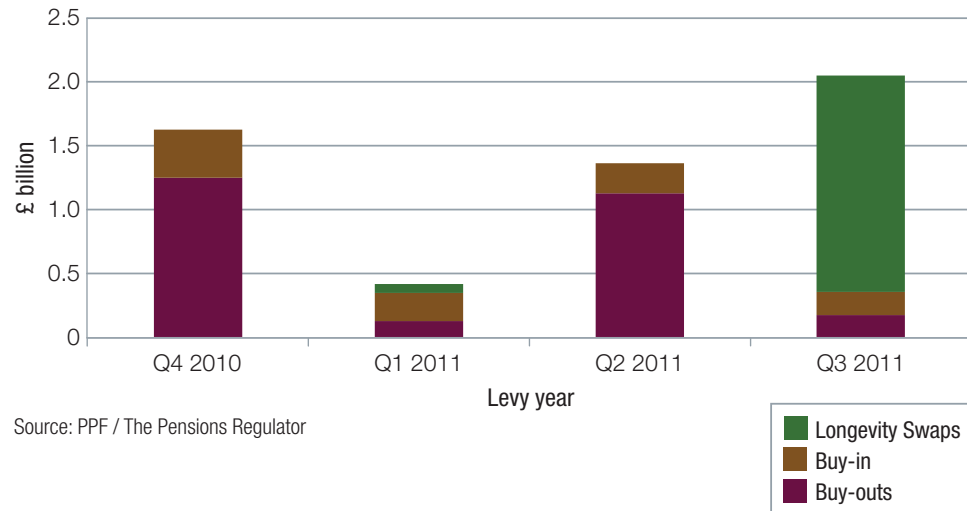
Over the year to Q3 2011, the total value of transfer deals was £5.4 billion of which 49 per cent were longevity swaps, 31 per cent were buy-ins and 19 per cent buy-outs.

Chart 12.5 | Value of risk transfer deals since 2007



Source: PPF / The Pensions Regulator

Chart 12.6 | Value of risk transfer deals in the year to Q3 2011



Source: PPF / The Pensions Regulator