Investment Tutor Surgery

Chris Wagstaff examines the details of reducing scheme risks

Why should a defined benefit scheme implement Liability Driven Investment?

Any defined benefit pension scheme must meet its liabilities as they fall due. This means preventing a further deterioration of the scheme deficit and ultimately plugging that deficit. Liability Driven Investment (LDI), with risk management, or risk reallocation, at its core, focuses on the mitigation of those so-called unrewarded risks, such as interest rate, inflation and longevity risk that can cause scheme liabilities to outpace assets and deficits to widen. However, it also seeks to capture a diversity of those potentially rewarded risks – those derived from market exposure to assets such as equities and credit – that ultimately contribute to the achievement of the long-term funding plan, all within a defined “risk budget”. For many schemes, as the unrewarded risk can far outweigh potentially rewarded risk, mitigating the former may free up some of the risk budget for an increased diversified exposure to the latter.

Only after these risks are mapped and measured, can trustees act to manage them. This is complex, not least because the tools, such as swaps and bonds, used to mitigate future movements in inflation and/or interest rates, for example, are not always available at the required sizes and prices. Trustees will need to draw on the expertise of a de-risking specialist and LDI asset manager. Moreover, the heightened investment governance required to oversee the LDI process may also result in the trustees delegating to an LDI sub-committee. This necessitates gaining the support of the sponsor, as working closely with the de-risking specialist and LDI asset manager in:

- setting up a panel of competing investment banks with whom to potentially transact swaps;
- outlining the trading etiquette to these banks, and the penalties of non-compliance;
- setting up the necessary infrastructure, or ISDA agreements, between the scheme and the chosen counterparty banks;
- gaining prioritised access to swap supply;
- obtaining the best possible prices and minimising transaction costs;
- continually tracking progress in reducing the scheme’s unrewarded risk;
- overseeing the collateralisation process, and
- actively managing the swaps and/or bonds as market conditions change.

In short, a successful LDI strategy is dependent on five factors: agility, flexibility, proximity to the market, an advanced level of trustee governance and intelligent execution, coupled with a strong five-way partnership between the trustees, sponsor, de-risking consultant, asset manager and the investment banks.

Should longevity risk within a defined benefit scheme be hedged? If so, how?

With increases in life expectancy and the underestimation of longevity of a scheme’s membership by just one year adding up to 4 per cent to the value of its liabilities, there’s no question that longevity risk should be hedged – accepting that it can be mitigated without materially impacting the scheme’s funding position.

Whilst longevity risk has long been traded in the insurance and reinsurance markets, the ability to manage this risk within a pension scheme had been the missing piece in the risk management jigsaw. It was either a case of insuring the pensioner liabilities – those pensions currently in payment – through a buy-in or going for an insured buyout of the scheme’s assets and liabilities. Both approaches started to prove quite costly in 2008.

However, everything changed very recently with the advent of the £800m Babcock International and £1.9bn RSA Insurance longevity deals. Described as DIY buy-ins, they each capped the longevity risk attached to the majority of their respective pensioner liabilities by using longevity swaps, with their low initial capital outlays. These oblige a scheme to pay, to an investment bank or insurance company willing to act as counterparty in this nascent market, a series of regular fixed payments (the “fixed leg”), over the expected lifespan of the scheme’s pensioners, in exchange for receiving a series of regular variable payments (the “floating leg”), over their actual lifespan.

These longevity swaps can either be based around general longevity indices, such as the JP Morgan LifeMetrics index, which provide protection against population-wide increases in longevity, or be bespoke, as in Babcock’s and RSA’s case, where sufficient mortality data on the scheme membership exists. Whilst the bespoke approach can provide a very close hedge for pensioner liabilities, the index approach might well (though has yet to) be used to provide protection against active and deferred member longevity risk, where the timing and amount of pension benefits to be taken remains very unpredictable, especially if the scheme is immature. For this very reason, this latter approach is likely to prove to be the more expensive of the two methodologies. Crucially, however, the use of longevity swaps allows the scheme to retain control of its assets so as to engineer an asset allocation strategy that fits with the scheme’s recovery plan.

When entering into a longevity transaction, the necessary due diligence should, given the long term nature of the contract, be conducted around the financial strength of the counterparty, the pricing of the deal, how effectively the longevity risks will be hedged, the collateral mechanics that protect both “legs” against counterparty risk and how viable an exit strategy is, should the scheme wish to go to buyout. Suffice to say, both the appetite for hedging longevity risk and the range of innovative solutions look set for a period of significant growth, though the market’s ability to accommodate deals could quickly hit capacity constraints. ■

Learn more about LDI: a case study

Hear first-hand from Chris Wagstaff – Pension Scheme Trustee Director – of his experience in scoping and implementing an LDI programme. 29 September – London.

Visit www.investmenttutor.com for more details.

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