

# Timing your swaps

Why timing is vital when it comes to implementing an LDI strategy; and how one scheme saved £10m by getting it right, by Bob Campion



The advent of longevity swaps has re-ignited pension fund interest in liability driven investment (LDI) strategies this year, as sponsors and trustees look towards 'DIY buyout' solutions now the market for insurance buyouts is unfavourable.

Many pension funds who have already embarked on some form of LDI approach are now exploring the next step – longevity – while others are looking at the whole topic with fresh enthusiasm.

But, as many schemes with experience of LDI have already discovered, the devil is truly in the detail with this complex approach. Setting up the infamous swap transactions can be costly and difficult to get right, even with an army of advisers.

One pension scheme which has adopted an innovative approach to its LDI strategy is the staff pension scheme of Aviva, the insurer. And despite setting up a swaps

programme during one of the most chaotic periods in banking history last year, the trustees believe their approach saved £10m in execution costs alone.

It was early last year when the Aviva trustees first took the decision to remove interest rate and inflation risk from their scheme, which at that stage had liabilities of £9bn.

Because of the nature of their organisation they were able to set up the complex LDI arrangements through their own in-house capital markets team – advised by specialist firm Redington – rather than take the traditional route of working with a third-party asset manager.

Analysis undertaken in conjunction with their advisers revealed that changes to interest rates and inflation was the biggest risk they faced – bigger than equity risk despite a 53% allocation – and that by hedging 35% of their exposure they would reduce risk in the pension fund as a whole by 30%.

The way this was calculated was to focus on the Value-at-Risk (VaR) measure, among others. "Risk is very complex but there are various tools you can use to assess it – and VaR is the most significant," says Robert Gardner, founder and co-CEO with Redington. "Selling equities obviously makes a huge difference to VaR – but the trade off is that you lose the exposure to growth assets." By concentrating on removing the relatively unprofitable risk of inflation rising and interest rates falling, rather than reducing equity exposure, the trustees felt they would be best placed to seek the growth they



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## case study



How the trustees did the deals, by Chris Wagstaff, Aviva trustee

Prior to the implementation of the de-risking programme, the Aviva Staff Pension Scheme (ASPS) had a typical committee structure with the trustee board delegating some powers/authority to the investment committee (IC). The principal role of the IC was to periodically review: 1. the scheme's rather traditional asset allocation and 2. the performance of the scheme's investment managers. Changes in strategy required the approval of the trustee board, which meets quarterly.

In June 2008, after having conducted an analysis of the scheme's risks, which identified that 30% of the scheme's VaR derived from unrewarded interest rate and inflation risk, the ASPS Trustee Board decided – with the support

of the sponsor – to implement a de-risking programme that would reduce the sensitivity of funding levels to changes in interest rate and inflation by 35%, so as to reduce the scheme's VaR by 30%. The de-risking strategy was to be executed in three phases using zero coupon interest rate and inflation (break-even) swaps.

However, there was concern about the potential market impact of undertaking large scale tactical transactions in volatile and highly illiquid markets. The trustee board therefore delegated powers to design and implement the de-risking strategy to the IC, which, in turn, established a small LDI Working Party (LDIWP) to:

1. set up the necessary infrastructure such as ISDA agreements – the documentation between the scheme and a range of counterparty banks

with whom the scheme might trade and

2. to work closely with Redington and Aviva Investors on the detailed execution of the swap transactions. In setting up the LDIWP, the IC took account of the skills we had around the table. The members of the LDIWP had to have the relevant investment skills, competence and confidence to make decisions in real time. The LDIWP, scheme secretary, sponsor, Redington and Aviva Investors met weekly via conference call to discuss: 1. market levels, activity and trends 2. execution progress 3. opportunities 4. tactical refinements to the strategy and 5. to instruct trades. The focus of the de-risking programme – interest rate and/or inflation risk, short or long term – was adjusted each week according to market conditions.

# Transferring pension risk responsibly

Emma Watkins explains how trustees can ensure they incorporate the Pensions Regulator's guidance on risk transfer into their scheme plans

needed to make up a £1.6bn deficit while reducing risk as a whole.

## How the deal was done

In June 2008 the deal was signed off, and after initial explorations directly with investment banks the costs of a traditional LDI approach were considered too expensive. "Most pension schemes used to simultaneously execute swaps across the curve with an asset manager," adds Gardner. "But this meant executing all of your strategy at the same time. It worked in 2006 and 2007 but the problem in mid-2008 was that the buckets were often out of kilter with each other. Inflation was 4% – so there was a serious risk of stagflation. 10 year and 20 year inflation swaps were almost unavailable and longer term swaps even less so."

The Aviva trustees and Redington invested a large amount of time in training trying to identify the best way of setting up the LDI arrangement. Liquidity was patchy because markets had dried up, and the conclusion was that the swaps would need to be set up in a series of transactions as and when prices became attractive.

It was a strategy designed to get the best value for money in a market where timing is everything, and demanded a completely new approach to governance from the trustees' perspective.

"We spent three months in training and analysis – and concluded we needed to upgrade our governance framework," explained Aviva trustee Chris Wagstaff. "We needed to have weekly conference calls between the trustees, advisers, sponsor and scheme secretary to review the programme in the light of changing market prices."

To manage this governance burden, the investment sub-committee set up a nimbler LDI sub-

committee with delegated powers to execute the swaps deals, putting in place complex agreements called ISDAs and CSAs with the investment banks.

Redington monitored market prices with a panel of banks via Bloomberg's interactive chat facility before recommending transactions to the LDI committee. Standard ISDA contracts already used by Aviva in its asset management capacity became a template to finalise the arrangements, with scheme secretary Karen Jones heavily involved with administering the contracts.

Thanks in part to the advisers' contacts within the investment banks, the paperwork was carried out quickly – the longest contract took two months and the papers were normally completed within four weeks.

The team admit it is impossible to get the perfect price for all trades but "we estimate the trustees' quick governance saved £10m in terms of getting the right prices and the right terms," says Gardner.

One example of Aviva's flexible approach is their approach to gilts. In October their advisers started looking at the price of gilts vs swap contracts, as prices had moved considerably in favour of the former due to increased supply – the trustees were always on the look out for the best deal.

And has the strategy paid-off? Since last autumn short-term inflation has fallen considerably, but long-term expectations have risen – which the Aviva scheme has been protected against. And although many schemes have benefited from rising corporate bond yields which have suppressed liabilities, schemes like Aviva which use a gilt-based discount rate have suffered. Either way, the wild swings in liabilities which most schemes have experienced this year were dampened for Aviva – and they still have their equities to fuel future growth. ■

To assist trustees, employers and advisers navigate the wide variety of risk transfer options available to pension schemes in the UK, the Pensions Regulator published new guidance on 29th June 2009 to enable responsible management of risk transfers in a changing landscape.

In its press release, the Pensions Regulator stated that, "In setting the framework for pension risk transfers, we have endeavoured to enable trustees and their sponsors to manage responsibly any transfer of this risk away from sponsor balance sheets. At all times, where the risk is transferred to another entity, trustees must be certain that there is no reduction in member security. Where the risk is transferred to the individual member, trustees must take all reasonable steps to ensure members understand the risk they are being asked to take on and the value of the benefit they are foregoing."

Part of the guidance issued is a new module to the Trustee toolkit (which is available at [www.trusteetoolkit.com](http://www.trusteetoolkit.com)) entitled 'Buy-ins and partial buyouts'. This was released to provide guidance to those considering transferring pensions risk to insurance companies. The module emphasises the importance of all key stakeholders being in agreement in advance of the process and is designed to provide trustees with the key information needed at each stage of the process. The toolkit also identifies criteria for choosing an appropriate insurance company.

The toolkit module was published alongside a new code of practice, "Code of practice No. 12 – Circumstances in relation to the material detriment test". This sets out the circumstances in which the Pensions Regulator expects to issue a contribution notice as a result of being of the opinion that

the material detriment test is met.

It is therefore important for any trustee or sponsoring employer considering a risk transfer exercise to review the circumstances detailed in this code of practice in order to determine the risk that a contribution notice might be issued for their proposed solution. In order to assist trustees and employers with their analysis, high level guidance and illustrative examples on how the material detriment test and the code of practice might affect them have also been published. The example provided on bulk annuities details a situation where trustees discharge scheme liabilities through the purchase of annuities from a regulated insurer, and indicates that as long as the trustees take proper account of members' interests in deciding to insure the scheme liabilities, reconcile the respective interests of different classes of members to ensure all are fairly treated, and conduct due diligence when selecting a product and insurer, the Pensions Regulator will be satisfied that they have conducted themselves appropriately.

The information provided by the Pensions Regulator through the new toolkit module, and the code of practice, and the high level guidance and illustrative examples, should assist employers considering the removal of pension risk and volatility from their balance sheet, whilst helping to ensure trustees conduct themselves appropriately through the process of securing their scheme members' benefits through an insured bulk annuity solution.

