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Practical implementation of Liability Driven Investment Working Party

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Working Party members

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What is the problem to which LDI is the solution?

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What is the problem?

- Funding a pension scheme is complex with many stakeholders and potentially conflicting objectives
  - Trustees
  - Sponsors
  - The Pensions Regulator
  - The PPF
  - Members
  - Shareholders
- The investment strategy is only one part of scheme funding

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What is the problem?

- Matching bonds are the lowest risk investment but…
  - Bond yields are too low
  - Bonds are too short
- LDI can be used to create a more ‘efficient’ strategy to overcome these problems

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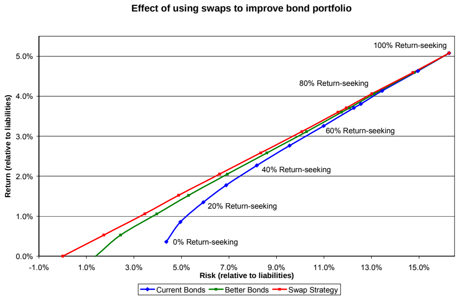
Which liabilities to hedge?



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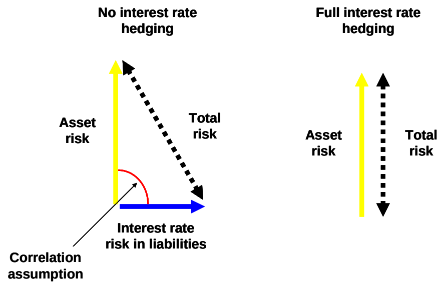
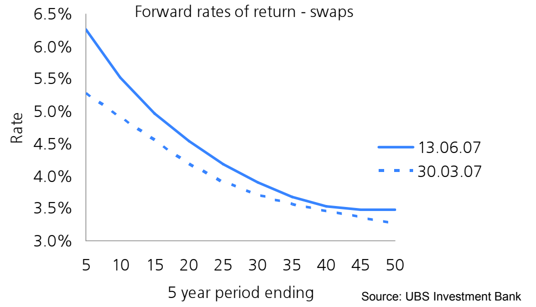


Which liabilities to hedge?

- Further points to consider:
  - Long term vs. short term
  - Liability categories
  - The optimal hedge ratio
  - Contributions and future service?
  - Level of precision
  - Optionality in the liabilities

Market conditions

Swap rates (forwards)



Source: UBS Investment Bank

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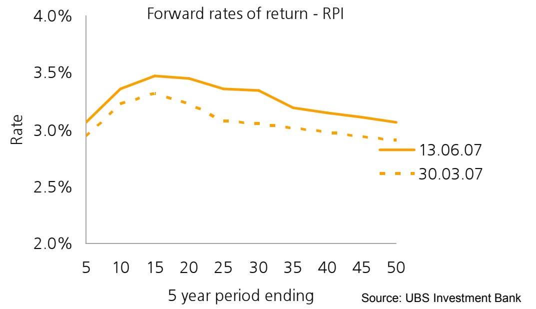
RPI rates (forwards)



Source: UBS Investment Bank

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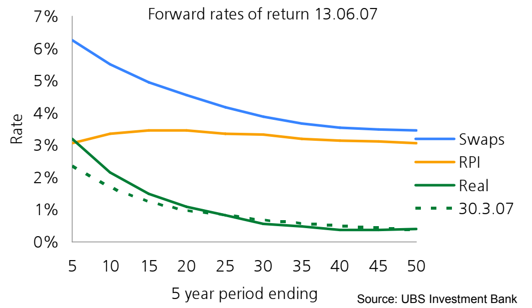
Forward rates of return (13.6.07)



Source: UBS Investment Bank

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Implication for hedging

- Long-dated real yields poor value
  - but could and have been lower (-ve)
- “Low” nominal yields and “reasonable” inflation
- But not an excuse not to hedge
  - Intelligent hedging – using risk budgeting
  - Phasing of hedging – roadmaps / options
- Swaps separate inflation and nominal yields c.f. IL gilts

LDI case studies

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LDI case studies

- 100% bonds (→ 85%)
- Long-term vs. short-term LDI
- Hedging liabilities, no change to assets
  asset target → Libor+

  followed by leveraged pooled funds

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LDI case studies

- Diversification + pooled funds (unlevered) — ICI

  or swaps — Schroders, Pension Protection Fund

- Close liability matching + equity upside — WH Smith PLC
- 75% cautious + 25% high risk/return — KVÆRNER

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LDI case studies

- CPPI vs. liability floor — vivendi
- Inflation sourced from internal assets — J Sainsbury plc
- Other public LDI adopters using swaps

BAA The world's leading airport company, telent, Durham County Council, XEROX, KINGFISHER, S&N

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Practical implementation

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Pooled funds

- Practical convenience vs. customisation
  - Separation of inflation / interest-rate risk
- Return expectations of underlying
- Leveraged pooled funds
  - Allow retention of return-seeking assets
  - But more complex + potential for further drawdown

Contingent assets

What is a contingent asset

- Asset with additional (cash?) value to fund on sponsor insolvency
- Either
  Outside fund, but ring-fenced on insolvency
- Or:
  In fund, with enhanced value on insolvency

Why use them?

- Reduce cash-flow impact of funding
- Ability for sponsor to
  - Share in surpluses – & risk/rewards of investment
  - Retain investment control
  - Use corporate assets (self-investment)
- But aim to retain tax and accounting advantages of funding

Contingent asset case studies

- Use of illiquid business assets to defer cash strain of funding
- Cash in escrow to enhance funding
- Covenants
- Letters of credit / CDS

Contingent asset case studies

- Corporate property
- Securitise corporate property & use to provide cash funding
- Hybrid debt issuance (ratings +ve)

Pension vs. life company approaches

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Life company approaches

- Same liabilities, but regulation ⇒ different investment
- Regulatory bias to 100% credit for life companies, and very close liability matching
- Orthodoxy being challenged
  - New entrants
  - New regulation
- Diversification – and tactical mismatching

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Insurance buyout

- Very "expensive" (130%-140% of IAS19)
  - FSA regulation - prudent reserves + risk margins
  - Bond-based investment
  - Cost of capital + profit margin
- But:
  - Competition reducing prices and driving innovation
  - Pensioners – "why buy gilts"
  - Partial buyout becomes another asset class

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