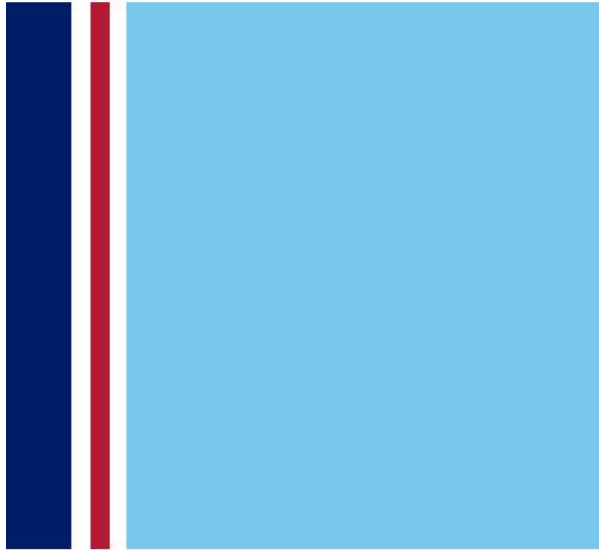watsonwyatt.com

UK Pensions – where are we now?

Edinburgh
January 2007

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Watson Wyatt *Worldwide*

UK pensions – where are we now?

- Why we are here
- LDI bandwagon
- Different solutions
- Issues to be considered
- Operational issues - swaps
- Pricing and costs
- Should I stay or should I go?

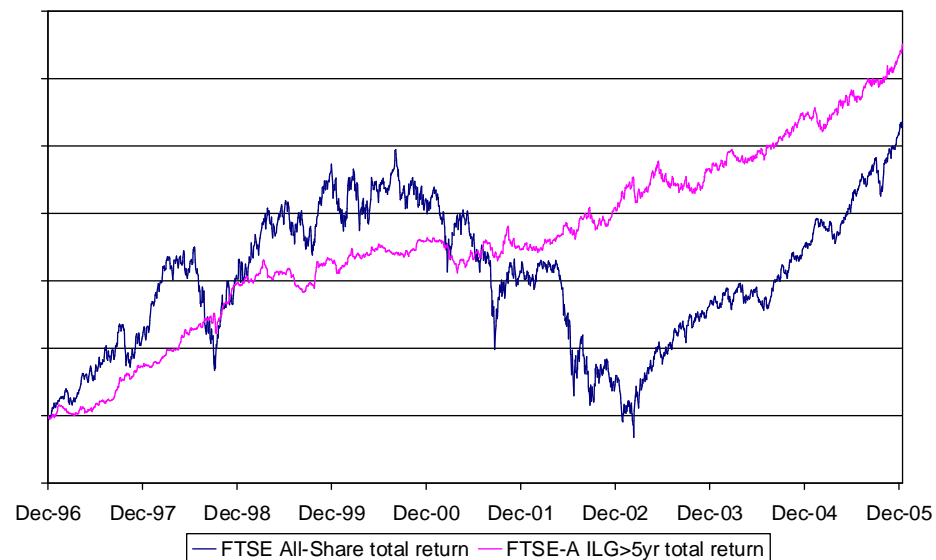**Pension funds need better solutions**

Why we are here

- **1980's and 1990's**
  - surpluses
  - discretionary benefits
  - off balance sheet accounting
  - high equity returns relative to liabilities

- **2000's**
  - deficits
  - changes to balance of powers in favour of Trustees
  - mark to market accounting
  - lower equity returns relative to liabilities?

Dec-96 Dec-97 Dec-98 Dec-99 Dec-00 Dec-01 Dec-02 Dec-03 Dec-04 Dec-05

— FTSE All-Share total return   — FTSE-A ILG>5yr total return

Greater focus on liability risk

LDI bandwagon

- Catalyst is often Corporate sponsor advised by an investment bank – agency issues
- Sponsor is concerned about
  - Balance sheet risk
  - P&L risk
  - Contribution risk
- Trustees concerned about excessive reliance on the Corporate
- Result is useful discussions for all parties using common language of risk
- From trustee viewpoint, eventual outcome is often reduced investment risk accompanied by increased contributions

Not for everyone - inappropriate transactions can be dangerous

Different solutions

- Spectrum of potential solutions
  - To reduce or remove risk relating to inflation or interest rates
  - Range from simple strategies that alter duration through to full liability cashflow matching
  - Physical assets or swaps
- The biggest absolute reduction in risk can come from simple solutions
- However swaps can give more flexibility to 'add value'

Expense and complexity spectrum

Appropriate duration bonds	Interest rate & inflation swaps	Full liability cash flow matching
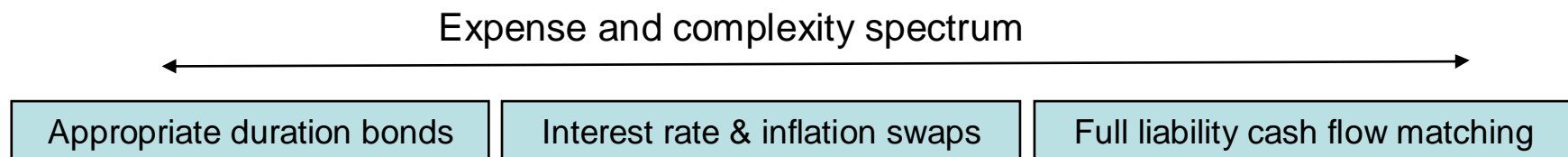
Issues to be considered

- Often the problem is 'not enough money' rather than the asset allocation
- Not all risks are addressed by physical assets or swaps
- Understanding how the swap will respond to different economic scenarios
- Interaction with overall asset portfolio
  - Is it risk reducing?
  - Additional risks introduced?
- Interaction with liabilities
  - Quality of liability matching?
  - Impact on the actuarial valuation?

No silver bullet

Operational issues - swaps

- **Operational requirements before executing swaps include:**
  - Finding an entity to execute swaps on the fund's behalf
  - Finding an entity to manage the assets backing the swap (bonds, cash etc)
  - Determining who will manage the collateralisation process
  - A number of legal and tax hurdles / checks

Impartial advice is essential

Pricing and costs - issues

- Most of the 'performance' of a derivative execution and maintenance occurs on day one

- The pension fund is then 'locked in' at the agreed rate with the agreed counter party

- Price transparency
    - Much of the work is in assessing competitiveness of offered rates
    - Easier with more liquid instruments
    - Very difficult for certain products (such as structured credit)

- Controlling executed rate
    - Funds can set economic bandwidths which limit the terms that are executed on their behalf, and also counterparty exposure

Buyer beware!

Pricing and costs - details

- One off:
  - Transaction cost paid to bank
  - Higher costs of UK inflation in swap vs. government bond market
  - Legal and tax advice
  - Investment consultant fees
- Ongoing:
  - Asset manager: additional fees for swap execution and management
  - Asset manager: bond portfolio management fees - similar to current
    charges depending on what portion of portfolio is actively managed
  - Increased custodian charges
  - Monitoring and performance measurement

Step change in ongoing administration

Should I stay or should I go?

- LDI becoming increasingly well established among pension funds

- Wide variety of solutions
  - LDI appropriate for some, not all, pension funds
  - Challenging to understand complexities
  - Can be expensive to implement
  - Many risks not addressed by LDI

- Strain on governance
  - Managing the decision making process
  - Understanding pricing and true costs
  - Operational and monitoring challenges

Impartial advice is critical