

Growing LDI trend - Opportunity for Ireland's Funds Industry

In recent times Liability driven investments (LDI) have become increasingly popular amongst pension funds. As a result, many of the service providers in Ireland are gearing up to meet the expected increase in LDI products being launched.

Liability driven investments (LDI) is a term which did not exist ten years ago but has become commonplace in pension fund investing in recent years. A survey of pension schemes by JPMorgan in June 2006 reported that 13 per cent of pension schemes surveyed in the UK already use an LDI strategy and that a further 31 per cent are considering using an LDI strategy. Yet there is no single agreed definition of the term, probably reflecting its newness. Despite being used commonly, different pension schemes have different interpretations of its meaning.

Liability driven investments focus on the future liabilities of the pension scheme. They aim to reduce exposure to the market risks related to those liabilities such as interest rate risk and inflation risk. One of the methods used to achieve this objective is by considering whether the make up of assets matches the liabilities - by considering for example asset classes and duration. In many respects this is not new and many pension schemes would consider that LDI is something that has always existed. However the use of derivatives (primarily swaps) to achieve these objectives is relatively new and most pension schemes view LDI as a means of achieving returns in excess of their liability costs.

There are some commonly identified but differing approaches by which a liability driven investment strategy can be implemented, and these are explained below. Despite the increased focus on LDI, the industry survey revealed that one in four pension funds across Europe viewed lack of knowledge about LDI as the primary hurdle to implementing an LDI strategy.

The accounting and regulatory environment

The change in the regulatory and accounting environment in the last 10 years has led to the current focus on LDI. In the UK and Ireland, FRS 17 "Retirement benefits" was issued in November 2000. In Europe all listed entities have moved to IFRS from 1 November 2005 and are required

to comply with IAS 19 "Employee Benefits". Both of these accounting standards require the disclosure of the market value of pension liabilities and FRS 17 requires that pension scheme surpluses or deficits be recognised on the balance sheet. These standards require companies to consider the value of their pension liabilities more than ever before and hence the move towards liability driven investments was natural.

In certain European countries the influence of regulation has been even greater. In Denmark in 2001, new regulations required that pension schemes be categorised on their ability to maintain solvency under different hypothetical scenarios. To meet these regulatory requirements Danish firms turned to swap transactions and this marked the emergence of Liability Driven Investing. The investment banks who provided LDI solutions for Danish pension schemes have exported the strategy to the rest of Europe and the UK in particular. Other countries - Sweden and the Netherlands - have brought in pension regulations in 2006 and 2007 driving the move to LDI.

Some commentators suggest that regulation in the UK is more lax than these countries and accordingly the need for LDI is less immediate. However undoubtedly FRS 17 makes LDI strategies more attractive and companies realise that it is possible to get liability plus returns (returns that exceed the benchmark of liabilities by one or two percentage points and thereby enable "gap closing" of pension deficits).

Interest rate sensitivity

Pension fund accounting regulations (FRS 17/IAS 19 and regulations) require schemes to value pension liabilities by discounting future cash flows using discount rates derived from current market interest rates. The current market value of the liabilities is therefore sensitive to current interest rates - when interest rates fall, the market value of the liabilities increases. This sensitivity is magnified

by the long term nature of the liabilities which generally far exceeds the duration of the assets held. Pension funds in turning to LDI were primarily looking to reduce the volatility from interest rate changes. Some LDI strategies have only this objective which is sometimes referred to as “immunising” or cash-flow matching. However many LDI strategies now go beyond such an approach to seek returns in excess of liabilities.

In order to match the interest rate risk profile of its liabilities, many pension schemes turned to bonds, as their cashflows most closely match pension liabilities. In many cases an LDI portfolio is constructed by initially putting together a portfolio of gilts, index linked gilts and corporate bonds. However most pension schemes contain a proportion of long-dated liabilities and it can be difficult to obtain sufficient long dated assets to match these. Accordingly most LDI portfolios make use of swaps. Swaps can be tailored to more closely match the duration and other characteristics (e.g. inflation linked) of the liabilities.

Alternatively some LDI portfolio hold only cash and swaps as a starting point, as interest rate swaps, inflation swaps and credit default swaps can be used to create the same exposures as a bond portfolio.

Generating higher returns

Whilst much of the LDI portfolio is allocated to creating a cashflow matching portfolio of cash, bonds and swaps, a certain proportion may be allocated to other asset classes such as equities or alternative investments to achieve a higher return. In cases where the LDI portfolio has been constructed using cash balances and swaps, some of the cash that is backing the swaps could be replaced with actively managed funds that enhance the LDI returns. This enhanced LDI strategy is more popular than merely “immunising”. JPMorgan’s survey indicated that most pension schemes in the UK (83%) are seeking returns of typically 1 to 2 per cent above liability cost from LDI (liability plus returns).

Because many hedge funds are “market neutral”, whereby they limit their exposure to movements in the overall stock market by having both long and short portfolios, their limited exposure to market risk can make them suitable for inclusion as part of an LDI strategy. Many hedge funds will have noted the increased prevalence of pension schemes among their investor base in recent years and this trend is likely to continue given the continued move to LDI.

Whilst a solely “immunising” approach may only be offered by large providers who can benefit from economies of scale, strategies based on generating higher returns do not require such scale and are offered by a number of different asset managers, investment banks and others. For example in 2005, hedge fund giant MAN Group launched a product that aims to match closely the liabilities of a pension scheme while boosting its returns.

Operational issues

The use of swaps is a key feature of most LDI strategies, although it is possible to implement a strategy without using derivatives. In some LDI strategies swaps are used to match the entire risk exposure of the liabilities, whilst in others they are only used when for example the duration of liabilities do not permit matching through holdings of gilts or bonds. Only a small minority of respondents to JPMorgan’s survey, who favoured an LDI approach, indicated that they would not consider using derivatives. Most respondents also indicated that they would prefer a fund manager to trade OTC transactions such as swaps on their behalf.

Trading in swaps creates operational risks because they are generally over-the-counter (OTC) instruments. Put simply risks arise because each contract is individual and counterparty’s have the opportunity to modify contracts. In such cases, the LDI provider needs legal teams that are capable of dealing with ISDA documentation and multiple counterparties. Managing collateral effectively to minimise counterparty risk also becomes important. Business processes specific to OTC transactions may need to be developed and implemented. Performance reporting is also more complex.

Because of such complexities and the expense associated with a segregated LDI mandate, LDI is offered to many pension schemes on a pooled basis. Pooled LDI products are aimed at pension funds whose small or medium size does not warrant a segregated LDI mandate.

Future outlook

Rapid growth in the swaps market over the next five years is to be expected. This is partly due to the increasing use of LDI and partly because there is a lack of sufficient long-duration issues in bond markets that would be needed to match the cash flow requirements of pension liabilities.

The demand for higher returns as part of an LDI strategy has led to an increasing use of hedge funds by pension scheme investors. Given the expected increasing prevalence of LDI in the future, this trend looks set to continue.

Some hedge fund providers already offer LDI solutions for pension scheme investors. For smaller schemes, pooled funds are the only viable option for accessing LDI solutions. New innovative products are constantly coming to market.

Given the changes to the accounting frameworks and funding deficits in pension vehicles, asset managers are under increased pressure from investors to develop LDI products and deliver them to market. Ireland remains well placed to service the LDI market given the industry’s knowledge of regulated products (UCITS and non-UCITS), structures and expertise in the alternative asset management space. Many of the service providers in Ireland are currently offering solutions to asset managers in the LDI space and have geared up to meet the expected increase in LDI products being launched.