Swapper's paradise

Executive summary

- An interest rate and inflation swap portfolio can offer a better match than index-linked gilts for the cashflows of a pension fund's benefit liabilities. And implementing liability-driven investment before a fund buy-out will provide a partial hedge for the buy-out/buy-in cost.

In September 2008 telecoms company Cable & Wireless announced that it had transferred £1bn of its pension liabilities to a specialist insurer. At the ACT Annual Pensions Conference in June this year, Roger Burge, director of treasury and corporate finance at C&W, explained the practical steps involved in implementing a liability-driven investment (LDI) approach and achieving a successful buy-out/buy-in.

With around 15,000 members, the Cable & Wireless superannuation fund is bigger than the company's current staffing levels. In many ways, it is a legacy scheme, having closed to new members in 1998. At 31 March 2007 the fund had gross liabilities of £2,229m and gross assets of £2,214m.

In 2007 the assets were split so that 59% were return-seeking (51% equity and 8% property) and 41% matching (overwhelmingly bonds), which Burge suggested was pretty typical of schemes at the time. The popular VAR 95 measure (value at risk at a 95% level of confidence) was £287m and the average duration of the liabilities was 21 years. The scheme was in a good position, fully funded at its last valuation in March 2007 after a £15m contribution from C&W.

The bond assets in the matching part of the portfolio had a mean duration of around 11 years, 10 years shorter than the liabilities. While the bond portfolio was well constructed from an asset management perspective, it fell a long way short of being a proper hedge for the liabilities.

The VAR 95 breakdown showed that exposure to real interest rates was £231m, greater than the equity value exposure of £216m, which Burge described as "quite surprising" given that 40% of the assets were supposed to be broadly matching the liabilities. As a result he asked the investment advisers how the fund could use swaps instead of its bond assets to match the liabilities.

The resulting analysis suggested that selling the index-linked gilts in the portfolio and replacing them with an interest rate and inflation swap portfolio would give a more precise match for the cashflows of the benefit liabilities. It would also extend the duration of the matching portfolio, making it closer to that of the liabilities, and provide a VAR 95 reduction equivalent to a 5% switch from equities to bonds. Finally, the move offered a higher running yield than the existing matching portfolio.

Burge suggested that this was one of those rare occasions when it looked like a free lunch really was on offer. Once the opportunity had been identified, the trustees and C&W set about trying to put the swap deals in place.

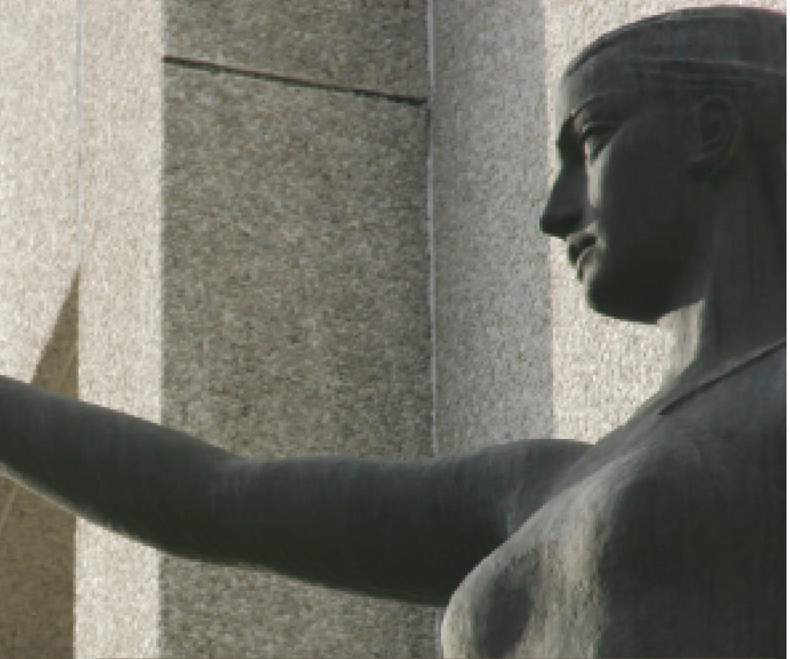
OVERARCHING PRINCIPLES Project management is the first issue to deal with and Burge recommends setting up a sponsor/trustee subcommittee to manage implementation. Issues are technical and complex decisions have to be made between trustee board meetings. The project is usually led by trustees' advisers rather than corporate treasury, and sponsors have an influencing role only. A key question is how much of the inflation and interest exposure should be hedged. The more swaps you do, the more you reduce VAR. However, if you overlay swaps on return-seeking assets, do they become return-seeking or matching, or neither, or both?

Trustees and sponsor need to understand clearly the risk/reward trade-off and the objective and impact of hedging.

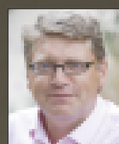
A key impact of LDI on the sponsor, if not the trustees, is the potential negative effect on funding valuation because of the bid/offer dealing spread, and the difference in returns on swaps versus government bonds. The fund's actuary should be asked to confirm the impact of swaps on return assumptions before going ahead.

Other elements that need to be considered include who to hire to do the deals and manage the margins calls, and who to use as swap counterparties in the light of the financial crisis and in particular the collapse of Lehmans. Burge suggested that trustees should be encouraged to deal with the sponsor's relationship banks and that great care should be taken over the documentation.

Trustees also need to think about how they are going to monitor the swap portfolio, so they need to define what reporting they



BY REPLACING ITS PENSION FUND'S BOND ASSETS WITH SWAPS TO MATCH ITS LIABILITIES, CABLE & WIRELESS TOOK ADVANTAGE OF THAT NEAR-MYTHICAL EVENT, THE FREE LUNCH, AS ITS DIRECTOR OF TREASURY TOLD THIS YEAR'S ACT ANNUAL PENSIONS CONFERENCE. **PETER WILLIAMS** LISTENED IN TO A PRACTICAL ROUTE MAP FOR A PENSION FUND BUY-OUT.



require and agree the related costs upfront. Thought must be given to amending swaps. These instruments are contracts that last between 30 and 50 years and they will need to be changed one day. Burge recommended being wary of bespoke structures that are difficult and expensive to unwind. While implementing LDI is a serious task in its own right, Burge suggested it should also be seen as the first step towards a buy-out/buy-in.

RISK REDUCTION Despite the LDI programme C&W still bore a material amount of financial risk from the pension fund, so it set about exploring ways to reduce it. Like many other pension scheme sponsors, the company was looking at ways of maximising risk reduction that did not involve putting significant extra cash into the fund. It was at that point that the company assessed the options to further reduce risk, including partially switching out of equities and into bonds/swaps, an inducement offer and a buy-out/buy-in. The last option offers the advantage of perfectly hedging the pension scheme's liabilities but has the downside of a potentially large cash cost to the company.

Implementing LDI has a number of merits as a precursor to buy-out. It sets the funding discount rate on the liabilities covered to a similar level to the insurer and it provides a partial, if imprecise, hedge for the buy-out/buy-in cost.

The decision to go for a buy-out/buy-in was partly driven by timing. When it first looked at the option, C&W had been quoted £500m to insure the pensioner and deferred liabilities. But in the first half of 2007 new providers were entering the market and so competition increased; bond yields were going up, so buy-out prices were lower and fund asset values were rising. That £500m price tag came down to £200m-£300m, at which point, as Burge said: "it started to look interesting" and possibly affordable.

However, completing a buy-out is not a simple process. It took around four months for the trustees and their advisers to investigate the market and draft a shortlist together with indicative prices rather than actual dealing prices. There followed a beauty parade and a comparison of indicative prices.

Box 1: Seven steps to buy-in/buy-out success

- Transaction management
- Policy features required
- Counterparty risk
- Pricing
- Maintaining competitive tension
- Asset transition
- Communication

The key question for the sponsor is how much to pay. Burge suggested there are likely to be competing views on the sponsor side. The treasurer may be prepared to pay a relatively high price to eliminate volatility/regulatory risk and convert the pension to a fixed liability, while the chief financial officer may find the risk reduction attractive but be concerned by the potential negative impact on the market value of the company and question the value of the benefit given that there is a large cash premium to pay. A further view may come from the HR side, which may see little benefit in paying out a lot of cash today to crystallise a liability that could be comfortably managed over a long time horizon, as it has in the past.

Comparing prices between providers is difficult and much work was needed for C&W to arrive at an apples-vs-apples price comparison. The outcome of the process was that while the cost of buying deferred members had become too high, the cost for pensioners was very close to the value of their ongoing share of the fund's assets, meaning a very limited cash cost to the company. The next step was to decide between a buy-out and a buy-in. The determining factor was the amount of sponsor contribution that would be required.

BUY-OUT OR BUY-IN? In a buy-out, both the annuity policies and the liabilities covered exit the fund. There are two cost drivers: the cost of annuities versus pensioners' share of assets assessed on a closed-fund basis, and the cost of derisking the residual portfolio.

With a buy-in, a bulk annuity policy and the liabilities covered stay in the fund. The primary cost is lower because the pensioner share of assets is assessed on an ongoing basis and there is no secondary cost as the strategy for residual investments should be unchanged.

There are seven key areas to focus on to ensure success in managing the buy-out/buy-in transaction (see Box 1). Burge suggested that the process should be managed in the same way as an M&A deal. In terms of policy features, while trustees and sponsor requirements may differ there should be an understanding of must-haves and nice-to-haves, and how the nice-to-haves affect pricing. Maintaining competitive tension is vital to achieving best value; keeping options open narrows the grounds for price adjustments, and granting exclusivity to one provider should be left late in the process and seen as sending a signal of the intention to close.

Communication is vital. What may seem like a successful deal from the treasurer's perspective may not seem so to other stakeholders. Assurance needs to be given on the probity of the deal, and its benefits have to be explained to pensioners, non-pensioners, shareholders and even journalists. Anticipate and be prepared to deal with adverse reactions.

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