



Securing the Promise: Is liability-driven investment the answer to the growing challenge of pension fund deficits?

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If proof were needed that the pensions promise is becoming a millstone round the necks of sponsoring businesses, it came in March this year, when British Airways announced drastic action to tackle its pension fund deficit, valued at around £2bn (\$3.5bn) pre-tax. In return for a package of changes to future service benefits that would reduce the deficit by £450m, BA promised to make a further £500m payment to the fund. BA's finance director was quoted as saying: "We have to resolve the (pension deficit) situation before we can consider buying more aircraft or making further investment."

This is not a specifically British problem. In the U.S., some estimates put the combined corporate pension plan deficit at around \$450bn, with high-profile problems at GM and United Airlines illustrating the extent to which pensions have become one of the most critical issues of the 21st century for senior business managers. Managing a pension plan is no longer a question of making the right investment decisions: it has become a key agenda item for corporate treasurers and CFOs.

One of the key reasons behind these bulging deficits is well known: global equity markets, to which many plans were heavily exposed, lost a third of their value between December 1999 and December 2002. But higher life expectancy, low interest rates, changes in accounting procedures and tougher regulatory scrutiny have also contributed to the crisis.

In the U.K., the Pensions Act 2004 has changed the basis on which defined benefit pension schemes are valued and

funded, while the Financial Accounting Standards Board in the U.S. has recently issued a draft proposal for changes to FASB87, the 20-year old standard for pension plan accounting. In the Netherlands, meanwhile, proposed new pension fund regulation, the Financieel Toetsingskader (FTK), is predicted to have a dramatic impact on the asset allocation and funding strategies of Dutch pension plans.

The Mother of Invention

Faced with these challenges, pension trustees and their advisers have been forced to come up with radical plans to reduce deficits and comply with new legislation and codes of practice. Some — like GM — have gone to the debt markets to raise capital to fund the deficit. But others have been more creative, proving the old adage that necessity is truly the mother of invention.

Perhaps the most innovative solution to date has come from the pension fund of WH Smith, the U.K. retailer. Although it had closed its £870m (\$1,523m) defined benefit plan to new members some 10 years previously, the trustees still needed to deal with a deficit of just under £100m (\$175m). They were also concerned about cashflow mismatches and, last year, the trustees settled on a new strategy that involved selling the fund's entire equity and fixed income portfolio. A new cashflow-matching structure was established, with 94 percent of assets put into swaps to protect against inflation and interest rate risk over a 50-year duration, and six percent going into

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longdated equity call options. WH Smith explained that its two objectives were to create certainty over future cashflows and to reduce volatility in the scheme. WH Smith's bold move certainly created a lot of excitement about the strategy that the market now refers to as liability-driven investing (LDI). Almost overnight, everyone appeared to have an opinion about the approach, as well as the underlying market conditions that had led companies like WH Smith to take such drastic steps. One noted U.K. analyst referred to "the unedifying spectacle of financial markets gripped by an entirely self-manufactured pension fund crisis."

If it has captured the imagination of some pension fund trustees, it is also causing asset managers to scratch their heads. Earlier this year, for example, Invest it, a U.K. investment management consultancy, asked a group of 25 asset management CEOs, COOs and IT directors to vote for their three most critical operational concerns in 2006. LDI topped the list.

Swapping Problems or Solving Them?

The fundamental question that is giving a lot of sponsoring companies the most concern is whether LDI represents the global panacea for all fund deficits, or whether it is a specialist technique that only has a very narrow application.

LDI is far from revolutionary. Pension fund managers have always attempted to invest plan assets to produce returns that cover liabilities, but over the years the methods and performance benchmarks have evolved to a much more scientific and precise level. What has also changed is the environment in which they operate: after the booming markets of the nineties, when many schemes were in surplus and actually took contribution "holidays," managers are now confronted with considerably more challenging conditions. As regulators force companies to identify funding shortfalls and deliver precise plans to reduce them, managers have sought to close the gap between asset and liability cashflows.

LDI has been touted by some as the solution to these issues. In essence, the LDI objective is to ensure that performance is greater than any increase in liabilities. That sounds straightforward, but the techniques behind an LDI program are highly complex, with no guarantee of success.

Some observers believe that LDI creates more problems than it solves. In a research paper published earlier this year, Con Keating, Principal of the Finance Development Centre, said: "Liability driven investment can be seen to be the hedging of an accounting convention not any economic reality; by using derivatives such as swaps in the attempt to hedge liabilities a pension fund is actually introducing a new sensitivity to interest rates since a swap merely consists of a long-term fixed-rate loan paid for with short term variable interest rate costs over the term of the swap. It is difficult to believe that this is the intention of most who are considering using derivatives or that it makes any sense for the majority of pension schemes."

Where LDI may make sense is for those pension plans that are fully funded and want to lock in their position, and for those sponsoring companies that want or need to minimize the impact of the fund on the corporate balance sheet. But the practical application of LDI is not without significant barriers, challenges and far-reaching consequences.

For example, the success of an LDI strategy is dependent on an adequate supply of long-dated index-linked bonds. With demand for this paper far outstripping supply, prices are pushed up and yields drop, which has the effect of increasing a pension fund's liabilities when these are measured against bond yields. LDI also reduces the investment opportunities of diversification as it attempts to mitigate risk and remove volatility from the fund. The net effect is that funds wanting to adopt an LDI structure will find themselves paying a very high price to match liabilities with little upside potential for superior performance.

No Silver Bullet

At least in part, the enthusiasm for LDI has been fuelled by the concerns of finance officers who want to see a decoupling of pension fund liabilities from the corporate balance sheet. The case of WH Smith, the U.K. retailer, clearly demonstrates the challenge facing the corporate sponsor: in 2004, a takeover bid for the retailer by Permira was abandoned after the trustees of the pension fund demanded that the deficit, then between GBP200-250m, be paid off by the bidder. The pension fund deficit was also cited as one of the reasons for a failed bid for Marks & Spencer in 2004.

With the U.K. Pensions Regulator holding the power to forestall corporate transactions — and other countries likely to follow this example — there are genuine fears that the current pensions crisis will have a serious impact on macro-economic activity and corporate investment plans. Analysts might look at the words of BA — putting the deficit ahead of investment in new equipment — and adjust their ratings accordingly.

To company finance chiefs, LDI might appear to offer a quick-fix solution, even if the initial cost of securing future benefits and closing the deficit are high. But LDI is unlikely to become the “silver bullet” for the current problems faced by pension funds. Its most obvious drawback is that it can only be used as an effective strategy if there is an adequate supply of long-dated, index-linked bonds. As

there currently appears to be little or no will on the part of national governments to satisfy this demand, the potential for growth of the LDI market will be severely limited.

Instead, it is likely that LDI will be part of a much wider review of the way in which corporate sponsors manage the assets and liabilities of their schemes. Regulation must be proportionate and reasonable, protecting the interests of scheme members while ensuring that the remedies are not worse than the symptoms. What is encouraging is that there has been a collective acknowledgement — by actuaries, sponsors, pension fund managers and regulators — that a new approach is required. Careful consideration of all the alternatives, rather than a rush to find a dubious cure-all, will ultimately lead to a better solution for the industry, and society, as a whole.

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