

MICHELLE WILLIAMS, Client Solutions Manager, Structured Solutions, Legal & General Investment Management outlines and refutes the common misperceptions of LDI

DISPELLING THE LDI IMPLEMENTATION MYTHS

Liability Driven Investment (LDI) strategies have built a solid reputation as a useful risk reduction tool. Through the use of derivatives (swaps), LDI strategies can help a pension scheme hedge its exposure to the headwinds of interest rate and inflation movements as well as mitigate potential credit risks. The strategies aim to lock in guaranteed returns over long periods corresponding to the long-term nature of scheme's liabilities. But not everyone has been keen to jump on board.

In the past, the costs (direct and indirect) of implementing these strategies could be prohibitive. Essentially the costs of implementing a LDI strategy are the costs of investing in bonds and swaps. Transaction costs (spreads), asset management fees and the implications associated with swapping a scheme's exposure to long-term interest rates for exposure to short-term rates caused many to avoid these solutions altogether.

However, there has been a great deal of work done to bring down the entry barriers and make LDI strategies more accessible, effective and beneficial for pension schemes.

The following are just a short list of common misconceptions about implementing a LDI strategy and the truth behind them.

Myth: Legal documentation around contracts is too complex and costly.

In order to perform an over-the-counter derivative transaction, a scheme must put in place an ISDA agreement between the Scheme and each counterparty bank with whom they may wish to trade. Typically, if this is being done on a segregated basis, ISDA agreements need to be established with around three to four counterparties – and the legal documentation required is considerable.

ISDA documentation comprises a significant amount of legal documentation, including:

- An ISDA Master Agreement – which provides a standard framework for trading derivatives. The two versions in use today are the 1992 and 2002 Agreements
- The Schedule to the ISDA Master Agreement – which covers any changes that the Scheme may wish to make to the Master Agreement
- The Confirmations – that include the specific details of the individual trades.
- A Credit Support Annex (CSA) – which dictates the operation and terms of a process known as collateralisation, whereby security payments are exchanged over the lifetime of the contract.

Negotiating all this documentation has previously been extremely costly and has demanded a lot of trustees' time. However, the implementation of segregated, bespoke

mandates has been greatly streamlined. Drawing on their experience and size, many asset managers have pre-negotiated terms with investment banks on behalf of trustees and can now offer trustees an agreed agency template, which reduces the time taken to implement from 4-6 months to 4-6 weeks.

Myth: Implementing takes a long time

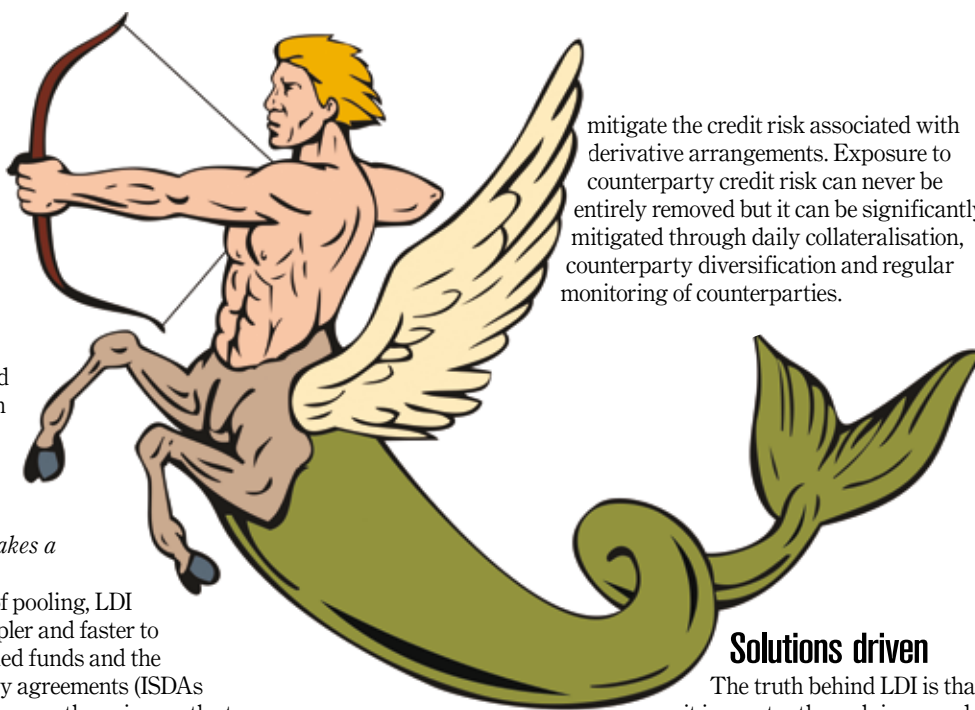
Through the benefits of pooling, LDI strategies are now simpler and faster to implement. Before pooled funds and the establishment of agency agreements (ISDAs and CSAs) it could take more than six months to implement a strategy.

In this time the market environment could have changed significantly and the scheme may have missed the very opportunity that it was seeking to capture. Pooled funds allow even small investments access to a range of strategies including corporate-bond backed, cash flow matching and enhanced matching funds, where implementation takes just a week from when the forms are signed.

Myth: Counterparty credit risk is too high

LDI strategies pay careful attention to the governing documentation and stringent collateral terms with the investment bank behind the transaction and therefore

mitigate the credit risk associated with derivative arrangements. Exposure to counterparty credit risk can never be entirely removed but it can be significantly mitigated through daily collateralisation, counterparty diversification and regular monitoring of counterparties.



Solutions driven

The truth behind LDI is that it is constantly evolving – and

the developments are making it far simpler to transition into.

Most pension funds have significant holdings in index linked gilts that are generally pooled via an index tracking fund. In the past, when moving into a LDI arrangement, the pension fund typically had to sell the gilts before buying swaps and underlying assets (unless gilts are being used as collateral).

More recently, however, asset managers are getting involved earlier in the process and developing in-house tools which allow pension funds to exchange gilts, reshape them and help build them into a LDI arrangement with banks. This can assist in reducing transaction costs and maintaining market exposure.

