

Pensions to learn from Lehman's collapse

The Big Picture

As a counterparty to billions, the bank's demise will have an effect on funds using swaps, says **Steve Johnson**

The collapse of Lehman Brothers has presented the first major test of the rapidly expanding liability-driven investment industry.

Although Lehman was not a front-line player in the market, it was a counterparty to billions of pounds worth of interest rate and inflation swaps contracts entered into by pension funds seeking to hedge their exposures by adopting an LDI model.

The indications are that the apparatus underpinning the derivatives contracts at the heart of the LDI concept will have been robust enough to keep potential pension fund losses within reasonable limits. However, there will be lessons to be learnt from Lehman's legacy.

The proportion of funds utilising LDI has doubled in the past 12 months, according to research by SEI, a US fiduciary manager, with 62 per cent of funds in Netherlands, 43 per cent in the UK and 36 per cent in the US having adopted the strategy.

Jon Exley, a principal in the financial strategy group at Mercer, the consultancy, put Lehman's market share in the UK pension sector at about 5 per cent.

Dawid Konotey-Ahulu, partner at Redington Partners, a pension consultancy, adds: "Lehman would have been one of a number of potential counterparties. They were not a top three provider to pension funds but they certainly would have been on the roster as one of the potential providers and they would have had various swaps with pension funds."

The ground rules covering a swap contract are set by the International Swaps and Derivatives Association. But, crucially, the parties have the freedom to customise the agreement via the schedule,

which among other things covers termination, and the credit support annex, which determines issues such as the provision of collateral – paid in the form of cash or bonds to whichever party is "out of the money" on a mark-to-market basis.

The regularity with which collateral is posted is a crucial issue in these circumstances. According to Mr Exley, this can be done on a daily, weekly or monthly basis.

As a result, a pension scheme may be out of pocket if the value of the swap has fallen since the last time that collateral was posted, placing it among the queue of secured creditors.

"There might be a bit of daylight or market loss which is then just a bill to Lehman, which may or may not be paid," says Nick Horsfall, senior investment consultant at Watson Wyatt.

Monthly collateralisation

'There was not enough "what, if" guessing by lawyers'

John Hastings, partner at Hymans Robertson

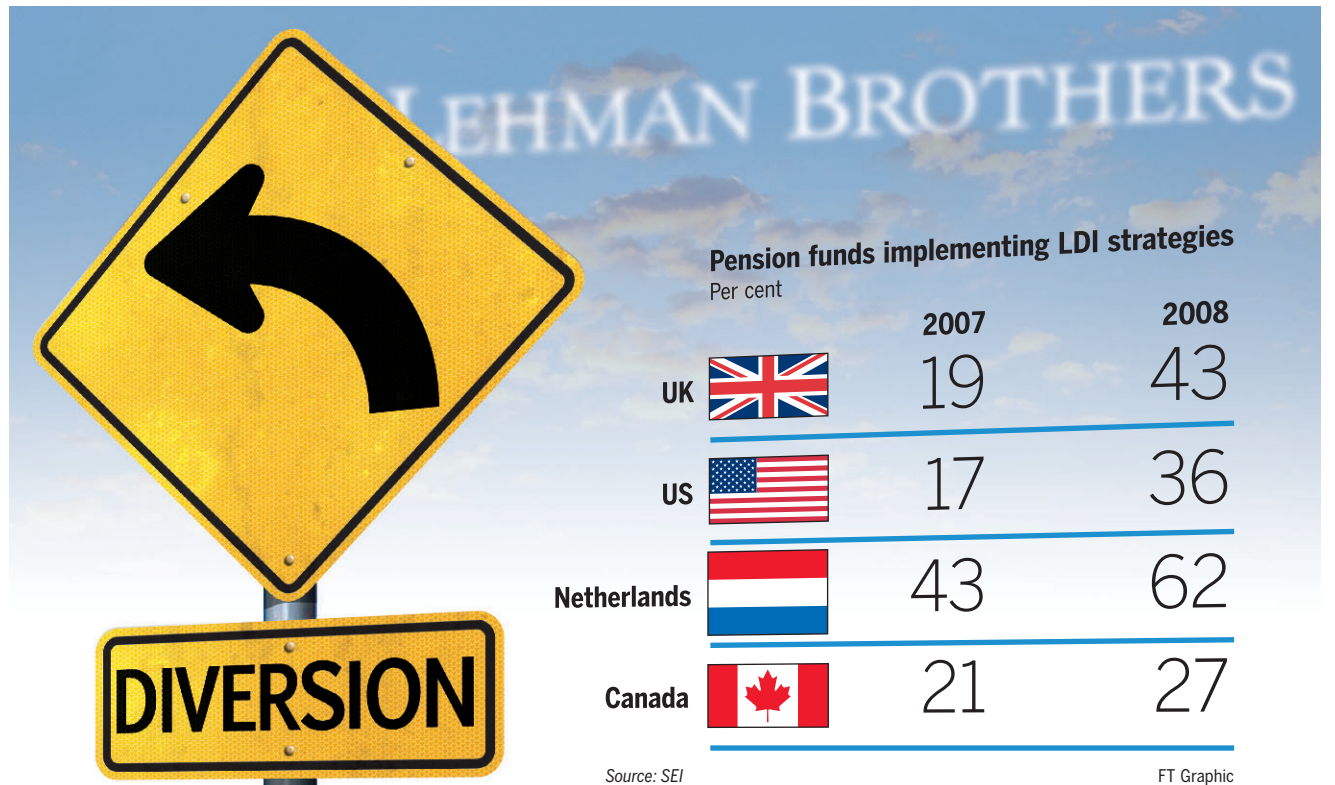
is now relatively uncommon, although John Hastings, partner at Hymans Robertson says such contracts may have been written during times of low volatility when the dangers of irregular payments were perhaps not fully appreciated.

"Historically it could have been monthly but daily or weekly is much more common. Markets can move a long way in a month," says Mr Konotey-Ahulu.

The vast majority of swaps are likely to be collateralised daily or weekly, meaning they should have been settled on the Friday before Lehman collapsed, limiting the potential damage to pension funds.

"It would have been squared off on [the] Friday evening. The big issue would have been anything that occurred over the weekend. You always have one day's market exposure in a swap," says Mr Hastings.

However, pension funds in some jurisdictions may have



a much greater problem. Legislation in some jurisdictions, such as New York State, allows collateral to be pledged rather than physically transferred. This could result in messy legal battles for affected pension schemes.

Some pension funds will have avoided such problems altogether by terminating their swaps with Lehman in the days prior to its demise, particularly if their contract had included a "termination trigger", such as a cut in their counterparty's credit rating.

However, all funds are likely to need to write a new swap with a different counterparty, potentially triggering a loss.

"The risks that you run are that, the markets may move against you and therefore you may not have enough collateral to get a complete replacement swap in this market," says Mr Konotey-Ahulu.

Mr Hastings adds: "One of the problems if you have a swap in place that has ceased is that you have to put it back again and you have re-investment risk. It may not be possible to put it back on at as attractive terms as it was initially."

According to Mr Konotey-Ahulu, the lessons to be learnt from this episode are that pension funds and their advisers need to select their counterparty carefully, diversify their counterparties and manage collateral sufficiently tightly that they are never owed a significant sum of money.

Mr Hastings believes some funds may need to fundamentally reassess their approach. "There was not enough 'what if' guessing by lawyers," he warns.

"There are things related to counterparties, stress testing and collateral risk that [pension funds] need to take care of. If you put too much into the 'too difficult box'

then circumstances may arise when you wish you had paid more attention.

"The first people who went into LDI would have done it on a segregated basis, they would have spent two years training their trustees and have had lawyers looking in every dark corner.

"As it becomes more commonplace they might have

thought 'the peer group has looked at it so I do not have to look at it so diligently'. They may not have understood all the quirks and risks."

However, Mr Exley stresses it is not a "cataclysmic event" for pension funds, arguing that even those with Lehman as a counterparty have probably

suffered more purely as a result of market movements on their assets.

And Mr Konotey-Ahulu argues that with inflation having risen globally, those pension funds that did not have inflation swaps in place will have taken a much bigger hit than their peers who opted to hedge their exposure via Lehman Brothers.

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