

Swaps – Getting trustees through the pain threshold

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Jonathan Berman, Head of the Investment Unit at specialist pension law firm Sacker & Partners, analyses why pension schemes may consider using swaps, and some of the issues that arise.

What are swaps?

The types of swaps that have been of most interest to trustees are 'interest rate swaps', under which two parties agree to exchange cashflows by reference to a notional amount of principal. One party 'swaps' payment by him of fixed amounts in exchange for the payment to him by the other party of floating or variable amounts.

Some surprising features of the swaps market

The swaps market is understood to be very large, very liquid and with low dealing costs, and to have a high degree of correlation with better quality corporate bonds. This means that, in certain circumstances, it may serve as a proxy for investment in corporate bonds generally.

Why are swaps relevant?

Managers and consultants are more frequently suggesting the use of interest rate swaps, including RPI swaps, within bond portfolios. This is happening mainly for the following investment purposes:

- to effect efficiently changes in asset allocation;
- to change efficiently the duration of a bond portfolio; and
- to achieve better matching of pension liabilities.

Changes in asset allocation or duration: in the same way that an equity manager may use equity index futures to adjust the asset allocation of an equity portfolio, a bond manager may use swaps to adjust the allocation and/or duration of corporate bonds within his portfolio (strategically or tactically) by taking advantage of the liquidity and low dealing costs of the swaps market.

Liability matching: in the case of a mature scheme with index-linked pensioner liabilities, utilising RPI swaps under which the scheme would receive RPI-linked payments, can enable the scheme to hedge its pension increase liabilities.

An index-linked gilt is seen as the most natural liability matching asset for a pension scheme. However, the market in index-linked gilts is limited and relatively expensive. The market in index-linked corporate bonds is very small. By combining RPI swaps with investment in corporate bonds, a manager can create synthetically the investment characteristics of index-linked corporate bonds. This has advantages in terms of:

- superior yield (and therefore saving of cost); and
- more precise matching of liabilities.

Agreements with counterparties

Swaps are 'over the counter' (OTC) instruments. This means that they are contracts which are not traded on any exchange, and are usually made with a banking counterparty. The documentation is based on the International Swaps and Derivatives Association, Inc. (ISDA) standard 'Master Agreement' which is then customised through a bespoke schedule agreed between the parties. Individual 'transactions' (ie swaps) are then effected and recorded in 'confirmations' which set out the precise price and series of dates on which payments will be made between the parties.

Default risk

The liability on a swap is limited to the profit or loss on the contract. There is no exchange of principal – the amount (called the 'notional amount') by reference to which the swap payments are calculated. The most important additional risk associated with swaps is the risk of counterparty default – the risk that the other party will default on its payments.

This risk is normally addressed by providing that the swaps are to be collateralised. This involves the transfer of collateral (usually cash or bonds) between the parties to ensure that if either were to default, the risk of loss is small.

Manager approaches to documentation

Managers take different approaches to the conclusion of the agreements with counterparties.

Trustees negotiate agreements: some managers require the trustees to negotiate agreements directly with each of the counterparties with which the manager wishes to transact swaps.

Manager negotiates agreements: another approach is for the manager to negotiate the agreements with the counterparties on behalf of all its clients. Transactions are then entered into by the manager as agent on behalf of the named trustees, and the ISDA Master Agreement takes effect between the counterparty and the trustees as principal.

The second approach is attractive because it avoids the need for the trustees to engage in potentially protracted negotiations with a number of counterparties. It assumes, however, that the manager is able to negotiate appropriate terms for its clients. This approach may be less satisfactory for long term agreements. If it is adopted, trustees should check:

- that their swap positions will be effectively segregated from those of other clients of the manager and the manager itself; and
- the accuracy of the representations and warranties to be given on their behalf.

Implementation issues for trustees

Capacity: although section 34(1) of the Pensions Act 1995 provides that trustees have the same power to make an investment as if they were absolutely entitled to the assets of the scheme, it is safer (and provides reassurance to counterparties) to include explicit power in the trust deed of the scheme.

Statement of investment principles (SIP): the scheme's SIP will need to be amended to include reference to the investment strategy utilising swaps.

Amendments to the investment management agreement (IMA): the IMA of the bond manager will need to be amended to provide for the intended use of swaps. The amendments should also cover:

- choice (and appropriate diversification) of counterparties and minimum credit ratings;
- a suitable package of restrictions and controls; and
- any operational issues.

Taxation: the Inland Revenue distinguish between using swaps for investment purposes and trading in swap contracts for profit. They are likely to view trading in swaps for profit as falling outside the tax exemptions for pension funds from UK income and capital gains tax.

Withholding tax could arise in respect of the yield on collateral, but it may be possible to avoid this depending upon the status of a counterparty and the nature of the collateral.

Conclusion

The array of issues for trustees to consider can be daunting. The most significant is the difficulty of negotiating ISDA documentation with counterparties. This aspect is much easier where managers organise this themselves.

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