

# Pension Schemes and the Current Investment Crisis Briefing Note

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*Barnett Waddingham*

## Background

Financial markets have been extremely volatile in the last few days.

- Lehman Brothers, a US investment bank, has gone into bankruptcy
- AIG (American International Group) previously the world's largest insurance group has been effectively nationalised by the US Government
- Merrill Lynch, a US investment bank, is being taken over by Bank of America
- Lloyds TSB has announced it is taking over HBOS after concerns that HBOS could not raise finance
- There are concerns over the ability of a number of other banks to survive in their current state
- Equity markets fell quite dramatically
- The UK and US regulators have now both temporarily banned short selling of financial stocks. Short selling is where investors borrow stocks from another investor (index tracking funds typically lend shares) and then sell those stocks hoping the price will fall – they then buy back the stocks later hopefully (for the investor) at a lower price and return it to its owner, pocketing any difference.
- The US government is proposing to set up a new institution to take on the troubled assets (most notably the sub-prime US mortgage debt) of the troubled financial institutions in the US. Conceptually, this could be tantamount to the 'nationalisation' of the toxic debt in the US.
- Equity markets are now rallying .....

What are the possible implications for pension schemes and trustees? This note sets out some of the items that trustees may wish to explore further with their consultant and investment manager.

## Why are 'markets' concerned?

There are many possible reasons for the recent equity market turmoil:

- Markets do not believe the financial accounts of many banks
- Banks are holding assets that are difficult to value (e.g bonds backed by US sub-prime mortgages)
- Banks are holding assets that have fallen significantly in value
- Banks are having difficulty raising finance because other banks and investors have doubts about their credit worthiness

- There is an expectation that more bad news will emerge from various banks
- The US Federal Reserve (the lender of last resort in the US) has demonstrated that it will let a bank fail e.g Lehman
- In a number of cases, banks assets have been acquired by borrowing or leverage. Banks are now reducing this leverage by selling off assets quickly
- There is a general concern that it will take some time to unwind many of the derivative trades that Lehman had in place.

There is little trust left in the lending market with the result that everyone is hoarding liquid assets. Hence yields on US sovereign debt have fallen (despite rating agencies now questioning whether there is a non-zero risk of default by the US) while the additional yields required on lending between banks have increased dramatically.

## Equity and bond exposure

Pension schemes may have exposures to the troubled financial institutions. Many of the exposures are clearcut, others are less so.

- Equity exposure – pension schemes may own shares that have fallen significantly in value. Problems can also arise if a fund manager has lent stock to a troubled institution, which may not be returned.
- Bond exposure – pension schemes may own bonds in troubled institutions. Bondholders rank higher in priority than shareholders, so in the event of a company liquidation, there will be the expectation of a partial payout from a bond, albeit the ultimate payout may take many years and could be minimal.

Pension schemes' fund managers can be asked to confirm exposure to troubled institutions and the actions that they have taken in response to the market turmoil. For example, will the scheme have an undue exposure to a single company's equity or bonds with the announced takeover of HBOS by Lloyds TSB?

## Cash exposure

The extent of the potential cash exposure to a financial institution in trouble is not obvious.

- Pension schemes may have money on deposit with a troubled institution

Pension schemes may be invested in a fund manager's money market or institutional liquidity fund. This money fund may have investments in the following investments issued by a troubled institution:

- Money on deposit
- Commercial paper - a short dated loan
- Certificate of Deposit
- Floating Rate Note - a bond where the interest rate payable is adjusted every quarter

All of these investments can fall in value over the short term, while uncertainty continues over the financial viability of a troubled institution. In the event of the troubled institution going into liquidation these investments could fall significantly in value, with only some recovery from the liquidator payable in the long term.

Trustees can review their 'cash' investments to identify the exposure to troubled institutions and consider any appropriate action to take.

## Fund managers

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A number of fund manager operations may be directly affected by the recent takeover action. Lloyds TSB owns Scottish Widows Investment Partnership (SWIP) whilst HBOS owns Insight. It is quite possible that there will be personnel changes in these fund management arms in due course. This should be monitored by pension schemes that have these fund managers in place.

Merrill Lynch owned 49% of BlackRock. This shareholding will now pass to Bank of America. It is unlikely that this will have an immediate impact on the BlackRock operations.

## Derivative exposure

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There are many potential derivative exposures. If the scheme or a pooled fund it invests in has entered into a derivative contract with the troubled institution, called the counterparty, the troubled institution may not be able to meet its commitments if it goes into liquidation.

Many derivative contracts have collateral arrangements which aim to mitigate the impact of the failure of the counterparty. The collateral consists of cash and bonds that are passed from one party to another as the value of the derivative contract changes.

Despite this protection, there are still some risks here:

- The value of the collateral may not be enough to replicate the previous derivative arrangement with a new counterparty. The 'market' could have moved dramatically in a short period
- The value of the collateral may have moved adversely
- It may take time to implement new transactions

## Swaps

Some pension schemes and Liability Driven Investment pooled funds will have entered swap agreements with counterparties. Normally the counterparty agrees to pay a fixed payment or a payment linked to inflation to the scheme/pooled fund. In return the scheme/pooled fund agrees to pay a variable rate of interest to the counterparty.

The risks to the scheme/pooled fund are:

- The counterparty fails
- The scheme/pooled fund invests in a money market fund to generate the variable interest payment and some of the underlying money market assets are in troubled institutions

## Credit Default Swaps

Some bond funds may have invested in Credit Default Swaps of companies. Here the bond fund receives an annual premium from the counterparty in relation to a specific company. In return the bond fund will pay a lump sum to the counterparty if the specific company goes bust.

The risk to the bond fund is:

- The counterparty fails
- The specific company fails and the bond fund has to make a payment

A review of fund managers' holdings can be carried out to confirm any exposures and identify what action should be taken to address any issues?

## Buyouts

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A number of pension schemes have been looking at buying out some of the pension scheme benefits. AIG Life, a subsidiary of AIG, is a participant in the buyout market.



Trustees should assess the creditworthiness of any prospective insurer and investigate the cover provided by the Financial Services Compensation Scheme in the event that the insurance company gets into difficulty.

## Scheme financial position

It is likely that the funding position of many schemes will have deteriorated as a result of the recent turmoil.

When setting the investment strategy trustees will have a number of influencing factors. The key question therefore is whether recent market movements have changed any of those influencing factors. If these factors have changed there may be a case for reviewing the investment strategy.

For example, have the Trustees' views of the covenant of the employer changed? If so, there may be a case for reviewing the strategy.

Markets have had these crises before and have recovered. We do not have an insight into which way markets will move in the short term.

A comforting factor in these times of crisis is the presence of the Pension Protection Fund. The price of this comfort is likely to be an increase in levies in the future.

## Conclusion

The recent market turmoil has given rise to a number of investment issues, many technical, that should be assessed by pension schemes and trustees.

*If you have any questions or need advice in relation to this, please speak to your usual Barnett Waddingham consultant.*

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