

Pensions: Mr Bond – we have been expecting you

UK pension funds own a lot of bonds. Many of the long dated bonds are issued by banks. The UK banks that accepted government support are under pressure not to pay coupons on the long dated sub debt and hybrid bonds that they have issued. The impact on the pension funds is potentially large.

The great pension liability myth

Practitioners who are familiar with UK pension liabilities are used to seeing them represented as an orderly set of cash flows that project out 50 to 80 years. This leads to the common belief that UK pension liabilities are “bond like” and should be backed by bonds. In reality UK pension liabilities are far from bond like and change dramatically with a myriad of risk factors, many of which no bond has any sensitivity to – such as wage inflation.

There is a lot of sense for a pension fund to match some of the more certain cashflows in the early years with bonds. Annuity payments to pensioners are relatively certain, at least for the first ten years.

Short term liabilities do not need long term bonds

This need for pension funds and life insurance companies to invest in long dated bonds has fuelled a market where some companies are issuing what looks pretty close to equity and extremely attractive prices. A few years back when BRAVE partner Christopher Cloke-Browne was running an Insurance and Pensions team at a bank, the talk was always of a 30 year McDonalds bond which traded at 32bps above the risk free rate. Thirty year McDonalds debt has to be close to equity as it is simply not possible to get an accurate credit view on the company across that time horizon. Thirty two basis points seems like slim pickings for that risk.

Another favourite long dated credit risk was bank sub debt and similar hybrid capital instruments. Here there was a second great myth.

The bank debt myth

The great bank debt myth is that bank debt will always pay, regardless of the actual terms of the bond. There has been some truth to this. Some of the major European banks that have failed and been supported by their governments have continued to pay dividends on

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preference shares throughout the process. The argument goes that if a bond ever fails to fully honour all of its obligations, then no investor will ever purchase its securities again and it will not be able to finance itself once rehabilitated. Bank sub debt has been seen as almost a free yield pickup for long dated liabilities.

The shark tank

Just as the lair of the master criminal in a Bond movie is strange and unworldly, the current credit crisis has changed the investment landscape substantially. Banks only need to continue to pay non contractual coupons through rehabilitation in a world where banks in general do not fail. In a world where about five major financial institutions have failed, then it is not clear that those that were saved by governments do need to make non-obligatory payments to investors. After all investors did take the risk.

A lesson in ALM

Should the UK banks not pay the non-obligatory coupons on their bonds it will cause a substantial loss to pension funds. This loss might well be exacerbated as many holders of the bond rush to sell in order to preplace the bonds with assets that do pay appropriate coupons to cover their short term liability payments.

Little analysis was done on the stress scenarios which is where this asset fails. In times of financial stress, the assets can skip coupons which is exactly the time that the pension scheme cannot afford to liquidate other assets to cover its immediate cash needs. Pension plans that own these bonds have inadvertently doubled down on one of their stress risks.

The reason for the loss really comes down to a lack of clarity of the purpose of these assets in the pension fund portfolio. On the one hand the coupon was seen as attractive as it provided cash to cover the immediate liquidity needs of current pension payments. On the other hand the yield pick up that these riskier assets provided was seen as attractive as a source of growth – ie making it cheaper to support the future liabilities.

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The end game

It remains to be seen if the coupons will be paid or not. Regardless of the outcome the episode should send a clear lesson to all investors who hold asset portfolios against liabilities to be very careful to consider the interaction of the exact terms of the assets against the exact nature of liabilities. As in the Bond movies – unexpected things can and do happen.

BRAVE Partners Services

BRAVE Partners LLP can assist pension funds to understand the detailed nature of the price drivers for a range of asset classes and how these match to the risk factors in the scheme liabilities.

- *Long dated bonds do not serve well as assets against pension fund liabilities.*
- *Sub debt and other hybrid capital actually represents a doubling down of a liquidity risk for pension funds.*
- *BRAVE Partners LLP can assist pension schemes and their advisors to identify the risk drivers of a wide range of asset classes.*

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