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ABI RESPONSE TO DWP "PENSION: INVESTMENT REQUIREMENTS: CONSULTATION ON DRAFT REGULATIONS" 21 MARCH 2005

KEY POINTS

- We welcome the exemption of schemes with less than 100 members (active and deferred) from the prohibition on borrowing and acting as a guarantor (Regulation 5) and from the investment rules (Regulation 4).
- We are also pleased that the DWP has recognised the special nature of certain wholly insured pension schemes (although we would like the DWP to widen its definition of wholly insured schemes).
- We are concerned that the definition of "small scheme" does not fully reflect the role of the employer in decision-making.
- We are concerned that the definition of "specified insurance policy" is drawn too narrowly and will exclude a number of insurance contracts and will not provide flexibility that will be necessary after A Day in April 2006.
- We are concerned that Regulation 4 could be interpreted conservatively by some pension schemes and their advisers in such a way as to impair the appropriate application of the prudent man principle and modern investment management techniques. This could result in sub optimal outcomes to the detriment of scheme beneficiaries. This concern extends to cover such techniques as overlay strategies, which could cover the whole of a schemes' assets and might be deemed by some parties to be impacted by both Regulation 4 and 5. Further clarification outside of regulation would be beneficial, in particular that the restriction on borrowing and giving of guarantees by trustees, Regulation 5, is not intended to restrict the proper use of borrowing or leverage within the individual investment activities covered by Regulation 4. We also suggest some amendments to the text that may be helpful.
- Should ultimately the application of Regulation 5 invalidate certain current commercial practices, for example large pension scheme activity in property, then grandfathering or transitional arrangements, to cover existing obligations, should be permitted.

1 INTRODUCTION

1.1 The Association of British Insurers (ABI) welcomes the opportunity to respond to the DWP Consultation Paper of March 2005 and to have discussed the issues arising at the meeting with DWP officials on 13 June

1.2 The ABI is the trade association for the UK's authorised insurance companies. Its membership, some 400 companies, provides over 94% of the insurance business undertaken by such companies.

1.3 They provide a diverse range of protection, investment and pension products to institutional and retail clients within both the UK and outside. The pension products and services include the overall management of occupational pensions on behalf of employers, investment management services and specialist advice on pension provision

1.4 The combined business streams for all products and services provided result in ABI members managing assets of the order of £1,100bn.

1.5 The members currently manage over a third of company pension schemes as well as providing an increasing number of employer-related individualised schemes (stakeholder schemes, group personal pensions)

1.6 This response has been prepared with the assistance of certain ABI members and reviewed by the following committees:-

- the ABI Investment Committee
- the ABI Bond Committee (which reports to Investment Committee)
- the Property Investment Panel (which reports to Investment Committee)
- the ABI Life and Pensions EU Sub-Committee
- the ABI IORP Group

1.7 In addition we have discussed the consultation paper with other bodies including the BPF, the IMA, the IPF, the NAPF and RICS.

2 GENERAL COMMENT – RESPONSE TO THE DWP's CONSULTATION QUESTIONS

2.1 The ABI welcomes the DWP's intention to apply the IORP Directive in a proportionate manner and to avoid unnecessary implementation costs.

General Approach taken on Investment by Trustees in Regulation 4

2.2 We applaud the decision to exempt schemes with less than 100 members from the investment rules set out under Regulation 4 (while continuing to require appropriate diversification of assets) and the confirmation that investment in collective investments complies with Regulation 4(3). Further to our recent discussions we would like the DWP to confirm that insurers' funds are included within the definition of collective investment used in the regulations.

2.3 However, we are concerned that some of the Directive's requirements regarding the prudent person principle could be interpreted in a way that would be contrary to current and developing best practice. In particular, the Directive does not explicitly recognise recent developments related to longevity, scheme deficits, asset liability management, liability driven investment and modern investment techniques such as overlay strategies. Therefore, while in general we favour the DWPs' "copy out" approach to the Directive, we believe that there is a case for providing additional clarification regarding the intentions of the investment provisions set out under Regulation 4. Such guidance could be either proposed by a professional association or, possibly, by The Pensions Regulator.

Issues Raised by Regulation 5 (Borrowing and Acting as a Guarantor)

2.4 We are pleased that the Government is proposing to exclude schemes with less than 100 members, from the prohibition of borrowing and acting as a guarantor under regulation 5. Had the exemption not been applied, we believe that many small employers who currently use flexible pension arrangements such as Small Self-Administered Schemes and other Executive Pension Plans would have been likely to close down their schemes. As we noted in our response to the DWP's 2003 consultation, we believe that most of the 50,000 schemes with between 2 and 12 members would be affected by these new requirements. Therefore, we believe that this decision will do much to reduce unhelpful disruption by the Directive.

2.5 We believe that clarification that borrowing or leverage as part of investment activity under Regulation 4, which will be subject to the safeguards thereby provided and in the schemes' Statement of Investment

Principles and without recourse to the trustees, does not fall under the provisions of Regulation 5 would be beneficial.

2.6 We understand that in the case of certain large pension schemes there may be instances where they enter into arrangements, particularly in respect of property investment which may constitute or be construed as borrowing or acting as guarantor. Should further investigation confirm this and Regulation 5 deemed incapable of amendment to current practice, then at the least transitionals should be provided to allow the run off of existing contractual obligations.

<u>The Exemptions for Certain "Wholly-insured" schemes, "small schemes" and schemes with fewer than 100 active and deferred members"</u>

2.7 The ABI is pleased that the special nature of certain "prescribed" wholly insured schemes has been recognised and that they shall be exempted from providing Statements of Investment Principles and from the investment rules set out under the Directive. They will, of course, continue to be governed by current UK disclosure and investment rules. Nevertheless, the ABI believes that the definition of wholly insured schemes does not fully recognise the range of schemes currently operating in this field and so an amendment to the proposed regulations is advisable (see Detailed Comments below).

2.8 We also welcome the exemption of "small schemes". Small schemes, which have less than 12 members and over which members have a high degree of control, do not need the same kind of regulatory regime as that which applies to very large schemes where members have no influence over the management of the scheme. However, once again, we believe that a modification to the definition used in the draft regulations is necessary (see Detailed Comments below).

2.9 The decision to exempt schemes with fewer than 100 active or deferred members is also helpful. If the new regulatory requirements of the Directive were to be applied to such schemes it is likely that they would close due to increased regulatory costs. It should be remembered that the cost of regulation falls disproportionately on small schemes.

3 DETAILED COMMENTS

Definition of Small Scheme – Regulation 1(2)(a)

3.1 Regarding 1(2a)(i), we are concerned that the current definition does not make allowance for situations where the employer, not just the trustees, has a role in making decisions over the scheme. (We intend to write to you in the near future with examples of such instances).

3.2 Therefore, we would prefer this part of the regulations to read, "the provisions of the scheme must provide that decisions to be made by the trustees must be unanimous". You will also note that this wording refers to "provisions" rather than "rules" as the unanimity requirement would be in the deed.

3.3 Regarding schemes with less than 12 members where all members are Directors of a company which is sole trustee of the scheme, we suggest that paragraph b(i) should be deleted. This is because we believe that, currently, no such schemes operate in this manner. Instead, decisions are made by the corporate body in the usual way for making company decisions.

3.4 In addition, we would like there to be some kind of factual test as to whether all members are trustees so as to avoid having to amend the deed if the scheme grows.

Definition of Specified Insurance Policy - Regulation 1(2b)

3.5 Our member companies are concerned that the definition is too narrow and may possibly not only exclude ear-marked money purchase schemes (due to ambiguity created by the wording in the brackets at the end of the definition) but also that it does not allow for flexibility that is likely to be required in the future following the implementation of the Finance Act. In addition, the suggested definition would also appear to exclude a number of currently available insurance contracts such as trustee investment plans which are not expressly defined as being dependent on human life. (We shall write to you shortly with specific examples of such contracts). We would prefer a much wider definition, for example, all class I and class III contracts of insurance but exclusion of Class VII (Part II of Schedule 1 to the FSMA (Regulated Activities) Order (SI 2001/544). NB. The existing wording is confusing as it suggests that it is possible to have a contract that is both a contract / annuity on human life and be a pension fund management contract.

Regulation 1: Interpretation

3.6 The definition of employer-related loans in Regulation 1 cross-refers to Regulation 9(3) which does not appear to exist. We also think that the second definition in Regulation 11(4) appears to clash with the first. Finally, please note that the second definition has an error in paragraph c as it cross refers to 8(b) and 8(c) – but it should refer to 10(b) and 10(c).

Investment by trustees – Regulation 4

3.7 The recitals to the Pensions Directive sets the right framework, the adoption of the 'prudent person' principle (3), asset allocation which suits the liabilities of an individual scheme and subject to appropriate prudence (31 and 33). It is the provisions of the Articles through their proposed transition in the Regulations which potentially present some difficulties. These are discussed below.

3.8 We suggest that the reference in 4(1) "and any fund manager etc" be deleted. We propose this on two grounds. First on our reading of Article 18 of the Directive which we believe does not require the fund manager to act in the way envisaged in the draft regulations. Secondly and more importantly the proposed provision is contrary to market practice of specialist mandates. Each fund manager is contractually bound by the investment management contract entered into with a pension scheme. Individual fund managers are not in a position to undertake the overall responsibilities placed on trustees through Regulation 4 in respect of the scheme as a whole.

3.9 Regulation 4(3) gives cause to several concerns notwithstanding the liberal interpretation of paragraph 12 of the consultation paper. ABI members are concerned that trustees and their advisers, unless provided with suitable assurances or guidance, may construe the regulation in a manner which results in sub optimal investment. A number of factors lie behind this concern.

The text of the IORP Directive appears to reflect the concepts of other Directives of the 1980s and 1990s. A more sophisticated approach to markets can be found in the more recent Markets in Financial Instruments Directive (MiFID) where the stress is laid on financial transactions with regulated parties.

Notwithstanding that "predominantly" is capable of liberal interpretation the fact remains that modern asset liability management and investment techniques for pension schemes rely heavily on assets transacted on an OTC basis. This is particularly the case for bonds and property. Whilst the diversification of assets element of prudence gives some leeway (recitals 31 and 3) it has to be recognised that the liability pattern of some pension schemes would suggest a predominance of bonds in the asset

allocation patter. Whilst bonds are not conventionally dealt with on regulated markets (though they frequently are listed on such markets), transactions are undertaken through regulated parties, i.e. broker dealers and execution venues.

The case of property is even more extreme given the lack of regulated parties status in property transactions and, bearing in mind the view expressed by some observers, that for some pension schemes an appropriate allocation to property would be 20-30% (compared with the average current level around 6%).

ABI members will be concerned that notwithstanding the qualification in 4(3) that prudent levels of assets not trading on regulated markets are permitted, trustees and their adviser may be deterred, without some reassurance from giving due weight to the property asset class and investment management techniques dependent on OTC markets.

It is worth bearing in mind that on a literal interpretation 4(3) runs against the Myner's exhortation to pension schemes to invest in alternative asset clauses such as private equity.

Whilst our concerns are probably best met through clarification of the intentions behind 4(3) the following amendment might be considered "(3) The assets of the scheme shall be invested predominantly on regulated markets or in such a way as to secure the transaction"….

3.10 We note in the second line of Regulation 4(4) that 'insurer' should read 'issuer'.

3.11 In respect of Regulation 4(5) we note that in the copy out from the Directive an extra word 'only' has been included. This is unnecessarily restricting and should be deleted.

ABI members are concerned that the tests in the Directive, copied out in the Regulation and derived from the consumer protection elements of other Directives covering the financial service sector, are not appropriate to the pensions sector where protection to beneficiaries is provided through other mechanisms.

Moreover the outlook of a low inflation low return environment combined with the liability pattern of many pension schemes argues for modern investment strategies such as liability driven investment and alpha returns to meet the requirements of beneficiaries. A regulatory environment which acts as a disincentive to trustees and their advisers to consider such strategies is not conducive to the interests of beneficiaries.

Some examples of the strategies currently offered by ABI members to their pension fund clients are given in Appendix A together with comment on the concerns that might arise under the proposal regulations

One simple amendment which may help in reassuring pension schemes and their advisers would be the removal of the word 'investment' in 5(a) thereby indicating a wider interest in risk management strategies rather than a narrow focus on individual asset risk.

3.12 In respect of Regulation4(6)(b) we note its inapplicability to the property market.

Borrowing – Regulation 5

3.13 We would reiterate the comments raised under paragraphs 2.4-2.6 above.

Definition of Wholly Insured Scheme – Regulation 8(2)

3.14 We are concerned that the definition of wholly insured scheme is too narrow and will result in many such arrangements having to provide a SIP with little benefit to members and at considerable cost to pension schemes. (We shall write to you shortly with an estimate of the number schemes affected).

3.15 Whilst it is common for the investment power of a wholly-insured scheme to be restricted to investment in insurance policies, it is unlikely that the amendment clause in the deed would contain a restriction that would prevent an amendment to the investment power.

3.16 Therefore, we suggest that Regulation 8(2)(b)ii should be deleted. In addition, in Regulation 8(2)b we suggest that "rules" should be deleted and replaced with "provisions".

June 2005

Appendix A

Extract One

- Currency forward contracts used in currency overlay products. These products are used both to reduce risk by hedging international asset exposure and to add value through active currency management. The return to risk ratio in the active currency management can be maximised by extending these strategies to long and short positions not represented by the currency underlying fund assets. (For instance, an active view can be expressed by a long or short position in New Zealand dollars even though the pension fund has no assets denominated in that currency.)

- Equity and bond market futures used in asset allocation strategies. BGI's core asset allocation strategies use futures and forwards to add value in asset allocation strategies, again enhancing returns versus risk by not limiting the exposures to those represented by strategic allocations for a particular fund. (For example, buying or selling Hong Kong equity futures where there is otherwise no allocation to Hong Kong equities or any intention to have one.)

- Fixed income derivatives (such as credit default swaps), which are used in a variety of fixed income strategies. These include the creation of synthetic instruments that are used to gain exposures that may not be purchased in the cash market, such as synthetic index-linked exposures, or which are more liquid in synthetic form (eg CDSs), which enable disaggregation of risk (duration, inflation, currency, credit), or which add value through relative value strategies which exploit mispricing between cash and derivative instruments.

- Individual stock or basket equity swaps which are used in long equity or market-neutral funds.

Source: BGI

Extract Two

Note: all examples have been simplified to illustrate the key points and should not be taken as accurate valuations or simulations.

1. Interest Rate Swaps

1.1 Objective: To mitigate the interest rate exposures in the pension fund.

1.2 The Problem: The cash flows of pension fund assets, even fully invested in bonds, typically have an average life of the order of 8 years. The cash flows on pension fund liabilities typically have an average life of the order of 16 years. If left unhedged, this means a typical pension fund would have the following interest rate sensitivity:

For a £100m fully funded scheme (100% invested in Fixed Income)

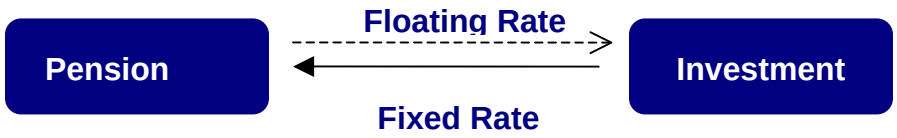
Interest Rate Move	-2%	-1%	0	+1%	+2%
New Asset Value	£116m	£108m	£100m	£92m	£84m
New Liability Value	£132m	£116m	£100m	£84m	£68m
Fund Surplus/Deficit	-£16m	-£8m	£0m	+£8m	+£16m

So, for example, if interest rates fall by 2%, although both the liability and the asset values will increase, because of the mismatch in interest rate exposure, the fund will now have a deficit of £16m.

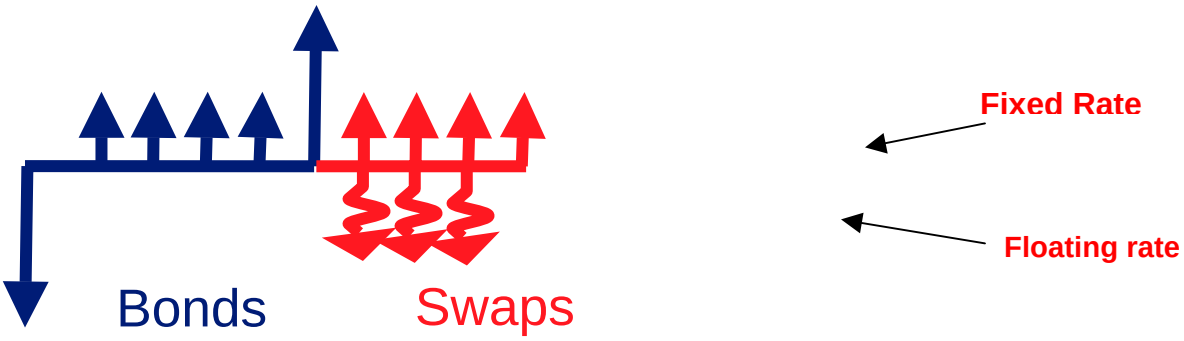
1.3 The Solution: To protect against this, the simplest approach is to add interest rate swaps to the asset portfolio. This is an instrument with fixed cash flows that will lengthen the average life of the assets so that they better match the liabilities.

1.4 How it works: The interest rate swap provides cash inflow at a fixed rate of interest, in return for paying a floating rate of interest. Adding these fixed cash flows to the existing asset portfolio gives a combined stream of cash flows with an extended average life – that matches the liability cash flows.

The swaps have zero value at the time they are added. However they rise and fall in value (just like bonds) as rates fall and rise respectively.

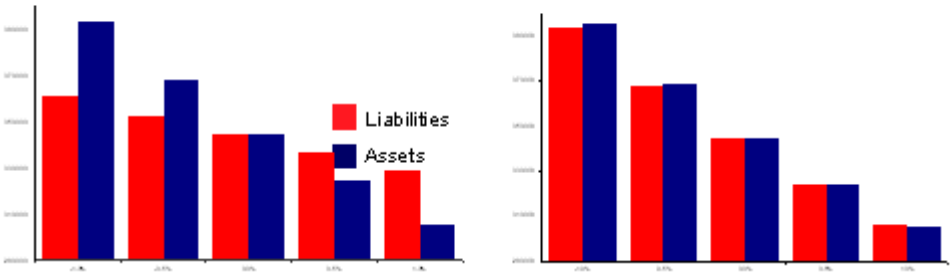


Stream of Cash Flows



What we can achieve with Swaps

- Before
- After, with swaps in place



1.5 The Outcome: With the swap, the scheme is now protected from broad interest rate moves, as shown in the table below (note: this is a simplified example, excluding transactions costs and assuming simple interest rate impacts):

Interest Rate Move	-2%	-1%	0	+1%	+2%
New Bond Asset Value	£116m	£108m	£100m	£92m	£84m
New Swap Asset Value	+£16m	+£8m	£0m	-£8m	-£16m
New Liability Value	£132m	£116m	£100m	£84m	£68m
Fund Surplus/Deficit	£0m	£0m	£0m	£0m	£0m

1.6 Concerns about the interpretation of new wording and the impact on this approach:

1.6.1 The interpretation of “regulated markets” – swaps aren’t traded on regulated markets as they are OTC arrangements between two counterparties – in this case, the investment bank and the pension fund. [Note: we understand this could be overcome by requiring transactions to be “between regulated parties” or “regulated”]

1.6.2 The interpretation of “predominantly” – (a) although the swap’s initial value will be zero, typically the swap is based on a “notional amount” that can approximate the full amount of the fund assets. We would want clarity that this notional value would not be used in assessing “predominantly”. (b) If “predominantly” is used as market value, it is possible that over time the market value of this risk reducing swap will increase to be a high percentage of the fund asset value – although this would be offset by a matching increase in the value of the liabilities. It may be better to define “predominantly” in terms of contribution to the risk of the pension fund when considered in the context of the liabilities.

1.6.3 The interpretation of “reduction of investment risks” - in terms of the asset portfolio alone, the swap is not reducing risk: it is only reducing risk when taken in the context of the assets and liabilities so it would be good to either define risk in this holistic context or to remove the word “investment”.

1.6.4 The interpretation of “borrowing” – (a) we would want to be sure that the commitment to make a future series of floating rate payments (and in return to receive fixed payments), which is the essence of the swap transaction, is not interpreted as “borrowing”, (b) we would want to be sure that a negative balance on the swap transaction (i.e. the pension fund may owe the investment bank money if the swap is closed out before maturity), is not interpreted as “borrowing” as in all cases collateral will be posted by the pension fund to offset that balance.

2. Inflation Rate Swaps

2.1 Objective: To mitigate the inflation risk in the fund.

2.2 The Problem: Often a significant portion of pension payments are indexed to the level of inflation. Although some of this risk can be mitigated by holding index-linked bonds as assets, there is limited volume and credit range of these assets in the market. Without matching the inflation rate exposure, as inflation rates change, the deficit and surplus in the pension fund can change.

2.3 The Solution: Include an inflation rate swap as part of the pension asset portfolio to mitigate these inflation rate exposures. This is an instrument which pays future cash flows reflecting the actual experience of inflation overtime in return for the break even rate of inflation today (i.e. 3.00%). When added to the asset portfolio, an inflation swap effectively converts a floating exposure to inflation into a fixed rate. Changes in the rate of inflation no longer have an impact on scheme solvency.

2.4 These would be as for 1.6.1, 1.6.2 and 1.6.4.

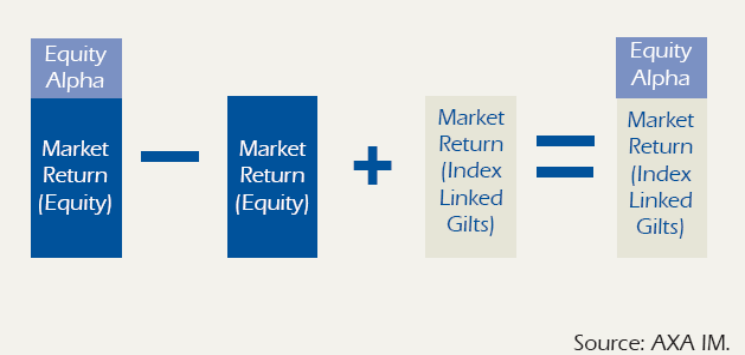
3. Portable Alpha

3.1 The Objective: Schemes would like access the best sources of outperformance, wherever they may be. They want the best of both worlds, alpha and beta, and do not want the hunt for the former to be encumbered by the latter. The desire is to achieve relative returns via exposure to markets of choice, and absolute returns via exposure to managers of choice, without necessarily having the managers be attached to the markets chosen.

3.2 The Problem: Historically, pension funds invested in assets like equity and hired active equity managers to deliver out-performance relative to an equity index. Similarly where they invested in bonds they frequently hired active bond managers to deliver out-performance. This led to a situation where they were looking for active management in some of the most efficient markets in the world – US large cap and US treasuries – where it was the hardest to add value. In order to source out-performance through manager skill (alpha), schemes have been compelled to accept the underlying source of market risk (beta) associated with that skill.

3.3 The Solution: In portable alpha, the asset class exposure of the pension fund is separated from its source of out-performance due to active management (the alpha). For example, a pension fund could have a 100% exposure to a bond asset class, but in terms

of its out-performance relative to that asset class, could be drawing on the stock picking skills of a small cap European Equity manager.



3.4 The Benefits: The benefit of this approach is that it gives the pension fund the opportunity to (a) have an asset allocation that's best designed to match its liabilities – usually bond oriented, and (b) to benefit from active management in the most risk efficient manner from a number of different sources.

3.5 How it works: These type of approaches are commonly implemented in one of two ways: (a) using a total return swap, where the pension fund receives a cash flow related to the out-performance of the selected active manager and pays a cash flow related to LIBOR, and (b) by combining an investment with the active manager with a sale of futures contracts based on their underlying index.

3.6 Concerns about the impact of the proposed wording:

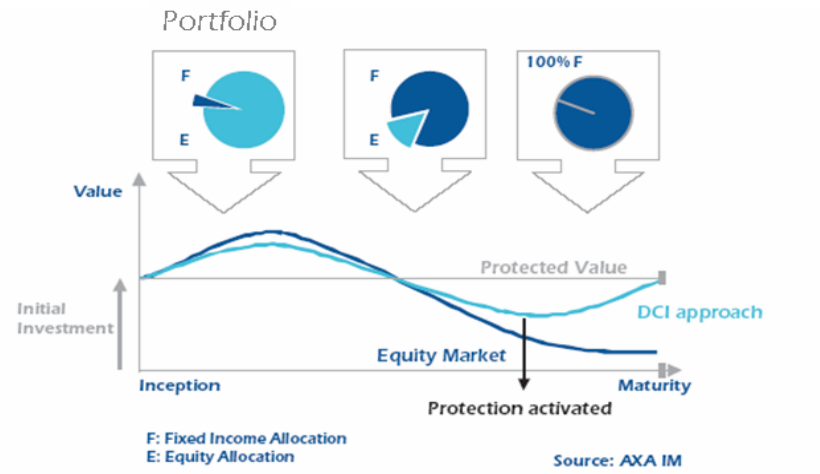
3.7 These would be as for 1.6.1, 1.6.2 and 1.6.4.

3.8 They would also be in terms of the interpretation of "efficient portfolio management" to ensure that the purpose here which, overall is intended to improve the risk/reward trade-off, would be included in the definition of EPM.

4. Portfolio Insurance

4.1 The Objective: A number of pension funds wish to benefit from the equity risk premium while having a level of protection against equity market downside. This is typically implemented using some form of Portfolio Insurance.

4.2 How it works: There are two main ways of implementing Portfolio Insurance: (a) Synthetically using a swap, whereby the pension fund receives cash flows related to the performance of equity markets and riskless assets and pays a cash flow that is typically LIBOR based, and (b) directly by dynamically managing an investment in equity markets and a riskless assets, in a manner that systematically provides the desired protection.



In this example of a negative market scenario, as the market falls, the proportion allocated to the equity asset class also falls and the portfolio's assets are shifted into fixed income, protecting the value of the liabilities on maturity.

4.3 Concerns about the Proposed Wording

4.3.1 These would be as for 1.6.1, 1.6.2 and 1.6.4

4.3.2 They would also be in terms of the interpretation of "efficient portfolio management" and "risk reduction" to ensure that the purpose here, which is to use derivatives to give an exposure to equity markets (a normal strategy for UK pension funds) while limiting the downside exposure, is encompassed somewhere between these two definitions.

5. Swaptions

5.1 The Objectives: Swaptions are options on swaps. Generally speaking, a pension fund would purchase a swaption, instead of simply entering into a swap directly, in order to potentially benefit from an upward move in interest rates.

5.2 How it works: As mentioned in point #1, we know that a scheme can mitigate its interest rate exposure with interest rate swaps. There are other strategies that they could adopt to do so, such as:

a) Instead of receiving 5% fixed on an interest rate swap, the scheme could purchase the option to receive 5 % on an interest rate swap in 5 years time, via a swaption. This would provide the same level of protection as the swap, but should rates rise to 7% in 5 year's time, the scheme would not exercise the option and receive the prevailing market rate of 7% on the swap. If rates are 3% in 5 years time, the swaption would be exercised, and the scheme would receive 5% on an interest rate swap. The scheme would pay an up-front premium for this flexibility and upside potential.

b) The scheme could apply interest rate swaps at 5%, and purchase options to remove them at some time in the future, at no cost, if rates have gone up. Once again, the scheme would be fully hedged, but enjoy flexibility at the premium price.

By purchasing swaptions, the scheme's downside is limited to the premium paid for the option, and the upside is unbounded.

6. Credit derivatives

6.1 The Objectives: If one considers the deficit of a pension scheme as “corporate debt” a scheme may be seen to have exposure to the credit worthiness of its sponsor. Pension funds, to a limited extent, have elected to reduce this exposure via CDS.

Additionally, pension funds recognise the additional value that exposure to corporate bonds can bring to their fund but are cognisant of default rates and as such have historically restricted the exposure to corporate bonds. This leads to sub-optimal bond investment strategies. In the last two years, pension funds have begun giving investment managers more freedom with respect to their corporate bond allocations.

6.2 How it works: Credit Default Swaps involve a pension scheme paying what amounts to an “insurance premium” in return for receiving protection against the default of the sponsor on its rated debt issuance. For example, a scheme may pay 15 bps annually on £100m notional, and in the event of their Sponsor’s default on £100m of debt they would receive the difference between par and the distressed value of the debt from their counterparty.

On the investment side, Credit Default Swaps represent one of the most important recent developments in fixed income markets. CDS enable the investment in or divestment of credit risk in single name entities. The CDS transaction seeks to separate credit risk from other risks (namely interest rate risk). (“*The protection seller*”) agrees to compensate another party (“*the protection buyer*”) for the financial loss it may incur following the occurrence of a “credit event” in relation to a “reference amount”. The CDS market can provide greater depth and liquidity for sterling fund managers. The sterling fixed interest market has circa 800 sterling denominated issues yet only circa 300 issuers. When looked at in the context of some 2000 issuers currently being priced for AXA by our external pricing provider, the diversification benefit of CDS speak for themselves.

7.3 Concerns about proposed wording:

Similar to 1.6.1, 1.6.2, and 3.6.2.

Specific to 1.6.3, using CDS entails buying protection so investment risk is actually minimised.

Specific to 1.6.4, using CDS entails paying away a premium where you have bought protection given a negative view on a specific credit.

8 Cash flow matching strategies

8.1 The objective: Pension funds, trying to match liabilities out to 30 years, may employ an asset manager to match expected future cashflows.

8.2 How it works: Given that bonds provide a relatively stable capital value and a fixed coupon, they are the most efficient asset class for an investment manager to use in a cash flow matching strategy. The investment manager may purchase bonds maturing in the expected year of payment and will use the coupon proceeds to assist in meeting prior year payment requirements.

8.3 Concerns about proposed wording: The interpretation of “excessive reliance on any particular asset” - given bonds are the most efficient and appropriate asset for this investment strategy it would not make sense to force a manager to hold other assets without the required properties for a cash flow matching portfolio. Replacing “excessive” with “inappropriate” may lead to a more efficient use of the available asset classes.

9 Gearing with CDS

9.1 The objective: Pension funds, faced with huge deficits and the restrictions imposed by FRS 17, have moved significantly out of bonds and into equities. The result of larger allocations to bonds has resulted in the performance required from bond portfolios being scaled up. CDS provide opportunities to enhance the returns on the corporate bond element of a portfolio.

9.2 How it works: CDS can be used to buy protection against the default of a bond but CDS can also be traded in their own right when the manager takes an outright view on a particular credit. This can result in the pension fund being "geared" in the sense that the notional exposure can be greater than the cash or capital available to the fund. Derivatives (CDS are a form of derivative) will gear a fund. Appropriate gearing restrictions are naturally implemented to meet the twin requirements of returns and risk reduction within an investment manager.

9.3 Concerns with proposed wording:

Though the wording does not appear to specifically prevent any gearing we do wish to alert the DWP to the potential use of gearing in this type of strategy. We do believe it remains appropriate for UK DB pension schemes.

Source: AXA Investment Managers, April 2005