Investment Insight:
UK pension schemes getting a grip of counterparty risk

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Defined benefit: **Relevant**
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From 1985 to 1991 Robert Maxwell used The Mirror Group Newspaper's (MGN) pension fund as his own private pot of money. It later came to light that he borrowed cash from the fund and used its holdings as collateral for further loans. He stole in total more than £420m of pensioners' money.

Such plundering of a UK pension fund is much more difficult to imagine today. The 1995 and 2004 Pensions Acts have placed major additional responsibilities on the shoulders of trustees. But despite the Acts and the creation of The Pensions Regulator, these did not prevent pension schemes suffering as a consequence of the Financial Crisis.

Since the collapse of Lehman Brothers in 2008 we have seen a host of regulatory reforms aimed at making the financial system safer and more transparent. Many of the reforms such as Basel 3 have focused on the banking sector and the need for banks to increase the quality and quantity of capital that they hold. Despite the plethora of financial reforms however, many commentators including the International Monetary Fund (IMF)[1] suggest that the structure of financial intermediation (how institutions connect with each other) is still far too complex.

In this Investment Insight I shall look at counterparty risk in the context of the frequent trades entered into by UK pension schemes where counterparty risk is more evident namely: over the counter (OTC) derivatives (including foreign exchange forwards and swaps), repurchase (repo) agreements and stock lending. I shall also comment on custodial risk (what if the pension fund's custodian defaults?) and bring you up to date with the latest developments in European regulation in this area.

[1] The Reform Agenda: An Interim Report on Progress Towards a Safer Financial System. IMF October 2012

So what's the issue?

Investment markets operate through a series of interconnected counterparties that include: banks, broker dealers, fund managers, derivative exchanges, custodians and sub custodians. The smooth functioning of the global financial markets relies on each of these intermediaries and counterparties fulfilling their contractual obligations. Pension funds need to be aware of what counterparty risks they run and adopt best practices for monitoring these risks.

What is counterparty risk?

Counterparty risk is the probability that a party to a transaction or contract (eg in derivatives) will be unable or unwilling to fill its contractual obligations. Counterparty risk increases when an intermediary's financial solvency comes under pressure due to loss, negligence, systemic (domino effect) risk or due to a regulatory claim or operational failure.

Best practices in counterparty risk management

Almost all pension funds appoint investment managers to manage their assets[2]. The Investment Management Agreement (IMA) is a key document that sets out how the investment manager will run the portfolios. The IMA should also include details of how counterparty risk is monitored by the investment manager to ensure that the investment manager has:

- A dedicated team and appropriate resources to review counterparty risk on a regular basis
- A robust and dynamic process to assess counterparty creditworthiness and a system whereby counterparties are assessed and approved
- A system to measure and monitor the credit exposure to each counterparty, broken down by asset class
- Aggregate (cumulative) position monitoring with timely feedback to pension schemes when aggregate positions become substantial
- Clarity on the level of discretion afforded to the investment manager in the event of a problem arising

Over the counter (OTC) trades

The Financial Crisis highlighted particular risks in the OTC derivative markets, particularly in the area of credit default swaps (CDS). Over the counter derivatives are not traded on a formal centralised exchange such as the London Stock Exchange. The trade is done directly between two parties (eg a bank and an investment manager). Pension funds via their investment managers are increasingly using OTC swap transactions as part of their liability driven investments (LDI) with the key objective of matching their liabilities more closely. The main counterparty risk in a OTC trade is that the counterparty to the derivative transaction defaults before the expiry of the contract they have entered into.

The two main risks faced by investors are:

- The loss of any positive unrealised (not yet banked) mark to market gain
- The loss of exposure to the market and the risks involved in replacing this exposure

A key tool to managing OTC counterparty risk lies in the legal documentation which governs the transactions. The International Swaps and Derivatives Association (ISDA) is the global trade association for OTC derivatives and maintains the industry standard ISDA Master Agreement documentation 'ISDA'. The ISDA is an umbrella agreement for all OTC derivatives between two counterparties. A Credit Support Annex (CSA) is not mandatory but is often used to define the terms under which collateral is posted or transferred between swap counterparties to mitigate the credit risk in a profitable ('in the money') transaction.

So what is collateral and collateralisation?

Collateralisation is a process whereby an OTC derivative is valued and assets (collateral[3]) that are equal to, or greater than, the value of the unrealised (not yet taken) loss or gain are exchanged between the two counterparties that have entered into the OTC trade. Details about how often the OTC

[2] A few larger pension schemes have in-house capabilities and are subject to FCA authorisation.
[3] For UK pension schemes, collateral is usually in the form of gilts and cash.

derivative and collateral are valued (eg daily), the minimum amount to be transferred and the details of the 'haircuts' applied are governed by the CSA. A 'haircut' reflects the perceived risk associated with holding the asset as collateral: the greater the risk, the more collateral (or 'haircut') is needed. In the event of a default, the other party to the transaction can sell the collateral it holds in order to cover the value of the unrealised gain on the OTC transaction.

The other risk with an OTC trade is called the 'exposure risk'. If a counterparty such as a bank defaults then the exposure from the trade needs to be replicated by another bank. In this instance, having a diversified list of counterparties and full documentation in place could mitigate the risk of not having exposure to the market.

The latest on regulation of OTCs

The European Market Infrastructure Regulation (EMIR) incorporates a myriad of new requirements for OTC derivatives that include:

- New reporting obligations
- Central clearing obligation for eligible OTCs (eg interest rate swaps and CDS)
- Initial Margin requirements for non-centrally cleared OTCs (eg Total Return swaps (TRS)
- Measures to reduce counterparty credit risk and operational risk for bilateral cleared OTCs
- Common rules for central counterparties (CCPs) and for trade repositories

EMIR was introduced in August 2012 but there is a 3 year exemption from central clearing (but not from new reporting requirements) for pension funds until 2015, with the potential extension to 2018. There remain major concerns about the different treatment for inflation and interest rate swaps, about the concentration limits on the collateral allowed for transactions that are not cleared, the impact on liquidity the sheer cost and complexity of the new system.

Foreign Exchange (FX) Forwards

The majority of pension funds use foreign exchange forward contracts to hedge their overseas currency risk. FX forwards are over the counter instruments that do not trade on a centralised exchange. At present these are not usually collateralised. At the end of the contract the pension scheme generally settles the difference between the rate 'locked' into at the beginning of the contract and the actual rate at the end of the hedge period through a cash payment. Under the new EMIR regulation, variation margin is likely to be required from 1 December 2015. FX transactions that are not physically settled may start to be subject to initial margin but this will, if the proposals made in the European Securities and Markets Authority's (ESMA) consultation earlier this year are taken forward, only affect the very largest pension schemes.

Stocklending

Before the Lehman crisis, stocklending was a popular way for pension schemes to add incremental investment return by lending (transferring) their securities to a third party (usually a bank). In return the pension scheme is given collateral in the form of shares, bonds or cash for the duration of the lending period. In stocklending the borrower pays the lender a fee for the loan of the assets and is contractually obliged to return the assets on demand. The borrower also passes any dividend or coupon payments to the lender who also retains corporate action rights.

Post Lehman many pension schemes stopped using stocklending as it was felt that the risks involved in stocklending outweighed the incremental return. Over the last few years stocklending has picked up again but it is increasingly done on an indemnified basis whereby the custodian carries out stocklending on behalf of the investor. Regardless of whether an indemnity is in place or not, it is still important to understand what counterparty risk remains.

Stocklending activity is underpinned by market standard legal agreements such as the Global Master Securities Lending Agreement (GMSLA). Investors must be clear about the rules regarding acceptable collateral and any concentration limits on certain types of assets (more illiquid assets could prove difficult to sell in a crisis). The level of over collateralisation ('haircut') also needs to be clear and legal documentation strong.

Repo

Repo is a generic name for both repurchase agreements and sell/buy-backs. In a repo, one party sells an asset (eg bond) to another party (eg a bank) at a specific price at the start of the contract and commits to repurchase the asset from the second party at a date in the future. If the seller defaults during the life of the repo, the new owner of the asset can sell it to offset the loss. The asset therefore acts as collateral and mitigates the risk of default. A key credit concern in repo surrounds multi-leveraged transactions. Repo activity is governed by the Global Master Agreement (GMRA).

Custodian

The range of service provided by a global custodian will vary depending on the terms of engagement. The core services can be broken down into: safekeeping of assets, administering the assets, record keeping and treasury. Custodians can also be involved in stocklending, FX hedging, performance measurement and transition management to name but a few additional activities. The role of the custodian is therefore pivotal and pension funds need to have a clear picture of what they require when appointing a custodian. Here are some of the key considerations:

Financial strength – Due diligence needs to be carried out on the financial strength of the custodian from such information as capital ratios, balance sheet analysis and credit ratings.

Asset safety – It is important to understand how the fund's assets are held, whether in an omnibus account (could contain many different clients' assets) or in a segregated account (specific to the client). Segregated accounts are more transparent: in the event of a sub-custodian becoming insolvent for example, transparency of ownership is likely to speed the recovery and return of the fund's assets.

To sum up

In June 2008 Moody's rated Lehman Brothers' debt at A1-investment grade. The rest we know is painful history. Swathes of regulation have since come our way which, though well intentioned may not fully address the issues of counterparty risk. Furthermore, the costs of implementing these new regulations will be substantial and will inevitably impact pension funds.

Pension schemes need to be vigilant and fully cognisant of the counterparty risks they run. Key lessons highlighted in this paper include the need for:

- **Documentation to be clear and robust**
- **Detailed credit support documents to be in place governing eligible collateral**
- **A diversified list of quality trading counterparties**
- **Strong governance**
- **The systematic monitoring and reviewing of counterparties with a 'disaster recovery' type approach in the event of a crisis**

A critical element in counterparty risk management is that pension schemes need to have timely and accurate information about counterparty exposures so that they can, for their part, have a holistic overview of the scheme's overall counterparty risk exposure.

> "Knowing how you can go about controlling counterparty risk is a central part of a trustee's fiduciary duty but it often gets less attention than the more exciting aspects of the job, such as asset allocation."
>
> *Clifford Sims, Squire Patton Boggs*

> "Counterparty risk isn't just an issue for the pension scheme alone as the sponsoring employer can ultimately bear the risk of counterparty default."
>
> *Jane Pilcher, Anglian Water Group*

If you have feedback on this edition of Investment Insight, or would like to speak to us about forthcoming editions, please contact our lead investment policy adviser:
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