Challenges in Pension Asset Liability Management

Michelle McGregor Smith
CEO
British Airways Pension Investment Management Limited

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Drivers of Change

Accounting

- Measurement / Transparency

Regulation

- UK Pension Regulator and Pension Act
- Introduction of the Pension Protection Fund
- Changing relationship between Trustees and Sponsor and, in some cases, the Actuary
- Clearance Events (Corporate Activity) give Trustees and Regulator greater control.
- Risk based monitoring

Financial

- Continued low interest rates
- Increasing longevity
- Growing deficits

Social

- Demographics
- Rising stakeholder pressures
- Transfer investment choice to individuals

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Implications of Change for the Pension Funds

- Continued shift from DB to DC
  Increased risk placed on the individual
- Mis-matching of assets and liabilities is visible/explicit to stakeholders
- Schemes increasingly targeting returns relative to liabilities
- Increased maturity means increased matching
- Increased use of treasury techniques and risk based monitoring & reporting
- Increasing complexity and increasing governance requirements

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Implications for Markets

- Demand for bonds or bond-like assets continues
- Interest in longer duration, index-linked and mortality issues
- Derivatives such as swaps and structured products continue to grow in usage
- Potential increase in assets held to capture an illiquidity premium rather than the equity risk premium
- Trend to diversify ‘risky assets’ into alternative investments
- Increased leverage inherent in structures
- Emergence of buyout/ partial buyout funds
- Time horizons are shortening – volatility spikes?

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Asset Structures / Classes

- Liability Driven Investments

- Increased use of derivatives
  Need for libor generating assets

- Search for alternative sources of duration and inflation which matches liabilities

- Diversification
  Infrastructure, PFI, Commodities, Private Equity, Active Currency, Hedge Funds, Separation of alpha and beta

- Use of Sponsor Assets
  Letters of Credit
  Contingent Assets / Charges
  Cash Sweeps

- Increased Long-term Investing
  Unconstrained Mandates
  Fundamental Indices

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Challenges

- Diversifying asset classes are less transparent and increase governance complexity. These often have higher embedded fees.
- Will Funds desire to be closer to the source of asset return to offset these issues? Changing skill requirements.
- Changing distribution channels – disintermediation.
  Investment Banks increasing presence versus traditional asset managers.
- Increasingly capturing an illiquidity premium.
  Cash flow modelling grows in importance
- Counterparty exposures require measurement and management.
- Financial stability. Is there less institutional capacity to act as a buyer of last resort? Are individuals less able or willing to be contrarian?

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BA Example

- Main DB schemes closed to new entrants.
- One scheme index-linked guarantee, well funded and very mature
- Increased matching since mid 90s

  High proportion of domestic and overseas index-linked bonds, corporate bonds and inflation swaps
- Increased alternative assets, PFI and infrastructure amongst other alternative assets
- Entered into direct property joint venture to capture inflation linked returns with benefits of real estate anchor/leverage
- Other scheme in deficit, less mature with 20 year plus duration - retained bias to the equity risk premium.

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