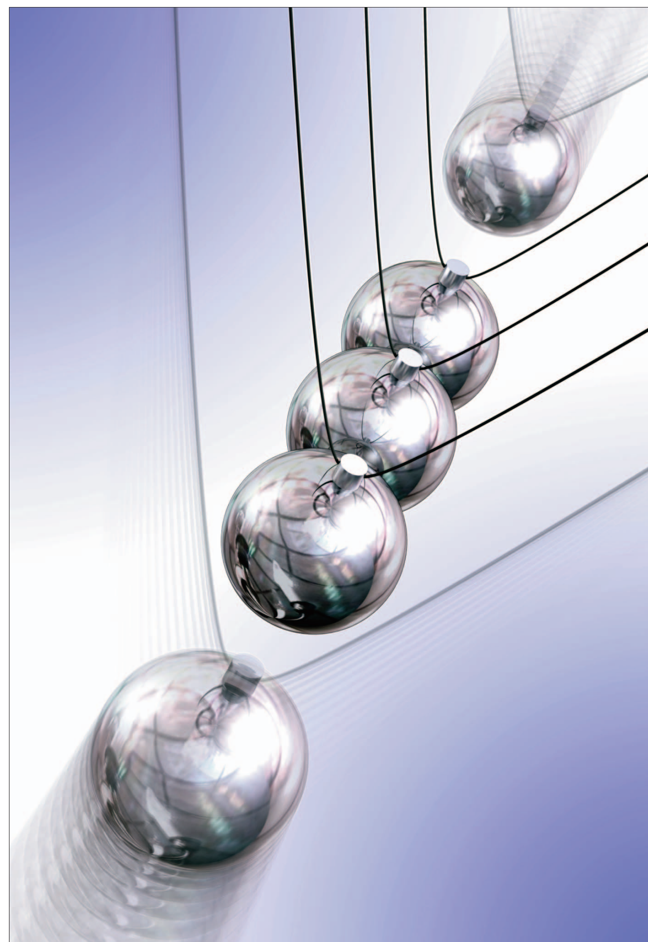
Anti-risk list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Derivatives are key in managing the deficits in defined benefit pension funds. Edward Jewitt and Edmund Parker report on the main legal issues

US investor Warren Buffett once bluntly described his feelings on derivatives and the trading activities that go with them. "We view them as time bombs, both for the parties that deal in them and for the economic system," he stated. Despite this strong view, careful use of derivatives is now a key element of strategies to manage the deficits in defined benefit pension funds. Indeed, the British Bankers' Association reported that, in the 2006 $20tr (£10.02tr) credit derivatives market alone, pension funds made up 2 per cent of the sellers' market and 4 per cent of the buyers' market, with both figures predicted to increase.

There are several key legal issues for pension fund trustees considering direct investment in derivatives. Trustees need clear guidance from their lawyers to ensure that they comply with their responsibilities under trust law and legislation and to reduce the risk that what seems a sensible investment decision at the time looks inappropriate with hindsight. This is an area where the complementary skills of pension and derivatives lawyers are needed.

Why use derivatives?

Derivatives are financial instruments whose price and value derive from the value of underlying assets or other variables. Derivatives used by pension funds include:

▶ **Swaps**. These are bilateral contracts under which the parties agree to exchange cashflows on future dates. Under an inflation swap the pension fund might agree to make fixed-rate payments in return for payments linked to the rate of inflation. Because pensions increase in line with inflation this allows the fund to match its liability for pension increases. Under an interest rate swap the fund might agree to make payments equal to interest at a floating rate on an agreed amount of money in exchange for payments at a fixed interest rate on the same amount. This can allow the fund to match its liability for pension payments more closely than is possible through conventional bonds. Inflation and interest rate swaps are often part of liability-driven investment strategies.

▶ **Futures**. These are contracts where the parties agree to buy and sell an underlying asset at a future date at an agreed price. The underlying asset can be an equity index such as the Standard & Poor's 500. Usually neither party expects the underlying asset to be delivered. Instead, settlement takes place by payment of a cash sum representing the difference between the underlying asset's agreed price and its market price at the relevant future date. One use of futures is to allow pension funds to gain exposure to a new investment market without having to purchase the underlying securities.

▶ **Options**. These are contracts where one party has the right, but not the obligation, to buy an asset at a set price from the other party (a call option). Alternatively, the contract may give one party the right to sell an asset at a set price to the other party (a put option). They can be used by pension funds to preserve the opportunity for gains when adopting cautious investment strategies or to reduce the risk of losses where markets fall.

▶ **Structured derivatives**. In these transactions, a derivative such as a swap is embedded into a bond issued by a special purpose vehicle. This gives the holder a tradeable security, which may also be listed on a stock exchange and/or rated by a rating agency.

The main legal issues

▶ **The trust deed**. Lawyers should check that the investment power in the pension fund trust deed allows investment in the kinds of derivatives proposed.

▶ **Trust law**. Trustees should be advised of their general duty to act prudently and in the best financial interests of the fund beneficiaries.

▶ **Knowledge and understanding**. The Pensions Act 2004 requires trustees to have sufficient knowledge and understanding about the principles of pension investment and funding so that they can perform their investment functions properly.

▶ **Section 36 of the Pensions Act 1995 and the Occupational Pension Schemes (Investment) Regulations 2005**. These require trustees who are making an investment to comply with specific requirements. These include requirements that derivatives must contribute to risk reduction or facilitate efficient portfolio management (including reduction of cost or the generation of additional capital or income with an acceptable level of risk). Trustees are also required to manage the risk of default by the other party to each transaction and their total exposure under all derivatives contracts.

▶ **Statement of investment principles**. Trustees are required to exercise their investment powers with a view to giving effect to the principles in their 'statement of investment principles' (the statement about investment policy that trustees must maintain under Section 35 of the Pensions Act). It may be necessary to amend the statement before using derivatives.

▶ **Investment advice**. Crucially, trustees must take investment advice before investing in a derivative contract. The matters that the advice must cover are set out in Section 36 of the Pensions Act.

▶ **Need for authorisation under the Financial Services and Markets Act 2000**. Trustees need advice on whether a decision to enter into a derivative contract would require authorisation.

▶ **International Swaps and Derivatives Association** (ISDA) **documents**. The key legal documents in a derivative transaction are:

i) **The ISDA Master Agreement and Schedule**. This is a set of standard terms for derivatives transactions published by the (ISDA). Specific terms are set out in a separate schedule. Particular issues to consider are the events leading to termination. For example,

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the start of the winding-up of a pension fund does not imply insolvency or an inability to make payments due and should not on its own be a trigger for termination.

ii) **ISDA definitions**. The ISDA has produced a series of definition booklets, which act as a hybrid document providing market-standard terms, fallbacks and definitions for different types of transactions.

iii) **Confirmation**. This sets out the specific terms of each individual derivative contract and incorporates an agreed master agreement and relevant definitions booklet. It should be reviewed by an investment adviser as well as a lawyer.

iv) **Credit support annex**. In a swap transaction the parties can provide collateral to control their exposure to each other in the event of a default or termination. The credit support annex to the master agreement documents this and sets out what collateral is acceptable.

▶ **Tax**. Trustees need guidance on whether the usual reliefs from income and capital gains tax for registered pension schemes will be available. They should be available where derivatives are used for investment purposes rather than 'trading'.

▶ **Exit**. A common-sense point is that the circumstances of a pension fund will inevitably change over time. Trustees should seek investment advice on the cost of exiting each derivative contract in different market conditions.

By addressing these issues, lawyers can help trustees ensure that their process for investing in derivatives is sound and reduce the risk that Buffett's sceptical view proves to be correct. ■

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