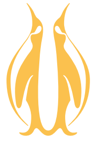


Interview with Tracy Blackwell

Q: Head of Liability Management at the Pension Insurance Corporation is Tracy Blackwell. Tracy, how would you describe the Pension Insurance Corporation to somebody who might not have come across it before?

A: The Pension Insurance Corporation is one of the new start ups that has been set up to provide pension insurance to companies with defined benefit pension schemes. So, basically, the Pension Insurance Corporation would take all the risk of the assets and the liabilities away from a corporate sponsor.

Q: Why do we need you? After all, we don't appear to have had the need for this sort of corporation before.

A: No, absolutely not; however, this is a time when a lot of companies have closed their defined benefit pension schemes, both to new members and to existing members. And they're not, the defined benefit pension schemes aren't exactly the HR benefit they once were to companies, and companies are finding that the burden of running them, the expenses, a lot of the volatility that's having to go through their income statement and balance sheet is more than perhaps they want.

Finance directors are finding it's a lot of their time, a lot of their effort to manage the pension schemes, and when it is a closed scheme, they want something, a safer alternative, perhaps, something that they don't have to spend their time on but also something that they can trust that the pensioners are actually going to get paid what they deserve to be paid in the end.

So, by transferring all of the liabilities and the assets to an insurance company, to take all the risk off the balance sheet, they know that they have the protection, the pensioners are going to get paid but also that it is something that they can transfer their time and energy onto something else and to running their own business.

Q: So what skills do you need to make this successful? After all, isn't this the sort of thing that actuaries used to do?

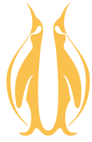
A: Well actuaries are only one part of it; actuaries provide the advice but actuaries don't actually take any risk on themselves. So, for example, investment risk, the actuaries will advise the pension fund trustees on the investment risk they take but they don't actually take that risk themselves. Longevity risk is a huge one. The only way that a company actually can get rid of their longevity exposure in a pension scheme is by transferring it to an insurance company like ourselves.

So that is something that there's no other way that they can get risk mitigation on. We think what we provide is a one stop shop, for example, so all the best of breed in terms of investment management, liability management, administration especially – which is a huge kind of forgotten risk that a pensions scheme has – all of those things together in one package are what we think we can provide.

Q: How do we know whether you're any good at it or not?

A: Well, good question, we have people from all expertises. We have people who are experts in investment management. We have people who are experts in liability management. We have actuaries on board. We have our partner in terms of providing administration to pension funds, there's Paymaster, who is one of the biggest pension fund administrators in the country, and so we think we have all the professionals and people who have done this for many, many years in-house to be able to provide the best of breed, to provide pensioners their pensions.

Whereas, with a typical pension fund, yes you have a consultant but you have a lot of people who are, and this is not slight them in any way, but they don't spend 24 hours a day doing this, this is something especially that they might spend one day a quarter on or one day a month on, and it's something that they don't have the expertise. But by bringing that expertise all under one roof, we think we can provide the most security that we can to pensioners.



Q: Who typically are your client, how do you create a client base for something which is as, apparently as novel as this?

A: Well it's not actually novel, it's been going on for a long time; there's just been very few participants in the market. So, traditionally, what's happened is when a company has had to get rid of its pension scheme, when it's had to actually get, buy insurance because, for example, they are in administration or going into administration, something like that, they would go to one of two providers in the market. Now, however, that's changing so there are a lot of people who are looking at pension insurance that would never have looked at it before. I mean the way we look at it is it's just another asset class; it's another type of contract that you can buy to mitigate your risk or to provide investment returns so it's another tool in the tool box.

So we are dealing with both trustees who are looking at buyouts as another asset class, we're also working with some companies who know that in the future they want to find a way to reduce their risk to their pension fund and are trying to find ways to do it so we work with both, but there's certainly a lot of people out there who are looking at it that never looked at it before. And part of the reason for that is there's a lot more schemes that have closed now.

Q: Should pensioners be worried at all?

A: Oh gosh no, I think pensioners should actually be exactly the opposite; they should have a lot more security. Insurance companies are regulated by the FSA. They have much stricter, much more conservative ways of managing their portfolios and their risk. They have to set aside capital which a pension fund never has to do. And so I mean in our view there's a lot more comfort than a pension fund trustee should have than for their scheme, the way it's run now.

Q: Liability Driven Investment (LDI) seems to mean to a lot of things to a lot of different people, how would you describe it from an insurance company perspective?

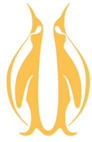
A: Well it's interesting because I think insurance companies have probably looked at LDI for a long time. They've always looked and because they have to look because of their FSA regulations at their investment policy versus their liability base. Whereas pension funds haven't. Pension funds have traditionally had triannual valuations so they only look at their assets versus their liabilities once every three years, which isn't an optimal outcome actually. And so for an insurance company, they've always done LDI.

LDI means a lot of different things to a lot of different people, people are talking about it in lots of different ways, but what it should mean is, if you look at your asset strategy versus what your liabilities are so you know at all times what your quote on quote solvency is, that's what we look at as an insurance company, what's our solvency, what do we need to put aside to mitigate the risks of the overall position.

Q: Traditionally people would use a portfolio of corporate bonds for activities such as this, why do you believe they should consider an alternative such as what you're offering?

A: We think it is an alternative. Well what we consider to be LDI is using swaps, interest rate and inflation swaps, those sorts of instruments to help us hedge the liabilities, and then we consider the asset risk on top of that, but to hedge the liability, to actually get it matched, it's a much more precise way than holding a portfolio of corporate bonds. If you just hold a portfolio of corporate bonds there's a lot of different problems.

You know, there are only certain bonds you can hold, there are only so many of them, and they might be much more lumpy than your actual cashflows. Using something like interest rate swaps, inflation swaps you can much more precisely hedge your interest rate risk and inflation risk on the liability side.



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The other thing is that holding a portfolio of corporate bonds, it means your investment risk, you have one risk, one huge concentrated risk, and that's quite a risk. And most of the insurance industry out there, a lot of pension funds, they have one risk in their portfolio, it's the only credit, and there's no way to mitigate it. You could us credit default swaps, that sort of thing but most of them don't.

By using something like LDI, where you have interest rate and inflation swaps, it opens you up on the asset side to invest in a lot of different risks. You can invest a little bit in equities, a little bit in credit, a little bit in currencies, a little bit all over the place, which actually mitigates the overall risk of the portfolio and provides a much better risk adjusted return on the overall portfolio.

Q: But the moment you mention credit default swaps and derivatives to trustees of pension fund, there's a feeling that this is a much more risky approach. What do you say to that?

A: That is just a matter of knowledge and understanding. Swaps, the funny thing about swaps is people say well if I hold a corporate bond it's a lot less risky than me actually holding the swap. From a credit risk perspective, actually it's a lot less risky. For example, the swaps that we will put on to hedge our portfolio will be collateralised daily with our counter parties, therefore every day there is a cash movement back and forth to make up the value, so your credit risk is only one day. Whereas if you hold a ten-year bond your credit risk is ten years against the counter party whose bond you're holding.

So actually it's a lot less risky, it's just scary because it's something they don't necessarily know, but once you understand all of the things behind it and all the things that mitigate the risks that are there, you actually find it's a lot less risky.

Q: How does this approach affect an investment policy?

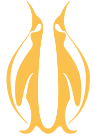
A: There are more things you can do. And we believe that there's no point in taking risk where you're not going to be compensated for it. So why take risks on things that you're not going to get paid for. For example, pension funds now that sit there and they have a string of liabilities and then they invest say 60% in bonds and 40% in equities or vice versa. The risk of that is slightly an unknown. There can be, projections aren't into the future but it's a bit of an unknown in terms of how that's going to turn down on the end.

By hedging the liabilities and hedging the duration and hedging the inflation, those are risks you're never going to get paid for but you have to hold them. So by hedging those out, you've mitigated those risks. You're left with the risks you actually want to hold so your investment risk, and by making intelligent decisions in terms of the risk adjusted return of different things you can invest in, it gives you a much better handle in terms of what you want to invest in.

And then you're left with longevity risk, and that is something clearly can't be mitigated now, there's lots of people out there who are trying to figure out how to do it –and I'm sure one day our market will develop – but it allows you to focus on what your real risks are, rather than having risks that you don't necessarily, you're not necessarily going to get paid for.

Q: Tracey, what's your specialism? Why should we come to you?

A: My specialism is I worked in derivatives for a long time. I used to work with UK corporates in particular on hedging their different balance sheet risks, understanding what their different risks are in the company. And then I spent a long time working in Goldman Sachs Asset Management as Head of Risk Management for the Asset Management Division, so I have a lot of experience in terms of mitigating risk. Which is really what the whole LDI component is about, it's about mitigating the risks that we don't necessarily want.



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Q: Okay, sum up the future of LDI for me and where the Pension Insurance Corporation fits into it.

A: The future of LDI, I struggle with LDI as a product. LDI to me just means managing your assets with a mind to what your liabilities are, it's that straightforward. I think everybody should be managing things that way. We think that pension funds perhaps in the future should be managed in a very similar way to insurance companies; there should be capital put aside for the risks that they're taking. Right now there are a lot of risks being taken in pension funds that they're not getting paid for and therefore and there's no capital set against it so there's a lot of unwanted risk out there, we think.

Q: And where does the Pension Insurance Corporation fit in this?

A: Pension Insurance Corporation is there to provide security for pensioners, for companies who, because they may have closed their pension scheme, because it does no longer benefit for their existing employees, they want to find a home for their pension scheme that provides the same level of security, even greater security than they would themselves as a sponsoring company. And that's what we're there to provide, we're there to provide, to take the risks away from them, to take the risks away from both the trustees, but also the sponsoring company.

Q: Tracy Blackwell, thank you very much indeed.

A: Thank you.

Important
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