

## **Implementation of Interest Rate and Inflation Hedging Policy: FAQ**

### **Q1: Why are we doing this?**

A1: The Trust's schemes are exposed to the risk of either falling (real and nominal) long-term interest rates and/or rising inflation expectations. Having a policy to manage these risks helps us to reduce the chance of our funding and solvency levels from deteriorating further. In essence we are trying to improve the security of members' benefits without imposing additional costs upon sponsoring employers.

### **Q2: What does LDI mean?**

A2: LDI stands for Liability Driven Investment. It means investment in funds that combine physical bonds (cash, gilts, corporate bonds) with derivative instruments called swaps, that together protect against (or 'hedge') the interest rate and inflation risks referred to above.

### **Q3: What is a swap?**

A3: An arrangement between a scheme/asset manager and an investment bank to exchange cashflow(s) at agreed amounts and points in time in the future. The two parties involved on either side of the transaction are known as 'counterparties'.

### **Q4: Why do swaps help?**

A4: In a conventional investment transaction one has to invest capital up front. In a typical swap transaction no money changes hands at outset; the value of cashflows being promised is equal to the value of the cashflows being received. Because of this, one doesn't need to sell existing (growth) assets in order to participate in this type of investment. This helps to reduce risk without impacting expected returns.

**Q5: Economically this is the same as gearing the portfolio, isn't this dangerous?**

A5: No, we will be receiving cashflows that behave like our liabilities, meaning we would expect a fall in the value of the swaps to be matched by a fall in the value of the liabilities, and vice versa. (This is different to a dangerous activity like borrowing cash and investing the proceeds in equities.) In effect for each £1 physically invested we will be getting £2-£2.50 of (interest rate and inflation) risk protection.

**Q6: But doesn't the value of assets become more volatile?**

A6: Yes, taken in isolation asset values will become more volatile compared to before. The point is we are trying to manage asset-liability outcomes. Swaps help to reduce deviations in assets minus liabilities (which determine sponsor contributions) and deviations in assets divided by liabilities (measure of the security of members' benefits).

**Q7: Frequently I hear that bonds and swaps are expensive, why do it now?**

A7: This is a common question/statement that fails to take into account the context of our schemes. We currently have very little in place to protect against unfavourable movements in long-term interest rate and inflation expectations. Our previous strategy has amounted to a 'do nothing' policy over the last four years. This has adversely impacted our schemes as real and nominal yields have generally fallen over this period (and could fall further). Putting some hedging in place is a compromise between the risk of things getting worse and the possibility that yields (and therefore price, being the inverse of yield) might become more attractive at some future point.

**Q8: So are we completely insensitive to price?**

A8: No, at current yields we are looking to hedge 20% (one-fifth) of our interest rate and inflation risk exposures (leaving the remaining four-fifths unhedged). If yields rise (prices fall) we will hedge more according to some pre-defined triggers.

**Q9: Would TPT have a direct relationship with investment banks?**

A9: No, our contractual relationship would be with the LDI manager. It is the LDI manager who has the contractual relationship with (multiple) investment banks. TPT's relationship with investment banks is therefore indirect, via the LDI manager.

**Q10: What is collateral management?**

A10: At the outset the value of a swap's 'pay leg' (the cashflows promised by us, via the LDI manager, to the banks) is equal to the 'receive leg' (the cashflows promised by the banks, via the LDI manager, to us). Over time this position changes as market conditions change, in effect one counterparty 'owes' the other counterparty the difference in value of the 'receive' and 'pay' legs of the swap. If the value moves in TPT's favour (which would be expected to occur when real yields fall), the swap is said to be 'in-the-money'; if it moves in the banks' favour (which would be expected to occur when real yields rise) it is said to be 'out-of-the-money'.

To ensure that each counterparty can be sure that the other will meet its obligations at all times, the counterparty that is 'out-of-the-money' has to pass assets (known as 'posting collateral') of similar value to the 'in-the-money' counterparty. The detail behind the process of how this happens is known as collateral management.

**Q11: Does this mean we might be forced to sell some of our non-LDI assets at short notice to meet collateral calls?**

A11: No, we will be investing assets in 'pooled funds' in which the swap contracts would be held (along with some physical bonds). (Pooled funds are investment vehicles that are divided into units so that different schemes, eg those within The Pensions Trust, can identify their own share of a bigger pool of assets.) Any collateral calls would be met from those physical bonds held within those pooled funds. What we would see is a declining value of our LDI pooled unit holdings (which would of course be more than offset by a declining value of our scheme liabilities) in such a scenario. The counterparty banks would not have any recourse to other (non-LDI) assets held elsewhere within TPT.

**Q12: Are there any past occurrences of counterparty failure?**

A12: Yes, Lehman Brothers went into administration on Monday 15 September 2008. To use the experience of a leading LDI manager as an example, the collateral that that LDI manager had received from Lehman Brothers (up to Friday 12<sup>th</sup>) in respect of in-the-money swaps was sold for cash and used to source replacement swap trades with other banks by Tuesday 16<sup>th</sup>. In short the collateralization process worked. The lesson learned is that in this scenario the bigger risk seems to be that markets could move against us in the short time required to execute replacement trades, rather than not getting our money back from a failing bank.

**Q13: Are there any ESG issues to consider with these funds?**

A13: We cannot think of any ESG issues, unless there is an objection to buying investments that include (indirect) relationships with investment banks.

**Q14: Will we be selling any growth assets to meet our hedging policy?**

A14: No, there are no plans to sell growth assets to implement our hedging policy, unless separately agreed under a scheme-specific de-risking strategy. In the event that this conflicts with the target hedge ratios (because some schemes have significant growth asset allocations and very little in liability-focused assets) then those schemes will have lower hedge ratios than the target.