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PENSIONS LIFE HACKS

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Derivative Contracts – Understanding the Risks

What Is the Issue?

Virtually all pension schemes use derivatives, whether they realise it or not. The involuntary stress-testing of liability driven investment (LDI) strategies used by defined benefit schemes last year, following the crisis in the gilts market that the mini budget induced, focused a lot of attention on leverage levels and liquidity requirements for schemes. Regulatory scrutiny of the market has followed, at the same time as volatility in banks has raised questions about counterparty creditworthiness and security.

Despite these factors, the contractual rights and obligations used in derivatives (which are entered into by investment managers on behalf of trustees) are rarely understood and often not even reviewed. Such unfamiliarity with important contracts means that trustees may not be managing legal and commercial risks in the derivatives instruments they are relying on to manage investment risks.

How Do You Know if You Have an Issue?

The starting point is to know whether the relevant derivative contracts are bespoke to your scheme or whether you have an indirect relationship with counterparties because you have exposure via investment in an LDI fund, where the fund is the counterparty. If you have your own contracts, check whether they were reviewed at the time they were entered into (which may be some years ago).

If you are invested in a pooled fund, it is highly unlikely that your LDI manager would have disclosed the derivative contracts to you, but that does not mean you cannot ask relevant questions of your manager that may impact on your rights and the value of your LDI protection. For instance, are there controls over the credit ratings of the counterparty banks used by the manager? How much notice is required for collateral calls? How are derivative risks dealt with in your risk register?

Lessons Learned

In the aftermath of the mini budget, some clients have established that operational controls that they thought were being managed by either their LDI managers or their investment consultants were not in fact in place. The lack of prompt communications and urgent demands for collateral indicated systemic issues in fund documents and investment management agreements. We have also seen that in some supposedly bespoke derivative contracts, basic protections such as credit downgrades of banks are missing, and inappropriate insolvency default triggers have been drafted.

Top Tips

1. Trustees should make sure that derivative contracts are reviewed, and the risks understood (and, if appropriate, negotiated so that they are fit for purpose).
2. Ensure appropriate ongoing monitoring of LDI.
3. If appointing a new LDI manager or entering into a fiduciary management agreement, do not take derivative legal due diligence for granted – it matters too much.