

White Paper

An analysis of the use of equity derivatives by pension funds

Adsatis

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EXECUTIVE SUMMARY

During the last decade dramatic changes have taken place in both the range and the mix of products used and offered within the pension market.

Banks that regarded their advisory/execution relationship with pension funds as a one way street have seen regulatory changes, the growing product expertise of (some) of the established pension consultants, the emergence of a new breed of (often investment bank trained) pension consultants and a reinvigorated asset management sector erode their market position.

Pension consultants who as little as ten years ago, while being seen as key gate keepers, had little derivative experience are becoming more expert and now play a vital role in advising pension funds on strategy, product suitability and choosing the right institution with which to execute.

Asset managers' services to pension funds have evolved considerably in the past 10-15 years, particularly as the use of derivatives by the funds has increased. Their positioning between the funds themselves and the investment banks has become increasingly critical to compliant investing.

Whilst all these developments have no doubt increased pension funds usage of derivatives, the majority of their activity is still relatively vanilla. Use of vanilla options is widespread but use of tailored OTC products is a much more limited activity, with the larger funds, unsurprisingly, more frequently active.

Finally, pension funds themselves are becoming more sophisticated and, with the help of the pensions consultancies and asset managers, are beginning to embrace a much wider product spectrum, with increased use of derivatives, to assist them to achieve the optimal outcomes for their members and sponsoring employers.

INTRODUCTION

From a financial markets perspective, pension funds are an important sector. At the end of 2009 the value of assets professionally managed in the world totalled €36.5 trillion, of which €12.4 trillion was managed in Europe (€3.8 trillion in the UK, €2.8 trillion in France, and €1.5 trillion in Germany). In relation to aggregate European GDP, total assets under management reached 97% at the end of 2009. Pension funds represent over 17% of the total¹. Trustee caution and the long term perspective of such funds meant that they were rarely early users of the derivatives markets. However, changing demographics, falling investment returns and increased longevity have meant that many funds have had to consider alternative strategies to long only investment in bonds, equities and property.

During March and April 2012, Adsatis consultants interviewed approximately 15 senior individuals from pension funds, asset managers, investment banks and pension consultancies to seek opinions on the effect the landscape changes that have taken place over the last few years have had on the pensions market and the use of equity derivatives in the market place.

Interviewees were selected who were either directly involved in the pension industry or who we recognised to have a high degree of insight into the pension world.

Although not all opinions expressed can be represented in a summary document such as this, we have attempted a balanced view of the responses and also allow coverage of some of the outlier opinions which inform the wider debate. We are grateful for all the time interviewees gave us to enable this study to be completed and hope that readers find the document useful. If any reader wishes to discuss any of the issues raised, please contact us as directed on the title page.

THE PLAYERS

PENSION FUNDS

Market Summary

The pension fund market encompasses a huge diversity of pension regimes and constituent sponsors. Across the sector the level of sophistication and hence, in the context of this study, equity derivative usage varies by assets under management, domicile of pension provider and, to some extent, whether funds are managed in house or by external advisors.

The very large pension funds have the internal resources, primarily staff with the knowledge of equity derivative products, to be active users. They can also manage and monitor their exposure to liability driven strategies. In addition, their trustees will typically have the knowledge and experience of such products. The needs of pension funds with assets of £1.5bn or more (of which there are over 100 in the UK) are frequently serviced by banks' pension advisory groups, who will typically provide strategic advice on a no-fee basis in the hope of winning execution business.

Almost all pension funds – and by law in some countries all pension funds – use independent external consultants who charge fees for their advice. These pension consultancy fees combined with lower in-house derivative knowledge often prevent smaller pension funds exploiting the more complex types of derivatives.

Regional and cultural differences have led to different usage of derivatives by pension funds. Regulatory differences have been a strong driver of regional variations. Dutch funds have been noted as more frequent users of sophisticated derivative strategies, in part due to stricter solvency regulations and in part due to having personnel more familiar with such strategies. Many put this down to the quality of staff in these pension funds and the fact that the compensation differentials between pension funds and banks in this market are such that there is no 'brain drain' to the banks. German funds have been noted as using option protection strategies, as a result of pension regulations (i.e. hard floors on funding levels). UK pension funds in comparison have on average seen more limited use of complex equity derivatives instead focusing on vanilla exchange traded options to aid market access and enhance asset allocation; although the size of the UK funded pension industry means it is as significant a market for banks' derivative desks. It was noted that some UK and US funds have caught up and are using relatively sophisticated techniques to manage risk. However, as one UK interviewee noted "sophistication levels vary enormously" and, from their bank's perspective, "we would put most UK pension funds at the less sophisticated end of the spectrum".

A number of banks noted that one of the major constraints preventing a large number of pension funds engaging in more sophisticated derivative products was their lack of the operational infrastructure to manage trade execution, position risk and cash flows over the lifecycle of a trade. To a significant extent this can be mitigated by appointing an asset manager to manage the pension fund's derivative portfolio.

The future for pension funds will continue along two broad themes. Firstly, the impetus from corporate sponsors (and government) for pension schemes to be based on a "defined contribution" approach rather than "defined benefits" approach and secondly, a move to a liability driven approach with the key aim of structuring the assets such that there is a defined and planned linkage to the liabilities.

ISSUES FACING PENSION FUNDS

The changing approach to pension fund management has been driven by the shift towards liability driven strategies. This has arisen through a combination of accounting and regulatory change, falling investment markets, declining funding levels and a reduction in the equity risk premium. The past decade has been characterised by moving from peer group comparisons through to scheme-specific benchmarks based on market indices and now on to "liability driven" strategies. Arguably the move to funds being driven by liability driven strategies has required a greater adoption and familiarity with derivative use, though this has focussed on fixed income (including inflation) derivatives.

Guaranteeing returns – the issue is how pension funds can ensure that they achieve the minimum returns mandated by the laws and regulations in their jurisdiction. These vary from country to country, but typically involve one or both of nominal and real return minima, applying to one or both of deferred and active members. Inflation and interest rate swaps are now commonly used to manage these risks. Bespoke option strategies are also used, but more rarely.

Managing "tail risks" – there are many examples of defined benefit pension funds which are very large relative to the size of their corporate sponsor. Such funds and their sponsors need jointly to take particular care in managing the downside funding-level risks, since the sponsor would in most cases find it hard to make extra pension contributions. This has led to a limited number of – usually larger – funds looking to using derivative strategies to manage this tail risk. In the future more funds will seek to protect against such tail risks using derivatives.

Longevity – the requirement for pension funds to hedge inflation and longevity risk has grown. The sellers of longevity risk (pension funds and annuity providers) have found limited buyers. Life insurers and reinsurers are potential counterparties. Inflation-linked and longevity bonds offer some solutions and investment banks are able to arrange swap structures to mitigate some exposure. However, the problem with matching counterparties has meant that the longevity swap market is not as large as believed. The actual size of the longevity market in the UK is difficult to estimate with no official data available and a wide variance in market estimates based on interview feedback.

Regulatory changes – increased capital requirements and changes to international accounting standards continue to put pressure on pension funds. In the UK the theme of de-risking schemes is strong (UK pension schemes have cut their equity allocation from 61% to 46% since 2006, according to the Pensions Regulator). So the opportunities for the UK pension funds to use derivatives at the expense of higher equity exposure and to achieve a closer match to their liabilities are persuasive.

Infrastructural changes – the move from defined benefit to defined contribution has been driven by the financial demands of corporate sponsors. This changes the nature of derivative usage by pension funds – at the moment defined contribution schemes use very few derivatives, conversely the closure of almost all corporate defined benefit schemes has been one of the main contributors to their significantly increased derivatives use.

New players in the market – only a limited number of players actively market their derivative capabilities to pension fund mandates whether new entrants who have grown out of the investment banking world or traditional asset managers who have grown into the role).

The position of pension consultants and other specialist advisory firms remains strong and they are a key part in the pension funds’ decision making processes, as trustees need to evidence both independence and best execution. A strong observation was that in the Dutch pension industry the specialists’ value is well established but that there a good growth opportunities in the UK for their services.

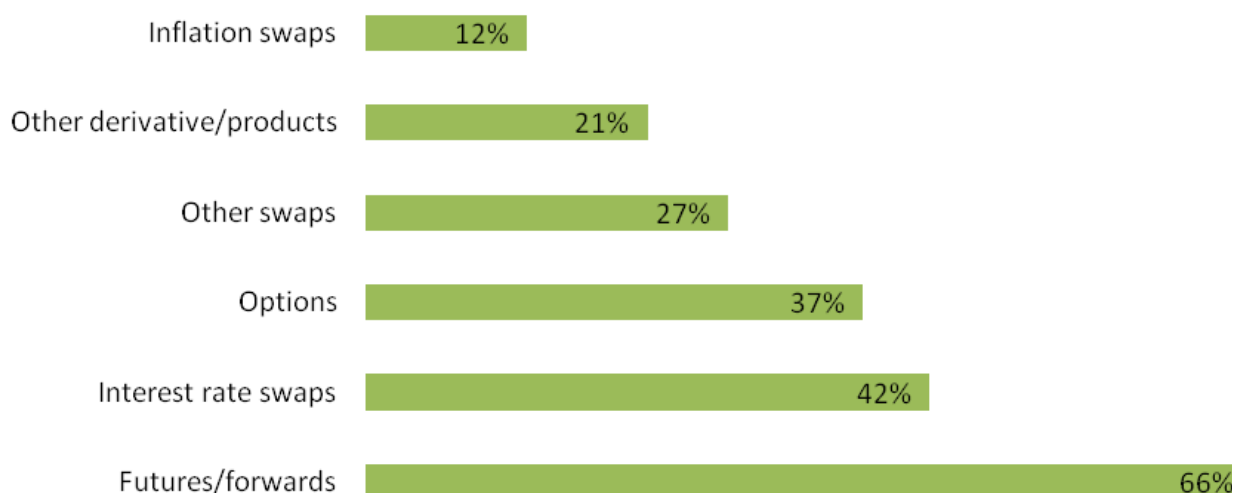
PRODUCTS USED

The use of derivatives on the asset side can be seen to provide two basic goals. Firstly, to provide downside protection and, secondly, to assist where funds have been mandated to achieve specific returns.

On the liability side we see the development of asset tracking strategies promoted by both the investment banks’ pension solution teams and the consultants. Typically this involves the use of more custom-made packages extending beyond equity derivatives, with LDI funds typically deploying rate and inflation based derivatives.

While definitive information on the use of derivatives by pension funds is hard to gather, an insight can be obtained from the 2011 European Institutional Asset Manager Survey that noted the following usage of derivatives or types of derivatives by the respondents polled.

% of 136 respondents



SPECIFIC DERIVATIVE USAGE

Equity Options

Where pension funds use OTC equity derivatives their most frequent usage is still of vanilla options, whether managed in house or externally. As might be expected investment banks' basic business with pension funds was seen in listed options and in particular on the main market indices. Option writing and covered calls was seen in a far smaller number of funds. Medium sized UK pension funds were not seen primarily to use equity derivatives as hedges but used in the context of their overall long equity exposure and/or managing specific market access.

Exchange Traded Funds

ETFs have wide usage amongst all sizes of pension funds. Some funds did express greater caution with synthetic ETFs compared to direct replication portfolios. The growth of ETFs with sector specialisation has assisted market access for smaller funds.

Volatility products

Market practitioners were not currently seeing funds allocated to volatility as an asset class however some use of VIX options was noted by a few sophisticated pension funds.

Total Return Swaps

The use of Total Return Swaps was limited to the larger pension funds and to pension funds with external asset managers, as most funds do not have the operational capacity to manage the transactions or the expertise around CSA documentation. In larger pension funds swaps might be used to fine tune an exposure or alternatively a predominantly synthetic solution might allow greater flexibility than the physical approach.

Rate Derivatives

As part of the growth of LDI strategies pension funds and pension fund consultants have been actively looking to manage interest rates and real interest rates via inflation products. The inflation swap markets in sterling and euros are established out to quite long maturities now.

Longevity Derivatives

As mentioned earlier, some business is done in portfolio specific longevity swaps, usually for closed defined benefit schemes or linked to corporate restructuring of / by the sponsoring employer.

Hybrid Strategies

The large Dutch funds have been seen to be active using hybrid derivatives (i.e. using swaptions and equity options together). This product typically has been designed for protection against the scenario of dramatic declines in both equity prices and interest rates.

If pension funds are looking for external firms to assist in equity and other OTC derivative strategies, rather than straightforward listed options execution, they will be typically looking for the following capabilities:

- Derivative trading ability
- Competitive fees
- Middle office competency (for swaps and collateral management)
- Counterparty rating

The consultant pension advisor will typically look to understand the pension trustee's point of view to assist in finding a suitable counterparty to match these capabilities. In some cases an asset manager will provide this independent execution advice to the pension fund: a range of approaches is being used dependent upon the derivatives expertise of the consultant appointed by the pension fund, whether the pension fund has a direct relationship with the investment banking counterparty, and the capabilities – and assertiveness – of the asset manager.

ASSET MANAGERS

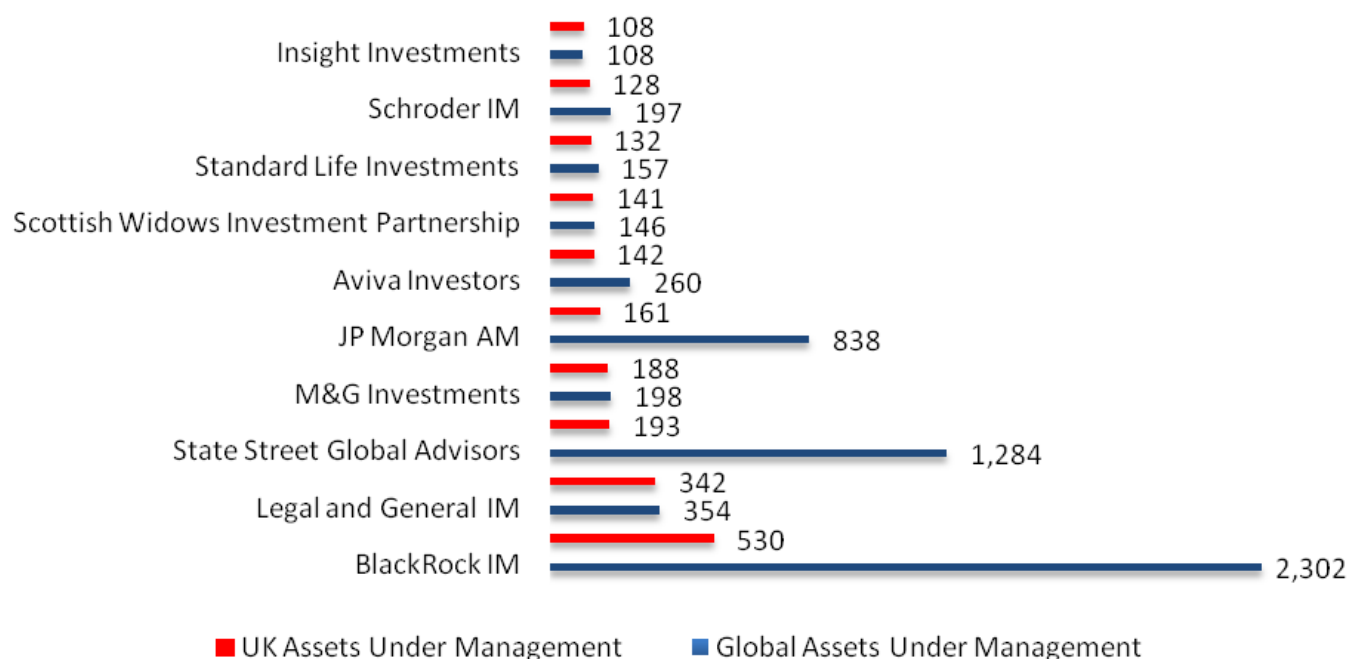
INTRODUCTION

Asset managers' services to pension funds have evolved considerably in the past 10-15 years, particularly as the use of derivatives by the funds has increased. Their positioning between the funds themselves and the investment banks is critical to compliant investing and the relationship between the managers and the other players will depend on the services offered – by the asset manager, the bank or the pension consultant. The relationship is self-evidently different for the in-house asset managers of the large funds but, from the banks' perspective, all asset managers must be regarded as the buy-side even if they are competing in some areas of pension fund advisory work.

THE KEY PLAYERS

Based on data from the IMA Annual Survey 2010-11 the leading firms in the UK market are:

Top ten firms by UK and global assets under management- Dec 2010 £Bn



THE KEY SERVICES

Although the range of services provided by asset managers to pension funds varies considerably, there are key roles that are central to the service offering of most of the established managers. These are:

- Advising on strategy – by definition mostly asset strategies but also, where the capability exists, liability management
- Executing a strategy
- Ensuring best execution in any transaction
- Managing the post-trade lifecycle, particularly for derivative trades

Within these services, the extent and sophistication in the asset managers' use of derivatives will depend both on the competence of the manager and the willingness of the pension fund trustees to approve their use. The asset managers' interviewed identified two main reasons why funds will use these within the portfolio:

1. To provide downside protection at the fund level
2. Within an investment mandate to achieve particular return targets

It is also clear that with the exception of asset managers which are explicitly acting in a fiduciary management capacity, there is a strong resistance to being seen to make strategy decisions, or even to be the formal source of strategic advice for the trustees, that being the role of the clients' investment consultants.

It was, however, noted by the asset managers who responded that all pension funds are instinctively against products with a negative carry, which leads to most schemes having little interest in option-based protection strategies. There was general consensus from asset managers on the qualities required to be a good implementer of derivative solutions to pension funds. The asset manager needs to have:

- Experts who can communicate well about derivatives both ways – to clients and to banks
- A good analytic, trading and portfolio management infrastructure
- A middle / back office which can execute OTC trades and manage lifecycle events
- Good collateral management (daily margining and movement of collateral is needed)
- A strong legal infrastructure (ISDAs & CSAs)

While pension funds (especially in the UK) generally like the idea of undertaking derivative trades, it was noted that they generally lack the expertise to do them and most were only interested in listed derivatives. Even pension funds which have a

good understanding of derivatives and are very comfortable with them often appoint a fund manager to manage their derivatives portfolios. Very few pension funds have invested in the infrastructure needed to manage OTC derivative portfolios themselves. While many of those interviewed believed asset managers were natural service providers for the pension funds, it was believed few asset managers could provide the integrated asset and liability management services that the pension funds needed, together with an understanding of all the different risks inherent in their pension obligations. It was noted that most asset managers tended to provide specific product expertise and could be quite siloed in their approach. While the pension funds at this stage are “not crying out” for this more holistic approach, it seems only a matter of time before they will require this from their asset managers. It is therefore incumbent on the asset managers to implement infrastructural improvement and deliver this. Asset managers which were cited as developing (or have developed) these capabilities were BlackRock, State Street, Insight and Legal and General.

CONSULTANTS

INTRODUCTION

“If they were any good they’d work for a bank”. Banker based sour grapes or otherwise, what is true is that the role and influence of the pension consultants, dominated by three firms - AON, Mercer and Towers Watson - is here to stay. Largely driven by regulatory concerns around deal structure, a lack of price transparency and more aware pension trustees, the specialist pension consultant has become increasingly influential in the market. Where historically a pension fund may have dealt directly with a bank or via an asset manager and kept their consultants in the background, pension consultants are now working directly with banks on behalf of pension funds. This may take the form of advising on specific issues such as a derivative structure or preparing an RFP and assessing bank’s responses for value. As one respondent noted, the consultants are “...now the police and in this respect, banks have to build a good relationship with them”. Another noted that where, historically, an investment bank being considered for a big deal would be selected mainly on the basis of capability (with perhaps the pension fund using a consultant to help) and the pricing of the deal would just be a bi-lateral process (i.e. no RFP), now consultants were involved right the way through the process.

RAISON D’ÊTRE

So what do these pension consultants offer the market place and why is their role so important?

The below table based on EIAM data identifies the following reasons for consultant usage:



Allied to this comments made by a number of interviewees concerning the level of derivative knowledge amongst pension funds and a general consensus that the standard of their knowledge of certain products was very poor indicate a definite need for their services.

At the most basic level, pension consultants provide advice, analysis and recommendations on investment options to the pension funds and act as an impartial buffer between the trustees and asset managers and banks. Pension consultants will recommend allocations based on the client’s needs, risk appetite and investment time horizon. Their role may also involve independent analysis of investment performance.

While difficult to generalise across different countries and different sized funds, it was noted that the larger pension funds, which have 'in house' portfolio managers, traders and risk managers, tend to be better equipped to enhance returns and manage downside risks and, hence, have less use for consultants. Conversely, smaller funds usually require more guidance and help. Most consultants have very good contacts with the investment banks and do a lot of work for the funds such as getting quotes, prices etc. For the banks this can be a bonus as the consultants tend to cover a large number of pension funds and this often allows the banks to see what is happening across a broader range of clients.

Others noted the role of consultants was to analyse what could go wrong for the fund and, also, to help the funds "not take what the banks were saying at face value". In terms of adding to pension fund strategies, it was also noted that their main influence was in widening the range of new asset types in which pension funds would invest. This point was highlighted by a number of the bank respondents who, whilst generally not lavish in their praise for consultants, did note they have helped to widen the product range pension clients were willing to entertain. One respondent even went as far as noting that "pension funds rarely invested in the alternative sector until the consultancies recommended that they did".

While it was noted that the asset managers were natural service providers for the pension funds, their typically siloed approach and (in many cases) inability to offer an integrated asset and liability management service allowed the pension consultants (who had always been there) to expand their role in the market.

HOW ARE THE PENSION CONSULTANTS EVOLVING?

Clearly as the market has matured and new entrants have been attracted, the role of the consultancies has changed. The larger consultancies are starting to evolve their business models by providing outsourced CIO type roles, giving more advice on investment opportunities and offering fiduciary management services. Fiduciary management, for example, involves the outsourcing of the complete pension fund governance to a third party. The leading providers of this type of service at present were quoted as Goldman Sachs and BlackRock. It should be noted however, that the pension consultants also see this as a natural extension of their business and the area is becoming more competitive.

The niche players on the other hand who have entered the market many with capital markets experience and specific specialism such as Cardano (very pension focused) and Reddington (strong derivative expertise) are changing the landscape. For the pension funds themselves, this increased diversity and appearance of specialist niche players is more than welcomed. A pension fund may now find itself using different consultants for different services or advice – fund strategy, use of derivatives, use of alternatives etc.

HAVE PENSION CONSULTANTS BENEFITED THE DERIVATIVES MARKET AS A WHOLE?

As discussed above, while many believe consultants' advice has benefited the pension funds by providing greater pricing transparency, enhancing industry knowledge and broadening the product pool funds are willing to invest in, others still feel that their role in some areas has been detrimental.

As for some of the niche players while their importance to the industry was recognised it was noted that they tended to be quite theoretical with very limited or no real market knowledge or experience: "They have never managed funds, never had to deal with operational complexities and risk". Another commentator noted: "They tended to favour certain banks and often ignored important elements of a trade - particularly counterparty risk concentration".

One interviewee observed that some consultants have clearly given quite bad advice to pension funds in the past, due to a lack of understanding of the practical implications of using OTC derivatives. An example was given of a pension fund invested in a derivative strategy which, if it had gone out of the money – significantly so but to a level which should have been covered in any sensible scenario analysis – could have required more collateral to be posted than the scheme had liquid assets to sell.

WHAT DOES THE FUTURE HOLD FOR PENSION CONSULTANTS?

Given continued funding problems of funds and increased regulation, it is unlikely that the role of the consultants will diminish in the near future. Issues facing pension funds, such as fund deficits, longevity issues, generating alpha etc continue to exist and the pension funds are likely to turn more towards the perceived impartial advice offered by the consultants.

For the consultants themselves to continue to grow there needs to be an active move towards:

- More involvement in asset management
- Capturing 'more of the wallet' – crystallising a larger share of the revenue they take, most obviously via "Implemented Consulting"

BANKS

INTRODUCTION

The pension landscape – characterised by its lack of homogeneity, different regulatory regimes, varying needs of sponsors and the varying levels of sophistication of the funds involved – has created a challenging environment for the banks.

It is also worth noting that the last 10 years or so has seen a seismic shift in this landscape and the players involved. The late 1990s saw the start of the growth in the pension funds market for banks. The funds reassessed their strategic drivers and the more forward thinking among them moved towards a liability driven approach. This in turn drove the investment banks to start selling solutions to pension funds and asset managers more aggressively. To take advantage of this market, the early 2000s saw many banks starting to build out their offerings to pension funds and asset managers and develop bespoke pensions solutions teams. These mainly consisted of actuaries, salespeople and structurers. With the collapse of the dot com bubble in 2000 many financial institutions were badly hit by declining stock prices and lower interest rates. As a result, asset managers and investment banks were quick to propose (LDI) solutions as a way to avoid or mitigate the impact of such an occurrence. This period also started to see the growing involvement of investment consultants in both designing strategies and deals and, towards the end, realisation by the banks that the costs of running a separate pension fund team were in most cases uneconomic. From 2007 onwards with the implementation of MiFID best execution rules, specialist pension consulting teams started to become more directly involved with deals. Throw into the mix the changing regulatory environment imposed on the banks post 2008, then add in the new global and regional capital adequacy changes and there is little wonder that the banks reappraised their position in the pension fund space.

It could be argued that increased competition and the intervention of asset managers and consultants, while negatively impacting per deal profitability for the sell side, has led to a greater understanding of the use of derivatives by the pension funds. This has directly increased the numbers using derivatives, with the resulting increase in turnover more than compensating for narrowing profit margins in terms of total revenues. Inevitably, though, the cost of carrying that business has and will increase with new capital requirements unless the funds move more towards use of standardised, and hence clearable, derivatives.

Given all of the above, the banks interviewed as part of the survey can be regarded as having the greater pool of derivative expertise compared to most of the other players. They endeavour to offer their clients a full product suite. However, there are differing approaches to their clients, depending on their size and the strategy they have chosen to pursue. Many of the banks noted that, while the business could be profitable, it was also extremely competitive with a large number of banks chasing the same business. One respondent commented that the OTC market was extremely competitive with pricing going 'down to the basis point'. Indeed, a number of the smaller players noted they were unwilling to go 'head to head' with very large investment banks for the more basic type of trade where price was everything. Instead they had decided to focus on smaller funds and develop more in depth relationships with them or create more niche based products (with subsequent higher returns). On the other hand, some of the large investment banks noted they were opting not to compete on some deals. They maintained some of their competitors were pricing deals at a level which did not take into account the true cost of capital, were not modelling their funding costs as accurately as possible or were pushing overly aggressive business models to win market share.

PRODUCT OFFERING

All of the banks approached as part of the survey, even the more niche players, maintained that they offered a full suite of products, including the equity derivative products discussed in the Pension Funds section of this document. Most banks noted that client needs were very much determined by the size and level of sophistication of the pension fund and its requirements. From an equity derivative perspective, most pension funds were interested in relatively vanilla products, such as equity puts and calls, put spread collars or basic index tracking products such as ETFs.

However, what is more interesting from the replies was the extent to which they would go to make business happen and the effects that regulatory changes have had or are having on the way they do business. Most respondents noted that all deals were now rigorously reviewed for their impact on RWAs and the cost of capital and this increasingly impacted on the upfront profitability of deals. In some cases this was leading to some banks being no longer willing to participate in 'balance sheet hungry' type deals. In a similar way it was also noted that regulatory change around the ability of the banks to take proprietary risk was limiting their ability to position to pitch for such business, drastically reducing the profitability of certain types of deals and, therefore, the willingness of certain banks to compete for this business.

BANKS' MARKETING STRATEGIES FOR PENSION FUNDS

For most banks, product marketing continues to be an area of on-going concern with most still looking to find the optimal solution. This has been further impacted by regulatory change and the increased role in the market place being taken by consultants and asset managers.

Historically, corporate relationships were maintained via relationship managers in the banks' Investment Banking divisions, with specialists being brought in from other areas to advise on pricing and execution. For more regular vanilla business the asset managers would deal directly with the banks' Global Markets divisions.

In the case of large portfolio restructurings or larger, more complex transactions, an ad hoc team would be created from various functions within the bank. This process is now changing due to regulatory concern about these deals, the lack of transparency in pricing and the involvement of the specialist pension consultants hired by the pension funds. A typical arrangement now would be for the pension consultant to agree with a pension fund what is required, prepare and RFP and assess the banks' responses for value. One interviewee noted "the consultants are now the police in this respect, banks have to build a good relationship with them".

Interestingly enough, from a Global Markets perspective, most banks seem to have started out in the market by developing specific pensions solutions teams staffed by actuaries, marketers and structurers and whilst some banks (such as Goldman Sachs and Barclays) still have a dedicated Pensions Solutions team, most teams have now been absorbed into more generalist sales/marketing teams.

In practice, most respondents said their institutions were highly pragmatic in the way they approached their clients. One noted "we have to use whatever works and whatever the client requests as a channel". All banks were, however, unanimous in preferring a direct selling approach and most noted that even where this was not possible, i.e. where consultants were involved or execution was conducted through asset managers, they would try and interact as much as possible with the end pension fund client. Most banks also noted that, wherever possible, their selling style tries to be advisory / educational to instil and build client confidence.

BANKS' VIEWS RE CONSULTANTS AND EXTERNAL ASSET MANAGERS

All the interviewees noted that, to be successful, they needed to maintain on-going relationships with both asset managers and consultants and, for the asset managers; this meant providing them with sufficient liquidity for their day-to-day business.

It was noted that the approaches used by consultants vary but, as noted above, the larger consultancies are in the process of changing their business models to provide more outsourced CIO and fiduciary management services, providing more advice on investment opportunities and, ultimately, get more involved in fund management / asset allocation. This directly impacts the way banks interact with them to minimise the potential conflict and overlap in their relationship with the funds.

A number of banks also noted the landscape was changing with the emergence of specialist firms such as Cardano and Reddington which were bringing their banking based experience directly to the pension funds. Pension funds, it was noted, were now becoming much more comfortable using the new "diversity" these firms were bringing to the market and were using a range of consultancies for different types of advice.

While a number of interviewees were less than happy with regard to the emergence of these types of consultancies, others were much more sanguine and saw them as opening up new opportunities as pension funds broaden their knowledge and this will ultimately lead to further growth in more complex trades and a greater use of derivatives.

WHAT DOES THE FUTURE HOLD FOR THE BANKS?

Conducting this research in Q1/Q2 2012, it was unsurprising that most respondents agreed that regulatory change is likely to continue to pose considerable challenges for the banks. This is not least around cost of capital for derivatives transactions. However, it is also clear that the existing legislation around best execution has also weakened the influence of many banks, with the consultant advisors and asset managers playing a bigger role around the pricing and execution of pension funds derivative trades.

Some of the banks still believe that the pension industry is important as a source of business and different enough to warrant dedicated pension sales and advisory teams but these seem to be in the minority. As the pension funds' requirements become better understood and the consultants and asset managers increase their involvement, the banks' derivative interaction with the funds seem to be moving to a more mainstream liquidity provider role. We would expect this to increase the trend towards combining all derivatives activities (all asset classes, listed and OTC) into one group. A pension fund, advised by a specialist

consultant and/or using the services of an asset manager with derivative capability, is likely to present business to a bank as a series of more vanilla requirements rather than as a problem for which a structured solution is required. Banks' pension expertise will increasingly be housed within these more general derivative groups, with these individuals being used to get closer to the consultants, trading research for a better understanding of the likely future business flow.

This is not to say that the provision of large bespoke structures to funds will cease. However, as the cost of providing these increases and the pricing environment becomes more competitive, the banks will only want to provide liquidity if they can expect an adequate return. As the costs of provision will hit most banks, one would expect the costs of these bespoke products to rise.

It may also be the case that these trends cause greater movement of staff with this pension fund/derivative expertise from the banks to the buy side; most probably to the asset managers and consultants rather than the funds themselves, although the big firms may well bring some expertise in house. This trend will be facilitated by increasing restraint on bankers' pay and the requirement for banks to take a longer view of the contribution of their employees to profitability where derivative transactions are concerned.

Adsatis Ltd – July 2012

If you wish to discuss any of the views expressed in this paper or require further information, please do not hesitate to contact us:

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