> **Summary**
> • LDI will remain central to how pension schemes manage their portfolios, but extra regulatory oversight seems inevitable.
> • All stakeholders could be affected, with trustees having to better scrutinise their third-party providers and vice versa.
> • Any major legal fallout seems unlikely at this stage, but claims could still materialise in due course.

Taking control

Although no one has claimed culpability for last year's LDI liquidity crisis, the expectation of tighter regulation in a number of areas is doing its own job of dishing out indirect criticism

Save for a few lone voices, the pensions industry was quick to close ranks following last September's liability-driven investment (LDI) liquidity crisis.

Leading the defence by mid-October was The Pensions Regulator (TPR), with its then-chief executive, Charles Counsell, defending not only his organisation's oversight of LDI, but the very concept itself. At the time he criticised "overblown" media coverage of the crisis, denying that schemes were at risk of collapse due to the change in gilt values. Others, such as prominent LDI player LGIM, were quick to turn the heat back on Liz Truss's ill-fated administration.

Nevertheless, when steps were taken to avoid a swift repeat, most of the industry welcomed them, pulling together in an attempt to reassure scheme members and government ministers.

The initial measures called for higher collateral headroom and were led by the Central Bank of Ireland and the Commission de Surveillance du Secteur Financier in Luxembourg, where LDI pooled funds are domiciled. By the end of November, yield buffers for pooled funds had built up to between 300 and 400 basis points. In the UK, TPR extended the ruling to segregated mandates.

As LCP partner, Dan Mikulskis, stresses, the increased buffers addressed the crux of the matter. "You've got to hold higher buffers against these derivatives," he says, referring to the synthetic leverage that was dubbed 'hidden leverage' by some critics.

To date, the new limits have done their job. "We've been operating in the framework for quite a while now," says Mikulskis. "There has been a lot of rate volatility this year and things have been fine."

Braced for new regulation

The question now is what happens next.

"LDI has worked for pension schemes for over 20 years and has served them – and their members – well," says BlackRock global head of indexed fixed income and LDI, Alex Claringbull. "So while we don't suspect it will be business as usual, and nor should it be, it is our firm belief that LDI will remain central to how pension schemes manage their portfolios."

XPS chief investment officer, Simeon Willis, agrees, saying that the TPR's funding consultation included a very clear requirement for schemes to cashflow match. "That means they need to use some degree of LDI, however you want to define it," he says.

The Bank of England's Financial Policy Committee (FPC) recently recommended TPR specify the minimum levels of resilience for LDI funds, suggesting the size of the yield shock to which LDI funds should be resilient should be, at a minimum, around 250 basis points. In response, TPR confirmed it plans to issue updated guidance on LDI in April.

Towards the end of March, Pensions Minister Laura, Trott, hinted that tighter rules were in the making as there were a number of "deficiencies" in LDI funds.

"The introduction of new regulation in this area is a real possibility," says Norton Rose Fulbright partner, Shane O'Reilly. How that will materialise, however, is unclear. O'Reilly suggests the wide variety of opinions fielded by the Work and Pensions Committee (WPC) on how to proceed could be pose a headache for policymakers. In addition, The House of Lords' Industry and Regulation Committee has advocated for a wholesale regulatory overhaul, while the Government Actuary Department has cautioned against potential over-regulation.

Trustee requirements

It is now expected that any new layers of supervision will take into account the nuances found between pooled and segregated funds, therefore avoiding the danger of creating a sledgehammer to crack a nut.

As Mikulskis explains, although schemes with segregated arrangements were highly levered, they were not the real problem in the crisis. Most held liquid assets that they knew they could sell quickly if the need arose. The pooled mandates run by managers however, had to operate in a straightjacket created by their own restrictive, but necessary, rules.

"The pooled group of funds *[represented]* a small amount of the total volume of hedging, but a big part of the issues," says Mikulskis.

Pooled or segregated, an evolution in manager reporting is likely to emerge. TPR has made it clear that trustees are the first line of defence against LDI leverage risks. But for trustees to be effective in this role, they need access to the right information, at the right time.

"Looking at information that's three months out of date, four times a year, is not good enough," says Mikulskis. "So there has to be an improvement from managers in providing much more frequent, timely, information."

More robust reporting will also help improve education of trustees on all LDI-related matters. "Trustees are expected to cast a much more critical eye on their LDI portfolios," says O'Reilly.

Should trustees end up having to closer scrutinise their managers and advisers, then this will certainly require a ramping up of scheme behaviour inspection. This could involve a requirement to state a scheme's LDI policy and a need to demonstrate how that policy has been adhered to. "So they give pension schemes freedom to choose their approach, and then they hold them accountable to whatever approach they've chosen," says Willis.

Digging deeper

Advisers may not escape further regulation either, suggests Willis. He would not be surprised if consultants begin being regulated in relation to capital allocation advice. "Some sort of coverage of investment strategy, how you advise on the liquidity of a portfolio – it's pretty likely that these areas will be regulated."

Willis also believes that LDI managers may find themselves having to grapple with raised Know Your Client standards from the FCA. This may involve having to discover what type of assets a scheme has access to beyond those invested in an LDI fund," says Willis. "As a minimum you may need to demonstrate that you've taken adequate steps to check that there is scope for them to top up if needed."

More integration

In Claringbull's view, the long-term response to the crisis will translate into higher collateral buffers, greater pooling of assets and further clarity in governance plans.

"These all contribute towards boosting resilience," he says. "For some this might start raising questions about their investment strategies around LDI. We need learn from our experiences over the past six months to evolve and improve LDI, including a move towards more integrated LDI. This was a trend we were already seeing, but we believe it will accelerate as a result of the autumn market volatility."

These integrated solutions can combine liability hedging with liquidity management and investment in diversified asset classes, which, on paper at least, could deliver new sources of return. "We're currently developing products and solutions that we believe will meet changing client needs for both segregated and pooled clients," reveals Claringbull.

A legal fallout?

Aside from extra supervision, there has been speculation that cases could be brought against investment managers who recommended LDI to clients.

"I am sceptical about this," says Shoosmiths employment partner, Paul Carney. "The problem for those considering bringing a claim is that doing so would need demonstrably to be in the best interests of the beneficiaries of the scheme in question and it appears to me that there would likely be too many defences to such a claim."

"From a broad, basic perspective, it could be demonstrated that the crisis was exacerbated if not actually caused by the government's September 2022 budget therefore; it would be harsh indeed to blame the consequences on an investment manager. In addition, investment managers would be able to point to their advice, in effect, being endorsed by guidance issued by regulatory authorities which actually favoured LDI strategies as a sensible way of managing pension scheme liabilities."

According to Norton Rose Fulbright senior associate, Suzie Kemp, there is some support for potential legal action — whether from trustees against managers and consultants or even aggrieved scheme members and employers against trustees. But lawyers are yet to see concrete evidence of who is accountable for any losses or damage caused by the actions taken as a result of last September's events.

"Claims, if any, will depend on the circumstances of each scheme and be very fact-specific," says Kemp. "They might depend on the contracts in place, investment delegations and instructions, if mandates were followed, and the information available to the advisers at the time. While there may be real obstacles to successful claims, it is certainly possible that the circumstances affecting some schemes might involve criticism of how LDI strategies were implemented.

"As yet, we have not seen significant legal fallout, but this is certainly an area that is being actively observed."

Marek Handzel, a freelance journalist

In association with LCP powering possibility