Cascading assets

As DB schemes assess their investment portfolios' overall liquidity in the lingering aftermath of the LDI crisis, renewed attention is being paid to collateral waterfalls

Summary

- To avoid a repeat of the 2022 liability-driven investment (LDI) crisis, attention has been turned to revisiting collateral buffers and governance arrangements within DB schemes.
- Calls are being made for trustees to either comprehensively review their collateral waterfalls or set up completely new ones. During the crisis many collateral waterfalls did not necessarily deliver the outcomes that they were expected to.
- As part of that process some portfolio restructuring may well have to take place in 2023, as well as further changes to decision-making processes within DB schemes.

With the dust now settled on the liability-driven investment (LDI) crisis sparked by Kwasi Kwarteng's ill-fated mini-Budget of September 2022, a familiar resolution has echoed its way through trustee meeting rooms: Never again.

In order to meet this collective promise and prevent a similar liquidity emergency, attention has been turned to revisiting collateral buffers and governance arrangements within defined benefit (DB) schemes. Prior to 2022, a DB liquidity programme was designed and checked to ensure that a scheme always had enough liquidity to pay out its immediate obligations, whether

that be payroll, transfer values or any collateral call generated by its investment or hedging strategies. Today, however, liquidity scrutiny is firmly centred on the need to create, or reassess, collateral waterfalls within an LDI context.

As a subset of an overall liquidity programme, most DB schemes running LDI plans would be expected to have a collateral waterfall in place, which is effectively a pre-agreed strategy that lists which assets should be sold – and which particular order – to meet cash needs. And as LCP investment team partner, Steve Hodder, explains, collateral waterfalls are often set up directly with a scheme's LDI manager, with all components including cash, bonds and other assets, being managed by that very manager. The problem post-2022, however, is whether or not these are any longer fit for purpose.

In a recent note on the topic, Hymans Robertson co-head of trustee DB investment, Elaine Torry, wrote that revising collateral waterfalls was expected to be a key priority for DB custodians in 2023. She identified a number of areas needing scrutiny, including factoring in the speed and impact of volatility when selling assets; reviewing hedging levels; and checking if proper management systems are in place to oversee new collateral requirements.

Torry's proposals follow on from one of the discoveries that came to light during the gilt crisis surrounding liquidity management. For a number of DB funds, prior to September 2022 it had not pre-agreed by trustees and third parties as to where to go to get liquidity – and what level of permission was needed to pull the trigger.

In Dalriada Trustees professional trustee, Paul Brine's, assessment, liquidity needs to be considered "in the round", which includes addressing how "perfect storm" events will be dealt with. This means working through what a scheme's governance process is to generate liquidity. "As the pension scheme move forwards, the risk mantra should change from 'I won't provide for this event because it is very unlikely', to 'Regardless of whether I think this event is going to happen, what will I do, if it does?'," he says.

"The collateral waterfall maybe better defined as a liquidity waterfall," says Brine. "You need liquidity (for any purpose): Where can you get it from, who can access it, where is the cash going to reside (so it can be used) and what are the triggers to access additional layers and take more aggressive action? How are those actions controlled and monitored by trustees and can some items be delegated?"

"The old world of high hedging, low volatility returns and high liquidity has been replaced by tighter monetary conditions and lower levels of leverage"

Granting an LDI manager or investment consultant access to a pool of liquidity under the terms of an investment management agreement is entirely consistent with this approach, he adds. "No doubt it will need to be constrained, but the access to liquidity and the processes by which additional liquidity can be obtained need to be mapped out prior to any liquidity event."

Not necessarily a silver bullet

While collateral, or liquidity, waterfalls make perfect sense and are intuitively simple, they are not necessarily a "silver bullet", warns Aon partner, Calum Mackenzie.

Their main benefit, says Mackenzie, is to speed up, or even remove decision-making processes. And while waterfalls undoubtedly helped during the 2022 gilt crisis, there were areas in which they were found lacking.

"For example, even where a single LDI manager held different parts of the waterfall they could not move assets to the collateral pool quickly enough," says Mackenzie. "For those pension schemes where decision making is a challenge, it is likely that a broader fiduciary management approach will be more appropriate than relying on a collateral waterfall in isolation. This offers speed of execution, alongside diversity of investment managers and asset classes."

Part of the reason that some collateral waterfalls failed to deliver last year was due to structural issues. Liquidity, for example, may have been within the confine of a scheme's overall investment portfolio, but it was simply in the wrong place, says Brine. Other barriers may have included some assets within a portfolio turning out to, in fact, not be very liquid at all. Some schemes may also have run out of liquidity, because a lot of assets simply could not be liquidated under any circumstances. "This is likely to have been a harsh lesson to those that consider pension schemes can make non-trivial illiquid investments without risk," says Brine.

Then there is the issue of some schemes only being able to turn to cash in the LDI emergency, either directly, or through the collateral arrangements of the pooled funds that some of them were invested in. In contrast, says Brine, those that had the ability to deliver gilts, or even corporate bonds, "sailed through the crisis".

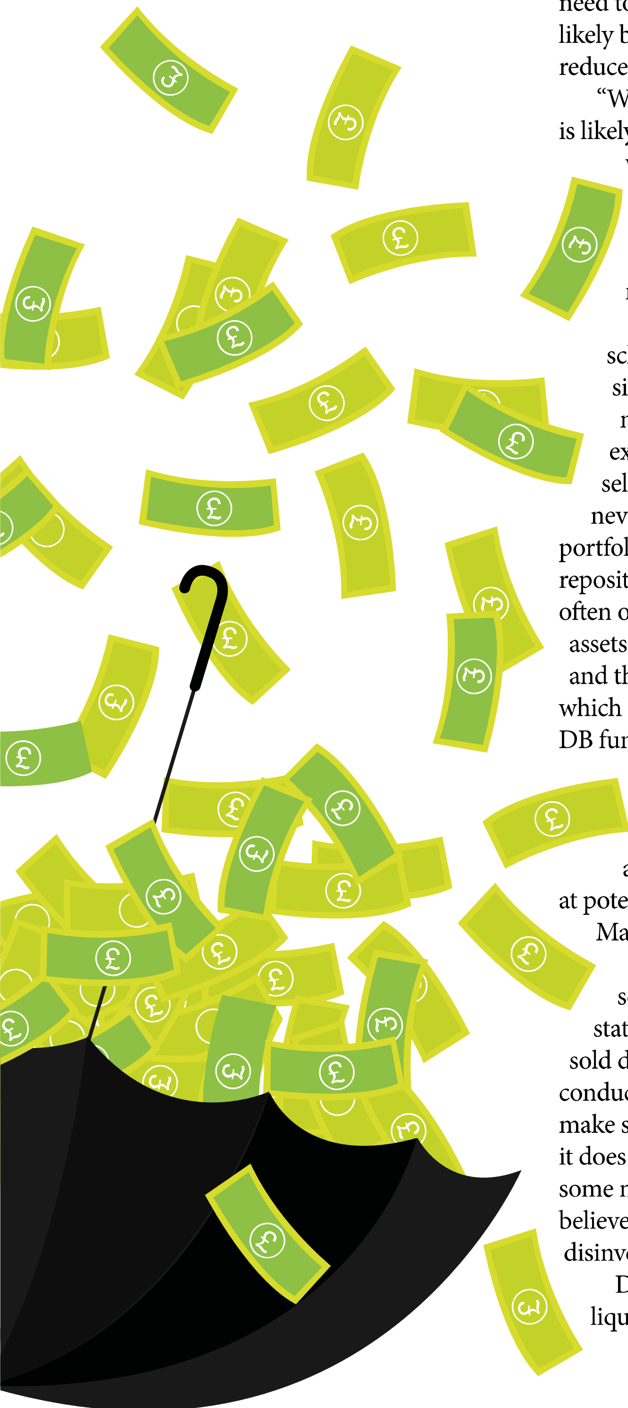
"If I was to correct one single need, it would be the ability to be able to deliver gilts (as opposed to cash) against a collateral call. If that had been the case for the majority of the market, there would have been no crisis in the first place," claims Brine.

Do they even need to sell?

Although a critical issue, questions remain over how much, and what sort

of portfolio restructuring needs to take place to back-up a trustee board's desired collateral waterfall plans.

Hodder categorises DB schemes with LDI plans into three broad categories. The first already had low LDI leverage ahead of September 2022, due to pro-active de-risking, and generally do not require much, if any, rebalancing activity.



The second used typical LDI leverage but had liquid wider strategies. Generally, these schemes have already carried out some rebalancing in the fourth quarter of 2022 and so it is arguable as to whether much more is needed. The third and final group used LDI leverage alongside significant illiquid asset allocations. These schemes have the most urgent need to review arrangements and will likely be taking action over 2023 to reduce illiquid allocations.

"We believe the third category is likely a minority of schemes, but with a large variation in how much illiquid assets they have depending on different circumstances and governance models," says Hodder.

Mackenzie says that pension schemes have already made significant increases to collateral, meaning that there is little expectation that there will be further selling for this purpose. Aon does, nevertheless, expect to see significant portfolio changes as pension schemes reposition their assets to reflect their often overweight allocation to illiquid assets, their improved funding positions and the new economic environment, which could prove beneficial for some DB funds. "Selling illiquid assets will present opportunities for long-term investors (such as LGPS pension schemes) to buy assets on the secondary market at potentially attractive prices," notes Mackenzie.

"Schemes are likely to be net sellers," says Brine. "But you cannot state when: Some may have already sold during the crisis and some may be conducting an overall strategy review to make sure that whatever action is taken, it does not have to be reversed soon. And some may be just waiting to sell if they believe it may be an appropriate time to disinvest from the market."

Due to the intense demand for liquidity during the crisis, schemes may well have sold significant non-LDI assets simply to be able to meet collateral calls. Brine says that these may or may not have been the "right" assets to sell at the time. Some schemes, however, could have sold in a hurry and then, in a stroke of good fortune, found out that they were not mistaken in divesting some investments as the drop in overall liabilities would have resulted in them being sold anyway.

"We can think of cases in both camps and we are sure there are others," says Brine. "Liquidity demand may have generated a tactical sale of return seeking assets, but the strategic re-balancing is on-going and there are myriad variations. The most likely problem in the medium term is that illiquid assets – assets that could not be sold in the crisis, or assets previously deemed liquid but, when you needed to sell, turned out not to be – will most likely be proportionately over-invested on a strategic level."

Wake-up call

However DB schemes play it out, 2023 will be a year of change, predicts Mackenzie, with the old world of high hedging, low volatility returns and high liquidity having been replaced by tighter monetary conditions and lower levels of leverage. "Schemes need to make tough decisions about how they manage risk, and ultimately what effect this has on sponsor contributions and recovery plans," he says. "At the same time they are likely to review their governance models and question whether their experience through the gilt crisis suggests they should consider delegating some, or all of their investment implementation to specialists."

Ultimately, sums up Brine, the crisis showed that change was needed. "The industry has had a real wake up call," he says. "Pension scheme management is not necessarily non-executive."

Written by Marek Handzel, a freelance journalist