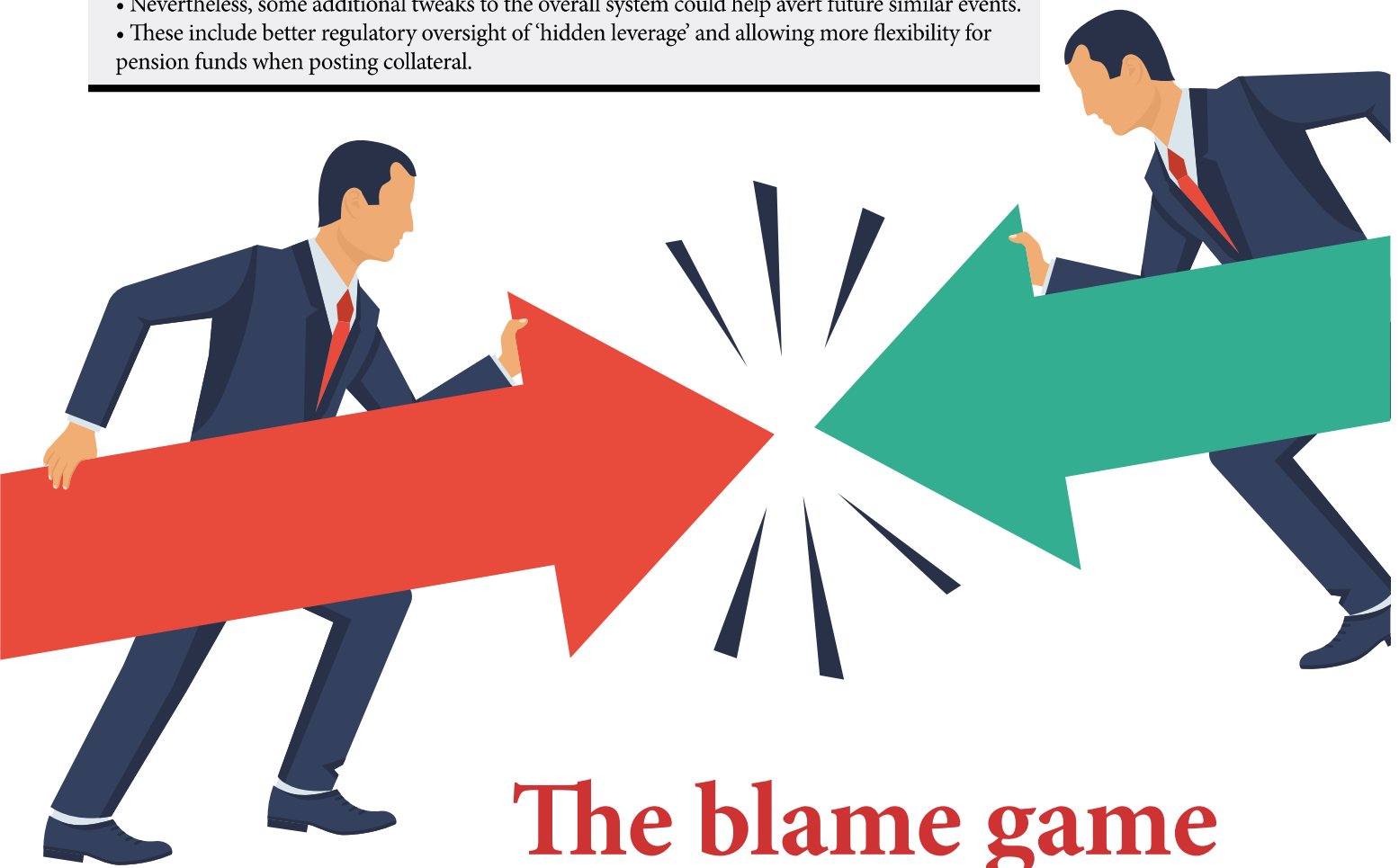


Summary

- Attributing blame to trustees, consultants or managers for the LDI liquidity crisis could be viewed as a harsh verdict. The mini-Budget that sparked the crisis was clearly a Black Swan event.
- Nevertheless, some additional tweaks to the overall system could help avert future similar events.
- These include better regulatory oversight of 'hidden leverage' and allowing more flexibility for pension funds when posting collateral.



The blame game

With almost everyone involved with LDI getting caught out by the dramatic events following the September 2022 mini-Budget, what needs to be done to improve oversight of the investment strategy?

Speaking at a conference run by the International Swaps and Derivatives Association and the Alternative Investment Management Association on 7 November 2022, Bank of England executive director of financial stability, strategy and risk, Sarah Breen, labelled the LDI liquidity crisis of September 2022 as the latest example in a list of “poorly managed non-bank leverage throwing a large rock into

the pool of financial stability”.

From Long-Term Capital Management in 1998, to the failure of Archegos in 2021, Breen said several episodes in the past two decades have highlighted the need to take into account the potential amplifying effect of ill-handled leverage that when aggregated, can escalate into systemic risk.

Attributing the LDI emergency in wholesale fashion to substandard

supervision, however, is viewed by many in the pensions industry as a rather harsh verdict, given the unprecedented nature of September’s mini budget. Nevertheless, some warning signs were there. Back in July 2022, Aon and Mercer both urged DB funds to prepare for bond yield spikes that had not been seen since the early 1990s. Any such rapid rises, said the consultancies, would place huge pressure on LDI strategies.



Is anyone to blame?

Such admonitions, clearly, came too late to make any difference. Everyone along the governance chain was caught out by events, making it hard to definitively pin blame on any particular group or regulator.

One commentator, who wished to remain anonymous, explains that most schemes would have been aware of the liquidity profile of their assets and the leverage in their LDI portfolios in the run-up to the mini-Budget. What caused the challenges for most schemes was the speed of the collateral calls, which was quicker and more extreme than had been stress-tested for, so collateral buffers were being rapidly eroded.

In parallel to this, the collateral buffers that LDI managers were requiring clients to hold were also being increased. In a classic snowball effect, this meant that once schemes had met collateral calls to maintain hedging positions, they were then required to raise more capital to build up a larger buffer against future collateral calls. “So even if a scheme had been holding a buffer sufficient to withstand the extreme movement in rate rises, they would still have been required to find more assets to build up the collateral pool,” explains the commentator.

In its response to a call for evidence from the Work and Pensions Committee on the crisis, the PLSA writes that its

research indicates that nearly all schemes believe they had a strong understanding of risks within LDI strategies. “It is also evident that various measures put in place following the financial crisis, worked as intended; i.e. collateral calls were made, and met. Despite the extreme circumstances, our data indicates that majority of schemes feel that their governance measures coped with the stressed conditions.”

“I would always caution against a knee-jerk change to regulation which takes away the ability for schemes to be able to reflect their own specific circumstances”

Decision making

Nonetheless, says the PLSA, there are clearly lessons to be learnt. “This was not a universal experience,” it says in its submission, “and even for those that coped very well there will be areas for improvement”.

For the PLSA, these fields include further scenario testing, enhanced liquidity reviews, and adaptations to scheme governance to act quickly in crisis.

This latter area is one that the Investment Association has also highlighted as worthy of investigation. In its written evidence to the Work and Pensions Committee, the Investment Association makes the case for further

delegation to eliminate the points at which communication can breakdown or be misinterpreted. “In this specific instance, decisions around whether to maintain hedging ratios and deciding which assets to sell to raise collateral once the initial pools had been exhausted, were needed more quickly than they were sometimes forthcoming,” writes the body. “Anecdotally, those schemes where greater discretion on these matters was granted to the LDI manager were able to respond more quickly to changes in market conditions. As a result, we expect that more schemes will seek to delegate more of these decisions to their LDI managers in future.”

Trusting stress tests

Another one of the PLSA’s recommendations, additional stress testing, has also come under scrutiny.

Addressing another investigatory panel, this time The House of Lords’ Industry and Regulators Committee, on 22 November 2022, Legal and General chief executive, Sir Nigel Wilson, admitted that the insurance giant — which is set to lose some £10 million in profits as a direct result of the crisis — had never stress tested a scenario such as the one that unfolded past September.

“We will now incorporate that into our stress testing,” he told the committee. “And we’ve already doubled the headroom that the funds have, and that’s an appropriate way to behave right now. When the dust has settled, there will be, I suspect, a review of the what stress testing models [*are appropriate*].”

Also speaking to the committee, the insurer’s chair, Sir John Kingman, claimed that LDI vehicles were now adequately shielded from bond market fluctuations following the actions taken in the wake of the crisis.

“We have worked with the authorities to ensure that they are extremely well insulated,” he said. “It was very clear that the Bank of England’s objective was at the moment at which support

was withdrawn, that LDI vehicles could sustain a very violent further market reaction were it to happen again.”

Now, however, he said there needed to be a debate as to where LDI strategies eventually settle in terms of protective measures. It was highly unlikely that anyone would advocate returning to the status quo pre mini-budget, but trustees would have to understand that elevating levels of protection would come at a cost. “So there’s some balance to be found here,” he added.

Only once that deliberation is complete however, can restructured scenario testing commence.

Hidden leverage

In the search to ascribe blame, a common feature of LDI strategies – the use of synthetic leverage through derivatives – has emerged as a clear scapegoat.

During his appearance before the Work and Pensions Committee in November, independent consultant, John Ralfe, described the component as hidden leverage, which has become a problem as LDI has evolved over the years. “Hidden leverage is undoubtedly a bad thing,” he stressed. “Leverage if you are being absolutely clear what you are doing, and that means being clear to the shareholders, clear to the members, clear to The Pensions Regulator (TPR) and anybody else, may be a bad *[or a]* good thing. But hidden leverage is always a bad thing.”

In a speech at the Lord Mayor’s City of London Banquet on 27 October, FCA chief executive, Nikhil Rathi, admitted that hidden leverage had undoubtedly concentrated counterparty risk. “I can see the need for better regulatory and risk reporting and oversight both domestically and internationally *[for hidden leverage]* and this is something we will be focusing on with our partners,” he told his audience.

Given the importance of synthetic leverage for modern-day LDI, how this could be effectively regulated is debatable.

At the same time, the danger of hidden leverage may decrease. As alluded to by Wilson, most schemes will be reassessing their liquidity requirements and running more extreme stress tests. This will lead to DB funds probably taking on less leverage in the future, which for some will mean lower hedging.

Margin requirements

An arguably more tangible change could appear in relation to margin requirements.

As the PLSA argues in its submission to the Work and Pensions Committee, one of the key components of the liquidity squeeze was the limited options that schemes had when posting collateral. The PLSA has suggested that regulators examine whether greater flexibility around margin requirements would have reduced market volatility and, if so, then whether they could be introduced in the future.

“This should include an assessment of whether the UK makes the ‘on-shored’ temporary exemption from the European Market Infrastructure Regulation permanent for UK pension funds, and associated bank capital rules, which makes this practically feasible.”

Dangers of an over reaction

As is ever the case, a danger remains that increased governance, stress testing and regulation, in particular, could be counter-productive.

As Breedan pointed out in here speech at the ISDA and AIMA event in November, the LDI liquidity issue was particularly acute for one small corner of the LDI industry – pooled funds, which make up around 15 per cent of the LDI market at most. “The speed and scale of the moves in yields far outpaced

the ability of the large number of pooled funds’ smaller investors to provide new funds who were typically given a week, in some cases two, to rebalance their positions,” she said.

Looking at improving mechanisms to further protect pooled funds could therefore be a better use of time and resources, rather than making sweeping changes across the entire LDI landscape.

“Any governance or regulation that helps to improve member outcomes and the security of members benefits should be considered,” says Hymans Robertson co-head of DB investment, Elaine Torry. “However, I would always caution against a knee-jerk change to regulation which takes away the ability for schemes to be able to reflect their own specific circumstances.”

“In practice this is a well-regulated industry however, any further changes in regulation should not, as a consequence, punish schemes who have used LDI and managed their investment strategy prudently. LDI has been, and will continue to be, a useful risk management tool for defined benefit pension schemes, therefore any regulation changes should seek to support rather than diminish the use of LDI as a risk management tool in the future.”

 **Written by Marek Handzel, a freelance journalist**

