Summary
- Inquiries around LDI have raised concerns around the use of derivatives to hedge liabilities, highlighting a discrepancy in the UK's transposition of the IORP I Directive.
- The Pensions Minister has recently provided further detail on the reasoning behind this discrepancy.
- Legal experts have suggested that the risk to trustees is "remote", and attention should instead be focused on the operational issues that the LDI liquidity crisis exposed.

The tip of the iceberg?

Concerns around a potential mis-selling issue have emerged as part of the inquiries around liability-driven investments (LDI), but in such a complex field, it can be hard to tell if this is a technicality, or a genuine concern for trustees. Sophie Smith reports

Inquiries into liability-driven investment (LDI) issues in DB schemes have continued over the past month, after headlines of pensions being on the brink of collapse shook the industry's standing last year.

The blame game is in full swing, as Squire Patton Boggs partner, Clifford Sims, says that there have already been rumours about potential claims against LDI managers and consultants, with pensions celebrities summoned to explain the way that LDI worked and the role of leverage in product design in various parliamentary committees.

One key issue that has been repeatedly raised as part of these hearings is over the potential use of borrowing, particularly the use of derivatives to hedge liabilities and the use of repo.

Creating a debate

This has been a growing area of focus, including in the House of Lords Industry and Regulators Committee, as Baroness Bowles of Berkhamsted argued that "there is no doubt that, economically, *[leveraged LDIs]* are borrowing", stating: "The Oxford English Dictionary defines leverage as the use of 'borrowed capital for (an investment), expecting the profits made to be greater than the interest payable'. Therefore, whether you can slide around the precise wording or not, are you not in the position of subverting the intent of the legislation?"

In response to Baroness Bowles' queries, The Pensions Regulator (TPR) investment specialist, Neil Bull, explained that while it is correct that pension schemes are not allowed to borrow money except for short-term liquidity requirements, the use of LDI focuses on two types of instrument: repos, and swaps, which are derivative instruments used by pension schemes.

"The use of derivatives is explicitly allowed in regulation 4(8) for "efficient portfolio management" and to reduce the risk," he explained.

Furthermore, Bull argued there "is a healthy debate about whether repos fall into the category of derivatives or money market instruments".

However, responding to a similar query, Financial Conduct Authority chief executive, Nikhil Rathi, said it "is clear that there was leverage and, effectively, borrowing going on in the system", stating that he would instead "wait to see what the leading opinion says on the precise technicalities of the legislation".

The devil in the detail

TPR has since written to WPC confirming that it considers borrowing as defined in the regulations to be different to the use of derivatives.

"When pension funds use leveraged LDI, they typically use swaps or 'repos' or a combination of both," TPR explained. "These derivative instruments are used in both pooled fund and segregated arrangements and allow pension funds to benefit from exposure to long dated cashflow payments.

"Regulation 4(8) of the 2005 investment regulations explicitly allows trustees to use derivative instruments. They may be used where they contribute to a reduction in risk or facilitate efficient portfolio management (including the reduction of cost or the generation of additional capital or income with an acceptable level of risk). In principle, use of derivatives in LDI funds is consistent with this provision."

TPR explained that it is not an issue that it felt required counsel on, arguing that the pensions legal profession, as a whole, has "not considered it to be a matter of significant debate".

Indeed, despite the concerns raised in the recent inquiries, Sims says that some of the critics of LDI have perhaps ignored the wholesale reform of the derivatives market that happened in the wake of the Global Financial Crisis (GFC) of 2008-9, which aimed to address systemic risks in the banking sector by introducing central clearing of trades and strengthened margin or collateral requirements.

Sims also suggests that if trustees did not have the legal power to enter into the complex financial instruments used in LDI strategies, most DB trustees would have "some serious soul-searching to do".

"The absence of a power to do something raises the spectre of acting in breach of trust and the risk of uncertainty about contractual obligations which is absolutely central to agreeing any contract, let alone a high-value investment derivative contract with millions of pounds at stake," he says.

Looking back, however, Sims says that a "basic statutory power to use derivatives could be established as far as 1997".

Echoing TPR's reasoning, Sims highlights the 2005 investment regulations, that were brought in under the Pensions Act 2004 to ensure that the UK complied with the IORP I Directive, arguing that these gave "clear authority by which pension funds may use derivatives".

"LDI as an investment strategy was built on these statutory rocks of risk reduction and efficient portfolio management", he continues, explaining: "Initially there was no linkage to borrowing in such arrangements but leveraged LDI funds became popular when LDI managers and investment consultants created pooled fund structures to capture enhanced returns from return-seeking asset classes in other structures. That made sense, especially in the low interest rate environment that followed the GFC, but in the wake of the September mini-Budget that created the liquidity crisis, it begs the question again about whether any borrowing was indeed temporary and for liquidity only.

"At one level, such an analysis will always be fact specific. But it is important to ask who was actually doing the borrowing too. Where a pension scheme uses an LDI pooled fund solution, the counterparty to any derivative transaction that has been entered into will be that fund, not the scheme. That principle applies to all financial instruments."

"We are confident of our interpretation of regulation 5 of the 2008 investment regulations, informed by the analysis of our experienced in-house legal team"

Danger ahead?

However, broader concerns have also been raised around the UK's transposition of this IORP I Directive.

In a recent Work and Pensions Committee (WPC) hearing, Brighton Rock Group head of research, Con Keating, argued that the "use of derivatives to hedge liabilities is also almost certainly illegal", stating: "The European directive limits the use of derivatives for investment purposes, for investment risk management. The UK transposition omitted the word 'investment' and added a second line, which appears to permit this.

"No English court, to our reckoning, would support that transposition. We believe that a court would just put a line through the added sentences and reinsert the word 'investment'. The use of derivatives to hedge liabilities is also almost certainly illegal."

Keating also expanded upon this issue in written evidence, making the point that, given the purpose of the directive is to protect against excessive risk taking by pension schemes, it would "seem strange that its restriction on borrowing could be easily circumvented by economic borrowing using repos".

Inquiries around the issue are still ongoing with Bowles also reaching out to WPC on the issue, while WPC chair, Stephen Timms, reached out to Pensions Minister, Laura Trott, to request further information as to whether the government took external legal advice and its reasoning for the amendments.

In her response, Trott confirmed that the transposition made reference to risks in general, rather than a specific reference to investment risk, explaining that this change was made in response to feedback on the consultation held at the time, in which the DWP explicitly set out that it wanted to allow derivatives and repos.

This is an extremely complex area, and one in which trustee knowledge concerns have already been raised, and with inquiries still ongoing, many in the industry seem to be waiting for the dust to settle, with experts even reluctant to comment on the issue to industry press.

But should schemes conducting reviews of their LDI programmes worry about having run the risk of acting illegally in entering into derivative transactions under an LDI mandate?

"In our opinion, that seems both an extremely remote risk but also one where, classically, trustees should be careful what they wish for," Sims says.

Instead, Sims suggests that it may be better for scheme trustees to spend their energy, and legal costs, on the operational issues that the LDI liquidity crisis exposed.

In particular, he encourages trustees to consider whether they understand what they are investing in, whether communications between managers, trustees and their advisers were clear, and whether improvements can be made to execution of instructions, e.g. by use of powers of attorney.

Written by Sophie Smith