Risk management lessons from the banking crisis

UK pension schemes may have felt a long way removed from the recent turmoil in US banking, but the knock-on effects have been felt much closer to home, Nick Reeve reports

Summary
- Following the banking crisis in the US and Europe, pension schemes have been assessing the potential impact.
- Risk management and portfolio diversification have been key factors in helping protect pension schemes from the aftershock.
- Trustees have been urged to learn lessons on risk management from the crisis and remain prepared for further volatility.

How does the collapse of a cryptocurrency trading platform lead to counterparty risk discussions at UK pension schemes?

The interconnected nature of financial services means that what began as the failure of a niche company based in the Bahamas has led indirectly to significant questions about monetary policy, counterparty risk and financial stability.

It all started with FTX. Once a darling of the crypto world, in late 2022, the digital currency trading company collapsed into bankruptcy amid accusations of fraud. The sudden loss of confidence swept through the crypto world, taking with it the fortunes of several other companies.

Investors began to scrutinise the activities of banks providing services to FTX and other crypto-asset companies. In early March 2023, after several of its digital asset clients walked away, Silvergate Bank announced plans to wind up. Days later, Silicon Valley Bank (SVB) – a key provider of financial services to the technology and venture capital sectors – folded after a rush of deposit withdrawals, and Signature Bank quickly followed.

While US federal regulators moved quickly to protect deposit holders, a wave of panic rippled around global markets. Investors were immediately reminded of the chaos of the 2007-09 financial crisis.

J.P. Morgan Chase came to the rescue of the beleaguered First Republic Bank, which was also haemorrhaging cash, adding to concerns about financial stability. In Europe, UBS bought Credit Suisse after its rival began to experience serious difficulties after years of poor performance.

Rapidly rising interest rates were blamed as banks struggled to liquidate assets to meet withdrawal requests. Higher rates lowered the price of longer-dated US treasury securities and, amid broadening financial stability concerns, offloading or even valuing large amounts of these assets became difficult.

So far, however, regulators have managed to contain the effects of these incidents. Bank share prices have mostly stabilised amid talk of regulatory reviews and stronger liquidity rules. The worst, it is hoped, is over.

View from the UK

UK pension schemes may feel somewhat removed from this US-centric chaos. However, trustee boards will likely have asked questions of their asset managers about potential exposure to US banks.

Northern Trust Asset Servicing pension and insurance executive, Mark Austin, says events in the US banking sector should remind pension schemes that "counterparty risk is real" and exists throughout the financial system.

"These impacts range from mere inconvenience to actual financial loss, and it is worthwhile for trustees to both understand the nature of these risks and ascertain their level of tolerance for them," Austin says.

For UK schemes, the direct impact will vary depending on portfolio construction and exposures but, as

Mercer UK chief investment officer, James Lewis, explains, market sentiment will have had a "far more significant" impact: "We always recommend building diversified portfolios to manage unknown and unknowable risks. There was a rapid response to each of the bank collapses and, while the rapidly rising interest rates of the last 18 months clearly played a major role, the authorities have acted quickly to support the banking industry. If interest rates continue to rise, we expect to see further volatility and stress in financial markets. However, that will also create opportunities."

"Markets are sensitive to rising interest rates, and a recessionary 'hard landing' remains a risk," explains Redington managing director, Carolyn Schuster-Woldan. "The impact of market dynamics will be uneven across asset classes, regions and sectors, and so it's crucial to maintain a well-diversified portfolio."

Diversification is key, trustees and consultants proclaim. Unless a scheme had allocated significant portions of its portfolio to US banks or technology venture capital funds, the effects were unlikely to divert schemes from their journey plan.

Vidett trustee director, Martin Collins, echoes this view, but emphasises a need to have robust conversations on risk with asset managers: "The main measure that pension schemes should be taking to protect against these risks is diversification – you shouldn't have excessive exposures to any institution or sector.

"Beyond this, you should also quiz your investment managers to ensure their investments don't have a concentration of risk from any source."

Risk management lessons

As well as providing financing to many up-and-coming technology firms, SVB also often provided personal financial services to the same firms' directors or staff. Furthermore, some venture capital investors interested in the US technology space had SVB as a lender. This concentration of activity in one sector meant that, once technology firms began to act on their concerns and withdraw their deposits, a trickle of exits became a wave.

It is not just about counterparty risk with technology investments. With liability-driven investment (LDI) strategies under scrutiny after last year's gilts crisis, trustees will be looking to understand the counterparties of any lending or collateral strategies within their LDI provider's portfolio.

Fortunately, LDI funds have not been unduly affected by these banking collapses. Some strategies, along with regular corporate bond mandates, may have had exposure to Credit Suisse debt, but a diversified approach will have minimised the effect on pension schemes.

"Trustees must take appropriate and proportionate actions to understand the risks inherent in the investments they select," says Entrust trustee director, Tom Neale. "Where these investments include strategies that take counterparty risk, they should understand that and satisfy themselves that the due diligence performed by their consultant in recommending the manager is detailed enough to ensure counterparty risk is managed adequately."

Such risks should not be difficult to monitor, says Austin. Counterparties should be assessed "as part of regular discussions with the providers to the scheme". He adds: "When investing in global markets it is difficult to avoid risk completely, but understanding it and identifying where it exists is key to deciding if it can be mitigated, or accepted as being within the trustees' level of tolerance."

Interest rates – too far, too quickly?

The banking collapses have also increased scrutiny of monetary policy. The US Federal Reserve has raised its core rate from 0.75-1 per cent in May 2022 to 5-5.25 per cent in May this year, while in the UK the base rate hit 5 per cent in June, having been just 1 per cent a year earlier.

Buck CIO and head of UK investment consulting, Carl Hitchman, says markets may not have fully adjusted to the implications of higher interest rates. The failures of US banks could be "the first rumbles of thunder of an approaching storm", he warns.

"The economic narrative has shifted quickly from an expectation of very low inflation for the long term to an expectation of persistently high inflation," he says. However, the next inflation "surprise" may be to the downside, Hitchman explains, and central banks may be judged to have overcorrected with the rapid interest rate rises – which could spell more economic and investment volatility.

Higher rates could also see capital calls from LDI providers as they seek to reduce leverage, further adding to the liquidity pressure on some pension schemes.

Hitchman says the current good environment for defined benefit funding, which has led to strong surpluses and a wave of interest in insurance transactions, could be ending soon.

Neale agrees that "significant economic challenges remain" through high inflation and short-term rate hikes. "Trustees should be alive to the risk this poses to their portfolios which extend far beyond a recurrence of these specific issues within the banking sector," he adds.

The roots of the US banking collapses may have been far removed from UK pension schemes, but the knock-on effects are being felt much closer to home. Continued vigilance and proper diversification will be vital to keeping these effects at bay.

Written by Nick Reeve, a freelance journalist