LDI: Taking stock

Summary
• LDI has formed part of DB scheme strategies for more than two decades.
• The strategy, in theory, is designed to ensure pensions are able to meet their liabilities and pay members.
• Truss and Kwarteng's mini-Budget in September 2022 threw the gilt market into turmoil and against a backdrop of already rising interest rates, this in turn caused a crisis for LDI.
• The Pensions Regulator published guidance in April 2023 aimed at averting future crises by ensuring schemes have adequate stress testing and sufficient collateral buffers.
• LDI is likely to remain part of schemes' strategies, but must evolve to match the challenges of a new economic landscape.

Following the LDI turmoil at the end of 2022, The Pensions Regulator has published new guidelines for LDI. We take a look at the role of LDI, and how its strategies have shifted in the wake of last year's crisis

The primary purpose of LDI strategies is to stabilise the funding level of defined benefit schemes, ensuring that the assets and liabilities move in tandem, according to Schroders head of UK client solutions, Ajeet Manjrekar, who continues: "LDI strategies focus principally on managing the risk of adverse movements in interest rates and inflation resulting in an increase to the deficit for the pension scheme."

While the crisis in September 2022 saw LDI enter as yet uncharted waters, there's nothing new about LDI itself. As Legal & General CEO, Sir Nigel Wilson, told the Industry and Regulators Committee in November 2022: "We initially started doing it in 2001. They are called liability-driven investments, and it is a recognition that pension funds need to be cognisant of their liabilities – that is, their capability to pay pensions to people. That is why there is an emphasis on liabilities as opposed to an asset-driven strategy, which can create a lot of volatility and risks around what assets people invest in."

LDI is meant to support pension schemes' ability to, in a nutshell, pay members an income in retirement. Manjrekar says: "In recent years, due to evolving accounting rules, sponsoring employers of defined benefit schemes need to reflect the funding status of any underlying pension scheme obligation on their balance sheet. Therefore, the stability of the funding level has become increasingly important for both trustees and sponsoring employers, which reflects the widespread adoption of LDI strategies in the UK." And, he adds: "Any increase in deficit due to adverse market movements may result in the sponsoring employer needing to inject more monies into the scheme. Therefore, LDI strategies improve the predictability in pension scheme funding and are there to avoid unwarranted surprises."

Borrowed time?

BlackRock head of the EMEA LDI business, Richard Wood, says: "LDI strategies typically use gilts, derivatives and repurchase agreements, which are all sensitive to interest rates and inflation." And the use of leverage, or borrowing to invest, a central part of many LDI strategies was a cause for concern. "Many LDI strategies often use some leverage – this releases capital to acquire other investments that are expected to pay a premium over gilts. Without using leverage, insufficiently funded schemes would have to shift the risk of closing a deficit to their pension sponsor, meaning the guaranteed payouts members receive would be less secure," says Wood.

Indeed, says Mercer senior investment consultant and partner, James

Brundrett, leverage is crucial – but it also, in this case, didn't help matters. "What derivatives do is allow you to use some leverage, which means instead of holding one gilt, you can borrow against that gilt and go and buy another one," he says. "And with that leverage, you've got more interest rate and inflation exposure for every pound you've got. So, you've got more bang for your buck – and that helps you hedge out these inflation and interest rate risks."

The idea, he says, is that if interest rates go up, the strategy still holds firm, because the scheme's liability value goes down. "So, the two things offset. But, that said, you will have a loss on the derivatives, and whilst the liability value has gone down as well, which offsets that loss, you may find that you need to find some collateral to shore up the position," he says. "And therefore, cash is held as a buffer to meet any losses on the derivative side. Normally, that wouldn't be a problem because you would have the cash."

When gilt prices plummeted, cash levels were low, leaving LDI strategies in potentially perilous waters. And while the mini-Budget may have caused the biggest wave, water levels had been swelling for some time. "Interest rates had risen by almost 3 per cent before the mini-Budget, 2022, which is a phenomenal increase," says Brundrett. "It's perhaps the second time in history that we've seen that speed of rate rise – so that was the backdrop to the mini-Budget."

More cash was required to shore up derivative positions, but that cash was hard to come by, says Brundrett: "It was very difficult to get cash quickly enough, because it was needed in the space of a day or two days. And that meant there had to be a fire-sale of any other liquid assets to raise that money, which wasn't a good position for anyone to be in."

Changing course

While the gilt crisis is still causing repercussions, things have begun to settle enough for some reflection and reaction to occur. "The LDI market is going through a period of transition as trustees review their existing arrangements with a far greater focus on stress testing the impact of adverse scenarios and the ability for the pension schemes to cope. This has led to much more scrutiny on the provider and their approach to LDI," Manjrekar says.

"While *[LDI]* will remain central to how pension schemes manage their portfolios, the events of last autumn have shown it needs to evolve"

So, questions have been asked, and some answers provided. Notably, one from Sir Nigel Wilson in the course of that committee hearing, during which he said: "This *[gilt crisis]* was not caused by leverage. This was caused by the mini-Budget." While Legal & General chairman, Sir John Kingman, added: "Wrongly, nobody anticipated that the British government would choose to create such extraordinary instability in its own sovereign debt market."

The crisis prompted The Pensions Regulator (TPR) to take a long, hard look at LDI, and in April 2023, TPR published guidance for trustees with specific steps to be taken in relation to LDI. Those include ascertaining: "Where LDI fits within a scheme's investment strategy; setting, operating and maintaining a collateral buffer; testing for resilience; making sure schemes have the right governance and operational processes in place," and "monitoring LDI".

Commenting when the guidance was published, TPR interim director of regulatory policy, analysis and advice, Lou Davey, said: "Many schemes use LDI as a tool to mitigate volatility risks and we continue to monitor the use of this type of investment. The unprecedented market volatility seen last September clearly demonstrated there is the need for stronger buffers, more stringent governance and operational processes and more oversight by trustees. Trustees must understand the risks they carry in their investment strategy, and only use leveraged LDI if appropriate. Our guidance provides practical steps to ensure they achieve this vital balance, and we expect trustees to use it."

Moving with the times

A changing economic backdrop, higher interest rates and higher inflation mean that strategies must inevitably change and a more robust system of buffers certainly looks to be an important part of any strategy going forward.

Wood says that change is already happening, and will continue to do so: "We believe that the way pension schemes use LDI will likely evolve in this new market environment, and in the UK specifically. We see a trend of schemes pooling their overall assets with fewer managers, a move that will help increase options for collateral management and speed of responsiveness."

As defined benefit pensions mature, a shift in emphasis is essential, he says: "Many schemes will increase their focus on their end game, as strong funding and hedging positions make this more attainable. For some this may be low dependency solutions, whilst there is an expected uptick in pensions risk transfer, and a focus on governance is likely to lead to a further increase in the prevalence of professional trustees."

But ultimately, says Wood: "LDI has worked for pension schemes for over 20 years and has served them – and their members – well. So while it will remain central to how pension schemes manage their portfolios, the events of last autumn have shown it needs to evolve."

Written by Sandra Haurant, a freelance journalist