Out of the woods?

The disastrous 2022 mini-Budget may be starting to seem like a distant memory – but the pensions industry is still feeling its effects

Summary
- The LDI crisis had a far-reaching impact on the pensions industry, with schemes re-examining their resilience and relationships with third-party managers.
- Trustees now have a greater awareness and understanding of LDI and the implications strategies carry.
- Despite the changes to LDI usage, another crisis could still happen.

In the year since Kwasi Kwarteng's ill-fated mini-Budget speech, pension schemes have been thoroughly reassessing their use of liability-driven investment (LDI).

The mini-Budget caused a sudden and significant rise in interest rates and schemes were acutely unprepared for the fallout. Brokers responded to the drop in gilt prices and corresponding rise in gilt yields by presenting pension schemes with a margin call – but trustees couldn't readily produce the collateral.

In an effort to meet collateral calls, trustees sold gilts, which pushed values even lower, and the cycle continued until the Bank of England was forced to step in to stabilise their value with purchases.

"It was a crisis in the gilt market rather than a crisis that threatened people's pensions," AJ Bell head of retirement policy, Tom Selby, says. "The vast majority of people's pensions were entirely unaffected. Even in the world of DB, provided the employer remained solvent and able to fund the pension scheme, the immediate cashflow issue some faced shouldn't have put the scheme itself in jeopardy."

SEI institutional client strategy team lead, Charles Marandu, says the lack of resilience in LDI funds was one of the key issues behind the crisis. "LDI funds, particularly those managed by third-party managers, fell in value and ultimately did not have much resilience to movements in the interest rate," he says.

Have lessons been learnt?

The LDI crisis revealed to many schemes the dangers of a 100 per cent hedging strategy, which had often been seen as the safest possible strategy.

"The schemes that were less than 100 per cent funded certainly saw the benefits *[of rising yields]* in terms of their funding gaps closing and their deficit getting smaller," Mercer UK chief investment officer, James Lewis, says. "For a long time, interest rate risk was seen as being unrewarded. But in 2022, it was definitely a rewarding position to take and was a diversifier as well."

The Bank of England's intervention in the crisis ended the hidden danger of the cycle schemes had fallen into following, but Lewis argues the intervention should have come sooner.

"They were actually a little bit slow to react," he says. "The Bank of England had been having calls with us and a number of other participants in the weeks leading up to it stepping in. If it had been able to come in quicker it would have created a

different outcome for the market.

"Understanding the pace with which stakeholders can move is important."

Baker McKenzie partner, Jonathan Sharp, identifies some grey areas around trustee obligations as another key cause of the crisis, which he has been working to rectify since.

"Some schemes didn't realise what their obligations were in terms of liquidity. The trustees weren't quite ready for it and didn't seem to fully understand the contracts," Sharp says. "There is much more focus on providing clarity on that now."

Marandu highlights changes to the regulatory framework as another major change. "The *[new]* regulations have been focused on operations and governance, looking at how to ensure trustees have the right framework in place, to be able to deal with capital calls if they come in very quickly," he says.

He emphasises that this risk is multifaceted, and schemes should factor in the different types of risk they introduce when using LDI.

Lewis notes that regulators are still in favour of using LDI as a risk management tool. "The Pensions Regulator is very supportive of LDI, but it's trying to be crystal clear on the importance of trustees understanding what they're using it for and how it can react in different market conditions."

Selby adds that the industry must take lessons from the crisis and trustees must apply them across their portfolios. "Trustees and regulators clearly need to reflect on what took place and make sure they understand the investment decisions being taken on behalf of members," he says. "In particular, when LDIs are leveraged, trustees need to understand the impact it could have in the event gilt yields move sharply."

No longer a free lunch

The perception of LDI managed by third parties has shifted since 2022; Marandu says schemes are now understandably treating them with more caution.

"Trustees definitely now appreciate that there's no free lunch," Marandu says. "LDI is used to hedge liabilities while allowing assets to be retained in the scheme to grow. It is still a useful tool, but managers are now trying to use it in a thoughtful way and consider all the issues that come with its use."

He adds that the crisis highlighted how reliant some schemes were on third-party LDI managers.

"[Trustees] are not moving away from LDI because it's still seen as an important risk management tool, but they do need support"

"The industry might have delegated a bit too much to LDI managers," he says. "This is about farming out money to LDI managers. If pension schemes invest in an LDI fund, it gives up the transparency to see what that fund's doing on a day-to-day basis. They lose control over what exactly the LDI manager is doing and how they are using leverage and derivatives to increase exposures. It's an area that really failed. Ultimately, the industry standard for using leverage wasn't sufficient."

Lewis emphasises that LDI is a highly technical area and says there is now "undoubtedly" a greater level of awareness and understanding around it. "Trustees require support with it. They are not moving away from LDI because it's still seen as an important risk management tool, but they do need support."

Sharp notes that a scheme's perception of LDI is dependent on how impacted it was by the crisis. "We had some clients who were impacted by it in a considerable way, while some were only slightly affected and others weren't affected at all," he says.

"Often in a crisis it's a case of 'everyone was affected', or 'no one was', so the LDI crisis was interesting. A small number of schemes that were materially affected. In general, there is definitely a feeling that they need to be aware of these kinds of situations."

Not quite out of the woods

The new measures introduced after the LDI crisis have left most experts in the industry confident that schemes are more prepared for another potential gilts crisis.

However, State Street Global Advisors EMEA head of LDI, Jeremy Rideau, predicts the UK economy will slow down "significantly" in 2024 and argues that another LDI crisis could occur.

"Everyone is running lower leverage after the crisis, but that should not be the only lesson we learn from it," he says. "Making sure that you have a well-structured collateral waterfall and access to the right amount of capital is crucial."

He emphasised the importance of diversification within a pension portfolio, particularly in sourcing leverage from asset classes other than gilts.

Lewis adds that the industry should not be complacent about LDI. He acknowledges that the industry has moved to build up resilience after the crisis – introducing new regulations and changes to operations which mean that if the same crisis happened today, the outcome would be far better – but says stakeholders have been left with more questions than answers.

He says: "What would have happened if the crisis were twice as severe? Have we actually just moved the problem down the road? If everybody will still react in exactly the same way when funds run out of headroom – rather than at 2 per cent headroom, just changing this to 4 per cent or 6 per cent headroom – then there is still going to be a slow-motion car crash coming."

Written by Beth Ure, a freelance journalist