Leveraged
LDI

Mark Colton
mark.colton@bwcigroup.com

> *The sheer scale of the problem caught pension schemes off guard*

The now infamous "Mini Budget" in September 2022 sparked chaos in UK financial markets. The headlines were filled with dire warnings of pension schemes becoming insolvent, yet many schemes' funding levels have actually benefited substantially as a result of higher long term interest rates. So what was going on?

The problems largely affected schemes which had adopted a Leveraged Liability-Driven Investment strategy, or Leveraged LDI for short.

As the UK Pensions Regulator's statement at the end of November 2022 put it:

> *The turbulence in longer-dated UK government debt in late September exposed shortcomings in the resilience of the liability-driven investment funds, as well as in the operational processes of the funds and of pension schemes investing in them.*

To understand why leveraged LDI has been an attractive option for some pension schemes, you need to understand the financial woes of traditional Defined Benefit pension schemes. These promise regular pension payments to members throughout their retirement.

Money has to be set aside to honour these promises; these financial reserves are particularly sensitive to market rates of interest and inflation. If trustees can earn a high rate of return on their investments over the coming years, then they need to hold smaller reserves now, than if they were expecting a lower rate of return. On the other hand, if pensioners are promised inflationary increases, and these look like they are rising, then more money needs to be reserved now, than if expectations for future inflation were lower.

Over recent years, as market interest rates fell, the reserves needed to pay for the future pensions kept increasing, with the increases far outstripping the returns on the assets. Consequently defined benefit pension scheme funding levels were volatile.

If only there were an investment that increased in the same way as the liabilities did to reduce funding level volatility. Well there is! Enter LDI.

LDI is a carefully selected basket of Government bonds ("gilts") and risk-reducing derivatives, tailored to fit each scheme individually. It did the job, but was expensive to put in place. Many schemes simply couldn't afford it.

Leveraged LDI appeared to address this affordability challenge. Typically it required only a fraction of the initial investment of plain LDI, but provided the same investment cover. No extra money was required if interest rates went down: the leveraged LDI assets increased in value, and the schemes received payouts.

Sounds as bit too good to be true? There's no such thing as a free lunch and the "catch" with leveraged LDI is that if interest rates go up then the value of leveraged LDI portfolios goes down. Then the payouts are reversed; schemes were expected to pay for the losses. It was a bit like having a nervous mortgage lender constantly looking over your shoulder at the value of your house, and expecting compensation from you if its price slid.

Leveraged LDI was designed to avoid financial strains in the normal run of things. However, the 2022 mini-budget, with an unfunded £50bn package, was not in the normal run of things.

The investors in gilts became understandably nervous of a £50bn hole in their security, so they sold heavily. The surge in supply in the gilt market meant that gilt prices tumbled. This meant that leveraged LDI funds lost value too and LDI managers issued margin calls to restore things. The sheer scale of the problem caught pension schemes off guard. Many simply did not have sufficient liquid assets to meet these demands for additional liquidity over very short timeframes.

A downward spiral became inevitable; the pressures on gilts caused further price falls. In addition, regulatory pressure on providers of leveraged LDI funds to increase the capital in their funds, created more demands for payments from pension schemes. Ultimately the Bank of England stepped in to steady the ship by buying up the additional supply in the gilts market to stabilise prices and things started to calm down.

The irony is that leveraged LDI funds behaved as intended. The reason why Defined Benefit scheme trustees tried so hard to meet the calls for cash was because Leveraged LDI funds are such effective risk-mitigation tools. They just need to be part of very liquid portfolios.

Action is now being taken to reduce the risk of future problems arising around leveraged LDI. This includes the UK Pensions Regulator guidance setting out a list of 10 practical steps for trustees using LDI to ensure that they are better aware of the risks, have improved liquidity and that the processes are well-documented and kept up to date.

The Pension Regulator's Guidance for Pension Schemes using LDI

Practical steps to ensure that trustees are able to react quickly in response to stress in the market:

1. Confirm authorised signatories are up to date and ensure that governance is sufficiently robust, and that decisions can be made at speed in stressed market conditions.
2. Stress the non-leveraged LDI asset allocation (eg equities, corporate bonds) using a yield shock as set out by the NCA[1]s.
3. Stress the leveraged LDI pooled fund / segregated mandate using the same yield movement.
4. Calculate the required collateral amounts, and the type of assets (for example, gilts, cash).
5. Specify the dates when these collateral / margin calls need to be made.
6. Specify what assets would be sold, when the sell instructions would need to be given, and when the cash is settled.
7. Confirm who the instructions need to go by and the method of signature.
8. Confirm that necessary collateral / cash margins can be paid on the dates specified.
9. Confirm the asset allocation post collateral / margin call.
10. Document these arrangements and review them regularly.

[1] National Competent Authorities (collectively the Central Bank of Ireland and CSSF - Luxembourg)

BWCI