AEGON Asset Management

The UK's LDI crisis: lessons for Dutch LDI investors

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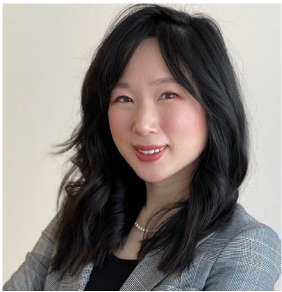

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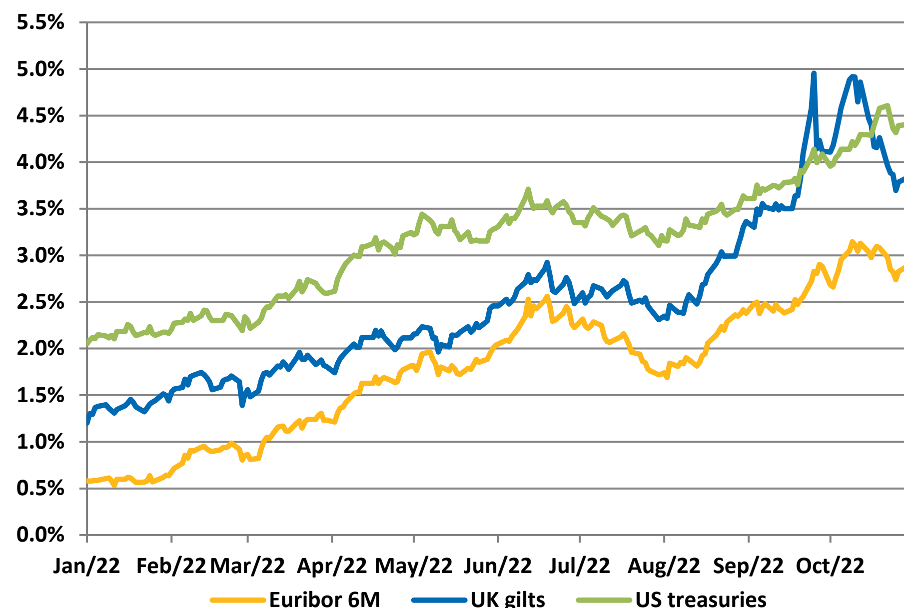
The world of Liability Driven Investment (LDI) strategies, one where "boring" is generally viewed as a strong selling point, became headline news in the UK last month. The much-awaited shift away from a low rate environment – generally a good development for pension schemes' funding positions – came rather too rapidly for many, so much so that the Bank of England became worried about systemic risk and decided to step in to stabilise the gilt market. This article looks at some of the background to what has happened and seeks to answer the question which may concern many Dutch pension scheme investors – could this happen to them too?

The UK gilts market - a fickle friend?

In line with government bond markets globally, long term UK gilt yields had been gradually rising during 2022. This was a response to increased inflation forcing central banks to increase short term interest rates, as well as a general increase in uncertainty around the future of the global economy.

Figure 1: 20-year gilt yields versus Euribor swap yield and US treasury yield



Source: Bloomberg & Aegon Asset Management. As at 31 October 2022.

Volatility in all government bond markets increased during this period but since August, the UK gilt market began to become more idiosyncratic. There was then a large spike, apparently as a reaction to a government announcement on 23 September of large scale tax cuts aimed at increasing growth. The market reacted unfavorably, concerned about the ability of the UK to manage its future debt obligations without creating long term additional inflation.

Between 19 and 27 September 2022, 20-year gilt yields rose by 1.5%. From the beginning of August the rise was 2.6%. Looking intra-day, the differences were even starker. Real yields on index-linked bonds (important for UK pension schemes as many pensions are linked to inflation) rose by similar magnitudes. This meant LDI pooled fund managers had to post increasing amounts of the collateral they held within their funds. As per their fund management process, they would then need to replenish most of this collateral to prevent the funds becoming too leveraged. This extra money would need to be found by pension schemes selling other investments, likely including gilts, and transferring the proceeds to the LDI managers, creating a potential selling spiral.

Most UK pension schemes will have pre-planned processes in place to do this – be that internal, delegated to a fiduciary manager, or organized by their investment consultants. However, a combination of the unprecedented size of the movements and their speed meant that many pension schemes will have been having to sell investments very quickly and potentially selling some which were not necessarily part of the planned process or were only to be sold as a last resort. With previous collateral calls, after more gradual interest rate increases, LDI managers would normally give pension schemes several days to provide additional collateral. In this case, however, the timelines were much shorter. Unexpectedly having to sell investments with a 3-day settlement period when the LDI manager would like the funds tomorrow would not have been in the pension schemes' collateral management plans!

In the worst case scenarios, LDI managers will have been forced to close swap or gilt repo positions and cancel the units held for pension schemes who did not meet the collateral requirements in time. This leaves them unhedged – fine if gilt yields continue to rise but in potential trouble if yields fall back.

The Bank of England was clearly aware of what was happening. Whilst it is not necessarily their responsibility to directly prevent pension funds experiencing such liquidity difficulties, they were sufficiently concerned about the potential contagion that they stepped in to buy gilts, thereby acting as a buyer for pension funds needing to sell gilts to realize cash but, perhaps more significantly, acting to support gilt prices. In short, they did not want to test the scenario that LDI managers default on many billions of pounds' worth of swap and repo contracts and the ensuing effect on the counterparties to those contracts and the wider financial system.

The impact on UK pension schemes' investment strategies

In principle, rising gilt yields is good news for pension schemes. Most pension schemes will not be fully hedged and therefore their funding positions will have improved. Some may have had triggers such that an improved funding position (or, as a proxy, a rise in gilt yields) would lead them to reduce risk in their investment strategy. If they have a longer term goal to buy out the pension liabilities with an insurer, this will have been a step closer to that goal, potentially even reaching it if they were already close.

This positive outlook for pension schemes which have made it through this surge in yields is, however, tempered by the impact of the speed at which it occurred. De-risking plans may have included increasing their hedge level which may now be impractical given the knock-on impact of the turmoil. Schemes may well also find their asset allocation is out of kilter with the strategic ranges they have set. Those invested in illiquid assets will likely be overweight those categories and rebalancing will therefore be an exercise in itself.

LDI managers which have experienced problems receiving collateral requests from pension schemes will necessarily be reviewing their LDI funds and the whole process by which they manage collateral calls. Schemes will have to take into account expected lower average leverage levels from their LDI managers which means less opportunity to invest in growth assets such as equities or, alternatively, accepting a lower hedge ratio. They will also be thinking about what might happen to gilt yields given the ongoing political uncertainty – is another yield surge on the cards and are they prepared with sufficient quickly realizable assets?

Is such a scenario possible in the Dutch LDI market?

The first question many Dutch pension schemes will be asking is whether euro swap yields could rise as much and as fast as UK gilt and swap yields did. The immediate response is a resounding "of course, they could". Whilst the rises seen in gilt yields and their speed have never been seen in euro swap yields, events like these are always seen as extreme until they occur. There are however reasons to think that such an outcome is less likely than in the UK:

- the broader base of the eurozone's economy meaning the actions of individual governments are less likely to affect the market overall;
- fiscal rules and mechanisms to restrict how much individual countries can borrow which, in turn, restrict potential taxation policies;
- the relative importance of the euro globally versus sterling and hence the willingness of international investors to hold euro government debt;
- the size of Dutch pension scheme exposure is a relatively much smaller part of the eurozone government bond and swap markets compared to the UK situation, so the risk of an upward yield spiral as pension schemes are forced to sell is lower. That said, Dutch pension schemes will not be the only institutional investors with exposure.

The next question is how well positioned Dutch pension schemes would be to meet their collateral needs and maintain their hedging policies. For a number of reasons, we believe that the Dutch market is generally in a better position:

- On average, larger, consolidated Dutch pension schemes which therefore should have the resources to have better collateral management processes in place;
- the popularity of fiduciary management in the Dutch market – an important part of a fiduciary manager's role is to oversee the pension scheme's assets, and therefore take a coordinating role to manage collateral transactions smoothly;
- Dutch LDI managers have generally been conservative in the leverage levels they offer compared to some UK LDI managers;
- Dutch interest rate hedging levels are generally lower than in the UK, due partly to the fact UK pension scheme indexation is largely compulsory and also, for strategic reasons, because many UK pension schemes are seeking to buy out their liabilities.
- Dutch LDI managers also often require the power to access some of pension schemes' other assets (with short settlement periods, e.g. t+1 settled). This means, at least in the first instance, they can transfer collateral directly, rather than needing to request it from the pension scheme.

Conclusions

Dutch pension schemes are important users of swaps in hedging their interest rate risk. Many larger schemes have segregated mandates and will have individual collateral management processes which will be regularly reviewed but which they are no doubt double-checking following the events in the UK. For small and medium-sized Dutch pension schemes, pooled LDI funds are a popular method of hedging liabilities and it is here that there was generally more collateral risk in the UK due to the time taken to sell assets and transfer the proceeds to the LDI manager.

We believe that the recent rises seen in gilt yields are extreme. Whilst it is impossible to discount the rapidity of such rises in the eurozone, there are reasons to believe it is less likely. We also believe that, in general, Dutch pension schemes are using less leverage than some UK pension schemes were and also have in place collateral management processes which mean they are better prepared for such rises. That said, pension schemes will no doubt want to look at their current position and stress test it against such extreme scenarios.

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