

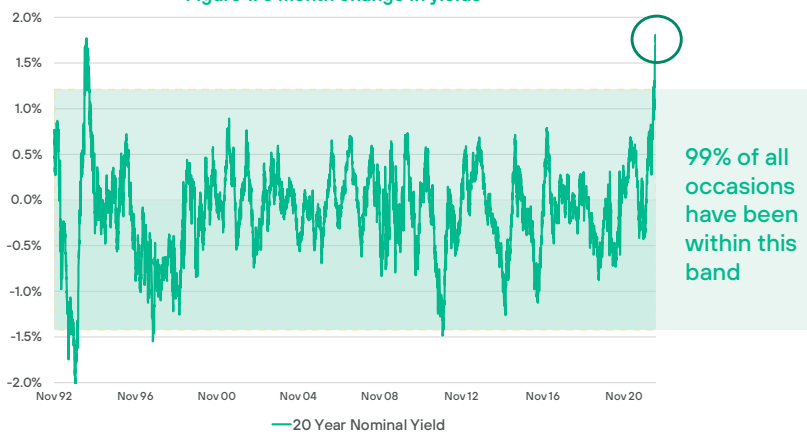
Vision Cast



Capital Punishment: Are you at risk of losing your hed-ge?

The speed of interest rate rises year to date has drained DB schemes of their liquid collateral. Can your scheme withstand another blow?

Figure 1: 6 month change in yields



Source: Bank of England

Many schemes will need to take action now, or face the ignominy of having their hedges reduced. In this short paper we pinpoint the immediate actions all schemes should undertake.

“Has the LDI friend now become a foe?”

Background

LDI has been the best friend to UK DB schemes over the last 15 years. Simple to use, superb at controlling unrewarded risk and (as a bonus) released additional capital to be reinvested into ever-rising markets as it moved further and further into the money. Has that friend now become a foe?

Whilst the risk control remains, year to date has seen the sharpest 6 month move in gilt yields (up or down) this millennium (see figure 1) which has led to supporting collateral being eaten up at a rate of knots. Many schemes are now in a position that only minor movements could be readily recapitalised and are being forced into selling longer term (monthly and quarterly traded) funds to replenish their liquidity buffers.

How have schemes fared in this volatile period?

Against longer term targets, this rate rising environment has been a tailwind that for most schemes will have offset the headwinds of credit and equity losses year to date. Below we show the expected change in Buy Out funding levels for schemes with typical higher risk and low risk investment strategies.

Buy Out funding level change	Higher risk strategy	Low risk strategy
Unhedged Tailwind	+12%	+6%
Equity / credit losses	-7%	-3%
TOTAL IMPACT	+5%	+3%

What does this liquidity squeeze mean for Pension Schemes?

Thankfully most schemes' funding positions are strong, so action can be taken from a position of strength – which is always easier. Unfortunately, time is now of the essence here so urgency is essential. We strongly recommend that Trustees immediately assess if action is required and, if it is, to move as quickly as their fund structure will permit.

Our calls to action are:



Assess how much liquid collateral remains based on up to date information and immediately top up if required.



If liquidity remains tight after the changes required in step 1, consider how to restrict further pressure in the short term:

- pause buy ins,
- postpone re-ups on private debt / equity / real estate programmes,
- slow pedal bulk transfer value exercises,
- diversify sources of leverage – e.g. sell physical equity or corporate bonds and replace with a stable liquid asset with a derivate equity or credit exposure to free up additional collateral.



Check funding levels, especially versus longer term targets, and re-define the journey plan following the changes required in step 1.



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