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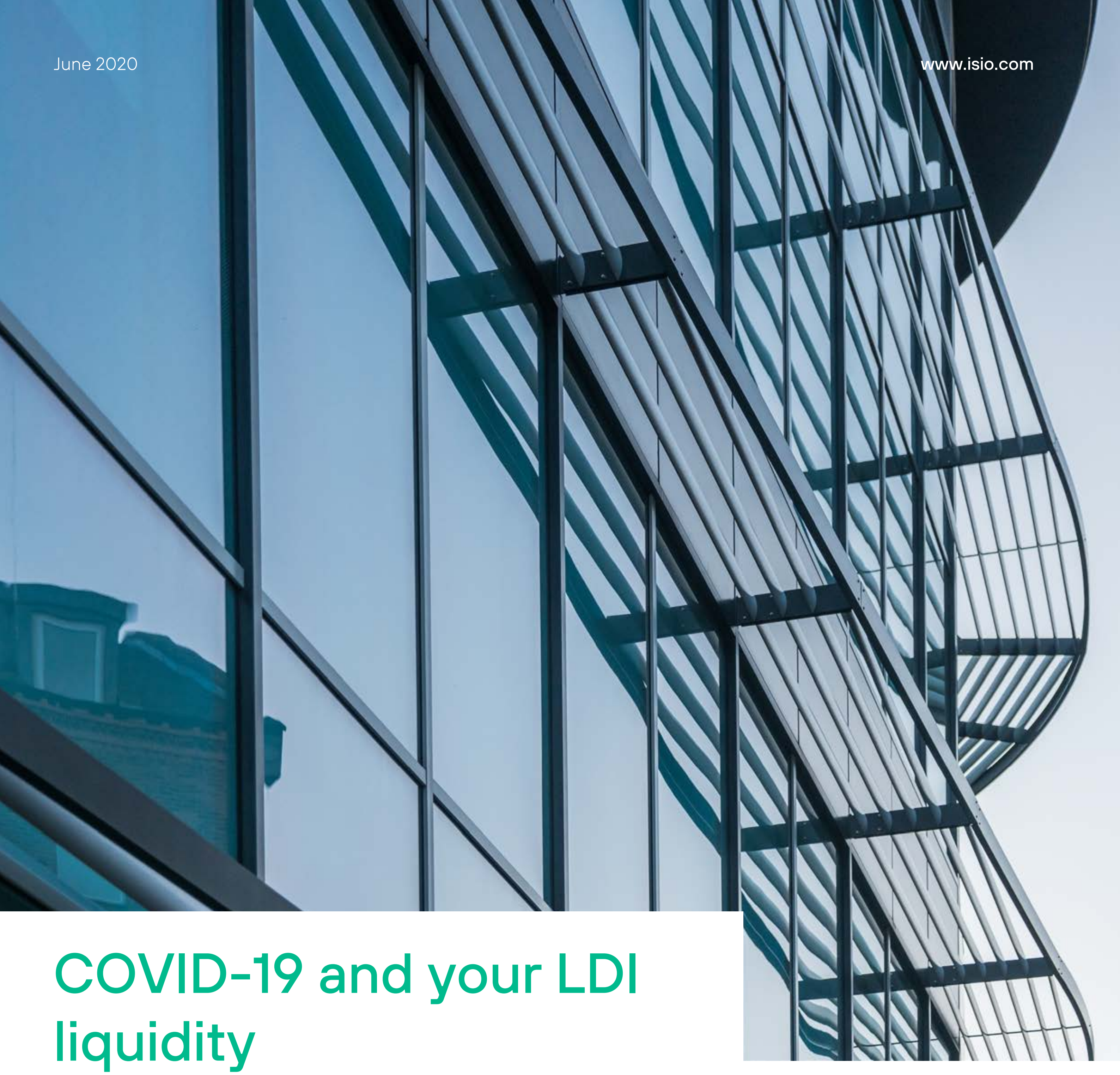

# COVID-19 and your LDI liquidity

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# LDI and illiquid markets don't mix...

Managing your Liability Driven Investments ('LDI') in periods of extreme market volatility, such as those witnessed in March, can be very challenging. Liquidity requirements tend to increase at exactly the time when transaction costs are high and market values are (potentially) low.

This paper looks at the LDI problems that the start of the COVID-19 crisis caused for pension schemes and, given the cloudy outlook for market volatility over the next 12-18 months, considerations to minimise the impact of similar liquidity issues in the future.

## Volatility could be here for some time to come...

The day-to-day gilt yield volatility over March has only ever been seen previously at the start of the Global Financial Crisis. Sharp increases in interest rates and falls in inflation expectations can lead to LDI managers requesting more capital from investors to maintain desired hedge levels. In addition, extreme volatility in either rates or expected inflation can provoke managers to call for more capital, even if the underlying markets are (currently) trading at levels consistent with the collateral held.

This level of gilt yield volatility is challenging for those with LDI mandates.

However, a well-structured arrangement with a suitable level, and type, of collateral can help navigate times like these.

Chart 1: 20-year nominal gilt yield movements to 29 May 2020


Source: Bank of England

**If capital calls cannot be met within the required timeframe, the scheme's hedge level will be reduced, re-introducing unrewarded risk into the scheme.**

## So, what are the problems?

Whilst the need for collateral top-ups has always been part of the operation of an LDI mandate, the March volatility has shone a light on an activity that simply hasn't been needed during a prolonged falling gilt yield environment. Many pension scheme trustees are now making liquidity management more of a focal point in LDI planning while the market outlook remains uncertain, giving consideration to:

- **Practicalities** – Uncharacteristically short notification periods from some LDI managers made raising the required capital an impossible task for a fraction of schemes. For example, some LDI managers asked for cash to be posted within a small number of days, whilst pension scheme executives were getting used to working remotely and balancing other, often complex, demands on their time.
- **Liquidity** – The collateral calls were made at a time when many asset classes had experienced a significant fall in value and liquidity had dried up. Selling assets would have crystallised losses and at trading costs 5-10 times the 'norm'.

## Where should we focus our attention?

### What if I have concerns over the cash/collateral levels?

You need to look at two areas – firstly, your 'direct collateral', which is what your LDI manager holds. Secondly, your 'supporting assets', which are the scheme's assets earmarked to give to the manager if the direct collateral is depleted.

| Direct Collateral | | |
|---|---|---|
| Action | Segregated arrangements | Pooled fund arrangements |
| **Check LDI mandate guidelines** | Double-check with your LDI manager and consultant that you are happy with your collateral levels.<br><br>Are the levels set suitable for your scheme's likely circumstances in extreme market conditions? | You will have no scope to change collateral levels, but you can still double-check that they are suitable, as well as considering any manager discretions, e.g. calling capital with less notice.<br><br>Do you want to switch to an LDI manager which can operate at a higher leverage, tolerate longer notice periods, or that can integrate 'tiers' of collateral into their LDI solution? |
| **Opportunities for cross-collateralisation** | A common collateral pool within the LDI arrangement can facilitate more efficient collateral management.<br><br>Can you use synthetic alternatives to 'growth' assets (e.g. equity/credit futures and options)? | 'Dual-purpose funds' (which provide hedging as well as exposure to equity/credit markets, for example) share a common collateral pool to give growth exposure and hedging in a capital-efficient way.<br><br>Would a dual-purpose fund help to free-up your scheme's liquidity? |

| Supporting Assets | |
| --- | --- |
| **Action** | **Why?** |
| **1. Review scheme return requirements** | The lower the returns you need from your supporting assets, the more liquid these assets can be (e.g. cash and 'near cash' investments).<br><br>Is the target hedge level appropriate given the collateral available to support it? |
| **2. Review stress levels** | Understand what level of gilt yield shock might be required to exhaust the scheme's direct collateral.<br><br>Were your existing supporting assets volatile over March 2020? Could they have been liquidated if needed? |
| **3. Optimise** | Whether you're in a segregated arrangement and can ask the LDI manager to do it for you, or in a pooled LDI structure, set up your scheme's 'collateral waterfall'.<br><br>This involves efficiently tiering collateral, setting the level and type, making it work harder while minimising risk of insufficient capital being available. |
| **4. Contingency planning** | In extreme times, even the best laid plans can be challenged. Trustees should 'scenario test' what they might do if a collateral call simply couldn't be made on time. This might include engaging with the sponsor for an advance on contributions, or perhaps allowing the level of hedging to fall for a period for example. |

### ... and what if I have no concerns over the cash/collateral levels?

Check whether your portfolio is carrying excess cash/liquidity and take the opportunity to optimise your liquidity profile where you can.

## Planning is key

Collateral calls are part of the operation of LDI portfolios and the risk reduction benefits they bring far outweigh the potential challenges accompanying them.

While there is no magic bullet for the problems posed by severe gilt yield movements, their effects can be mitigated by the development of a solid plan. And we're here to help you do that.

Stay safe.

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