Truss Me, I Don't LDI
Global Lessons from a U.K. Omnishambles

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In Italy, a country that has had 68 different governments since the end of World War II, the people have grown accustomed to political upheaval. The U.K. is looked upon differently, and typically has been regarded as an international role model for good governance and stability. At least, that was its reputation pre-Brexit. Since leaving the European Union, it appears it may have adopted Italy's proclivity for political crises.

Having lost its longest-reigning monarch on September 8 with the death of Queen Elizabeth II—herself a symbol of longevity and stability—the U.K. faced a political and financial crisis entirely of its own making later that month. The crisis also provided a shot across the bow for other nations on the intended and unintended consequences that can occur when fiscal and monetary policies are at odds with each other.

Leverage & Liability

On September 28, the new government of Prime Minister Liz Truss announced a fiscal plan that will go down in infamy. The U.K. Chancellor of the Exchequer Kwasi Kwarteng's announcement of extraordinary fiscal stimulus, which

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included tax cuts and a freeze on energy bills, came as the Bank of England (BoE) was set to begin quantitative tightening in an attempt to combat soaring inflation. This fiscal/monetary incongruity sent bond markets into a tailspin, and a violent sell-off in Gilt markets led to a liquidity crisis for U.K. pensions. Central to the drama was the use of a lesser-known investment strategy, Liability-Driven Investing (LDI).

LDI is designed to match investment payouts with cash requirements. This approach can involve the use of leverage in the repurchase agreement (repo) market, as well swaps to hedge exposures linked to interest rates, inflation and foreign exchange. These strategies have proven useful for pension plans in matching assets to future liabilities, but with leverage, there is always inherent risk, and that became crystal clear on September 28.

As bond yields soared, pension plans faced a deluge of margin calls. To meet those calls, the pension groups were forced to sell their more liquid assets, principally U.K. Gilts, as yields spiked by 100 bps in a single day and 10-year and 30-year U.K. Gilt yields reached 4.5% and 5%, respectively. The value of the pound, meanwhile, collapsed, and briefly approached parity with the greenback for the first time in its history. This left the BoE with little option but to step in as the "lender of last resort" and reinstate quantitative easing through the purchase of Gilts, thus safeguarding the U.K. bond market and avoiding a potential global contagion of financial markets.

A mini-budget that flew in the face of the BoE's fight against inflation and almost caused a financial meltdown meant both Kwarteng's and Truss's time in the hot seat was short-lived. First Jeremy Hunt was appointed Chancellor to replace Kwarteng, and then Rishi Sunak replaced Truss as Prime Minster—Truss's

Exhibit 1: United Kingdom 30-Year Gilt Yields

This line graph shows U.K. 30-year Gilt yields, from November 1, 2021 to October 31, 2022. After hovering between 1% and 3% for much of the period, yields touched 5% at the end of September 2022 amid a violent sell-off in Gilt markets.

Source: Beutel Goodman, Macrobond, as at October 31, 2022.

44-day tenure at Number 10 was the shortest in U.K. government history. This latest example of political bloodletting meant the U.K. has gone through five prime ministers since the Brexit vote in 2016, including three in 2022 alone.

Since then, the BoE started the quantitative tightening program it intended before the crisis, and global bond markets have responded favourably to Rishi Sunak taking the reins. Far from a honeymoon period, it's clear that the new government has some difficult decisions to make; the U.K. is facing a long period of austerity in order to bring government finances back in check. Double-digit inflation and a looming energy crisis mean it's likely going to be a long, hard winter for the British people.

On the LDI side, pension plans appear to have improved their funding ratios and it's expected that U.K. regulators will move to ensure greater liquidity and less leverage in the industry. This can be achieved by increasing exposure to liquid assets such as Gilts, while reducing the use of less liquid assets such as collateralized loan obligations (CLOs), as well illiquid assets such as infrastructure and real estate.

Governments, Central Banks Must Work in Tandem

The crisis provided a perfect example of what can happen when monetary and fiscal policy are not moving in concert. Similar to other central banks, the BoE is aggressively hiking interest rates (by 275 bps in the year to date, as at November 3) to try to tame inflation. The fiscal stimulus measures introduced by the Truss government, while aiming to support consumers (voters) impacted by rising prices, were themselves inflationary.

The BoE's monetary policy, similar to most other central banks around the world currently, is trying to dampen demand through higher interest rates, while Truss' fiscal policy was trying to stimulate demand through tax cuts. These powerful forces cannot act against each other in a properly functioning economy; forgetting this fact ultimately led to the downfall of the Truss government.

The crisis should also be a lesson for countries such as Canada and the U.S., where elected officials may want to help offset some of the negative impacts on consumers resulting from higher prices.

Both the U.S. Federal Reserve (Fed) and Bank of Canada (BoC) have been aggressively hiking rates this year, following a period of unprecedented fiscal stimulus stemming from the COVID-19 pandemic. The Trudeau government in Canada and the Biden Administration in the U.S. have introduced some inflation-relief measures, but neither government's actions to date appear likely to undermine central bank actions. In Canada, proposals are relatively modest (approximately $4.5 billion) and are focused more on low-income households. The U.S., meanwhile, has passed a wide-ranging *Inflation Reduction Act* (IRA). The legislation contains approximately US$500 billion in new spending and tax breaks that aim to boost clean energy, reduce health care costs, and increase tax revenues, but none of the elements of the Act are currently inherently inflationary, although we will continue to closely monitor how fiscal policy is affecting central banks' fight against inflation.

Liquidity Crisis

Events in the U.K. have shined a spotlight on the use of leverage by pension plans and the potential severe consequences of a lack of liquidity. U.K. pension plans had invested heavily in relatively illiquid assets such as infrastructure, real estate and CLOs, leaving them exposed when the margin calls came rolling in on September 28. This made the pension plans forced sellers of their most liquid assets such as stocks, corporate bonds and Gilts, upsetting the equilibrium of the markets.

Comparisons were made to the sub-prime crisis that became the Great Financial Crisis (GFC), and many observers wondered if this was a Lehman Brothers moment (where the collapse of Lehman in turn led to the collapse of AIG and threatened global contamination). Fortunately, this wasn't the case, as the BoE stepped in to steady the ship, averting a potentially much more serious and damaging

contagion. The Bank of England emerged from the situation with its reputation enhanced—as the lender of last resort, it did its job to protect the system. Crucially, it also gave a timeline for pension plans to get their balance sheets in order, as well as the government to change its fiscal position—both of which have since happened. Providing that three-week timeline also sent an important message that stimulus would not carry on indefinitely, and quantitative tightening would return soon.

History teaches us that tightening cycles can result in unintended consequences, and particularly for levered strategies. Also, in our interconnected global securities marketplace, a crisis in one country or region can also spread quickly across borders.

Lessons from Across the Pond

The U.K.'s problems with LDI have caused many Canadian and U.S. investors to question if such a calamity is possible here. Firstly, on the leverage front, U.S. and Canadian pension plans are generally less leveraged than their U.K. counterparts. This is partly due to the fact that Canadian pension plans tend to be less indexed to inflation and typically do not employ as many derivative strategies. That being said, leverage can be used, such as in the case of the Alberta Investment Management Corporation, which lost approximately $3 billion in wrong-way volatility trades during the pandemic-led market swings of March and April 2020.

In the U.S., derivatives are mostly used to hedge currency and interest rate risk. In addition, according to Fitch Ratings, U.S. state and local government pensions discount their liabilities using the same fixed long-term investment return rate that they assume for their assets, whereas U.K. corporate pensions discount their liabilities using variable, market-based rates.[1] The difference in assumptions means U.S. pension funds are less exposed to margin calls as their assets and liabilities tend to move together, thus generally keeping their funding fairly stable.

Regulation also plays a key role in managing risk in Canada, as public pension funds are actively supervised by the Office of the Superintendent of Financial Institutions (OSFI).

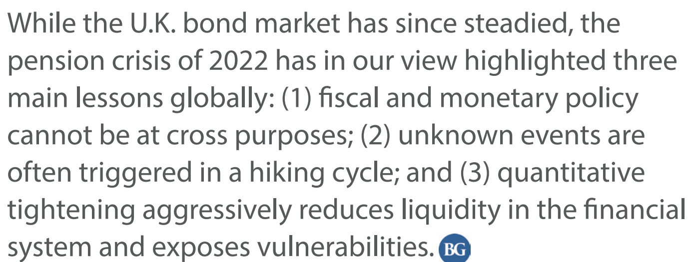
Looking at liquidity, and according to Statistics Canada, Canadian Trusteed Pension Funds held $2.21 trillion of assets as of Q1/22; this is broken down as follows: 38.7% equities, 25.8% fixed income, 7.8% infrastructure, 11.5% real estate, 4.7% short-term investments, and 11.5% assets that StatsCan considered "nationality unknown". Typically, infrastructure and real estate are considered illiquid assets. What is unknown is how much of the investments in equities and bonds are private (i.e., more illiquid) versus public (more liquid). Canadian pension plans appear to have sufficient liquidity, although it is an issue that remains front and centre for the BoC. In the 2022 Financial System Review, the Bank wrote that fragile liquidity in fixed-income markets is an ongoing structural vulnerability. A sudden spike in demand for liquidity from asset managers could exceed the willingness of banks to supply such liquidity, potentially causing large price movements and a freeze in some markets. The recent tightening in financial conditions and increased market volatility have also reduced liquidity.

In the U.S., pension funds do hold a significant amount of illiquid assets. According to the Public Plans Database, as at year-end 2021, U.S. state and local pension plans had US$4.5 trillion in assets, broken out as follows: 47.3% equities, 21.4% fixed income, 11.3% private equity, 8.1% real estate, 2.1% cash, 1.8% commodities, 6.1% hedge funds and 2% other. Typically, private equity, real estate, and hedge funds would be considered illiquid.

Overall, in our view, the chance of a U.K.-style pension fund crisis in Canada or the U.S. is relatively low but is still a risk to be monitored.

Lender of Last Resort

In the future, the U.K. pension crisis should act as a test case for the role of central banks. Since the GFC, central banks have been heavily involved in capital markets as quantitative easing has become an increasingly used tool. Markets have therefore become conditioned to central banks stepping in whenever liquidity dries up. Going forward, central banks arguably need to be more tactical, moving in as the lender of last resort when necessary and for a defined timeframe, rather than constantly stimulating the economy with quantitative easing.



While the U.K. bond market has since steadied, the pension crisis of 2022 has in our view highlighted three main lessons globally: (1) fiscal and monetary policy cannot be at cross purposes; (2) unknown events are often triggered in a hiking cycle; and (3) quantitative tightening aggressively reduces liquidity in the financial system and exposes vulnerabilities.

Notes

[1]"US Public Pensions Unlikely to Face UK Pension-Style Crisis", *Fitch Ratings*, 14 October, 2022. See link here: https://www.fitchratings.com/research/us-public-finance/us-public-pensions-unlikely-to-face-uk-pension-style-crisis-14-10-2022)

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