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Did the UK Stimulus Plan Create a Massive Liquidity Problem for UK Pension Plans?

Whatever doesn't kill you can still put you in a world of hurt

- Friedrich Nietzsche (with some edits by Advocate)

The market response to UK Chancellor Kwarteng's new stimulus plan has been fast and furious. What is the impact of sharply higher interest rates on UK pension plans? Advocate's analysis indicates that the potential for a pension liquidity squeeze is quite real given the recent rate spike and typical pension asset management practices.

[update on 28 Sep] The Bank of England announced this morning that it would buy an unlimited quantity of long-dated UK government bonds in order to "restore orderly market conditions". BOE's Financial Policy Committee mentioned "material risk" and the "unwarranted tightening of financing conditions and a reduction of the flow of credit to the real economy" as the reason behind the move. In Advocate's view, the specific targeting of long-dated gilts is a clear reflection of the pension liquidity concerns we highlighted in this article. However, the fundamental issue of pensions having to post short-term collateral against long-term assets remains unchanged and thus the return of another pension liquidity episode may just be a matter of time.

Rate Movement in the UK: Already Large and Even Larger post-Stimulus Plan

UK's latest stimulus plan unveiled by the Chancellor of the Exchequer Kwasi Kwarteng last week was not well-received by the market. The pound dropped by more than 5% and UK rates rose 120-150bps in the 4 days since the announcement. To put this move in perspective, it took 7 months (31 Dec 2021 – 29 Jul 2022) for 30yr UK swap rate to rise by the same amount.

FIGURE 1. 10YR (GREEN) AND 30YR (BLUE) UK SWAP RATES IN 2022

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Data period 4 Jan 2022 – 27 Sep 2022. Source: Bloomberg

The background: UK pensions are required by law to minimize their asset-liability risk gap

1. UK defined benefit (DB) pension schemes hold a total about £2.5Tn pounds ($2.7 trillion) of assets[1].
2. The UK Pensions Regulator requires DB pension plans to minimize their asset-liability risk using asset allocation and/or derivatives[2].
3. The great majority of UK DB pensions do not just entirely buy long-dated Gilts and inflation-linked bonds to fulfill this requirement.
4. UK pensions generally employ over-the-counter (OTC) derivatives such as interest rate swaps and total return swaps to bridge the asset-liability risk gap.
5. Investment Association[3] estimates that £1.6Tn notional of liability-driven investing (LDI) instruments are currently being used by UK DB pensions. These LDI hedges are bond-like in risk and thus drop in value when interest rates rise.

The problem: Rapid rise in rates may challenge many UK DB pensions' liquidity buffer

1. Almost all LDI derivative hedges are collateralized and cash margins must be posted daily to cover mark-to-market changes
2. According to Mercer[4], a typical UK DB pension has a cushion (liquidity buffer) to cover 1.5% rise in rates, an amount that has already been exceeded by the year-to-date rate rise even prior to the latest rate spike.
3. The 4-day rise of 120bps in 30yr UK swaps (from 21 Sep 2022 to 27 Sep 2022) is almost the entire size of most pensions' liquidity buffer
4. The cumulative year-to-date rise in 30yr UK swap rate is 350bps, more than double the average DB plan's buffer

UK Pension Regulator rings the alarm to alert pensions to review cash positions

On September 27th, David Fairs, an executive director with the Pensions Regulator (the UK pension regulator) issued an email statement that pension scheme trustees should understand the availability of cashflows subject to their ability to liquidate assets held in the context of "collateral requirements in a variety of markets, including one under great stress". This sounds to us like a clear warning that large collateral calls on LDI hedges may pose a significant challenge to UK DB pensions.

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[1] Source: UK Office for National Statistics
[2] https://www.thepensionsregulator.gov.uk/en/document-library/scheme-management-detailed-guidance/funding-and-investment-detailed-guidance/db-investment/matching-db-assets
[3] "Britain's pension regulator warns on cash flow risk from market stress", Carolyn Cohn, Reuters, Sept 27, 2022
[4] www.top1000funds.com/2022/09/warnings-increase-as-rising-rates-puts-ldi-under-strain/

UK DB pensions may have to liquidate £200Bn of assets to meet margin calls and maintain buffer

Using the aforementioned £1.6Tn notional of LDI hedges, we assume an average duration of 10-years for the hedges, which may be somewhat conservative. The impact of 120-150bps of rate rise in the mark-to-market of these LDI hedges would amount to margin calls totaling £190Bn to £240Bn, or 8-to-10% of the total assets of a typical UK DB pension plan. That is a significant portion of a DB plan's assets that may need to be liquidated to replenish a pension's liquidity buffer after margin calls.

The Liquidity Squeeze: Short timeframe to generate a large amount of cash

If a pension plan manages its assets in-house, the margin call may be met by liquidating its asset portfolio, subject to standard settlement periods that are usually more than a day. We would note that liquidating £200Bn of UK assets in the span of a week is no simple task in the best of times. This is especially true for less liquid pension investments such as hedge funds or private equity.

Most UK DB pensions hire external asset managers. Asking for cash back from external managers on short-notice on an intra-month basis may be quite difficult, if not impossible for typical asset management mandates.

In the Long Run, We Might Look Back on this and Laugh

In the long run, higher interest rates should have minimal long-term consequence to UK pensions that have immunized their asset-liability risk gap. The value of pension liabilities would drop in concert with the drop in their asset and hedge valuations, resulting in no material change to their solvency ratio. But that is of little comfort today for pensions requiring immediate liquidity to meet margin calls on their LDI hedges.

Final Thoughts – Short-Term Margin Call plus Long-Term External Asset Management Equals A Classic Liquidity Squeeze

UK DB pensions have some of the lowest asset-liability risk gaps in the world and have benefited from the multi-decade long bond bull market. Many UK DB schemes utilize OTC derivatives to manage and minimize their asset-liability risk gap These derivatives are usually collateralized via daily margin calls. The recent spike in UK rates in the aftermath of the latest UK stimulus plan resulted in significant losses in these LDI hedges and sizable margin calls from derivative counterparties that must be met quickly. Once a DB pension's cash buffer has been exhausted from the margin calls, its sole source of liquidity is its asset portfolio. If the assets are managed in-house, they may be liquidated to meet the margin calls. The unavailability of such cash from external asset managers on very short notice could be a major contributing factor to this pension liquidity squeeze.

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