Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Macroprudential measures for GBP Liability Driven Investment funds – Consultation Paper 157

Feedback from Mercer

April 2024

Do you have any specific feedback on the scope of the measures and the proposed definition of LDI funds as set out in the consultation paper?

Response:

We note that a number of funds, particularly bespoke funds built for a single investor (but also in some cases for pooled funds such as integrated solution fund ranges), contain a combination of LDI and non-LDI assets. Most typically the non-LDI assets held will comprise other liquid assets (most typically corporate bonds, equities and derivatives of other asset classes) though we have seen a range of structures. The over-arching liquidity guidance is important in this regard and it may not always be appropriate for all assets within the fund to count towards the yield buffer. The Central Bank may also wish to encourage allowance for an appropriate market stress on non-LDI assets when calculating the yield buffer.

For the liquidity guidance, would you see merit in setting a minimum speed for the transformation of non-eligible assets into eligible assets (in days)? What would you consider the right minimum number of days, considering the settlement period for posting collateral to maintain leverage (repurchase agreements and/or derivatives)?

Response:

Yes. Whilst we think the flexibility you provide around the potential to temporarily fall below 300bps is sensible and necessary, we think it would be useful to limit the time period over which such a position be allowed to persist. This ultimately minimises the potential that a fund below 300bps yield headroom is vulnerable to further rises in interest rates. You are right to note the settlement period in this consideration and something that inevitably extends the period over which non-eligible assets can be moved into LDI funds. Based on our experience, we would anticipate the required period to be up to 10 working days depending on the exact definition. This allows for communications to investors, a reaction period to calculate and place trades, pre-

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notification of trades and trade settlement cycles which we note may vary.

Do you have any specific feedback on the proposed calibration of the measures, including the proposed treatment of third party assets in the yield buffer, the buffer usability proposal and the level of the yield buffer?

Response:

From a practical perspective we think it is sensible to limit assets accounted for in the yield buffer calculation to only those held in the fund (and of appropriate liquidity) and to set a minimum yield buffer level commensurate with that. With that said, pension schemes will be reliant on these third party assets to replenish collateral and yield buffer levels when they fall below 300bps and so the value and liquidity of those third party assets is a relevant consideration. Where those third party assets are highly liquid, have short settlement periods and there are clear, automated processes for how third party assets are moved to LDI funds, there may be sense in some allowance for these assets in calculation of the yield buffer. In the same vein, funds that are able to recapitalise in a very short amount of time, for example in a single day, could be allowed to maintain a lower buffer.

Practically, the experience with our clients suggests that most LDI funds have sufficient collateral within the fund to be above the 300bps buffer and so will be in compliance with regulation at outset. In addition, most clients have a material level of liquid third party assets should they be required (at least in part driven by the UK Pensions Regulator's guidance issued in April 2023).

Do you have any specific feedback with the proposed approach to the implementation of the measures?

Response:

The implementation period of 3 months will be critical to ensure reporting and risk system readiness for these new measures. Regarding reporting to the Central Bank it would be useful to understand how you intend for a monthly calculated and reported figure to feed into the existing weekly reporting cycle.

In addition to the analysis provided in the consultation paper, what potential unintended consequences do you see from the proposed measures, and how could these be mitigated?

Response:

Whilst we agree the codification of existing measures will not lead to a substantial adjustment in the exposures for GBP denominated LDI funds, this does increase the regulatory reporting requirements on these funds and so is likely to increase the cost of running GBP LDI solutions.

We also note that mandating a target buffer level does lead to the risk that forced selling dynamics could simply start at an earlier point than they otherwise would. Whilst higher buffer levels (than those in place prior to the gilt market crisis) reduce the risk of this materially, they do not reduce the risk to zero. Potentially a principles based framework would be less likely to cause this to happen.

Do you have any further feedback on the proposals outlined in the consultation paper?

Response:

The guidance focuses on leverage management through re-capitalisation of funds rather than exposure management (i.e. increasing the £ NAV of the fund, rather than reducing the £ exposure

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of the fund). There are funds that expressly use exposure reduction as the means by which leverage is controlled. Such funds can still abide by the proposed regulations, albeit the "small and often" means of leverage management is different.

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