

The LDI crisis

What kinds of claims did we expect, what are we seeing in practice and how has our perception of the shape of potential claims changed?

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Topics to cover

- The kinds of “LDI claims” that were anticipated
- The kinds of issues I am seeing in practice
- Have views of the kinds of claims we might see changed?
- A “war story” from the financial crisis of 2007/08
- A few closing words

LDI - the (very) basics

- LDI are designed to achieve funding stability (not growth), matching assets and liabilities
- Historic focus on assets but increase in liabilities exceeded asset growth
- Need to close gap between assets and liabilities
- Investment theory changed – schemes started to invest in assets to match liabilities
- The birth of LDI – gilts-based

What kinds of LDI claims
did we expect ?

Setting the scene

- Value of gilts dropped, so cash calls to maintain hedges v liabilities
- Fire-sale of assets to enable schemes to meet calls
- Where no collateral provided, contracts closed
- Hedges against liabilities reduced to avoid contracts closing
- Schemes less hedged than anticipated
- Scene was thought ripe for claims

What might trustees ask themselves?

- Why couldn't we meet cash calls? Was our investment portfolio right?
- Should we have reviewed portfolio as value of gilts decreased?
- What steps should have been taken in first half of 2022?
- Why wasn't available cash posted in time?
- Did our arrangements with 3rd parties enable advice/input to be obtained?
- How did the pooled fund operate?
- Were the LDI appropriate and properly explained to us?

The kinds of issues I
have seen so far

Buying & selling of units in pooled funds

- Trustees hold *units* in pooled funds
- Number of units reflect how hedging is calculated
- Impact of any delay in sale of units?
- Impact of instructions to sell given in £s not units?
- Were the instructions to sell in accordance with industry practice?

Impact of past errors on hedging

- Due to pricing error, lower number of units sold than intended
- Scheme held more units than if pricing had been correct
- Correction of error by later reducing number of units
- Impact of hedging ratios being lower than reported?

Hedge monitoring

- Importance of effective hedge monitoring
- Importance of monitoring scheme liabilities for hedging purposes
- Importance of accurate data on scheme liabilities
- Reviewing whether hedge should be adjusted (and when)

Loss

- Fire-sale of illiquid assets – difference between usual market value (at what date?) and price realised
- Schemes closed out of contracts – funds released at low value
- Schemes reduced hedge and later adjustment was expensive
- Over-hedging
- Impact of historic gains?

A “war story” from 2007-08 credit crisis

Background

- Sophisticated LDI strategy (“credit default swap”)
- Collateral “cash” (or “equivalent to cash”) accounts
- Assets invested in asset- and mortgage- backed securities
- Investment strategy had to be re-set
- Claims against investment adviser and fund manager

Some issues in the case

- Did the advisers inform the trustees about the features of the LDI and the risks involved?
- Did the trustees understand the risks of the LDI strategy and the assets in the collateral accounts?
- Was the LDI strategy appropriate for the scheme?
- Did the fund manager do proper benchmarking?

Some issues in the case (2)

- What *caused* the loss – poor advice or the 2007/08 financial crisis?
- But should advisers protect v losses due to extraordinary events?
- Did the trustees have to show the crisis (and its extent) was reasonably foreseeable?
- Relevance of wide terms of investment management agreement
- Role of benchmarking
- Defendants had distinct but overlapping duties

Some concluding remarks

- Need to wait for “war stories” following mini-budget
- Expected claims based on failures to react *pre* and *post* budget
- Questions about the basics of LDI management and hedging
- LDI crisis shone a light on possible failings or crystallised losses
- Few questions about whether LDI was appropriate
- Impact on claims environment unclear



Questions?



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