Commission de Surveillance du Secteur Financier

# Macroprudential measures for GBP Liability Driven Investment Funds

## Public Consultation Reply Form

Commission de Surveillance du Secteur Financier

# Macroprudential measures for GBP Liability Driven Investment Funds

## Responding to this paper

The Commission de Surveillance du Secteur Financier (hereafter 'CSSF') invites all relevant stakeholders to provide responses to the specific questions listed in the Consultation Paper on Macroprudential measures for GBP Liability Driven Investment Funds, published on the CSSF website.

### Instructions

Please note that, to facilitate the analysis of the responses, you are requested to use this file to provide your response to the CSSF so as to allow us to process it properly. Therefore, CSSF will only be able to consider responses which follow the instructions described below:

- use this form and send your responses in Word format (pdf documents will not be considered except for annexes);
- if you do not have a response to a question, do not delete it and leave the text "TYPE YOUR TEXT HERE".

Responses are most helpful:

- if they respond to the question stated;
- contain a clear rationale, including on any related costs and benefits; and
- describe any alternatives that CSSF should consider.

### Naming protocol

In order to facilitate the handling of stakeholders responses please save your document using the following format:
CSSF_LDI Funds_ NAMEOFCOMPANY_ NAMEOFDOCUMENT

E.g. if the respondent were ABCD, the name of the reply form would be:
CSSF_LDI Funds_ ABCD_REPLYFORM or CSSF_LDI Funds_ ABCD_ANNEX1

### Deadline

The deadline for receiving feedback is **18 January 2024.**
All contributions should be provided by filling in the present response form and sending it to the following address: opc_prud_risk@cssf.lu.

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### Publication of responses

The CSSF intends to make feedback available on its website after the deadline for receiving responses has passed. Please do not include commercially sensitive material in your response, unless you consider it essential. If you do include such material, please highlight it clearly, so that reasonable steps may be taken to avoid publishing that material. This may involve publishing feedback with the sensitive material deleted and indicating the deletions.

While as indicated above, the CSSF will take reasonable steps to avoid publishing confidential or commercially sensitive material, the CSSF makes no guarantee that it will not publish any such information and accepts no liability whatsoever for the stakeholders' consultation responses that are subsequently published by the CSSF. Please be aware that you are making a submission on the basis that you consent to us publishing it in full.

### General information about respondent

| Name of the company / organisation | **Columbia Threadneedle Investments (Columbia Threadneedle Management Limited)** |
| --- | --- |
| Activity | Investment Manager |
| Are you representing an association? | No |

### Introduction

Please make your introductory comments below, if any:

"TYPE YOUR TEXT HERE"

**List of questions**

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| QUESTION 1: | Do you consider that the proposed calibration of the minimum yield buffer is appropriate and the calculation of the actual yield buffer sufficiently clear? |

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| ANSWER 1: | Yes, we consider the proposed minimum yield buffer of 300bps as appropriate, given the definition of "yield buffer" set out in section 2 (page 10) of the consultation paper:<br>"…the level of increase in yields that a fund can withstand before its NAV turns negative."<br>In our view, this definition is sufficiently clear. We consider the proposed calibration to be appropriate for several reasons. In our experience, a yield buffer of c. 300bps is a prudent figure; allowing for a measure of subsequent market moves to be absorbed before we are required to reduce client exposure or accelerate a call for additional capital, in turn allowing clients adequate time/leeway to recapitalise funds in an orderly manner and minimising the likelihood of having to sell gilts (or other LDI assets) to reduce leverage. We also consider the proposed threshold prudent considering the extreme market moves experienced during September and October 2022. In addition, we are already working to minimum yield buffers of 300bps across our LDI fund range and have been doing so successfully since the 2022 gilt market crisis. We therefore see this minimum buffer calibration as a codification of the current market-wide status-quo.<br>However, we note that the consultation paper contains several other definitions, which are somewhat ambiguous or unclear. Specifically in section 3.1 (page 10) of the consultation paper:<br>"This will require funds to develop a weighted average of the interest rate sensitivity of all their exposures to calculate their portfolio duration (and convexity)" footnote: Where exposures = assets (excl. m-t-m derivative positions) + net notional of derivative positions."<br>We agree that it is essential to include convexity in the assessment of the buffer, however this description is not the same as the impact of a specific increase in yield. Duration and convexity are not constant, nor are they clearly defined or reported between organisations and systems. This calculation in section 3.1 could be meaningfully different for a shock of 300bp (and, importantly, overstate the resilience of a fund). We think that the more fundamental definition "…the level of increase in yields that a fund can withstand before its NAV turns negative." is preferred as it allows some discretion over the precise calculation, whilst being very clear regarding the expected outcome. All other definitions or explanations should be removed from any policy to avoid ambiguity. For example:<br>"The yield buffer is approximately equivalent to the assets of a fund not committed to maintain their leverage (i.e. collateral/margin for repo/gilts)."<br>This introduces ambiguity as to whether initial margin or haircuts on repo are included in the definition or not.<br>We would strongly urge that these ambiguous references be excluded from the definition for the following reasons: |

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| | - Each adds significant complexity to the calculation which gives rise to potential inconsistencies between managers, whilst at the same time having only a modest impact on the calculated buffer (e.g. c. 15-30bps across our fund range).<br>- Including these ambiguous references in the calculation is likely to lead to unintended behavioural consequences. For example, managers may elect to trade repo only with banks that do not apply a haircut, which may not be the most cost-effective solution for investors and therefore impact investor returns. It may also encourage managers to trade swaps bilaterally rather than through clearing, to avoid the need to post initial margin. Whilst having a small positive impact on the calculated buffer this is entirely counter to the regulatory direction of travel for the last decade, which has incentivised use of central clearing to minimise systemic risk.<br>- LDI managers will typically have sufficient flexibility built into their investment parameters to allow them to respond to any detrimental changes to initial margin or repo haircut requirements. For example, if repo haircuts increased to the point that they were materially detrimental to investors or buffers, managers could employ gilt total return swaps. Similarly, if initial margin requirements became materially detrimental, managers could hedge more via gilts or trade bilaterally. This flexibility could be brought to bear only when necessary. However, prescribing that haircuts and initial margin requirements are part of the buffer calculation risks forcing a behaviour from the outset and in perpetuity, that increases costs and systemic risk.<br>There are also several references to 300-400bps which are slightly contradictory to the explicit 300bps minimum buffer referred to elsewhere in the consultation paper. Our understanding is that it is expected that typical day to day buffers will be 300-400bps (but could clearly be higher), and that action must be taken if the buffer falls below 300bps. Our expectation is that only the 300bps will be referenced in any final drafting, but we note for clarity and to avoid any future potential ambiguity.<br>Please also refer to our response to Question 5 (usability) and our comments on the proposed introduction of a monthly average yield buffer requirement. |
| QUESTION 2: | Would you see merit in setting a minimum speed for the transformation 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)? |

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| ANSWER 2: | We believe that there may be two potential scenarios here. The first is where the asset transformation occurs outside the LDI fund (i.e. growth assets are sold and cash is moved into the LDI Fund) and the second where it occurs within the fund. Where the transformation occurs outside the LDI fund, we have taken the phrase "speed for the transformation into eligible assets" as referring to the timeframe between calling for additional capital (in response to the yield buffer falling below 300bps) and that capital arriving in the LDI fund by means of an additional purchase of fund units. Where the transformation occurs outside the fund, it is intended to remediate and top-up the buffer to above 300bps. Where it occurs within the fund, the overall buffer size does not change, we simply increase the quantity of eligible collateral/margin assets within the buffer.<br>With respect to where the transformation occurs outside the fund, we do not see merit in setting a minimum speed (i.e. maximum timeframe) for this activity. Any sort of prescribed maximum timeframe may force hedging to be reduced and positions sold when they otherwise may not need to have been, leading to forced sales in the market.<br>It is in investors' interests to respond to capital calls as quickly as possible. This minimises the likelihood of having to sell LDI positions to reduce leverage should a stop-loss threshold be breached (see below). Following the gilt crisis, we believe this point is generally well understood across the industry and client base. Indeed, collateral waterfalls and client governance models have widely been adjusted to support a rapid response to LDI capital calls. For example, clients have created streamlined decision-making processes and/or delegated the rebalancing of LDI portfolios to LDI managers, advisers, and fiduciary managers.<br>Rather than setting minimum timescales for transforming eligible assets, we believe the more prudent model is the one we currently operate of an additional stop-loss trigger, whereby having breached the 300bps minimum yield trigger, if markets continue to fall (yields rise), before recapitalisation proceeds arrive, the stop loss trigger accelerates the timescale for the call that has already been made. We believe that this approach strikes the optimum balance between giving clients adequate time to recapitalise in normal market conditions, whilst preserving the flexibility to take accelerated action to protect fund solvency.<br>In any event, we observe that LDI managers have shortened the notice periods relating to capital calls into their multi-client LDI funds following the gilt crisis, making this a somewhat moot point. In addition, for single client funds, it is not necessary to specify a maximum timeframe for recapitalisation. As mentioned above, clients are incentivised to recapitalise quickly to minimise the risk of hedging having to be reduced; specifying a maximum timeframe may have a detrimental impact and force LDI asset sales where additional capital is in-transit, but perhaps not arrived due to operational or settlement delays beyond the control of the LDI manager, and markets remain benign. In any event, the stop loss threshold would serve as the additional safety net, forcing hedging to be reduced if additional capital is not received and |

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| | headroom deteriorates further. An alternative way of looking at this is that a maximum recapitalisation timeframe would have the effect of accelerating the stop-loss action in scenarios where market movements do not justify it.<br>The preceding comments are made on the understanding that LDI managers and investors are still required to act in a timely manner to restore resilience should the yield buffer fall below 300bps, which could be evidenced by LDI managers even if the action was not yet completed.<br>Where the transformation of assets into eligible collateral occurs within the fund, we refer to our response to Question 4 (below), whereby we recommend that only assets on the fund's balance sheet and with appropriate liquidity/settlement cycles are included in buffer calculations. Assuming buffer eligible assets have settlement cycles of T+4 or less (including pre-notification periods) a maximum timeframe (T+4) for conversion of those eligible assets, into eligible margin/collateral assets could be applied. However, there could be instances where the manager elects not to undertake to translate these assets into eligible collateral/margin as additional assets are forthcoming from an alternative source e.g. income due from credit or a client contribution into the portfolio. We would suggest that codifying a minimum settlement cycle for buffer eligible assets captures this overall principle whilst leaving flexibility of application day-to-day. |
| QUESTION 3: | Do you agree with the proposed definition of LDI funds? In particular, do you consider that the definition is sufficiently clear and specific (i.e. only covering LDI funds)? |
| ANSWER 3: | We agree with the definition of LDI funds which is set out in section 3.2 (page 11) of the consultation paper as: "Any fund whose investment strategy seeks to match the interest rate or inflation sensitivity of their assets to that of their investors' liabilities" as it is clear and specific. We note that the proposed rules are only intended to apply to GBP LDI Funds and suggest that this is made clear alongside any definition of LDI funds. |
| QUESTION 4: | Do you agree that LDI funds should not be allowed to consider for the yield buffer calculation any assets that are not their balance sheet? If not, please elaborate. In this case, what safeguards should in your view be considered? |

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| ANSWER 4: | Yes, we agree that LDI funds should only be allowed to consider assets that are on their balance sheet for the purpose of calculating the yield buffer. Assets that do not sit on an LDI fund's balance sheet are not readily available for day-to-day collateral purposes without having to be moved into the fund first, which adds an additional operational step to the process, as well as some lead time. Additionally, non-balance sheet assets may not be under the unique discretionary control of the LDI manager, there is no guarantee that those assets would be available to support positions within the LDI fund if needed. Furthermore, bank counterparties and clearing houses will have recourse to the assets of the LDI fund should collateral not be forthcoming. They will not have recourse to assets outside the LDI fund and so would not consider such assets when assessing the leverage of the LDI fund. It would therefore be imprudent and inconsistent for the LDI manager to consider such assets outside the fund when assessing the yield buffer.<br>Even assets within the LDI fund (i.e. on its balance sheet) should be subject to an "appropriateness test". We would suggest that only assets (directly held or via pooled funds) that are daily dealt with T+4 or shorter settlement cycles (including any trade pre-notification period) should be considered in the yield buffer calculation. Assets with less frequent liquidity or longer settlement cycles cannot reasonably be expected to support day-to-day collateral activity. |
| QUESTION 5: | Do you consider that the mechanism driving the buffer usability is appropriate and sufficiently clear? |

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| ANSWER 5: | Please also see our response to Question 1 above.<br>In summary, we support the intended flexibility of application of the yield buffer. In terms of monitoring a yield buffer, we believe daily monitoring is appropriate and that this metric should be used to trigger recapitalisation as necessary.<br>However, we do not agree that a month-end averaging mechanism is practical. There may be scenarios beyond the LDI manager's control, which will not be known until after the event, where the manager is unable to meet this rule. We highlight that funds will only be aware that they have not met this requirement after the fact; it is not possible in all cases to adhere to a retrospective rule. There may be scenarios where a fund (or funds) falls below the desired 300bps monthly average for more than one month in four, despite the manager consistently recapitalising in a timely manner when the buffer falls below 300bps. For example, where yields rise persistently, resulting in multiple consecutive calls, the manager will be triggering capital calls at the 300bps threshold and as soon as, or even before, the first call settles a subsequent call is required. The prudence built into the buffer means that fund solvency remains adequate throughout this example period, but the average monthly yield buffer may be less than 300bps. Practically speaking, it is very difficult to pre-emptively adhere to a requirement that can only be assessed after the event (i.e. month-end) and where adherence is beyond the control of the manager unless some sort of predictive or pre-emptive action is taken. We also do not see pre-emptive action as appropriate as it is generally difficult (if not impossible) to accurately predict yield movements in advance, and such an approach would lead to recapitalisation taking place before the buffer falls to 300bps, ultimately undermining the capital efficiency associated with LDI funds, to the detriment of investors. Our view remains therefore, that the monthly calculation should be removed, and daily monitoring remain the default model.<br>We do, however, note references to the framework being intended to avoid the forced sale of LDI assets and to the intended flexibility of application by the CSSF, which we welcome. The avoidance of forced LDI asset sales is consistent with the objectives of our LDI clients who generally wish to maintain their liability hedging positions in all market conditions. We would be pleased to engage with the CSSF to share market intelligence, which may help inform to the appropriate application of this flexibility. Such collaboration is likely to lead to the avoidance of unintended consequences, to the benefit of investors and markets more generally.<br>In terms of usability, whilst we support the headline definition of the buffer, we highlight several potentially ambiguous references in the consultation paper which would benefit from being removed or clarified in final drafting (see our response to Question 1 above).<br>We also note the following text from section 3.4 (page 13) of the consultation paper:<br>"It is proposed that fund managers will only notify the CSSF that their yield buffer has fallen below 300 bps in real time if they expect the deviation to be prolonged and/or substantial. Minor deviations of the yield buffer below the minimum 300 bps do not |

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| | need to be reported in real time, thus providing LDI funds with the incentive to re[1]build their buffers appropriately”<br>Assuming action is taken when the buffer falls below 300bps, any sustained deviation will be the result of markets continuing to erode the buffer at the same time as it is being rebuilt, necessitating multiple consecutive capital calls. It is therefore impossible to predict whether the deviation will be substantial or sustained as it will be entirely driven by market conditions. There is therefore the risk that managers fall foul of this requirement by not pre-empting the deviation, or simply notify all deviations to the CSSF to avoid this risk.<br>Our suggested approach would be that managers monitor against the 300bps minimum yield buffer threshold daily and take action to reinstate portfolio headroom should the yield buffer fall below this. Any period where the portfolio yield buffer is below this should solely be the result of the lead time associated with the remedial action. We do not foresee any scenario where a manager declines to act once the yield buffer falls below 300bps. |
| QUESTION 6: | What potential unintended consequences do you see from the proposed measures, and how could these be mitigated? |

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| ANSWER 6: | Any yield buffer is very sensitive to the calculation methodology and model assumptions used. It is unrealistic to expect all managers to model yield buffers in precisely the same way. Therefore, some pragmatism should be employed in comparing numbers between managers and when assessing numbers to multiple significant figures or decimal places.<br>As we have detailed in our response to Question 5, a potential unintended consequence of requiring managers to report and comply with average monthly yield buffer requirements is that it may force pre-emptive de-leveraging, either through calling capital into LDI funds or through selling LDI assets. For example, if a manager has experienced a monthly average below 300bps they may be forced to take pre-emptive action the following month if yields continue to rise, to avoid a second consecutive month with a below-300bps average. This pre-emptive action is unlikely to be in the best interests of clients, and we would suggest that it is unnecessary given the increased buffers currently employed. It would simply be a forced response to the monthly averaging approach. To avoid this, we would again suggest focussing on daily monitoring against the 300bps threshold and dispensing with the monthly averaging concept, in combination with an additional stop-loss threshold as described in our response to Question 2.<br>If off-balance-sheet assets are permitted in the buffer calculation we would expect commercial pressure to include various assets, of which LDI managers may not have direct visibility in the calculation. This would introduce significant operational risk, complexity and potentially cost, as LDI managers would need to have regular, reliable and scalable visibility of asset values and transactions. Regulatory monitoring of this would also be challenging with a risk that resilience of strategies is materially understated but with little transparency. It would also add risk and complexity for non-LDI managers holding non-LDI assets of a client, who will be under pressure to support the buffer calculation process. There is material scope for off-balance-sheet assets to be sold unbeknown to the LDI manger, inadvertently reducing the buffer, and creating significant systemic risk as it would potentially force a sale of LDI assets when this discrepancy comes to light. The clear solution is to permit only assets on the fund's balance sheet to be included in the buffer calculation. |
| QUESTION 7: | Do you have any other comment on the proposal? |

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| ANSWER 7: | We note that the proposed codification of yield buffer requirements will only apply to Luxembourg domiciled AIFMs and that the consultation paper has been produced following coordination with the CBoI.<br><br>We welcome regulatory coordination and consistency of rules between different jurisdictions where they apply to the same product and end user market. To this end, we would expect any formal rules implemented by the CSSF in respect of sterling LDI funds to be identical to any rules implemented by the CBoI in respect of the same. We would also ask for any clarity that the CSSF can provide in respect of Luxembourg domiciled sterling LDI funds managed by EU AIFMs. For example, would any rules applying to LU AIFMs be mirrored in guidance in respect of EU AIFMs. Any differences arising between fund structures and jurisdictions could have the unintended consequence of creating a competitive advantage/disadvantage based solely on the legal jurisdiction and management framework of a fund range.<br><br>Finally, we would welcome further dialogue with the CSSF on any of the points raised above and thank you for the opportunity to feed into this process. |

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