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.

Commission de Surveillance
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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	**"Dr. Laura E. Kodres"**
Activity	"Consultant"
Are you representing an association?	"No"

Introduction

Please make your introductory comments below, if any:

"The following comments represent my own opinions and are not to be attributed to the Golub Center nor the International Monetary Fund. I am the former Distinguished Senior Fellow at the MIT Golub Center for Finance and Policy at the Sloan School of Management. Prior to this appointment I spent 25 years covering financial policy (specifically macroprudential policy) at the International Monetary Fund." My additional work on the topic of the LDI funds and the gilt market dysfunction can be found at https://papers.srn.com/sol3/papers.cfm?abstract_id=4445632.

Commission de Surveillance du Secteur Financier

List of questions

Commission de Surveillance du Secteur Financier

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?
ANSWER 1:	"Using the work of the Central Bank of Ireland and its similar proposal as a guide, a 300-basis point buffer would have prevented the large, forced sales of gilts in October 2022. Hence this calibration is well-formulated and convincing. The description of its calculation could usefully include the fact that the buffer is meant to keep the net asset value (NAV) of a GBP LDI fund above zero and thus ensure the fund continues as a "going concern" during a period of stress. As well, the description should explain how the weighted average (the duration) of the assets (including the notional principal of derivatives) relates to the 300 basis points. That is, that the duration x 300 basis points provides an estimate of the sensitivity of the portfolio to the 300 basis point yield changes. The level of the buffer has been calibrated based on the need for collateral and margin in the past (relative to the October 2022 shock). There is no mention of the potential to move positions that are currently in the OTC markets to Centralized Counterparties (CCPs). Clearing of repos and use of derivatives in exchange markets that utilize a CCP would require different (potentially higher) amounts of collateral and margin. The move to CCPs could imply higher buffers but this is offset by improved margin calculation transparency, the vetted clearing member structure, and the more intense oversight of the risk management capacity of CCPs relative to the LDI managers or their OTC counterparties. The document could be more explicit that the calibration assumes the market structure of GBP LDI funds (e.g., their use of OTC markets) is unchanged."
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)?

ANSWER 2:	Ideally, any LDI fund should have the ability to obtain assets from the investor in the same time frame as they are required to post with their counterparties (daily or even intraday). However, the purpose of the buffer is to "buffer" this immediate pass-through during a period of stress. Hence the buffer size should be directly calibrated to how quickly a fund can obtain or, if needed, transform the necessary assets to provide eligible collateral or margin. The 300-basis point yield buffer was demonstrated in the Central Bank of Ireland's document to be sufficient to avoid the need for replenishment for most of their funds, showing the need to (fire) sell a small amount of gilts. That said, the 5-days that appears in the UK's Financial Policy Committee's LDI buffer guidance appears too long for most counterparties during stress. Gilts currently settle in less than 5 days (T+2) with pressure to move to T+1. Some evidence (perhaps from the LDI fund managers, their counterparties, or the LDI investors) about the length of time it now takes for them to obtain and transform investor's assets into eligible collateral/margin is needed to assess the right minimum number of days, contingent on the proposed buffer size. UK pension schemes' use (or potential use) of collateral transformation services should be part of this analysis. Thus far, without further evidence it is inadvisable to determine a minimum number of days. Any existing evidence about relevant time frames is not reported in the document so an assessment of a potential number of days cannot be made without additional information.
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:	"Given the Luxembourg authorities can only impose domestic regulations on the GBP-denominated LDI funds within its own jurisdiction, the definition of an LDI fund appears broad enough (and activity-based) to encompass the funds that were implicated in the gilt market dysfunction. The language that requests those seeking authorization as GBP LDI funds in Luxembourg to self-report that they are within the existing framework appears reasonable. Additionally, the possibility that the CSSF may "conduct thematic analysis on the in-scope population of funds" could incentivize self-reporting, assuming there are some consequences for failing to self-report. What those consequences are should be made clear. "
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?

ANSWER 4:	“The rationale of excluding 3rd-party funds from inclusion in the buffer as mitigating direct contagion across assets held outside the LDI fund is mostly valid. Another reason for excluding 3rd party assets would be to avoid hidden buildups of leverage as LDI fund managers may rely on such assets to help offset buffer reductions during a period of stress. The ability to dip below the buffer (and the remote possibility to “disapply” the buffer by the CSSF in exceptional circumstances) helps to remove a predilection for (hidden) leverage. It bears mentioning that contagion can occur due the perceptions (not the positions) of market participants and their incentives to move early to avoid crystalizing larger losses later. An exclusion of 3rd party assets will not prevent such contagion. The document also notes that prescribing haircuts on external assets is too difficult to determine and enforce. While time-varying (countercyclical) haircuts for such assets are likely beyond the scope of this policy, the notion that there should be a haircut floor on the repo transactions in the LDI portfolio is not. Reportedly, a zero haircut was imposed by repo counterparties (who are regulated) and clearly this is inappropriate to offset counterparty risks. Haircuts floors on bilateral repos that go through a regulated entity can be imposed and, with additional resources, enforced. The top 3 Alternative Investment Fund (AIF) managers account for 90 percent of the number of LDI funds, suggesting risk-based enforcement of a haircut floor through these entities would not require excessive resources.”
QUESTION 5:	Do you consider that the mechanism driving the buffer usability is appropriate and sufficiently clear?
ANSWER 5:	“Yes, the example of the mechanism for buffer use is clear. The ability to dip below the buffer one month out of four and the (remote) possibility that the CSSF will “disapply” the buffer during a systemic event both assure that cliff effects or counterproductive fire sales to maintain the buffer are not done for regulatory reasons. However, allowing an LDI fund to dip below their buffer does not ensure they will use it, as doing so will have reputational implications. Similar issues were present during the COVID-19 pandemic with a relaxation of leverage ratios and capital requirements not being used by most banks.”
QUESTION 6:	What potential unintended consequences do you see from the proposed measures, and how could these be mitigated?

ANSWER 6:	"Some unintended consequences are outlined in the final paragraph of section 5. The document recognizes that there are long-term implications besides the short-term transition costs. The document notes that for LDI pension schemes this includes an opportunity cost of placing more low- or zero-return assets in a buffer and the potential impact on long-dated gilts of a decline in demand as deleveraging occurs. However, the document ignores the some further knock-on effects. Regarding UK pension schemes, additional effects could include their lessened ability to generate enough returns to pay retirees and additional corporate topping-up of the pension plans, affecting UK corporate profits. Perhaps this is appropriate as over-leveraging has led UK corporate pension schemes (and their trustees) to rely on LDI strategies to compensate for their underfunded pension schemes, without sufficient attention to the liquidity risks involved. That said, another option is for UK pension schemes to take on riskier assets to avoid corporate infusions—perhaps withdrawing from Luxembourg's LDI funds, implying less financial intermediation through Luxembourg. Alternatively, UK pension schemes could continue to use LDI strategies with higher buffers and eschew long-term riskier investments, such as infrastructure, "green" bonds, and assets that require the "deep pockets" long-term investors are meant to supply. This could slow the take-up of these asset classes and hinder governments' goals for climate change policies. Regarding gilt markets, the increased buffers remove short-term gilts from the market. In the post global financial crisis environment, the worldwide attention to liquidity risk and the introduction liquidity regulation has removed high-quality liquid assets from traded markets with consequent implications for their liquidity. For instance the liquidity coverage ratio for banks, the liquidity requirements for money market mutual funds and open-ended funds, the movement of OTC derivatives to CCPs and additional initial margin requirements, let alone the acquisition of government securities by central banks (notably the Bank of England in this case) have lowered the liquidity of government debt markets across the maturity spectrum, but perhaps even more so at the short-end of the yield curve. The maturity structure of the Debt Management Office's gilt issuance will have an impact on liquidity (perhaps positive or negative). The document could usefully note that not just the demand for gilts will change, but also the supply—and differentially across the maturity of gilts held predominantly held by LDI funds and other market participants—with uncertain consequences for gilt market liquidity. Regarding the international dimension, the CSSF acknowledges and attempts, as best as it can, to mitigate cross-border effects of the LDI buffer increase. It notes that Ireland and Luxembourg (with EMSAs involvement) alongside the UK are (or have) implemented higher liquidity buffer guidance for their GBP-denominated LDI funds.

	These three jurisdictions are the most relevant since most GBP-denominated LDI funds are housed there. However, the asset management industry is broader than these jurisdictions and LDI-fund managers are typically part of larger asset managers and investment banks, institutions that can move across borders. Some migration to less-restrictive jurisdictions could be expected. Moreover, these regulations come at a time with the Financial Stability Board (FSB), the International Organization of Securities Commissions (IOSCO) and the Committee for Payments and Infrastructures (CPMI) are examining how best to mitigate the systemic impact of NBFIs, generally, and open-ended funds, in particular. Waiting for this outcome to better coordinate those policies with LDI fund liquidity buffers is not advisable since the honing the global policy advice for the NBFI sector has taken significant time already and could take even longer. It would, however, be advisable to explicitly state that the LDI buffer regulation will be re-evaluated when other related policies are in place. They will undoubtedly have an impact worth examining. ”
QUESTION 7:	Do you have any other comment on the proposal?
ANSWER 7:	“Overall, the notion of increasing the LDI funds’ buffers is an important component of lowering their liquidity impact on the gilt market, and by extension, Luxembourg and UK financial and economic stability. The buffers have the added benefit (given the gilt laden LDI portfolio composition) of lowering leverage. Codifying the existing buffers gradually and during a period of relative market calm is helpful to market participants. Going forward, the ability to explicitly revisit these specific LDI buffers when other policies, including ones enacted globally, or when the structure of the financial system may impact their effectiveness will be important. A thorough cost/benefit analysis will need to be redone when such changes occur. Moreover, some method for judging effectiveness should be instituted before these rules go into effect.”

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