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.

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	**Schroder Investment Management (Europe) S.A.**
Activity	Management Company for SCHRODER MATCHING PLUS SICAV
Are you representing an association?	"TYPE YOUR TEXT HERE"

Introduction

Please make your introductory comments below, if any:

Schroders is a global asset management group headquartered in London and listed on the London Stock Exchange. We manage over £725bn (€835bn) on behalf of institutional and retail investors, financial institutions, and high net worth clients globally. Specifically, we manage around £44bn (€51bn) of UK Liability Driven Investment (LDI) exposure across:

- multi-client pooled funds (£8bn; equiv. €10bn) covering 95 schemes and approximately 60,000 deferred and pensioner members;
- Segregated and client specific pooled funds of 1 (£36bn; equiv. €42bn)

Figures as at 30 September 2023 unless otherwise stated. Member estimates are based on the 2023 PPF Purple book total members of 8.9m people pro-rated vs Schroders pooled LDI exposures under management at the same date and LDI coverage levels of 95% of assets.

The exposures are directly for UK pension schemes or via Luxembourg and UK based pooled funds. This response draws on contributions from specialists within our Schroders Investment Management Limited and Schroder Investment Management (Europe) S.A. businesses.Schroders believes that LDI strategies are an important tool for pension schemes. They allow schemes and their trustees to manage a range of risks stemming from interest rates movements and market volatility. This helps underpin the resilience of schemes, and ultimately their ability to meet their liabilities to pensioners on an ongoing basis. The extreme market events of Autumn 2022 were a vivid illustration that at the same time, poorly designed LDI strategies are exposed to extreme movements in interest rates, and in these circumstances, they risk amplifying market shocks, contributing to systemic risk.

We believe the specific structure of our LDI strategies allows us to meet this important client demand without introducing such risks, even in a range of extreme market conditions. Prior to the crisis, as at 31 August 2022, Schroders' daily dealing leveraged GBP LDI pooled funds (SMP SICAV), taking into account a required Schroder controlled money market fund holding, had interest-rate collateral stress to exhaust minimums of c.100 bps. This compares to the 300bps being proposed under your consultation.(And the equivalent consultation from the Central Bank of Ireland https://www.centralbank.ie/publication/consultation-papers/cp157---macroprudential-measures-for-gbp-liability-driven-investment-funds) Despite this, we were not forced sellers of gilt exposures, did not utilise a fair value adjustment, did not suspend price releases, and collateral payments were made to relevant counterparties for all of our leveraged GBP LDI funds.

The key to our setup is the use of Schroders' controlled, daily dealing money market fund(s) and other highly liquid assets directly under our control as the LDI manager (described as "off balance sheet assets" in your consultation) to enable (i) the next day recapitalisation of all LDI funds on our platform and (ii) the smoothing out of settlement mismatches. Without access to such assets UK LDI fund recapitalisation can be slow and administratively burdensome for clients. We believe the lack of immediate access to comparable liquid assets was the key factor driving the forced selling by other LDI funds highlighted in the CBI and CSSF supporting documentation. Despite some of the assets in our LDI structure being "off balance sheet" they are nevertheless under our direct contractual control and are chosen for their high levels of liquidity and short (or in the case of the money market funds – same day) settlement cycles. We believe this model lends us flexibility, and the scope to act at speed, both of which were critical to our ability to withstand the market pressures of Autumn 2022.We fully agree that the events of Autumn 2022 warrant a review of the regulatory regime for LDI and accept that there is a case for increasing the absolute level of resilience required of funds. But we wish to highlight that, in our view, there are factors beyond the resilience buffer size that are equally important to the overall resilience of LDI structures. We believe this is illustrated well by the fact that despite our funds at the time having the lowest business as usual buffer size, the structure of our pooled LDI solutions allowed us to manage what were unprecedented market conditions without adding to the systemic risk in the system.
This suggests to us that models that incorporate reliable, flexible access to liquid assets (even if off balance sheet) may not require the proposed 300bp calibration of the stress to exhaust to secure the level of resilience you and other authorities are seeking. While we understand the importance of managing systemic risks, this matters, as a 300bp calibration will inevitably impact on the returns of LDI clients, with a direct consequence for the ability of schemes to meet their liabilities. We are pleased to see recognition of the possible benefits of access to off balance sheet assets in your consultation and urge you to retain this possibility in your final framework where under the clear control of the relevant LDI Manager.

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:	Appropriate? Given the September 2022 data point (which forms the most severe event for G7 sovereign bonds ever), the minimum yield buffer seems to have been set in a manner that looks at the appropriate level assuming the relevant LDI fund can recapitalise in a 5 day period. Assuming the aim is to maintain financial stability and provide a 'level playing field, if an LDI fund can recapitalise quicker than 5 business days, then the level seems overly cautious; if an LDI fund can recapitalise more slowly than five business days (or not at all) then the level seems inappropriate.' We see LDI fund resilience as a combination of capital within the fund, and the speed at which the funds can be recapitalised. In our view 'GBP LDI funds must maintain resilience to a minimum of 300 bps increase in yields.' is sufficiently clear. We do note that this does not directly translate into the likelihood of an LDI fund causing a systemic disturbance to the UK financial system. The flow through to the banking sector is more related to LDI fund's ability to continue to post collateral to banks in rising yield environments. A better measure is therefore eligible collateral stress to exhaust, which is more penal on instruments that post initial margin. Usually, the LDI instruments that require initial margin are centrally cleared derivatives such as cleared interest-rate swaps and RPI swaps and various futures contracts (referencing gilt and equities). Sufficiently Clear? We note buffer composition description 'assets its investor owns' would include underlying their LDI funds, so the definition is somewhat unclear."
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)?

Commission de Surveillance du Secteur Financier

ANSWER 2:	Yes. During September 2022 UK gilts crisis, of all the major UK pooled LDI fund managers, our pooled LDI funds were not forced sellers of gilt exposures nor did we make a temporary or permanent reduction in exposures, we did not suspend price releases and did not utilise a fair value adjustment (Source: XPS Investment Paper 'LDIWatch: The crisis and the importance of choosing the right LDI manager' (published February 2023). We did this while having the lowest stress to exhaust buffer of any of the leading UK pooled fund managers going into the crisis; were able to provide the most optimal outcome from a financial stability perspective and maintained client hedging objectives due to the speed at which we could transform client's assets into eligible collateral. If the aim of the regulation is to enhance UK financial stability and to provide a 'level playing field' for managers with UK LDI funds domiciled throughout Europe, then the focus of the regulation should specify the speed at which client assets can be converted to LDI fund eligible collateral. While the calibration specified appears appropriate for funds that can turn ("in fund" and "out of fund") assets into eligible collateral within five business days, it is very restrictive for managers who can do this quicker (such as Schroders) and benefits managers and, fund domiciles who have not invested in systems/processes to enable speedy recapitalisation.
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:	The Schroders prospectus for leveraged LDI funds includes the wording: 'view to hedging against changes in interest rates.,' which we believe would appropriately align to the definition of an 'investment strategy seeks to match the interest rate of inflation sensitivity of their assets to that of their investors' liabilities.' per the CSSF definition. Even so, a broad range of investment objectives are used to described leveraged UK LDI exposures via pooled vehicles. These include but not limited to 'deliver nominal returns and/or inflation-linked returns' 'provide leveraged exposure to an underlying reference gilt' 'seeking to reduce investment risk directly relating to the Shareholder's financial solvency and where Pound Sterling denominated returns provide retirement benefits' Given the aim is to understand the systemic risk of use of leverage within the UK government bond market and knock on effects to macro-prudential risks, we would expect a definition to focus on the use of leverage and having gilt total return swaps, gilt repurchase agreements, GBP interest-rate swaps and GBP RPI inflation- swaps as eligible assets to be more appropriate.
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?

Commission de Surveillance du Secteur Financier

ANSWER 4:	No, we don't believe this is appropriate. We believe to achieve the 300bp minimum resilience buffer firms should be allowed to use the LDI pooled funds and additional cash within Money Market Funds where these are under the direct control of the Investment Manager and where the LDI pooled Funds (tier 1) and Money Market Funds (tier 2) are subject to a settlement cycle of t+1. As highlighted previously, where an LDI manager can utilise specific assets to facilitate speedier recapitalisation of their LDI funds they should be given credit for the improved resilience versus slower recapitalisation vehicles. This is consistent with the lower financial stability risks posed by LDI funds that can recapitalise rapidly. The speed at which assets can be transformed into eligible collateral rather than whether they are held on the balance sheet of the pooled LDI fund is a key determinant of potential forced selling for an LDI Fund. Safeguards We take this view because Schroders is granted exclusive authority under an investment management agreement (IMA) to manage the clients' assets that are invested in the pooled LDI funds and in other Schroders funds (like Money Market Funds) at our discretion. For our Schroders pooled fund offering each client, under our sole control, holds a Schroders EU domiciled UCITS Money Market Fund(s), denominated in GBP, used to provide immediate liquidity (sometimes referred to as tier 2 cash buffer). For each tier Schroders has, amongst other powers under the IMA, the ability to transfer or sell a client's holdings to allow it to subscribe for further units in the LDI pooled funds to help the LDI pooled funds meet their obligations to trading counterparties (such as collateral calls under derivative or repo agreements). In addition to this for a number of clients we hold further pooled fund assets (which we call tier 3) which are under our control as well and can be utilised to quickly top up the tier 2 cash buffer or to subscribe directly into the relevant LDI pooled fund (tier 1). The client undertakes to us that it will not trade assets from any tier without Schroders' consent. Timeliness and risk profile We believe that assets should be eligible versus the specified buffer level regulatory minima if they can be transformed into eligible collateral and invested in the relevant LDI fund for onward transmission to counterparties in line with the fund's collateral agreements. Additionally, appropriate hair cuts could be applied to assets in line with

	their risk profile, and are not used to support other sources of leverage. This restriction should apply irrespective of whether the asset is held in the fund or not. Assets held within Schroders tier 1 and tier 2 fulfil these criteria. They have at most a T+1 settlement cycle which supports/allows efficient and timely movement of cash between tiers and within collateral settlement cycles. We have developed our proprietary workflow platform allowing us to manage assets in a scalable and automated way. Internal assets only In addition to the above, the CSSF may consider whether to restrict off balance sheet funds to those solely managed by the relevant LDI Manager and/or the same Management Company. For Schroders pooled LDI Solutions, tier 1 and tier 2 are exclusively managed by Schroder Investment Management Limited, and most tier 3 assets are client-selected Schroders funds but can also be funds managed by third party managers under certain offerings. Schroders takes comfort from investing the tier 2 cash buffer in Schroders funds as we have confidence in our own oversight and risk and liquidity management frameworks which are all managed by independent teams in Luxembourg. Independent operational oversight and control framework for Schroders funds For our LDI pooled funds (tier 1) and cash funds (tier 2) the management company, the administrator and transfer agent in Luxembourg are the same service providers which minimises operational complexity and leads to a more comprehensive and tighter control framework. From a governance perspective in line with regulatory requirements both structures are covered by an Investment Management Oversight team, independent Risk Management team (that applies its liquidity risk framework to these products) and independent Operational Risk Management team – all are domiciled within the Luxembourg Management Company. As a result of the exclusive control that we exercise over the assets in the Money Market Fund as well as our confidence in our own control environment covering the LDI pooled funds and the tier 2 supporting assets, we believe that there is no need for those assets to be held on the balance sheet of the LDI fund to qualify for the required minimum yield buffer. This framework has been successfully stress tested during the September 2022 UK gilt crisis and undergoes a regular review and adjustments as needed.
QUESTION 5:	Do you consider that the mechanism driving the buffer usability is appropriate and sufficiently clear?

ANSWER 5:	Yes. We believe this is reasonably clear and should be aligned to the Central Bank of Ireland's approach, which appears to be the same as the CSSF specification.
QUESTION 6:	What potential unintended consequences do you see from the proposed measures, and how could these be mitigated?
ANSWER 6:	We believe, the structure of the yield buffer as specified may lead to herding of LDI Managers to focus on the 300bps stress to exhaust measure rather than focussing on the speed at which assets can be transformed into eligible collateral. The current draft legislation promotes looser recapitalisation structures given the material buffers required is likely to be able to withstand all historical bond market shocks (excluding the September 2022 gilt crisis) without the need for further recapitalisation. With the current wording, there is an incentive to create LDI pooled structures that rely on leverage sources other than UK interest rates and inflation. Instead, the focus should be on preventing forced selling by improving the speed at which LDI funds can be recapitalised. Another approach could be to adopt a constant leverage strategy, where gilt exposures are sold to maintain a buffer above a stress level of 300 basis points to avoid exhaustion. The 1987 flash crash has been ascribed to this type of Constant Proportion Portfolio Insurance (CPPI) strategy for insurance companies and we do not believe a simple yield buffer minimum is helpful; albeit we believe the usability mechanism for monthly values below 300bps should be sufficient to mitigate this. The use of safe and stable leverage within LDI strategies allows UK defined benefit pension schemes to allocate to UK government securities for liability hedging purposes while also providing productive capital to various liquid strategies (equities/credit) that naturally sit alongside these mandates. Further penalisation solely of on balance sheet 'yield buffers' will (i) potentially restrict asset flows into these asset classes from UK defined benefit pension schemes and (ii) encourage schemes to run more investment risk (less liability hedging) for longer (fewer growth generating assets).
QUESTION 7:	Do you have any other comment on the proposal?
ANSWER 7:	We would welcome continued engagement with the CSSF on the development of this regulation.RE"

Commission de Surveillance du Secteur Financier
283, route d’Arlon
L-2991 Luxembourg (+352) 26 25 1-1
direction@cssf.lu
www.cssf.lu