Chancellor Kwarteng (and government?) taken out by Pension Funds

John Clancy

The funds and their advisers learned nothing from 2008 and went to the Casino again – this time with £trillions. Kwarteng should have seen the express train coming down the track towards him. Did he?

Remember those words which everyone (outside the financial markets) learned for the first time in 2008 – Swaps, Credit Default Swaps, Derivatives, Leveraging, Hedging, Repos, Collateralised Debt Obligations, Margin Calls? Most of us have probably forgotten what they were. Probably Kwasi Kwarteng had, too. Because they took him out.

And you recall how those things brought the entire global financial system to its knees? And how the banks were bailed out? And how the watch words "never again" rifled around the world?

Well, as *Twin Peaks* from back in the 1990s would have it : "It is happening again."

So much so is it "happening again", indeed, that the Bank of England warns us there is systemic risk to the financial stability of the U.K. financial system. I think that is right.

LDIs were coming to get Kwasi

And with a PhD in Economic History ex-chancellor Kwarteng really should have seen this coming.

This time the complex mess of pottage was bundled up in a new market-killer acronym, pretty much combining all of the above in a 2022 complex of nonsenses.

An LDI.

This financial instrument eventually weaponised itself with others and took out a chancellor and possibly will take out a government.

Pension Funds, their managers, their boards of Trustees, the treasury, the Bank of England were gulled (again) by the smart-suited, Gordon Gekkos and their ilk. Just as no-one outside the math "quant" experts had a real clue what collateralised debt obligation instruments were in 2008, so was, and is, the case with LDIs.

Derivatives, Swaps, Repos, a maze of hedges (as complex as Longleat's) and leveraging like it's 1999 are all wrapped up in a sausage-machine produced LDI insurance policy.

And, again, the entire house of cards has fallen with margin calls louder, more frequent, and as panic-laden, as good old 2008.

There is a case to be made that the sudden unraveling and effective collapse of the caught-out LDIs would have happened without the mini-budget, the financial statement was just a catalyst, or the straw that broke the camel's already severely fractured back. Kwasi might have got away with it if it hadn't been for this car crash just waiting to happen. Or it might have happened in the summer interregnum.

As in 2008, these last few years (unbeknownst to the rest of us) pension funds decided the time was ripe once more to play dice, craps, roulette and blackjack at the tables of the Capitalism Casino you couldn't lose in, and suddenly lost. And lost big. An 2022 Oktoberfest of feeding Trillions of pounds

sterling at the casino slots – in London's financial markets. And using U.K. pension savings as the seed money to get in.

When the music suddenly stopped, LDIs (liability driven investment vehicles) had no seats available to rest on and fell like a stone to the hardest of floors, as did the Chancellor. Sunk in a pool of LDIs.

Pools of LDIs in which pension fund advisers and managers swam round and round until they met themselves swimming the other way. Again, like the Chancellor, not waving, but drowning.

How do LDIs work, then? Who knows?

No-one can really explain how LDIs work normally, because each package and policy works differently and is tailor-made. But like CDOs, it's a financial sausage machine with allsorts thrown in.

Never invest in or take out a policy which you or your family can't understand should have guided the pension funds. Pensioners and contributors, and Boards of Trustees should also have been added to that list. And what are pension funds borrowing for in the first place, anyway?

One view of how to understand an LDI policy is that it is like getting great 10-1 odds from a bookie for a horse which would otherwise be the odds-on favourite over the fences. But the catch is – you need to put your house up to the bookie as collateral and that if it the horse falls you also have to pay the winnings to the punters who backed the actual winner, and those that came in the first 5 too.

To make sure you do pay the bookie, you have to pay up these other punters' winnings in cash to cover the bookie in chunks during the race as each fence is jumped. How much of a chunk depends on how far ahead or behind your horse is. If your nag does fall, then the bookie calls for the lot. If it looks like your horse is going to lose you'll need to put in more liquid cash at each further fence to cover likely losses.

If you can't, the bookie takes control of the house to sell it (at whatever price can be got quickly) and get the cash that would need to be paid out if your horse loses badly. You'll get back what's left in the house sale balance.

The problem was that the bookie also lent you money to make a bet even bigger than the house value (a 'leveraged' bet) and that's got to be paid back too.

And the name of your horse was 'Falling Interest Rates'. The name of the winner is 'Sudden Spike in Interest Rates'. I mean that one was never going to win, was it?

Big Bets by Big Beasts – How big are the Pension Funds?

Very few folk realise or understand, as I have been writing in blogs and books since 2008, the sheer size of Pension Funds in the U.K. and the impact they have on the economy, banking, and finance. It should be the number one political consideration in U.K. economics and policy.

I have made this point here at the BCU Centre for Brexit Studies again and again. And politicians and chancellors ignore Pension Fund politics at their obvious peril.

How big an impact?

How about £4Trillion? That's how big U.K. pension funds are.[1]And what they do, or do not do, impacts on every person, family, business, bank, politician in the U.K. and its Chancellor of the Exchequer. £4,000 Billions-worth of impact.

U.K. GDP annual GDP is £3Trillion as a (sort of) comparison (and pension funds are a big part of that in terms of financial services). The U.K.'s Net Worth is £10Trillion (again, the pension funds are much the biggest entity in that).

So when U.K. Pension Funds totally mess up, then the U.K. gets totally messed up. They are in the financial, banking, economic and political DNA of the country.

When we learned (pretty much everyone was unaware – certainly not the government) that as much as £1Trillion in Pension Fund assets and further leveraged borrowings were wrapped up in dodgy LDI vehicles, and pools of those vehicles, which were suddenly in actual danger of default, it was actually genuine news in the sense that nobody beyond the participants had any idea this was going on.

This default tsunami was then putting brokers and banks and financial houses in danger of collapse. The funds would be bruised, yes, but the Bank of England's intervention was more about saving banks and financial institutions than it was the funds themselves. £65 billion is small fry anchovies in the context of the schools of blue whales that are Pension Fund assets.

Pension Fund Collapse?

Many in the media believed that pension funds were (some mused most were) in imminent danger of collapse when the size of both LDIs and Bank of England intervention became known. That wasn't the case. I also strongly suspect that most of the Pension funds who were in LDI trouble were in the vast, but massively populous Corporate Defined Benefit (i.e. final salary) Pension Sector. They are more in the shadows than the big corporate and public sector mega pension funds.

Firstly, the funds' asset bases were so huge that most could actually absorb the losses and had the liquidity to stump up liquid assets to make the ridiculously large sudden margin calls from the banks/brokers/bookies. Some didn't though. ***They weren't in danger of collapse***, they were in danger of ***defaulting*** on the LDI bets. Like a householder defaulting on a loan, but still having massive equity in the house. But, as they say, if you owe the bank £100,000 you have a problem; if you owe the bank £1million, the bank has a problem.

Secondly, the rapid rise in interest rates had made the multiplier used to calculate pension fund liabilities (the discount rate) went suddenly so positive that liabilities started to shrink exponentially. LDIs only work (indeed are only needed in extremis) in a low interest rate and falling interest rate environment.

But the sheer size of the LDIs in play meant that its tentacles were everywhere.

The need to dump and unravel your LDI positions (otherwise known as bets) was crystal clear for at least the last year and certainly back in July. Obviously many funds did. But those who didn't can only have themselves to blame, and their managers and boards of trustees have some very difficult questions to answer. So does the office of the Pensions Regulator.

So "Liability Driven Investment" vehicles rolled off the assembly line and were bought by pension fund managers on behalf of their funds, and worse – much of them on credit. They call this leverage.

Because you couldn't possibly lose. As night follows day, you *had* to come out ahead at the very least. They put them in massive car pools of LDIs and watched them become even bigger car pools. Until the Repo folk arrived to take all the vehicles away. Formula 1 turned into stock car banger racing in the dirt.

Pension Funds in surplus?

And the joke was – the thing they had thought they had better insure themselves against (hedge themselves against) was the thing that meant they never needed the insurance in the first place. Because the liability gap they had hedged against actually disappeared almost overnight (and in truth was never there in the first place). But they bet on it getting bigger instead. Madness.

Worse – they borrowed 100s of £Billions to add to the assets they had to put into the vehicle to get it started. And to fund the insurance product they never needed.

So much so that it's highly likely that during the next 6 months we will see most pension funds actually in surplus all over the U.K.

They will literally have too much money. They have hoarded cash and assets and taken out insurance which they never needed, because they were naïve about the markets their funds existed in. They thought they were real.

Because they insured themselves against the impact of falling interest rates. When interest rates started to rise (I mean, who knew?) and then started to rise suddenly very quickly, the horse effectively fell at the last fence and the bet was lost. But what a bet. Just the £1trillion?

When there's a £trillion or so swilling around, you can bet your LDI dollar that the associated never-to-be-seen again transaction fees and cuts and slices of commissions and expenses are also eye-wateringly related too.

Q.E. and political intervention should have changed the sums

For more than a decade Central Banks' eye-watering pumping of freshly minted bazooka cash via whatever-it-takes Quantitative Easing propped up the markets and finances of the world. But that created a pretence of standard functioning markets when there was no such thing. They were on QE stabilisers and narcotics combined. They couldn't and shouldn't have been trusted by pension funds as something to use to assess their assets or liabilities.

But pension funds pretended there was a functioning set of pre-crash normal markets out there and used especially the interest rates in the false markets (converted into the killer 'Discount Rates') and came up with mind boggling (and now undoubtedly incorrect) estimates of how much their liabilities were.

Carry On Pension Funds was the problem. The people in pensions – especially the actuaries in them – were unable to adjust to a world where politics had saved them. They were above all that.

So all of the current nonsense in Pension Funds has stemmed from a dumb failure of those in pension funds to kick out the stupid carry-on-as-normal calculations and accounting and actuarial practices of the pre-2008 world. Quite literally they have spent the last decade chasing liabilities which were illusory.

Pension Funds right themselves

So Pension Funds themselves became Liability Driven Vehicles. Funding positions which it turns out were just fantasy actually had to be hedged with all of the 2008 type nonsense with swaps and leveraged vehicles, and repos and derivatives, in the £Trillions, for goodness sake.

There needed to have been a suspension of the normal rules of valuation of a Pension Fund's assets and liabilities from 2008 to now. And funds should have concentrated on running a fund which could

pay the benefits out to current pensioners until a time was reached when more normal market conditioners without the stabilisers and narcotics present.

But guess what? Once the stabilisers came off and the drugs only just started to be withdrawn, this inevitably led to inflation and interest rates rising. Suddenly the nonsense economics of pension fund accounting of the last decade were and are laid bare – a crisis in the £trillions emerges, which then threatens the very stability of the entire U.K. financial system.

The Bank of England and the Office of The Pensions Regulator and successive Treasury top mandarins, P.M.s, Chancellors and politicians were simply asleep at the wheel, because we had a world of Carry On Pensions. And perhaps Kwasi Kwarteng was the wrong Chancellor in the wrong place at the wrong time. And the car ran out of road.

What a carry on!

God rest them, Sid James and Barbara Windsor would undoubtedly have done better.

[1] https://www.theia.org/sites/default/files/2021-09/IMS%20report%202021.pdf