IN FOCUS

REPOCUSSIONS? LEGAL CLAIMS ARISING OUT OF THE LDI LIQUIDITY CRISIS

By Paul Neman KC

In the latest episode of the *Talking Pensions* podcast, Philip Bennett of Durham Law School discussed his views on the legal consequences of so-called leveraged LDIs, which required many DB pension schemes to come up with substantial amounts of cash to meet increased calls for collateral due to the dramatic fall in gilt values at the end of 2022. His thesis was that such investments were potentially beyond the powers of the trustees as they amount to unauthorised borrowings.

The purpose of this article is to look more closely at the legal analysis supporting Philip's views, and to consider whether trustees may as a result have claims against their investment advisers for the mis-selling of LDIs.

Leveraged LDIs and repo contracts

The broad objective of LDIs is simple and well-intentioned: to ensure that the scheme's funds are invested in assets which generate returns that move in a similar direction to the changes in the value of the scheme's liabilities. This commonly involves investing heavily in index-linked gilts, the value of which moves in line with changes to interest rates, which broadly matches the movement in value of scheme liabilities, thereby reducing volatility.

Direct investment in gilts, however, reduces the scheme's ability to profit from more growth-seeking assets such as equities. This is where LDI comes in, allowing schemes to be more heavily

exposed to gilts while retaining their other investments. This is done through a gilt-based derivative contract, which allows the scheme to be exposed to a gilt without needing to purchase the physical instrument. A popular way of achieving this is through a gilt sale and repurchase contract, colloquially known as a "repo", which works in this way:

- The scheme receives money from an investment bank, secured by a gilt which the scheme already owns, and uses the money either to purchase more gilts to increase interest rate protection further, or in growth assets to increase expected returns. The interest rate applied to this borrowing is known as the "repo rate";

- In practice, this is achieved by the scheme selling the gilt to the bank but simultaneously agreeing to buy it back on a particular date in the future and at a specified price.[1] Because the repurchase price is fixed at the outset, the scheme retains economic exposure to the gilt: if, during the term of the contract, interest rates fall and gilt prices rise, the scheme will make a profit; but if interest rates rise and gilt prices fall, the scheme will make a loss;

- For present purposes, the key feature of the repo agreement is the requirement for the scheme to provide collateral should the value of the gilt fall below the sum loaned to the bank by the scheme, to ensure that the bank is adequately secured against the scheme's potential default.

The need to provide increased collateral where gilt prices fall can be easily managed in normal times, where price fluctuations are relatively small and gradual. However, the sudden crash in the value of gilts following the Mini-Budget of September 2022 led to schemes having, in a very short space of time, to provide cash as collateral to secure their LDI positions. This caused schemes to sell more gilts in order to raise the cash, which put further pressure on the already-beleaguered gilts market: the so-called "doom loop".

[1] The difference between the sale and repurchase price is the repo rate.

These events have put LDIs and repo contracts into the legal spotlight, and caused trustees to consider whether they may have any claims against their advisers for the losses caused to schemes by the need to meet collateral calls at such short notice. An important consideration in this respect, according to Philip Bennett, is whether the trustees had the power to enter into repo contracts in the first place.

The prohibition on borrowing

The starting point is reg.5 of the Occupational Pension Schemes (Investment) Regulations 2005 (**"the Investment Regulations"**), which provides as follows:

> *(1) Except as provided in paragraph (2), the trustees of a trust scheme, and a fund manager to whom any discretion has been delegated under section 34 of the 1995 Act, must not borrow money or act as a guarantor in respect of the obligations of another person where the borrowing is liable to be repaid, or liability under a guarantee is liable to be satisfied, out of the assets of the scheme.*
>
> *(2) Paragraph (1) does not preclude borrowing made only for the purpose of providing liquidity for the scheme and on a temporary basis.*

Does this prohibition on borrowing, save in the case of providing short-term liquidity, apply to repo contracts? In purely economic terms, such contracts do appear to fall within the prohibition, at least where the trustees were direct parties to the contract:[2] the trustees receive money from a third party for a specified period of time, secured on scheme assets, and at the end of the period the trustees are required to repay the money, plus interest, out of the scheme assets. However, such contracts are legally structured as the sale and repurchase of a scheme asset, and are not a straightforward contract of loan to the trustees.

The prohibition on borrowing in the Investment Regulations originally derived from art.18(2) of Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision, known as IORP, which provided as follows:

[2] This can be contrasted with the use of LDI by pooled funds, where the transaction will be entered into by the fund rather than the scheme, which is simply an investor in the fund.

The home Member State shall prohibit the institution from borrowing or acting as a guarantor on behalf of third parties. However, Member States may authorise institutions to carry out some borrowing only for liquidity purposes and on a temporary basis.[3]

Whilst the wording of art.18(2) does not expressly extend the concept of borrowing to transactions which have the same economic effect, there is scope for argument that, not only should it be so extended, but that the same extension should be applied to reg.5 of the Investment Regulations:

- EU directives are required to be construed by reference to their purpose, which takes into account the recitals and other principles referred to in the recitals:[4]

- Such recitals are also relevant in determining the scope of a directive;[5]

- The purpose of IORP was to protect the security of pension scheme members' pensions: see, for example, the following recitals of IORP:

  (7) The prudential rules laid down in this Directive are intended both to guarantee a high degree of security for future pensioners through the imposition of stringent supervisory standards, and to clear the way for the efficient management of occupational pension schemes.

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[3] IORP was superseded in December 2016 by EU Directive 2016/2341, known as IORP-2: art.19(3) of IORP-2 is in materially identical terms to art.18(2) of IORP.

[4] *R (Broadcasting, Entertainment, Cinematographic and Theatre Union) v Secretary of State for Trade and Industry* (Case C-173/99) [2001] 1 WLR 2313 at [37]-[39]. This principle continues to apply to the interpretation of retained EU law in English Courts after Brexit: *Lipton v BA City Flyer Ltd* [2021] 1 WLR 2545 at [83(iv)].

[5] See *Re Proceedings Brought by C* (Case C-435/06) [2008] Fam 27 at [51]-[52].

(17) *In order to protect members and beneficiaries, institutions for occupational retirement provision should limit their activities to the activities, and those arising therefrom, referred to in this Directive.*[6]

- In the light of that purpose, the concept of borrowing in art.18(2) of IORP should be given a wide meaning and thereby extend to transactions which have the same economic effect as borrowing, such as repo contracts;

- Where UK legislation implements an EU directive, the legislation must be interpreted where possible to conform with EU law: this is known as the "*Marleasing* principle";[7]

- Regulation 5 of the Investment Regulations should therefore be given the same wide meaning as the corresponding article in IORP.

A difficulty with interpreting the concept of borrowing in IORP and the Investment Regulations to include repo contracts is that they may also be regarded as derivative agreements, on the basis that the value of the contract is based on the fluctuating value of the gilt which is the subject of the contract: [8] derivatives are authorised pension scheme investments under both EU and UK law.[9]

Although there are no private law remedies for contravention of reg.5 of the Investment Regulations,[10] if repo contracts are found to have been prohibited by that provision, it is likely that the trustees will be liable for breach of trust in the exercise of their investment functions.

[6] See, to the same effect, recitals (17) and (29) of IORP-2.

[7] Named after *Marleasing SA v La Comercial Internacional de Alimentacion SA* (case C-106/89) [1992] 1 CMLR 305; and see *Lehman Brothers International (Europe) (in administration) v CRC Credit Fund Ltd* [2012] 3 All ER 1 at [131]. This principle also continues to apply to retained EU law after Brexit: *Re Allied Wallet Ltd* [2022] EWHC 402 (Ch) at [12].

[8] Indeed, both tPR and the PPF regard repo contracts as derivatives: tPR Guidance on DB Investment (March 2017, as updated); para 30 of the Investment Risk Appendix to the PPF Levy Determination 2022/2023 (December 2021).

[9] Art.18(1)(d) of IORP; reg.4(8) of the Investment Regulations; art 19(1)(e) of IORP-2.

[10] failure to comply with the Investment Regulations potentially gives rise to civil penalties: s.36(8) Pensions Act 1995.

Mis-selling claims

Plainly, if repo contracts turn out to be prohibited investments and a breach of trust results, the advisers who recommended the purchase of such contracts to the trustees will be exposed to claims for negligence for any losses caused by the need to disinvest assets in order to meet collateral calls, assuming (as is likely) that the trustees were not warned about this possibility and decided to proceed in any event.

Otherwise, any claim by trustees against their advisers will be based upon the inappropriateness of the repo contracts as an investment. The response is likely to be that the contracts were a

normal part of a scheme's prudent investment strategy, and that the events which caused the loss were not reasonably foreseeable at the time of the investment. The claim and any defences will be highly fact-specific and are likely to differ depending on when the advice was given: the closer to the events which caused the losses, the more reasonable it might have been for the advisers to focus on the downside risk.

One aspect of a claim, even where the advice long pre-dated the crash in the gilts market, may be reliance on the fact (assuming it was a fact) that there was insufficient warning about the possibility, however remote, of a sudden decline in gilt prices requiring immediate collateral calls and the consequent need for the trustees to liquidate assets to meet such calls. There may well be circumstances, particularly where the trustees could not be regarded as sophisticated investors, where it was incumbent upon the advisers to emphasise the risks of the investment. In this respect, it may not be sufficient for the advisers to establish that their advice accorded with what a body of reasonable advisers would have done in the same position, as there is authority in the context of investment advice which indicates that the materiality of the risk which had to be explained

depends on whether a reasonable person in the client's position would be likely to attach significance to the risk.[11]

If the Court decides that the downside risk was one on which the advisers ought to have placed more emphasis when explaining the nature and effect of the repo contract, it will as a practical matter be difficult for the advisers to establish as a matter of causation that the trustees would have proceeded with the investment in any event. The Court would not be inclined to permit advisers to avoid liability on such a ground, where the negligence means the trustees never had the opportunity to show how they would have acted. This might prove a significant advantage to the trustees in any claim for LDI mis-selling.

Final word

It is likely that many trustees who have purchased these investments will be seeking advice from their lawyers on what should do in view of the consequences of those investments having been made. The points discussed by Philip in the podcast and elaborated in this article are serious and interesting ones and will no doubt be ventilated before the Courts before too long.

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[11] *O'Hare v Coutts & Co* [2016] EWHC 2224 (QB at [199]-[206]: query, however, whether this decision is based upon the enhanced obligations imposed by the adviser's regulator: *Wemyss v Simon C Dickinson* [2023] PNLR 7 at [88].