30 November 2022

Re: Liability Driven Investment Funds

Dear Sir or Madam,

The present letter is addressed to you as a result of interactions between the Central Bank of Ireland (CBI – Ireland), the Commission de Surveillance du Secteur Financier (CSSF – Luxembourg) and the European Securities and Markets Authority (ESMA) in relation to Liability Driven Investment Funds ("LDI Funds").

The recent volatility in yields associated with UK gilts exposed vulnerabilities in LDI Fund products, giving rise to a concerning cycle of collateral calls and forced sales.

Throughout this period, the CBI and CSSF ("the NCAs") engaged proactively with the managers of LDI Funds with a focus on LDI Funds denominated in Great British Pounds ("GBP"). The resilience of GBP LDI Funds across Europe has subsequently improved, with an average Yield Buffer(1) in the region of 300-400 basis points being built up. Given the current market outlook, the NCAs expect that levels of resilience and the reduced risk profile of GBP LDI Funds are now maintained, and do not consider that any reduction in the resilience at individual sub-fund level is appropriate at this juncture.

(1) Yield Buffer refers to the level of yield adjustment on long-term gilts that the GBP LDI Fund is insulated from or may absorb before its capital reserves are exhausted. Such capital reserves are the capital in the GBP LDI (sub-) Fund, excluding any shared pool of assets or other capital of investors that the GBP LDI Fund may have access to. When stress testing funds with real interest rate exposure, inflation expectations should be held constant so that the real interest rate is stressed appropriately.

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To the extent that you might consider it necessary to advertently reduce an individual GBP LDI Fund's resilience below the levels that were achieved in the period following the dislocation in the UK gilt market, you should:

1) Inform in advance the NCA supervising the investment fund manager and, in case of cross-border setups, the NCA in the country where the LDI Funds are domiciled, of the proposal to advertently reduce an individual GBP LDI Fund's resilience and of the level; and
2) Complete the following actions prior to making any reductions (with such documents to be made available to the above-mentioned NCAs upon request):
    a. Undertake and document a detailed analysis justifying the need to reduce the GBP LDI Fund's current resilience.
    b. Complete and document a risk assessment with relevant modelling of how the proposed reduction in the GBP LDI Fund's resilience will not impact the orderly functioning of the GBP LDI Fund in the current and in stressed environments.
    c. Detail and document a step-by-step plan for returning the GBP LDI Fund to current levels of resilience in the event of increased market volatility, noting any assumptions that the framework is based on.

The GBP LDI Fund must ensure that clear policies and procedures are established to increase resilience in the event of further volatility in the market.

In the event of an inadvertent decrease of GBP LDI Fund resilience due to a changing market environment (notably also a decrease of the market value of the assets held), the NCAs expect the GBP LDI Fund to have procedures in place to recapitalise and/or de-risk their portfolios by reducing their exposures following exceptional market circumstances in a timely

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manner. This should include accounting for the second-round effects of actions taken by other market participants on the individual funds, for instance the market impact of asset disposals triggered by rising yields.

For LDI Funds in other currencies, the above-mentioned notification system does not apply for the time being. However, the NCAs expect that the LDI managers maintain for these LDI Funds an appropriate level of resilience at an individual sub-fund level in order to be able to absorb possible market shocks. Again, this should include accounting for the second-round effects of actions taken by other market participants on the individual funds.

The CSSF reserves the right to define additional requirements and safeguards, where deemed appropriate.

Yours faithfully,

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