

Bank of England

Looking through a glass onion: lessons from the 2022 LDI intervention

Andrew Hauser



Four lessons from the LDI intervention



1. LDI and the dash for cash were not isolated symptoms of a polycrisis world: we are entering a new era of systemic liquidity risk, originating in non-banks and capital markets



2. Bagehot still applies. Central banks have to be the backstop, not the frontstop. But the divide between public and private insurance is a key social choice. Must it keep happening by trial and error?

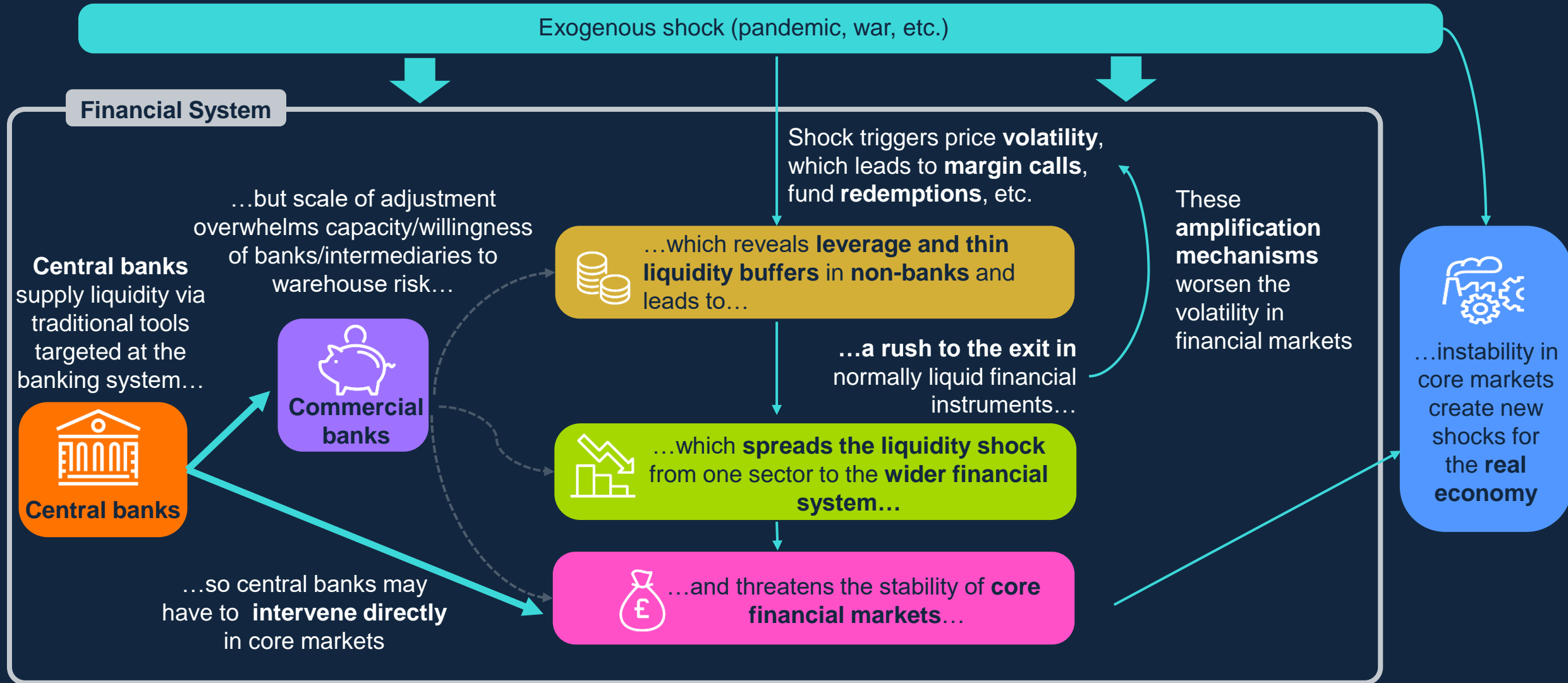


3. Central banks need new tools for a new era – capable of getting liquidity to new places, through new channels, in a stress. One size will not fit all.



4. Careful design is needed to maximise effectiveness while minimising risks: to the stance of monetary policy; to public funds; and to market incentives.

Dysfunction in core markets causes systemic liquidity risk



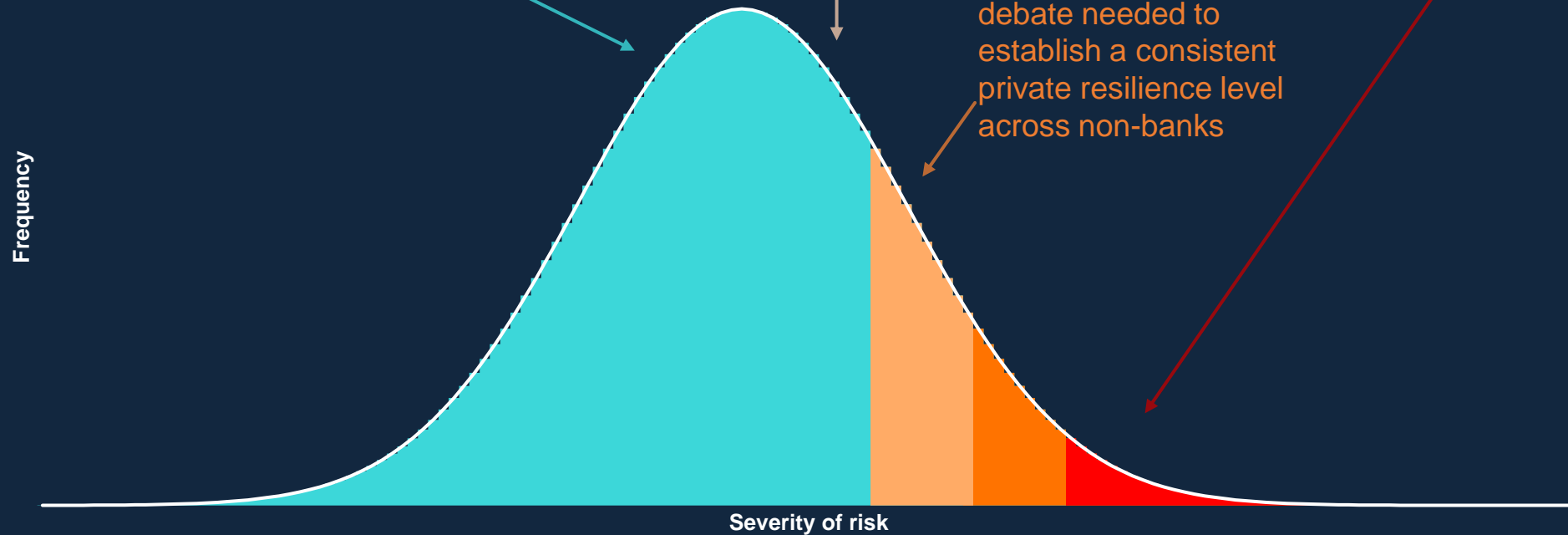
Public vs private insurance against non-bank liquidity risk

(1) Private sector firms should be responsible for self-insuring against a wide range of risk scenarios...

(2) Public authorities / central banks have a role in backstopping against severe stability-threatening risks...

(3) But excessive public insurance would be costly and dampen private incentives to manage risks

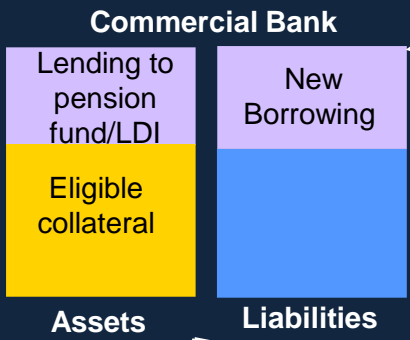
(4) And important public debate needed to establish a consistent private resilience level across non-banks



Central bank liquidity options to stop the LDI doom loop

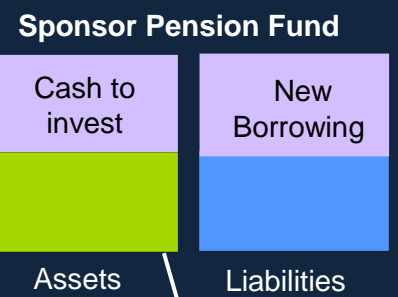


Option 1: Lend to commercial banks, who on-lend



Lending tools inoperative, via banks or direct

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Gilt purchases effective at stemming price spiral and allowing LDIs to reduce leverage

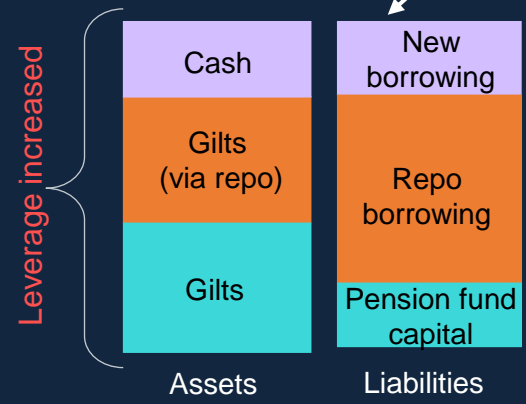
Lending to LDI funds would have further increased LDI leverage



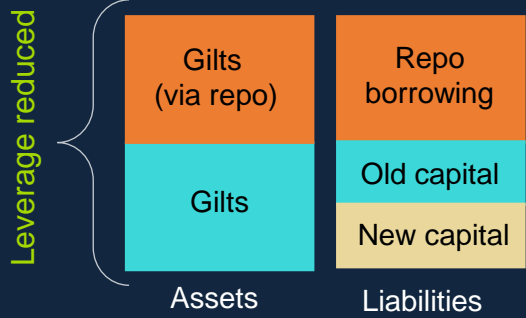
Pension funds not well placed to borrow and deploy new liquidity rapidly



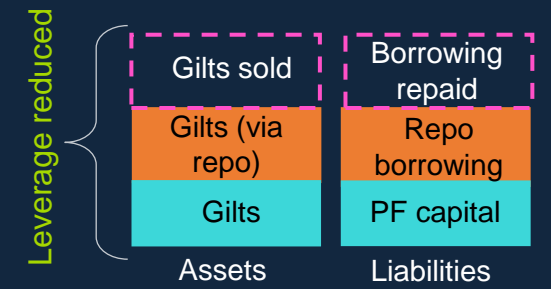
LDI fund



LDI fund



LDI fund



Option 2: Lend directly to LDI funds

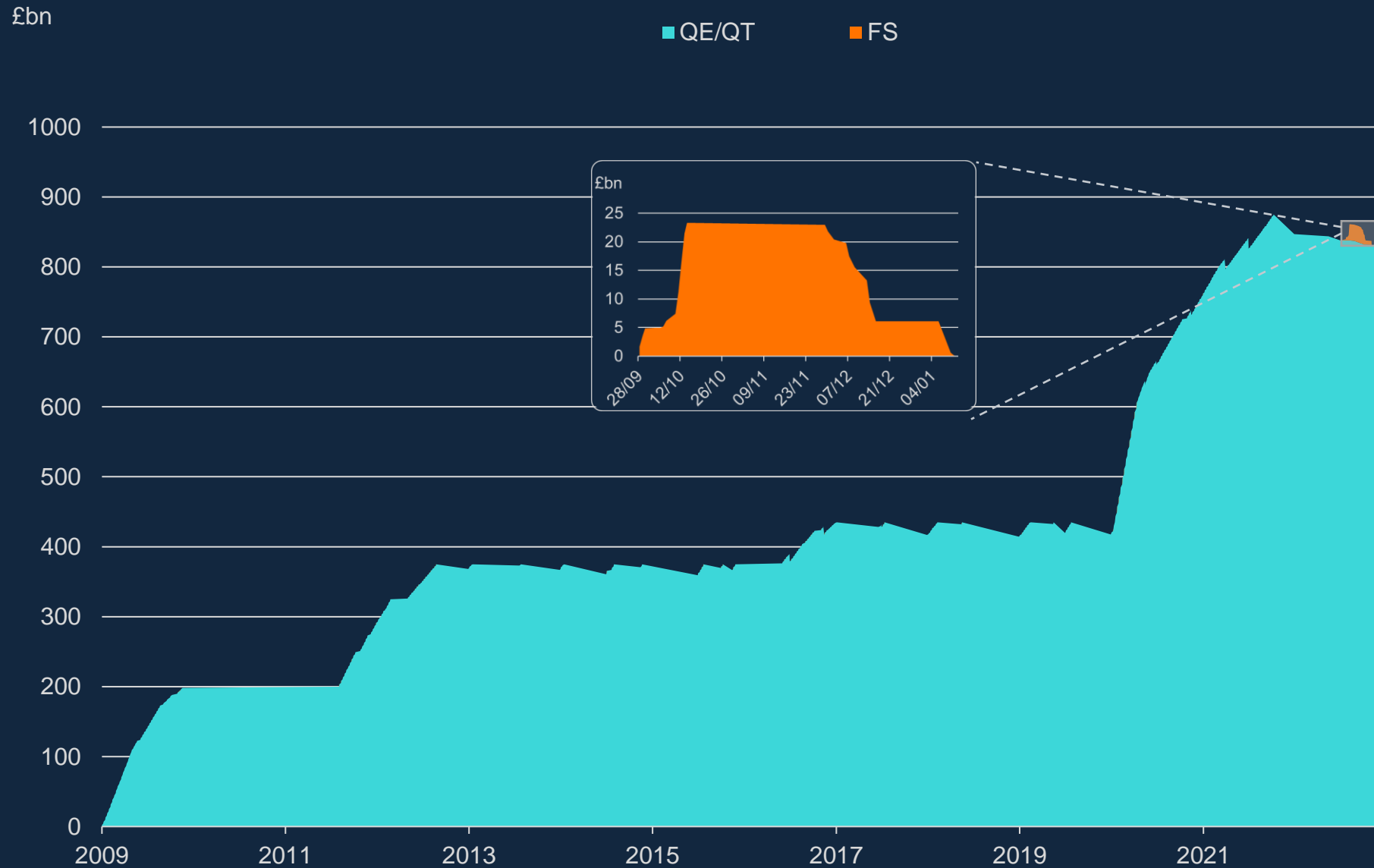
Option 3: Lend to sponsor pension fund

Option 4: Purchase assets held by LDIs

Comparing gilt purchases for financial and monetary stability purposes

	Financial stability purchases (Oct 22 – Jan 23)	Monetary stability purchases (QE)
Purpose and governance	Aimed at reducing the risk of a self-reinforcing price spiral triggered by LDI vulnerabilities. FPC recommended action to tackle financial stability risk; MPC informed, in line with the Concordat regarding balance sheet operations; Bank executive implemented.	QE aimed at easing monetary conditions in pursuit of the inflation target. MPC voted on quantity targets; Bank executive implemented.
Duration of purchases and exit plan	Temporary: purchases undertaken for only as long as required by financial stability issue; and unwound through sales back to market in timely and orderly way once dysfunction resolved.	High level targets for purchase, unwind and sales programmes voted on by MPC as part of its monetary policy process.
Asset selection	Targeted: at assets most affected by financial stability issue.	Appropriately broad based to achieve monetary policy goals.
Pricing	Backstop pricing: to ensure the facility did not unduly interfere with price discovery or substitute for the need for market participants to manage their own risks over the medium term.	Priced to deliver MPC-determined quantity targets.

Comparing QE/QT and FS purchase portfolios



Differential reserve pricing for conventional and index linked gilts

