

LASH Risk and Interest Rates

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**19th Annual Central Bank Conference
on the Microstructure of Financial Markets**

Session 6: Policy

November 21, 2024, Mexico City

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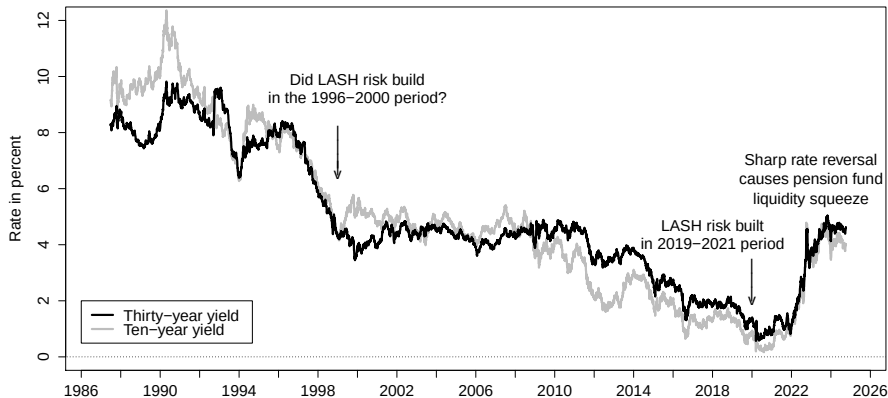
Overview of the Paper

- The paper teaches us a new word: “LASH”—liquidity after solvency hedging—risk. Do we need it?
- The paper then introduces a model in which this type of risk materializes—maybe put this after the empirics?
- The second part of the paper contains an analysis of the UK repo and swap markets in the January 2019-March 2023 period dedicated to documenting
 - The build-up of LASH risk in 2019-2021;
 - The avalanche of liquidity needs unleashed by the rate tightening in the 2022-2023 period.
- Finally, the paper includes some discussion of financial stability and regulatory implications.

Some Basics about Hedging of Financial Risks

- Financial institutions hedge against major risks they face.
- Standard hedges, say, through swaps without any embedded options, pay off in “bad” states as intended.
- However, by their linear nature, they have the “negative” side effect that there is a negative payoff in “good” states.
- Downside risks are reduced, but so are upside gains.
- That’s how hedges work!
- The paper seems to consider this outcome as something unusual, even introducing a separate term: “LASH risk.”
- This is good old plain-vanilla interest rate risk hedging.

Long-Term U.K. Gilt Yields and LASH Risk



- Note persistent decline in U.K. yields since the 1980s.
- This offers occasional potential for LASH risk to build as pension liabilities have longer duration than their assets.
- If a pension fund hedges the solvency risk **AND** long-term rates reverse sharply and abruptly, a liquidity squeeze can materialize.

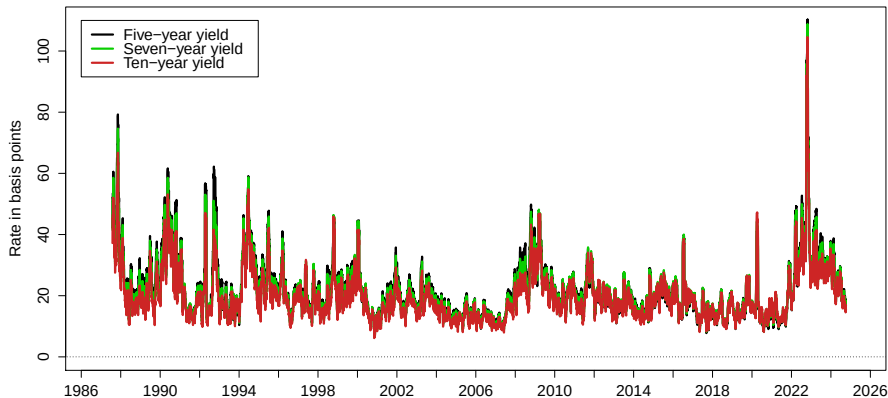
Financial Stability Issue?

- When an entire sector hedges against the same risk, there is a chance of systemic problems materializing.
- In this paper, though, we are talking about liquidity challenges in a “good” state for the sector in question, so pension funds are solvent.
- Still, they may be forced to fire sale some of their liquid assets, which may be down in value thanks to rising interest rates.
- In the “bad” state with declining interest rates, one hopes that the bank counterparties will be able to pay as well.
- Hence, on paper, the financial stability systemic risk looks manageable for this particular problem.

The Real Policy Question

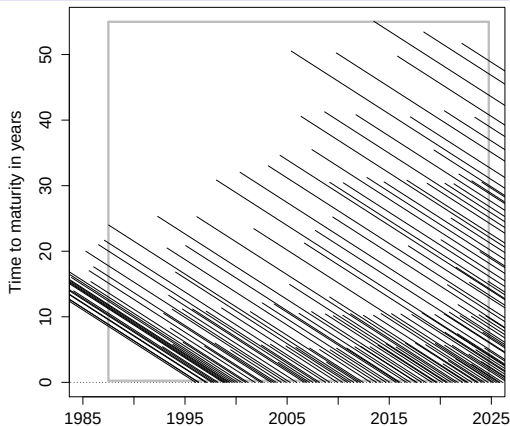
- The paper talks vaguely about a policy remedy—but what is the obvious negative externality here?
- If you want banks to hedge interest rate risk for real—they currently don't, SVB is a prime example—then you want the counterparties to banks' swap contracts to be able to pay out in a timely manner.
- In that context, I can see a systemic problem related to pension plans' ability to raise liquidity.
- However, if you go down that path for real, we are talking about trillions of dollars ...
- ... and when central banks have raised rates by 400-500 basis points, the money is gone in the sense that asset values are down across the board like in 2022-2023.

One-Month Realized Volatility of U.K. Gilt Yields



- The size and persistence of gilt yield volatility during the recent tightening episode were extraordinary, even outside the September 2022 crisis.
- It's surprising things didn't turn out worse – why?
- Is it because hedging was costly in that environment and few did it?

Maturity Distribution of the U.K. Gilts



- Shown is the universe of U.K. gilts since 1987.
- Note the diverse set of bonds issued with maturities of up to 55 years.
- To what extent did pension funds use the very long-term gilts to avoid LASH entirely?

- An interesting paper on the challenges facing UK pension funds in V-shaped interest rate episodes.
- As a reader, one wonders whether LASH risk is unique to the UK? Why? Why didn't this happen in Canada, Germany or the U.S.?
- The 2019-2023 V-shaped interest rate episode was a category 5 perfect storm, maybe we need to be careful about drawing policy implications from it.
- The same applies to the pandemic itself, the true cause for the V-shaped outcome.