UK financial markets face "cliff day"

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The UK financial system is at the centre of fears in global financial markets as "cliff day" dawns. The Bank of England (BoE) has said that today it will end its £65 billion bond buying program launched to counter the market turbulence which erupted after the Truss Tory government's mini-budget of September 23.

The bond market's violent response was not the result of opposition to the pouring of further money into the coffers of the corporations and the super-rich via tax cuts to the tune of £45 billion. Rather, it was because they were to be financed by increased government debt when they needed to be paid for by savage cuts in government spending on social services.

The first week of the intervention went fairly smoothly as the selloff of long-dated treasury bonds, gilts, which had sent yields rising by unprecedented amounts, eased.

But that all changed this week amid further mayhem as the markets confronted the fact that no long-term solution had been put in place.

Earlier this week the BoE had to intervene twice within the space of 24 hours as yields began to spike again.

They mounted so-called repo operations. Pension funds, seeking to cover margin calls from lenders who had financed the derivatives aimed at trying to protect their assets in liability-driven investments (LDIs), were able to place bonds overnight or for a couple of days with the bank to obtain cash. This was aimed at preventing further selloffs.

The first operation failed, and the BoE had to intervene again to extend the assets that could be lodged with it.

A BoE statement said the purpose of its operations was to enable LDI funds to address the risks from volatility in the gilt market. It said the funds had made "substantial progress" in the previous week.

"However, the beginning of this week has seen a further significant repricing of the UK government debt, particularly index-linked gilts [those with a mechanism aimed at protecting the holder against inflation]. Dysfunction in this market, and the prospect of self-reinforcing 'fire sale' dynamics pose a material risk to UK financial stability."

The threat to the stability of the entire financial system is underscored by the fact that, according to the Investment Association, LDI investment funds manage £1.5 trillion worth of assets in the UK. When the crisis first broke, there were estimates that up to 90 percent of these funds could have become insolvent had the fall in bond prices continued.

But the BoE's interventions have so far had little effect. Earlier this week Daniella Russell, head of UK rates strategy at HSBC, told the *Financial Times* the measures were "sticking plaster" and insufficient because they did not "fully recognise the long-term nature of the challenges."

The connection between the pension fund crisis and the broader financial system was spelled out in a statement by the Financial Policy Committee (FPC) of the Bank of England issued on September 30 but only published this week. The statement has been little reported but is highly significant.

"The FPC discussed that further corrections in global asset prices, especially if sharp and accompanied by rising credit risk concerns, could trigger further and faster redemption from money markets funds and open-ended funds investing in less liquid and riskier assets," it said.

The potential for open-ended funds, which allow daily withdrawals by investors but use those funds to invest in long-term assets, which cannot be quickly turned into cash, to cause a major crisis was the subject of the chapter in the International Monetary Fund's *Global Financial Stability Report* issued earlier this

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week.

The FPC said that, as with the LDIs, these funds could be forced into selloffs of assets financed by debt because of margin calls—demands for more collateral to back the loans they had taken out.

This could “interact with lower market-liquidity conditions and pose the risk of dysfunction in other funding markets, such as those for high-yield corporate bonds [so-called junk bonds whose rating is below investment grade] and leveraged loans.”

In other words, what began as a crisis for pension funds could end up with the meltdown of the entire financial system.

As its interventions failed this week, the BoE governor Andrew Baily began flailing about like some financial King Canute as he confronted the market waves and surges.

Speaking at an event organised on Tuesday by the Institute of International Finance on the sidelines of the meeting of the IMF in Washington, he said the BoE’s bond buying intervention would not be extended beyond today’s deadline.

“We’ve announced we will be out by the end of this week. My message to the [pension] funds is you’ve got three days left. You’ve got to get this done,” he said.

Whether they have will soon be tested out. But whatever the outcome, the UK crisis marks a decisive turn in the ongoing crisis of the international financial system as has been noted by a growing number of financial commentators.

Financial Times contributing editor, Megan Green the global chief economist at Kroll, a financial advisory firm, wrote in a column this week that the UK crisis would not be the last.

“As the era of cheap money comes to an end amid a global central bank tightening cycle, UK pension funds have been among the first bodies to float to the surface. I am certain they will not be the last.”

She noted that “an even bigger trigger point is Italy, which is particularly exposed to Russian gas, has little fiscal room and is already under pressure in bond markets despite support from ECB [European Central Bank] bond reinvestments.”

Posing the question of what is likely to break, she wrote big US banks were better capitalised but that was not always true for Europe and “on neither continent can regulators be confident about what lurks in the shadow banking sector.”

Corporate debt was also a problem for the US because in the non-financial sector it had hit almost 80 percent of GDP, with a third of this rated at BBB, the bottom rung for investment grade.

Sydney Morning Herald business columnist Stephen Bartholomeusz wrote that when it began the UK crisis could have been considered a unique event and posed the question: “Could it have been, however, the symptom of a wider problem and a foretaste of future crises to come?”

The rest of the article indicated an answer in the affirmative as he drew attention to the tightening of the US treasury market, the basis of the global financial system, and noted that “the liquidity issues in bond markets that traders are complaining about… point to markets, and financial systems, that are fragile and vulnerable.”

Bloomberg columnist Allison Schrager wrote that the UK pension dustup is only “the first buried body higher rates have uncovered.” US pension funds were less exposed but over time had acquired an equally troubling vulnerability because “they are underfunded and dependent on risky assets paying off” and could discover they had less money than they thought.

“Pensions may be just the beginning,” she concluded, “as the US economy has become dependent on low rates. And that means the new source of vulnerability may come from parts of the economy once thought of as boring and safe, like mortgages and now pensions.”

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