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LASH risk and Interest Rates

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This paper studies a form of liquidity risk that we call Liquidity After Solvency Hedging or “LASH” risk. Financial institutions take LASH risk when they hedge against solvency risk, using strategies that require liquidity when the solvency of the institution improves. We focus on LASH risk relating to interest rate movements. Our framework implies that institutions with longer-duration liabilities than assets—e.g. pension funds and insurers—take more LASH risk as interest rates fall. Using UK regulatory data from 2019-22 on the universe of sterling repo and swap transactions, we measure, in real time and at the institution level, LASH risk for the non-bank sector. We find that at the peak level of LASH risk, a 100bps increase in interest rates would have led to liquidity needs close to the cash holdings of the pension fund and insurance sector. Using a cross-sectional identification strategy, we find that low interest rates caused increases in LASH risk. We then find that the pre-crisis LASH risk of non-banks predicts their bond sales during the 2022 UK bond market crisis, contributing to the yield spike in the market.