Bank of England

Lord Bridges and Lord Hollick
Economic Affairs Committee Industry
& Regulators Committee
House of Lords
Committee Office
House of Lords
London SW1A

Andrew Bailey
Governor

7 October 2022

Dear George and Clive,

Thank you for your letter of 3 October.

The Bank welcomes the opportunity to answer your questions on the subject of liability-driven investment funds, and the Bank of England's gilt market operation launched on Wednesday 28 September. As you will know, the Bank is very conscious of the importance of its accountability to Parliament.

The Bank's Deputy Governor for Financial Stability, Jon Cunliffe, recently wrote to the Treasury Select Committee in response to a similar set of questions. I have attached his detailed letter to the TSC by way of responding to your queries.

In addition, you raised a number of points around the regulation of liability-driven investment (LDI) funds. Our letter to TSC sets out the different responsibilities of the Bank and the TPR, background to the identification of this vulnerability in 2018 and recent activity.

Whilst the PRA regulates bank counterparties of LDI funds, the Bank does not directly regulate pension schemes, LDI managers or LDI funds. Pension funds and LDI managers are regulated by The Pensions Regulator (TPR) and the Financial Conduct Authority (FCA). LDI funds themselves are typically based outside the UK, underlining the importance of work on this topic being pursued internationally.

Given the Bank's financial stability objective to protect and enhance the UK financial system, we have worked closely with other regulators – including TPR and the FCA – to enhance understanding of the financial stability risks that relate to pension funds. The Financial Policy Committee (FPC) has also supported domestic and international work on vulnerabilities in the system of market-based finance, including those related to pension funds.

The FPC conducted an assessment of the risks from leverage in the non-bank financial system in 2018. That included assessing the capacity of the biggest derivatives users among UK pension schemes to cover the posting of variation margin calls on OTC interest rate derivatives from up to a 100 basis point instantaneous increase in interest rates across all maturities and in all currencies, which was a historically unprecedented move in rates at the time and is larger than the moves during the 'dash for cash' in March 2020. The results suggested that pension funds would be resilient to a severe but plausible shock of that magnitude. However, the exercise also concluded that it was not clear whether pension funds pay sufficient attention to liquidity risks.

Following the FPC's 2018 assessment, the findings of the work were discussed with TPR. The Bank assisted TPR in surveying defined benefit (DB) pension funds' use of leverage, including via derivatives. The survey documented the use of interest rate swaps, inflation swaps and gilt repo borrowing by these funds. The Bank continued to work with TPR, alongside the FCA, to enhance the monitoring of potential losses generated by non-bank leverage.

The Bank and FPC also conducted extensive work to understand the role of pension funds in the March 2020 'dash for cash'. As part of its Financial Sector Assessment Program (FSAP) on the UK earlier this year, the IMF noted the response of the Bank in supporting the liquidity of non-banks, including pension funds, during that episode and endorsed further work. The Bank discussed how pension funds fared with TPR, prompting further work to improve pension liquidity risk management. There has been significant progress, both domestically and internationally, on the regulation and monitoring of the non-bank sector in recent years. Through the work of the FPC and the Bank more widely, as well as that of the FCA, the UK continues to be actively engaged in this programme.

The recent episode underlines the necessity of this work leading to effective policy outcomes. However, as Jon Cunliffe's letter to the TSC notes, it should also be recognised that the scale and speed of repricing leading up to Wednesday 28 September far exceeded historical moves, and therefore exceeded price moves that are likely to have been part of risk management practices or regulatory stress tests. The 30 year nominal gilt yield rose by 160 basis points in just a few days, having only had a yield of around 1.2% at the start of the year. On Wednesday 28 September the intraday range of the yield on 30 year gilts of 127 basis points was higher than the annual range for 30 year gilts in all but 4 of the last 27 years.

The Bank stands ready to provide further information to your Committees as and when you require it, and will keep Parliament updated on developments around its operations.

Yours sincerely

Andrew Bailey

cc: Charles Counsell, Chief Executive, The Pensions Regulator