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Making workplace pensions work

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Rt Hon Sir Stephen Timms MP
Chair
Work and Pensions Committee
London
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Dear Sir Stephen

Impact on defined benefit pension schemes of movements in financial markets

Thank you for your letter of 4 October regarding the recent movements in the financial markets and their impact on defined benefit (DB) pensions schemes.

We acknowledge that rapid movements in the markets will, for many savers, be concerning. There has been some media reporting that pension schemes were at risk of “collapse” due to rapid movements in the price of gilts. It is important to reassure the committee and savers that this is not the case. Contrary to this, the longer-term funding position of the majority of DB schemes has improved as a result of the increase in gilt yields, with the value of scheme liabilities falling by up to 50% depending on the scheme’s circumstances.

In our responses below, I explain the action we, as a regulator, have taken to set out our expectations for trustees in relation to liquidity and to update the committee, where possible, on next steps.

Q1 The nature of the problem and the causes of the difficulties DB schemes have been experiencing in the last week. For example, is it primarily a liquidity problem?

The nature of the problem facing DB schemes that adopted Liability Driven Investment (LDI) at the end of September was primarily an issue about short term pressure on liquidity (rather than a funding problem). Many DB schemes that operate LDI faced large cash demands from their investment managers at short notice due to the steep rise in long-term gilt yields.

LDI is an investment tool that has existed in the market for nearly 20 years. It has typically been used to protect schemes from adverse movements in interest rates and inflation and to reduce the impact on funding levels when interest rates fall. The key aim of LDI is that the assets of the pension scheme more closely match the liabilities.

Schemes that used LDI strategies to lessen the impact of falling or volatile interest rates over the past decade have been impacted less by previous market shocks such as the 2008 financial crisis and the recent pandemic. Over the past 20 years, long-term interest rates have been falling and LDI has also helped mitigate the impact of this. Overall, for many schemes, hedging has made funding more stable and improved funding levels. Whilst LDI provides downside protection in the event of falling yields, it does require collateral to be posted when yields rise, and this therefore requires planning on the part of trustees to ensure that they have liquidity available to match these calls.

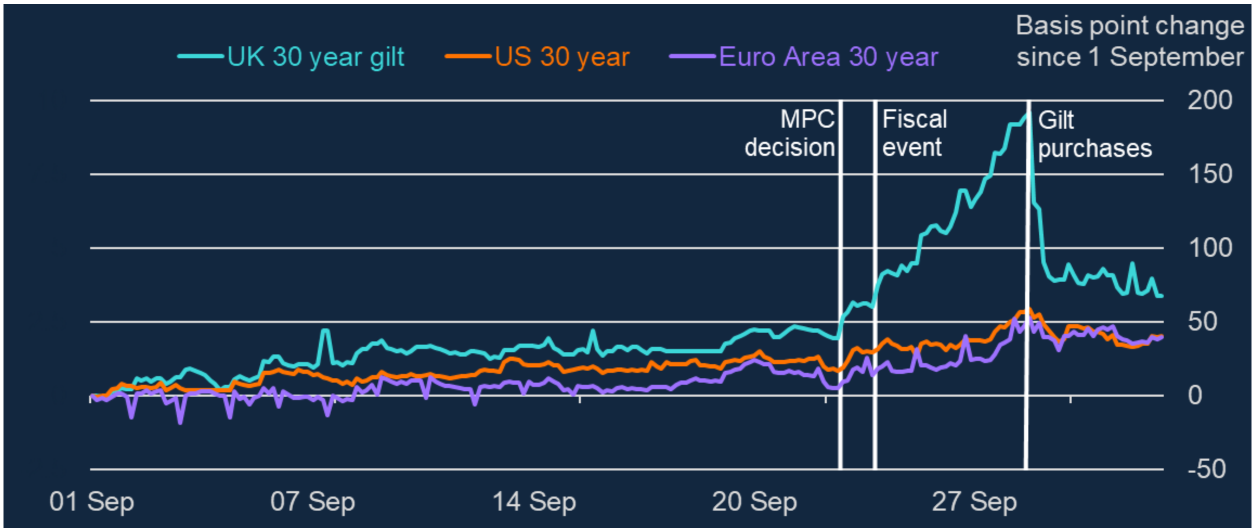
The risk of long-term gilt yields rising and the consequent need to post capital was well understood by the industry and dealt with through liquidity plans. It is the speed and the magnitude at which gilt yields increased at the end of September that caused the squeeze on liquidity.

In general DB schemes hold cash and gilts for liquidity purposes and can raise cash from assets (such as equities and corporate bonds). However, because of the size and speed of moves in gilt prices, LDI funds also sought additional collateral at a greater speed and scale than in any previously experienced market move. Put another way, a similar increase in yields spread over a number of months would not have resulted in the same challenges we have seen recently.

This created operational difficulties for some schemes because it takes time to raise an instruction to sell assets (for example trustee consent may be required) and it also takes time for cash proceeds to settle into bank accounts (often three to four working days).

The graph below of 30-year gilt yields (when compared to other regions) demonstrates this significant increase. Gilt yields have fallen back but remain more volatile than normal, and we have seen some rises in the last few days.

Increases in 30-year bond yields: UK, USA, and Euro area, basis points (1bp = 0.01%)



(Source: Bank of England)

Our view is that most trustees of DB schemes, their investment advisers, and LDI managers do think carefully about collateral requirements for their LDI funds, particularly the risk of gilt yields increasing. Generally, trustees will have pre-determined plans for the sources of collateral and how they will post collateral should the need arise. LDI managers typically work with a scenario of bond yields increasing by 1% within a few days. As can be seen in the chart, the change experienced in September was twice this amount and came against a backdrop of long-term gilt yields rising by 2% already in 2022.

At the end of September, counterparty banks asked for greater collateral (very significantly more than had been anticipated by the usual downside scenarios envisaged), and trustees of schemes/LDI managers found it challenging to source this liquidity at short notice.

If additional collateral is not posted, or LDI managers decide to reduce their exposure, LDI managers begin to sell the LDI assets and sell gilts. However, the collective selling of gilts pushes the price of gilts down further, and increases gilt yields, further exacerbating the problem and creating a negative feedback loop. Therefore, the Bank of England stepped in to stabilise the market to prevent that loop forming and to provide space for LDI managers and schemes to replan their liquidity needs

The exact outcomes for pension schemes is mixed. We understand that many pension schemes were able to continue with their LDI programmes but some may have been adversely affected by selling LDI at a low price and subsequently replacing it at a higher price. Pension schemes which did not have a significant amount of LDI in general will have seen their funding levels improve materially. This is covered in the next section.

Q2 **What do you expect the impact to be on DB scheme funding in the longer term?**

While it is too early to say with certainty, we continue to meet with the Bank and other regulators and stakeholders, including schemes of all sizes, to assess the impact on DB scheme funding, and to plan ahead in what is a fast-moving situation.

Increases in yields will have generally resulted in improved funding positions, in some cases materially so, and employers will have seen the absolute size of their DB obligations fall materially. The significant fall in gilt prices relative to other asset classes will also cause schemes to look afresh at their asset allocation and whether they should rebalance their portfolio and consider the balance of illiquid to liquid assets.

Where schemes have seen a significant improvement in their funding position, it is highly likely that they will seek to lock in that improvement. Some schemes might be significantly close now to achieving a full buy out.

It is important to state that the DB funding system gives trustees discretion and flexibility over the way they invest to deliver on their pension promises and manage risks, and we expect this to continue. Our new funding code will guide schemes to take less risk as they mature and particularly beyond the point of high maturity. It will also provide us with greater opportunity to intervene where the level of risk is not supported by the employer covenant.

Whilst we don't drive particular investment strategies, we do currently require trustees to consider the risk they are carrying and whether the employer covenant supports that risk. We do this primarily through our regulation of scheme funding and governance (and we consider enforcement action where appropriate).

We have consistently reminded schemes to have contingency plans in place, particularly given the likelihood of interest rate rises. In our 2022 Annual Funding Statement, we said:

> *Since the start of the year, long-term interest rates have risen and gilt yields continue to be volatile. The impact on scheme funding will vary depending on scheme investment and funding strategies, and the level of hedging in place. There could be collateral calls for schemes with substantial levels of geared hedging, and liquidity issues for investments remain as important as ever. (Our views on these can be found in the **AFS 2021**.)*

Q3 **What proportion of schemes use LDI strategies and for what proportion of their investments?**

We do not record in-depth data on the scale of collateral or leverage agreed to by DB schemes, and we do not ask every scheme to provide this data. In 2019, we produced a leverage and liquidity study with the Bank of England to gain a clearer picture of industry behaviour and this has informed how we assess and alert trustees to risk.

Generally speaking, from our engagements, and by speaking with the investment industry, we have good intelligence about what is happening in the DB investment market and the types of investment strategies adopted by trustees of DB schemes.

We have considered a number of external sources, and broader scheme data we hold to generate some estimates of the current size of the LDI market. It should be noted that due to the volatility of gilt prices and yields, these estimates cannot be absolutely accurate but provide a helpful insight for the committee.

There are two types of LDI agreements:

- Pooled – investors club together, buy assets, and share in the returns like any other fund.
- Segregated / bespoke pooled – the LDI assets are bespoke and the funds or assets are specific to the pension scheme.

At the end of 2018, there were c.2,400 LDI agreements. We expect this had grown to c.3,000 agreements by the end of 2021. Of the c.3,000 agreements, we expect about 60% are in pooled funds and 40% segregated. Given there are just over 5,000 DB schemes in the UK, this means about 60% of pension schemes have LDI.

When we consider assets under management (AUM) in DB schemes, our landscape analysis suggests c85% are in segregated LDI while c15% are in pooled agreements.

In terms of the size of liability hedging in the leveraged LDI market, one LDI survey we studied indicated that the total level of liability hedging was just over £1trn at the end of 2018. The hedging covers interest rates and inflation. We estimate that by the end of 2021, total hedging with LDI funds covered c.£1.4trn of liabilities for DB pension schemes. This is consistent with data we have from Scheme Returns, market movements, and the increased appetite for LDI. The rise in gilt yields in 2022 has significantly reduced the total amount of hedging. However, the total value of liabilities for DB schemes has also fallen by similar proportions.

Q4 **To what extent scheme members' benefits are secure?**

DB pension schemes are not at risk of "collapse" due to rapid movements in gilt yields. Our engagement with the industry in recent days has indicated that, for the vast majority of DB schemes, the overall impact of the rises in gilt yields in recent weeks has been to strengthen their funding position.

Individual DB schemes are managed by a board of trustees which makes independent decisions on investments, after receiving appropriate advice from experts, and are supported by their sponsoring employer.

Volatility in the investments held by pension schemes can have a knock-on effect on the overall funding of individual pension schemes and this risk needs to be managed prudently.

We have been consistently clear for many years, through our Annual Funding Statement and elsewhere, that DB scheme trustees and advisers should monitor and manage their level of liquidity and take action to ensure they are ready for any volatility in the markets. We remain vigilant to the risks and expect trustees to do the same and plan accordingly. The importance of schemes closely monitoring, and having plans in place to manage liquidity risks, was mentioned several times in this year's Annual Funding Statement.

Q5 **Regarding the Bank of England (BoE)'s intervention of 28 September: Who do you think this intervention has protected in the first instance?**

When the rapidly evolving issue with gilt yields emerged, the Bank of England intervened to address what it has described as unprecedented.

In a letter to the Treasury Select Committee, Sir Jon Cunliffe Deputy Governor, Financial Stability, set out the financial stability motivation for intervening. He wrote: *"The Bank acted to restore core market functioning and reduce the material risks to financial stability and contagion to credit conditions for UK households and businesses. The Bank's action is in line with its statutory financial stability objective to protect and enhance UK financial stability. The Bank's operation is intended to give the affected LDI funds time to put their positions on a sustainable footing, increasing their resilience to future stresses."*

More stable long-term gilt yields is helpful to pension schemes. It provides stability which gives schemes time to consider their current position, consider the extent to which they might need to rebalance their asset portfolio given the dramatic market movements and most importantly to put in place a new liquidity plan based on their current position.

Funding levels of schemes have been maintained, limiting potentially significant calls on sponsoring employers for higher contributions when they do their next valuation. Indeed, the generally more favourable funding positions might lessen the burden on sponsoring employers.

Ultimately, a well-funded scheme requires less covenant support, reducing or eliminating the need for deficit repair contributions and allowing a sponsoring employer to focus on its own sustainable growth.

Q6 **Did TPR ask the Bank of England (BoE) to intervene?**

As the gilt market instability developed, we established regular contact with the Bank of England and other regulators about what action could be taken to mitigate risks from rapid changes in the gilt market. Fundamentally, it was the Bank's decision to intervene in the way it did.

Q7 **Without the intervention, would responsibility have fallen on sponsoring employers? Was there ever a risk to the Pension Protection Fund?**

The Bank of England's intervention to restore orderly conditions through temporary purchases of gilts meant the risk to schemes and their sponsoring employers was minimised.

Without the Bank's intervention, some schemes would have faced much larger collateral calls and would either have been forced to reduce levels of hedging or possibly seek support in the form of liquidity from their sponsoring employers to protect their LDI investments. This, in turn, could have had an impact on the scheme sponsor. As noted above, the generally more favourable funding positions might lessen the burden on sponsoring employers.

Whilst the impact of this rise in yields has been favourable to schemes, if a scheme's deficit had increased, the sponsoring employer may be required to increase its payments to the scheme to reduce the deficit over the period of a recovery plan.

We do not believe that the recent issues significantly increased the short-term risk of schemes entering the PPF. They have been clear in correspondence with us that they were not at risk, were well prepared (through prudent liquidity management and maintaining a healthy cash buffer) and managed to keep all their liabilities fully hedged without needing to sell assets.

Q8 **What impact do you expect the end of the BoE intervention on 14 October to have?**

We continue to work with the Bank, other regulators, and pensions schemes to put in place mitigations for events that might happen after 14 October and to assess the impact on DB scheme liquidity, and to plan ahead.

Q9 **What was the outcome of the emergency meeting of regulators reported at the end of last week?**

We meet regularly with regulatory colleagues. That regular engagement increased, as you would expect, in response to the urgency of the situation. These meetings allow for the regular flow of information and intelligence. Discussions are ongoing.

Q10 What further communications do you intend to issue to pension schemes, sponsoring employers and scheme members?

We will shortly be issuing a regulatory guidance statement for trustees. This will set out our expectations of the risks that pension schemes should be considering at this time and seeking to ensure that they have robust plans in place to manage them.
We have been consistent in our call on trustees to follow our guidance but given the volatility witnessed in the markets, we will continue to strongly remind schemes and their advisers that they must fully understand the risks they currently have and refer to our existing guidance.

Q11 Your guidance on DB investments says trustees may wish to consider LDI but that it has risks: "*Trustees may wish to consider LDI to enable them to better manage the interest and* *inflation risks within their schemes. However, LDI introduces some additional risks, e.g. around leverage and collateral management, and trustees should understand these and take appropriate steps to manage them.”* **In light of the events of the last week, do you think still think LDI is fit for purpose? Do you intend to issue new guidance?**

The DB funding system was designed to give schemes flexibility over the way they invest; to find the right strategy that enables them, within an acceptable level of risk, to generate the returns they need to deliver the pensions that savers expect. A fundamental cornerstone of the trust-based pensions system is the fiduciary duty that trustees have.

As mentioned in Q2, while we don't drive particular investment strategies, we do require schemes to consider the risk they are carrying and whether the employer covenant supports that risk. As such, we believe it is right that schemes make their own assessments about what is a prudent investment, backed by the right level of liquidity and in line with our clear expectations.

LDI may continue to be used as a tool by schemes to make scheme funding levels less volatile. In light of changing market conditions, funding levels and other factors, prudent pension funds will regularly review their LDI strategies, and the level of leverage within them. It is unclear whether the use of LDI will change as a result of the significant changes in funding levels as a result of bond yields and the associated asset allocation decisions that trustees may make as a result of that. We will be giving further consideration to this alongside other regulators.

Pension schemes that use LDI should have plans in place so that if interest rates rise and they are required to post collateral, they understand where that capital will come from. Schemes and LDI managers consider risk, and typically conduct a stress test against a 1% rise in long term gilt yields (over a period of weeks). What we have seen recently is an extreme event in which gilt yields increased at unprecedented speed by over 1.5% in less than three days making it challenging for funds to respond quickly enough. This followed a more gradual increase in bond yields during the previous six months.

To add further insight, in his recent letter to the Economic Affairs Committee and the Industry and Regulators Committee, Bank of England Governor Andrew Bailey pointed out 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.

Whilst schemes have generally coped with the additional capital calls required, this went beyond the contingency plans that most schemes had in place and was creating stress within the financial system.

We will keep the need for new guidance under review in light of any further announcements from the Bank of England and we are now planning to issue a regulatory statement.

Q12 A blogpost published by TPR in August said that: “a*necdotally, we hear that some schemes may have been under-prepared, after years of falling interest rates in which LDI funds were paying collateral back to schemes. But we know that advisers were making trustees aware of the risks, and our DB investment guidance covers it too […] We remain vigilant to the risks* *and expect trustees to do the same."* **What were you doing to monitor the risk to pension funds? Do you now think you should have taken stronger action earlier?**

As mentioned in question 3, from our engagements, and by speaking with the investment industry, we have good intelligence about what is happening in the DB investment market and the types of investment strategies adopted by trustees of DB schemes.

We have consistently alerted trustees to liquidity risk. In May this year, we used our Annual Funding Statement - our milestone publication for DB schemes each year – to call on trustees to consider their liquidity plan and take necessary precautions in light if rising interest rates.

In our communications to trustees, we have consistently called on trustees to ensure they have the liquidity plans in place in the event of any significant downside risk.

In our supervision work, and when we have cause to engage with a scheme, we consider a scheme's investment approach and within this, how the trustees are managing risk.

Our detailed investment guidance to schemes is clear, and as mentioned above, we have used our Annual Funding Statement for many years to update schemes on emerging risk, such as rising interest rates, and to set out our expectations, noting we will intervene if those expectations are not met.

We use our communications to trustees to alert them to the danger of risk. This includes direct emails and also external communications such as speeches and blogs. As well as the blog you refer to, we also published a blog in 2020 entitled 'Now is the time to manage liquidity risk', which you can read here. David Fairs wrote: *"…we have become more interested in understanding how trustees manage their scheme liquidity risks and to ensure that trustees actively monitor and manage their scheme liquidity requirements."*

Next steps

We will be issuing a regulatory guidance statement to trustees to update on our expectations regarding LDI.

To build on our understanding of the LDI landscape, our investment consultants and actuaries are conducting some new analysis, which includes issuing data requests to a number of schemes. Our supervision team is also reviewing information gained from previous engagements to help clarify the picture we have.

As well as meeting with schemes and advisers, we have also recently met the Pensions and Lifetime Savings Association and the Association of Professional Pension Trustees to discuss their experience and their members' plans.

We are also now examining how we can update our guidance for DB schemes and ensure that in light of the current economic conditions our supervision teams are setting out very clearly our expectations on managing liquidity.

We will continue to communicate our expectations clearly and effectively to trustees.

It is clear the rapid movement in gilt yields has been extreme and unexpected. However, we always learn lessons from situations such as this – as we did following the pandemic - to update and improve our approaches. As well as the lessons we will learn, there will undoubtedly be lessons for the pensions industry. This may include governance improvements so schemes can react more quickly and make decisions in real time.

I hope this information is useful to you and the committee.

Yours sincerely

Charles Counsell
Chief Executive

cc: Andrew Bailey, Governor, Bank of England
Sir Jon Cunliffe, Deputy Governor – Financial Stability, Bank of England
Richard Lloyd, Chair, FCA
Alex Burghart MP, Parliamentary Under Secretary of State, DWP
Oliver Morley, Chief Executive, Pensions Protection Fund

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From Sir Stephen Timms, Chair of the Work and Pensions Committee

Charles Counsell
Chief Executive
The Pensions Regulator

4 October 2022

Dear Charles,

Impact on defined benefit pension schemes of movements in financial markets

Many people – including members of defined benefit pension schemes and sponsoring employers - will have been extremely concerned to read about the impact on pension funds of the fall in the price of long-dated government bonds last week. We understand this led to pension funds using liability driven investment (LDI) strategies facing unexpected 'margin calls', effectively, demands for cash. According to press reports, schemes were selling stocks and bonds and making demands on their corporate backers to meet these demands. While the Bank of England's announcement on 28 September under its Financial Stability remit of the temporary purchase of long-dated gilts appeared to ease the pressure on schemes, there remains concern at what might happen when this intervention ends on 14 October.[1]

We would be grateful if in response to this letter, you could set out your analysis of:

- The nature of the problem and the causes of the difficulties defined benefit (DC) schemes have been experiencing in the last week. For example, is it primarily a liquidity problem?
- What do you expect the impact to be on DB scheme funding in the longer term?
- What proportion of schemes use LDI strategies and for what proportion of their investments?
- To what extent scheme members' benefits are secure.

Regarding the Bank of England (BoE)'s intervention of 28 September:

- Who do you think this intervention has protected in the first instance?
- Did TPR ask the Bank of England (BoE) to intervene?
- Without the intervention, would responsibility have fallen on sponsoring employers? Was there ever a risk to the Pension Protection Fund?
- What impact do you expect the end of the BoE intervention on 14 October to have?

Regarding your own approach:

[1] UK pension funds sell assets and tap employers in rush for cash, Financial Times, 30 September 2022

- What was the outcome of the emergency meeting of regulators reported at the end of last week?
- What further communications do you intend to issue to pension schemes, sponsoring employers and scheme members?
- Your guidance on DB investments says trustees may wish to consider LDI but that it has risks: "*Trustees may wish to consider LDI to enable them to better manage the interest and inflation risks within their schemes. However, LDI introduces some additional risks, eg around leverage and collateral management, and trustees should understand these and take appropriate steps to manage them.*" In light of the events of the last week, do you think still think LDI is fit for purpose? Do you intend to issue new guidance?
- A blogpost published by TPR in August said that: "a*necdotally, we hear that some schemes may have been under-prepared, after years of falling interest rates in which LDI funds were paying collateral back to schemes. But we know that advisers were making trustees aware of the risks, and our DB investment guidance covers it too […] We remain vigilant to the risks and expect trustees to do the same.*" What were you doing to monitor the risk to pension funds? Do you now think you should have taken stronger action earlier?

Given the widespread concern about and urgency of this issue, I would appreciate an initial response by Monday 10 October.

Yours sincerely,

Rt. Hon. Sir Stephen Timms
Chair
Work and Pensions Committee