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Lords Hollick and Bridges
Chairs of the Industry and Regulators, and Economic Affairs Committees
Houses of Parliament,
Parliament Square,
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20 October 2022

Dear Lord Hollick and Lord Bridges,

**RE: Liability-driven investment funds**

Thank you for your letter of 14 October.

On 23 September and for a short period thereafter the gilt market experienced a very rapid and significant repricing that was more extreme than any previous period of volatility and wider than many market participants had deemed plausible in such a short timescale. That required close working between the Financial Conduct Authority (FCA), the Bank of England and the Pensions Regulator (TPR) to monitor and respond to the impact this unprecedented volatility had on Liability Driven Investment funds (LDI funds). That close working will continue given ongoing volatility across a number of markets and as we look at what lessons may be learned from this episode.

As you note, the FCA is one of several regulators involved with this market: TPR regulates the defined benefit (DB) pension schemes. Some schemes choose to apply LDI strategies to mitigate interest rate risk. A subset of these schemes (around a tenth) does so through pooled LDI funds. Pooled LDI funds allow smaller DB schemes, which are not sufficiently large to manage their own segregated accounts, access to this mitigation strategy.

The FCA regulates the fund managers, which make investment decisions based on strategies agreed with the trustees of DB pension schemes for a segregated mandate or in a pre-agreed way for a fund.

Fund managers based in the UK must be regulated by the FCA. This means they must apply to the FCA to be authorised, must demonstrate they meet minimum standards on an ongoing basis, their senior management must be approved by us, and they must adhere to our rulebook.

To ensure fund managers meet our standards, the FCA has powers to request information from those it regulates, to make requirements of them, if necessary, and, where there is evidence of serious misconduct, to take enforcement action.

Most of the funds marketed here are domiciled outside the UK, often in European Economic Area (EEA) jurisdictions. Funds' risk management is overseen by an Authorised Fund Manager (AFM), most often based and regulated in the same jurisdiction as the fund. This AFM may delegate day-to-day portfolio management. We are responsible for supervising those portfolio managers based in the UK, including that they have adequate systems and controls to undertake their role.

LDI funds are generally based in EEA countries and are typically managed in this 'delegated' way.

The UK banks which lend to LDI funds or are their derivative counterparts are regulated by the FCA for conduct issues and the Prudential Regulation Authority (PRA) for their prudential supervision.

**LDI funds and their managers**

As Charles Counsell noted in his letter to you[1], LDI strategies have been important in mitigating the impact of low, long-term interest rates over the last 20 years. This has improved funding levels in DB pension schemes and generally ensured funding is more stable from the perspective of the sponsoring employer. The TPR estimates, for example, that a 100 basis points fall in gilt yields results in a 15% increase in a DB scheme's funding gap. LDI strategies have enabled DB schemes to manage this risk, and this important hedging role has been in evidence again this week as long-dated gilt yields fell.

In addition, LDI strategies allow DB pension schemes to borrow to increase their long-term gilt holdings, assets which most closely match the value of pension liabilities. DB pension schemes in the UK have typically been underfunded, so leverage allows DB schemes to mitigate exposure to changing interest rates while investing in productive assets that might seek to close any funding gap.

This approach does contain within it risk in the event of rising gilt yields; a risk that was well known. Indeed, the FCA had worked closely with the Bank of England on an in-depth review of LDI funds as part of wider work on non-bank financial risk. The result of this work was published in the November 2018 Financial Stability Report[2]. This work included scenario analysis of funds' ability to cope in adverse markets.

In the context of rising bond yields, interest rates and inflation over recent months, the FCA was alive to developing risks for LDI funds, as were the funds and their managers.

In March this year, the FCA contacted the largest LDI fund managers asking them what plans they had in place to deal with increased volatility and to absorb volatility in excess of the previous scenario analysis. We also probed large managers on the speed with which they could call money from underlying pensions funds in the event of stress, in some cases leading to a shortening of this period and an increase in their resilience.

In May and June, we saw these funds subject to significant margin calls, which they met according to their plans without systemic issues or concerns

We remained in close contact with fund managers through the summer and early autumn. By Thursday 22 September firms had buffers in place to deal with greater market stress than they had experienced previously, in accordance with what they saw as extreme but plausible in terms of sharp moves in the value of UK gilts.

It is important to acknowledge that, as in any risk management system, there are tradeoffs with increased resilience: the higher the 'buffers' or insurance that funds hold against extreme price moves, the lower the leverage and the potential for DB schemes to close their funding gaps, potentially requiring higher contributions from sponsors.

**Market stress**

As Sir Jon Cunliffe reported in his letter to the Commons' Treasury Committee[3], the scale and speed of the repricing of gilts far exceeded historical precedent.

[1] https://committees.parliament.uk/publications/30357/documents/175427/default/
[2] https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2018/november-2018.pdf
[3] https://committees.parliament.uk/publications/30136/documents/174584/default/

At the start of this year, 30-year gilts had a yield of around 1.2%. In less than a week after 23 September, the yield rose by 160 basis points. Over this four-day period, the yield increase in 30-year gilts was twice as large as the previously most significant increase since 2000. This occurred in March 2020, during the early part of the Covid pandemic when investors rapidly increased cash holdings.

The scale of this repricing and the speed at which it happened caused LDI funds the significant challenge of having to sell gilts into an increasingly illiquid market, further depressing the price, and/or asking DB pension schemes for more capital in order to meet increased margin calls. It was in response to this historic pressure that the Bank of England intervened on the recommendation of the Financial Policy Committee.

During this intervention, the FCA worked closely with fund managers to ensure that they took advantage of the time provided by the Bank of England's intervention to de-leverage and to recapitalise LDI funds, which they have done.

In addition, we and the Bank of England have been working closely with the LDI managers to ensure they have increased resilience to deal with possible future volatility. We will also continue to work closely on what lessons might be learned from recent challenges. In addition to financial resilience, one area of focus for the future is likely to be operational resilience – whether the funds and their managers have the systems in place to adjust to rapidly changing market conditions.

**Protection of DB scheme members**

It is important to stress that – contrary to some press reports – we have no indication that this episode put at risk the solvency of DB pension funds. In the proximate worst-case situation, we were concerned pension funds would have lost their LDI hedges, but it should not have threatened their solvency.

The fund managers we oversee have a responsibility to treat their customers fairly and to have adequate systems and controls to manage their business effectively.

The primary protection for DB scheme members is scheme trustees, who have a responsibility to ensure a pension scheme is run properly and that members' benefits are secure. In its role as the relevant regulator, the TPR provides guidance to trustees. Typically, trustees are professional or professionally advised.

Our rules and supervision of fund managers focuses on systems and controls, including financial and operational resilience. This focus provides protection to investors, including DB schemes.

Rules in place for fund managers include a high-level requirement to have suitable risk management systems, including to manage liquidity risk. These are there to ensure funds are managed in such a way that they are able to deal with a range of conditions, including normal and extreme but plausible market stress. As discussed above, we have supervised against this standard, requiring fund managers to provide us with information and asking them to bolster their risk management systems during periods of heightened volatility and these systems have been sufficiently tested.

The FCA and TPR recognise we have shared responsibility for the pension sector and for consumer protection within it, which is why we have had a joint strategy in place since 2018. This strategy, which is shortly to be updated, sets out a number of workstreams, joint and complementary, that are designed to improve the pension sector for DB and defined contribution savers alike.

This strategy is underpinned by a memorandum of understanding, which supports the FCA and TPR coordinating policy and as well as the sharing of information and intelligence. The aim is

that we can work together, and support each other, in taking action where we are concerned about risks to consumers in either the DB or DC pension market. We drew on this, for example, where we have had concerns about pension transfers from occupational schemes.

As noted above, the prevailing model of asset management is that of delegation, with most funds marketed here and the AFMs responsible for their risk management based outside the UK. Additionally, any Alternative Investment Fund registered under the national private placement regime can market freely to professionals in the UK.

Given the cross-border nature of funds and the interconnectedness of global markets, we work closely with other securities regulators and central banks. This collaboration includes monitoring the activities of and potential risks posed by non-bank financial institutions, as well as coordinating policy designed to protect market integrity and reduce potential financial stability risk. We look to enhance both domestic and global standards through our international work at IOSCO and the Financial Stability Board (FSB). I sit on the FSB's Steering Committee on non-bank financial intermediation.

We worked with international counterparts to develop the FSB's proposals to enhance the resilience of money market funds, following the 'dash for cash' witnessed in March 2020. We have since published a joint discussion paper with the Bank of England on potential policy remedies that we will take forward domestically, while continuing the international dialogue. Additionally, we are actively involved in the FSB's work on liquidity risk management tools for open-ended funds, which will help inform G20 decision making.

The FCA has good working relationships with the Central Bank of Ireland and Commission de Surveillance du Secteur Financier in Luxembourg, the regulators in those jurisdictions in which funds marketed in the UK are most often based. This enables the sharing of information and intelligence, as well as supervisory cooperation. Inevitably, regulators have different approaches, which may include the intensity of supervision, the availability of resources and what reporting they require or expect from the firms they oversee.

The FCA's 2017 Asset Management Market Study[4] noted the important role investment consultants play in advising pension fund trustees on which asset manager to select and which investment strategies to adopt. That study included a recommendation for government to bring investment consultant services within our remit as they are currently unregulated. We reiterated that recommendation in our 2020/21 Perimeter Report[5].

I hope your committees find this input helpful.

Yours sincerely,

**Nikhil Rathi**
**Chief Executive**

[4] https://www.fca.org.uk/publication/market-studies/ms15-2-3.pdf
[5] https://www.fca.org.uk/publication/annual-reports/perimeter-report-2020-21.pdf