Government Actuary's Department

Rt Hon Sir Stephen Timms MP
Work and Pensions Committee

Finlaison House
15-17 Furnival Street
London
EC4A 1AB

www.gov.uk/gad

14 December 2022

Dear Stephen

Subject: Inquiry into Defined Benefit (DB) pensions with Liability Driven Investments

Thank you for inviting us to contribute to your Committee's inquiry into defined benefit (DB) pension schemes with Liability Driven Investments (LDI).

My responses to your questions are set out below.

1. **In light of recent problems related to the use of LDI products by pension funds, is the current system of pensions regulation adequate to manage systemic risks?**

   Systemic risk refers to the risk or probability of breakdowns in an entire system, as opposed to breakdowns in individual parts or components, and is evidenced by correlation among most or all the parts. Within the UK pensions landscape, the pursuit of similar investment strategies by a significant proportion of otherwise independent pension schemes can create the sort of conditions where systemic risks arise.

   The movements in long-dated bond yields in late September, although part of a longer upward trend, was unprecedented and well above the levels for commonly applied stress tests. It should also be noted that overall, the increase in long term interest rates since early 2022, culminating in the sharp increases at the end of September, has improved the overall funding of pension schemes. However, during the crisis many schemes that were invested in leveraged LDI had significant operational difficulties to meet the collateral calls required under their LDI contracts. A number of pension schemes may not have managed to meet these collateral calls and as a result may have lost part of their hedging protection in early October which in turn exposed them when long dated bond yields subsequently reduced. Some schemes may have incurred financial losses.

Liquidity

The liquidity crisis was caused principally by the unprecedented and frequent collateral calls on pension funds operating leveraged LDI strategies that exhausted their cash pools and, for some, forced sales of long-dated gilts into a falling market, causing further downward pressure on bond values, which in turn required yet more collateral to be posted. It was exacerbated by governance and operational bottlenecks within parts of the system, particularly in relation to pooled funds.

To ease the pressure on the system and prevent further escalation and possible contagion to other parts of global financial markets, the Bank of England acted to calm bond markets by announcing an intervention to buy gilts.

Two of the main contributing factors were therefore:

- The large aggregate volume of assets that were aligned to the same strategy, with an estimated 1,800 separate pension schemes using pooled LDI funds (with a further 1,200 schemes using non-pooled LDI, out of a total universe of more than 5,000 UK schemes), of which some were employing high levels of leverage.

- The inadequacy, in the event, of collateral plans to prove resilient in the face of such large market movements.

Even for schemes with adequate plans to post collateral there were significant governance challenges that had to be overcome to effect the required collateral postings.

Governance and operational risk

One of the lessons to be learned from the liquidity crisis might, therefore, be to increase the visibility to all stakeholders of the operational and governance risks associated with strategies such as leveraged LDI and especially those associated with pooled funds.

- The Pensions Regulator (tPR) has the power to collect data from schemes for regulatory purposes and can therefore obtain good aggregate and specific data on the use of critical investment strategies such as leveraged LDI. We are aware of the DB Pension Scheme Liquidity and Leverage Survey of December 2019 in which tPR sought information from 137 of the largest schemes to help regulators assess the potential for systemic risks to arise as a consequence of the use of leverage. A more systematic, regular and comprehensive collection of data on such strategies and the collateral and operational risk management approaches adopted by schemes of all sizes may now be considered appropriate. Having such information to assess the scale and range of exposure, assists in engaging across the regulatory space to form mitigation strategies.

- Consideration may also be given to requiring schemes to perform and report on the results of investment stress tests.

- TPR also works to educate trustees and advisers of the risks and offer guidance on mitigations and precautions. The comprehensive guidance, “Maintaining liability-driven investment resilience”, published last month following the recent events is a good example of this. More generally, consideration might also be given to the sufficiency of disclosure requirements on trustees about their governance and management of investment and associated operational risks in, for example, the annual report of the scheme or the statement of strategy (as is set out under the new draft funding and investment regulations). Requirements such as these can be very effective “nudges” to further embed good practice.

Measures that seek to reduce the risks that individual schemes face may not in themselves be sufficient to prevent the systemic risks arising, caused as they are by the concentration and similarity of the individual scheme investment strategies. Consideration might additionally be given to how tPR itself reports on systemic risks within its regulated landscape.

2. **Are there further risk mitigation steps that financial regulators and/or the Government should consider based on reflections on recent events?**

There should be some caution against an over-reaction or the introduction of overly restrictive regulations. Many schemes that use LDI did weather the issue as they were well prepared. A number of mitigations have already been voluntarily introduced from various stakeholders and the wide coverage of this issue is expected to have provoked users of LDI to challenge their investment strategies and governance processes.

It is worth noting that in general, leveraged LDI allows schemes to manage funding risks from changing bond yields, whilst still having funds available to invest in non-bond assets, such as equities, that are expected to generate a higher return than bonds. In some cases, the mitigations to the LDI issue may result in a lower allocation to leveraged LDI or reduced allocations to non-bond assets, which could increase funding risk or reduce expected return, lengthening the time it takes a scheme to reach its objective (typically to buy bulk annuities and wind up).

Many schemes are used to making such compromises but is worth noting that whilst schemes remain on their journeys to eventual wind up, they (and indirectly their sponsors) are also bearing investment and other risks.

Risk reporting

As noted above, more detailed and widespread reporting on pension scheme investment strategy and risk could improve understanding of those risks. Elements of that reporting could be made available to inform trustees where they stand relative to peers and allow challenge to their advisers.

Improved availability of data on LDI should help trustees appropriately challenge their advisers and LDI managers and to make judgements on the potential benefits of using LDI relative to the complexity and risks it can introduce.

Looking beyond LDI

We note in the new year there will be a further inquiry looking at DB schemes more widely.

Increases to long dated yields have in general left most schemes better off, even if some have endured stresses from LDI. This has brought forward many schemes’ funding journeys by several years which, for most schemes, means they have got closer to their eventual goal of buying bulk annuities with an insurer and winding up the scheme.

We expect LDI will continue to have an important role for schemes on this journey, potentially right up until the purchase of bulk annuities, although we would expect leverage levels to be reduced as schemes near this target. During this phase we expect ‘traditional’ funding and investment risks will be low (e.g. those from asset volatility), with other risks such as those posed by operational aspects of investing and administrative aspects of running a pension scheme to become proportionately greater.

Other related factors will also influence the funding journey and use of LDI, such as the economic outlook, the role of DB scheme consolidation and insurer capacity for bulk annuity transactions.

Yours sincerely

Martin Clarke
Government Actuary

Work and Pensions Committee

House of Commons | London | SW1A 0AA
Tel 020 7219 8976 Email workpencom@parliament.uk Website www.parliament.uk/workpencom

Martin Clarke

Government Actuary

From the Chair

1 December 2022

Dear Martin

Inquiry into Defined Benefit (DB) pensions with Liability Driven Investments

My Committee is conducting an inquiry into defined benefit (DB) pension schemes with Liability Driven Investments (LDI).

We are aware that the Government Actuary's Department (GAD) has excellent insights from advising on policy risks across a wide area, whether these are risks to government policy achieving its objectives, or perhaps risks created by government policy. It would therefore be helpful to have a view from the GAD on the following questions:

1. **In light of recent problems related to the use of LDI products by pension funds, is the current system of pensions regulation adequate to manage systemic risks?**

2. **Are there further risk mitigation steps that financial regulators and/or the Government should consider based on reflections on recent events?**

It would be very helpful to have a response by Wednesday 14 December.

Yours sincerely,

Stephen Timms

Rt Hon Sir Stephen Timms MP
Chair