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Rt Hon Sir Stephen Timms MP
Chair
Work and Pensions Committee
House of Commons
SW1A 0AA

18 January 2023

Our ref: C221221C

Dear Sir Stephen,

Re: Bank of England's Financial Stability Report recommendations on the resilience of LDI funds

Thank you for your letter of 21 December, and for the opportunity to attend the Work and Pensions Committee in December.

Since the events that occurred in the gilt market last year, we have worked closely with regulatory partners in the UK and in Europe to ensure liability driven investment (LDI) funds retain an appropriate level of resilience. We are undertaking further work to identify where the firms we regulate might make improvements, focusing particularly on their risk management and operational effectiveness, and published our statement in connection with this in November[1]. As I will set out below, we intend to publish a further statement on good practice in March.

Your letter asked about our response to the recommendations of the Bank of England's Financial Stability Report. I will address these in turn. As I explained in my oral evidence, our responses to recommendations made by the Bank of England's Financial Policy Committee (FPC) are published and are taken forward in a public and transparent manner. We would be happy to share our response to the FPC on this matter with the Committee should this be of interest.

The Pensions Regulator (TPR) should take regulatory action, in coordination with the FCA and overseas regulators, to ensure LDI funds remain resilient, and that trustees and advisers ensure these levels are met in their LDI arrangements.

Consistent with the above, our immediate focus, and that of other domestic and international regulatory bodies, was and remains on ensuring that funds retain an appropriate level of resilience. As we saw in the first half of 2022, well managed funds are capable of handling significant price movements which occur incrementally over time. But beyond this, sufficient liquidity buffers are necessary to be able to withstand very sudden price movements of the sort seen last Autumn, and schemes now have liquidity buffers in place of between 300 and 400 basis points on average. Moreover, schemes and their asset managers have taken other actions to improve their readiness to deal with future stress events, such as enhancements to collateral management systems, improvements in reporting and management information on collateral processes, and measures to expand their ranges of counterparties and available collateral sources.

[1] https://www.fca.org.uk/news/statements/statement-liability-driven-investment-ldi

We continue to work closely with TPR as it responds to the FPC's recommendation. In our November statement, we welcomed those made by TPR as well as the Central Bank of Ireland (CBI) and Luxembourg's Commission de Surveillance du Secteur Financier (CSSF) – the overseas authorities which oversee the pooled funds which were in focus in Autumn last year – on the resilience of LDI portfolios and the operational governance of pensions schemes using LDI strategies.

We have also continued to engage directly with firms within our perimeter which are involved in the management of LDI portfolios, to ensure they have increased resilience to deal with price volatility in future and continue to monitor for resilience weaknesses.

The FCA expects asset managers to take any necessary or appropriate action in response to these discussions, including to ensure they operate in a way that does not pose risks to market integrity or financial stability. Measures such as liquidity buffers are a necessary but only partial solution, as there will always be the potential for events or conditions that exceed the protection they provide, as was apparent in the extraordinary shocks in the gilt market in September. Managers of LDI funds should learn lessons from these events to understand and reduce the impacts of such 'tail events'. These include operational lessons, including on the speed at which they are able to rebuild buffers or rebalance funds, client and stakeholder engagement, and reliance on third parties. For example, where LDI managers require others, including clients or other agents, to act urgently to address challenges, they need to be able to communicate clear and accurate information on a timely basis.

Given the operational strains we saw asset managers exhibit during the period, they need to consider whether they are capable of communicating critical information at an individual client level, often in large batches, in a timely manner. They also need to ensure they and their key stakeholders (such as bank counterparties) have arrangements – including the operational capacity and contractual authority – in place to carry out required actions, ultimately such that sufficient liquidity in LDI funds can be realised in the event of a stress.

Moreover, it is important that lessons are learned by all parts of the market that were exposed to LDI-related events, including banks and custodians. As we touched on in our Committee session, market issues involving leverage, volatility and concentration have arisen with increased frequency, and so we also expect other firms which were not directly exposed to LDI risks to give appropriate consideration to these broader underlying themes.

All market participants should factor market conditions of the sort witnessed last Autumn into their risk management considerations, acknowledging a wider horizon of scenarios that might be considered extreme but which may nonetheless prove plausible. The FCA will maintain a supervisory focus on ensuring firms identify and address their vulnerabilities in this regard. We are reviewing firms' operational contingency planning and intend to publish a further statement on good practice towards the end of Q1 2023.

In terms of the information and powers available to us as part of this wider programme of work, as well as in looking at the role of advisors in this space, we consider it would be beneficial for investment consultants to be brought into our regulatory perimeter. These entities provide advice to pension schemes and recommendations on strategy, but are not required to be FCA-authorised for those activities, and so are not subject to our rules and guidance on considering the suitability of such recommendations. This creates a fragmented perimeter. The CMA previously recommended that the FCA's regulatory perimeter be expanded following its Investment Consultant Market Investigation Review in 2018[2].

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[2] https://www.gov.uk/cma-cases/investment-consultants-market-investigation

Longer term, regulators should set out appropriate steady state minimum levels of resilience for LDI funds including in relation to operational and governance processes and risks associated with different fund structure and market concentration.

While the financial resilience of DB pension schemes is a matter primarily for TPR, as noted above we are working closely with it to ensure resilience across the system. There is a need for better regulatory and risk reporting and oversight both domestically and internationally, and this is something we will be focusing on with our domestic and international regulatory partners.

Given the cross-border nature of LDI funds and the interconnectedness of global markets, we work closely with other securities regulators and central banks. While the FCA is not the regulator of LDI funds which are domiciled overseas, we are currently working with the Bank of England and TPR to develop a longer-term resilience standard for LDI funds for the FPC, of which I am a member, to consider in the first half of 2023.

Our collaboration with these other authorities includes considering potential risks posed by non-bank financial institutions, as well as coordinating policy measures 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), and as you may be aware I have recently been appointed as a co-chair of IOSCO's Financial Stability Engagement Group (FSEG).

We agree with the FPC's overall conclusion that there is a need for urgent international action to identify and reduce risks in non-bank finance, wider than in relation to LDI alone. It is clear that market structures have evolved considerably since the financial crisis, and it is important that market participants update their assumptions on how fast-moving markets may operate or impact their ability to manage their positions. Our work domestically and internationally aims to ensure the UK's regulatory framework helps to deliver this outcome.

I hope this is helpful.

Yours sincerely,

Nikhil Rathi
Chief Executive