Napier House
Trafalgar Place
Brighton
BN1 4DW

0345 600 0707

www.tpr.gov.uk
www.trusteetoolkit.com

mpcorrespondence@tpr.gov.uk

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

20 January 2023

Dear Sir Stephen

Defined Benefit pensions with liability driven investments (LDIs)

Thank you for your letter dated 21 December 2022 following TPR's oral evidence to the Committee on 14 December.

In our response we will directly address the Committee's questions relating to the Bank of England's recommendations made in their Financial Stability Report, dated 13 December 2022, which we have welcomed.

We will also provide additional information that we did not cover in our oral evidence.

The Committee's questions

How will TPR 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?

As background to this question, we would like to point your attention to:

- The statement dated 30 November 2022 made by the Central Bank of Ireland (CBI) (jointly with the Commission de Surveillance du Secteur Financier of Luxembourg) – which TPR welcomes and was active in brokering alongside our regulatory partners. This increases the financial buffers in GBP-denominated leveraged LDI pooled funds to levels capable of withstanding increases in interest rates of at least 300-400 basis points.
- Our Guidance (dated 30 November 2022) which recommended that the increased financial buffers in LDI pooled funds are also applied to segregated mandates and single-client funds. It further sets out TPR's recommended practice so that requests for collateral can be met with reduced risk of liquidity stress.

The improved buffers that have now been introduced across the industry (to c300-400 basis points) are part of the preliminary lessons we have learnt from the previous stress testing practice (to c100-150 basis points), which proved insufficient to maintain resilience again the large shocks witnessed in late September 2022 (which were unprecedented at the time). The new buffers are designed to improve that resilience.

The CBI's joint statement and our guidance are the first step in our regulatory activity – which the Bank of England refers to and welcomes in its Financial Stability Report. They cover both pooled and segregated mandates and are aimed at improving liquidity buffers both within LDI funds and in the rest of pension schemes' portfolios. This increase in buffers combines with a general reduction in leverage, providing further protection against a sharp movement in rates.

The second step, which is covered by the Bank's first recommendation, is to seek to ensure the industry maintains resilience by adopting the approaches set out by regulators.

As the Bank recognises, doing so requires ongoing collaboration with between regulatory partners. TPR acknowledges the need to collaborate with other members of the regulatory community, and we will continue to work with the FCA and overseas regulators to monitor levels of resilience, and take coordinated action where necessary.

Adequate monitoring of resilience will require enhanced data collection, and TPR is actively considering how to expand our collection of data on LDI arrangements and consequent liquidity buffers.

To do so, we must first identify the right combination of additional data to collect. The additional requirements that would inevitably be placed on our regulated community must be proportionate to the usefulness of any data acquired. We are keen not to place an undue burden on schemes at a time when they are facing a number of other new regulatory requirements.

Secondly, we must identify the appropriate channels and infrastructure through which to collect the desired data. This may require an overhaul of our current data-sharing infrastructure (which is geared towards annual collection, and thus may not be suitable for these purposes), or collaboration with our regulatory partners (who may be better placed to collect information about systemic risks relevant beyond the pensions industry) or a system where schemes notify us where they are unable to maintain a minimum buffer level – this may be through the notifiable events process.

The recent announcement by the ONS to gather data on LDI exemplifies how obtaining such information is a priority for a number of public bodies. Successful delivery and use

Please note that information obtained by The Pensions Regulator (TPR) may be 'restricted' within the meaning of section 82 of the Pensions Act 2004. If so, TPR, and any person who receives the information directly or indirectly from TPR, is subject to the restrictions on its further use and disclosure set out in that section. Your attention is drawn in particular to the provisions of section 82(1) and 82(2) of the Pensions Act 2004. Onward disclosure of restricted information other than in accordance with the Pensions Act 2004 is a criminal offence.

TPR is a data controller for the purposes of the General Data Protection Regulations (GDPR) and the Data Protection Act 2018 (DPA). For further information on how we use data please see our privacy notice at: www.tpr.gov.uk/help

Website: www.thepensionsregulator.gov.uk

of data will benefit from collaboration across the industry and we will be contacting the ONS to discuss this in due course.

How will TPR, over the longer term, 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?

TPR's ongoing collaboration with the BoE, FCA and overseas regulators will stretch beyond monitoring resilience against the recommended levels set out in our November 2022 guidance.

We will collaborate with a view to ensuring that the financial buffers applied within LDI pooled funds remain suitable to evolving market conditions, and that schemes with segregated arrangements continue to adopt a similar approach to resilience as that applicable to their pooled counterparts. We will also look at the regulatory architecture and see what changes need to be made for more effective oversight and regulation.

Our Annual Funding Statement 2023, due to be published in the Spring, will give TPR an opportunity to reiterate our views on minimum levels of resilience, and comment on future changes if any. It will also allow TPR to give guidance on the governance processes needed where schemes have leveraged LDI arrangements (for example, to enable them to react in good time to market events).

Does TPR have the information and powers needed to meet the Bank of England's recommendations?

As noted in our answer to the first question, a significant workstream for TPR and our regulatory partners is the collection of more data.

Our normal approach to monitoring behaviour is either directly where schemes are in relationship supervision or through specific regulatory initiatives across a large number of schemes in a particular area. For schemes outside these groups, the information being collected on LDI is not sufficiently detailed for us to fully assess whether the guidance is being followed or any engagement is necessary with those schemes.

As we noted in the previous answer, there are various ways in which data could be obtained – and it is likely no single route will be the sole solution, with complementary approaches to be taken depending on the nature of the pieces of data being collected (and their frequency).

One such approach, which lends itself to more "real time" collection of relevant data, is through a "notifiable events" regime, where Schemes disclose to us (or one of our

Please note that information obtained by The Pensions Regulator (TPR) may be 'restricted' within the meaning of section 82 of the Pensions Act 2004. If so, TPR, and any person who receives the information directly or indirectly from TPR, is subject to the restrictions on its further use and disclosure set out in that section. Your attention is drawn in particular to the provisions of section 82(1) and 82(2) of the Pensions Act 2004. Onward disclosure of restricted information other than in accordance with the Pensions Act 2004 is a criminal offence.

TPR is a data controller for the purposes of the General Data Protection Regulations (GDPR) and the Data Protection Act 2018 (DPA). For further information on how we use data please see our privacy notice at: www.tpr.gov.uk/help

regulatory partners) the status of their LDI arrangements should – for example – the financial buffers in place be eroded beyond a certain threshold (or thresholds).

If we were to go down this route, schemes would be encouraged to comply on a voluntary basis until legislation was in place. We are discussing with DWP the possibility of introducing a notifiable event to put this into effect. An amendment to legislation would be a matter for government.

Further information

We would also like to take this opportunity to highlight three further items for the Committee to consider.

The use of LDI by smaller schemes

The Committee expressed concerns about the use of LDI by very small schemes. Around a third of the c5,200 defined benefit schemes we regulate have fewer than 100 members. Typically, these *very* small schemes have a relatively simple asset allocation and do not use LDI.

The larger the scheme, the more likely they are, in our experience, to use LDI. Small and medium size schemes (up to around £1bn in assets) typically use pooled funds to get their LDI exposure. Large schemes (over £1bn) typically use segregated LDI mandates and are able to tailor these to the specific requirements of their scheme. There are of course exceptions to the above based on individual scheme circumstances.

Role of consultants and sponsoring employers in investment decisions

We think it would be useful to clarify the role that investment advisers and sponsoring employers play in the way pension scheme trustees access investment products.

Trustees are obliged under the Pensions Act 1995 to receive investment advice at two critical junctures: before adopting or revising the statement of investment principles (SIP) setting out their investment strategy and before making any investment decisions which have not been delegated to an FCA authorised manager. As such, the decision to hedge a portion of the scheme's liabilities using leveraged LDI is, almost universally, the outcome of a process involving advice to trustees from third-party investment consultants. Similarly, the structuring of the rest of a pension scheme's investment strategy to be able to withstand collateral calls by its LDI managers is preceded by the trustees obtaining expert investment advice.

Please note that information obtained by The Pensions Regulator (TPR) may be 'restricted' within the meaning of section 82 of the Pensions Act 2004. If so, TPR, and any person who receives the information directly or indirectly from TPR, is subject to the restrictions on its further use and disclosure set out in that section. Your attention is drawn in particular to the provisions of section 82(1) and 82(2) of the Pensions Act 2004. Onward disclosure of restricted information other than in accordance with the Pensions Act 2004 is a criminal offence.

TPR is a data controller for the purposes of the General Data Protection Regulations (GDPR) and the Data Protection Act 2018 (DPA). For further information on how we use data please see our privacy notice at: www.tpr.gov.uk/help

The SIP sets out, amongst other things, the trustees' selected high level strategic asset allocation and their policies in relation to risk and risk management and the realisation of investments. The SIP must be reviewed at least triennially or whenever significant changes are made to the scheme's investment arrangements – such as the inclusion of leveraged LDI in the investment portfolio. Crucially, the scheme's sponsoring employer must be consulted on any changes made to the SIP. Schemes with fewer than 100 members are not required to produce a SIP but as noted in the previous section, such schemes are typically unlikely to use LDI.

Trustees are also required to take advice before making any specific investment decision (not being a decision which has already been delegated to an FCA authorised manager). Where the giving of the advice is a regulated activity, the trustees must seek it from an FCA authorised person, and otherwise from an adviser whom they believe to be qualified in terms of ability and practical experience and to have appropriate knowledge and experience.

Trustees are thus not left to navigate complex financial instruments alone. The requirements to seek and consider expert advice and consult the sponsoring employer on strategic investment decisions are both important ingredients in the governance and risk management of a pension scheme.

For the avoidance of doubt, investment consultants do not fall under TPR's regulation. Where investment consultants undertake regulated activities they fall under the FCA's oversight. The FCA has called for the expansion of its regulatory perimeter to include all major investment consulting services provided to the pensions industry (most recently in the FCA's 2020/2021 Perimeter Report).

Long-term role of leveraged LDI

During our evidence session, we described leveraged LDI as an important tool, enabling DB pension scheme trustees to protect their funding level and concurrently access growth-seeking assets, without (all else being equal) demanding additional cash injections from the sponsoring employer.

This is particularly true for schemes for whom investment returns are key in closing a funding deficit. Once a scheme, particularly one that is closed to accrual and is mature, reaches full-funding against a suitable measure of the value of its liabilities, access to growth-seeking assets may be less necessary. A scheme in this situation may naturally convert its growth-seeking allocation into assets which generate cashflows (e.g. bonds), from which member benefits can be paid.

As the degree of cashflow generation to match benefit payments increases, so too does the natural hedging that assets provide against movements in interest

Please note that information obtained by The Pensions Regulator (TPR) may be 'restricted' within the meaning of section 82 of the Pensions Act 2004. If so, TPR, and any person who receives the information directly or indirectly from TPR, is subject to the restrictions on its further use and disclosure set out in that section. Your attention is drawn in particular to the provisions of section 82(1) and 82(2) of the Pensions Act 2004. Onward disclosure of restricted information other than in accordance with the Pensions Act 2004 is a criminal offence.

TPR is a data controller for the purposes of the General Data Protection Regulations (GDPR) and the Data Protection Act 2018 (DPA). For further information on how we use data please see our privacy notice at: www.tpr.gov.uk/help

Website: www.thepensionsregulator.gov.uk

rates. Concurrently, as pension schemes mature, their projected benefit payments are likely to extend less into the future, making the value of their liabilities less sensitive to changes in interest rates.

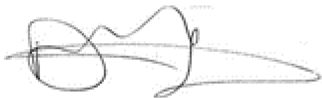
In aggregate, a pension scheme in this situation would not require as much (or any) leveraged LDI to protect its funding level against interest rates. If the cashflows being generated are inflation-linked, then there would also be reduced need of leveraged LDI to protect against inflation.

Therefore, given the DB pension landscape is primarily made up of closed, maturing schemes, as funding levels improve, leveraged LDI's role in DB schemes asset allocation is likely to decline.

We hope the Committee will find our additional considerations helpful. In addition, the final version of our DB Funding Code – currently out for consultation - will be published in June, with an aim for it to be operational in October 2023. In the meantime, we will be more than happy to come back to the Committee to consider any recommendations to the Code.

Yours sincerely,

Charles Counsell
CEO of the Pensions Regulator



David Fairs
Executive Director of Regulatory Policy, Analysis and Advice at the Pensions Regulator

Please note that information obtained by The Pensions Regulator (TPR) may be 'restricted' within the meaning of section 82 of the Pensions Act 2004. If so, TPR, and any person who receives the information directly or indirectly from TPR, is subject to the restrictions on its further use and disclosure set out in that section. Your attention is drawn in particular to the provisions of section 82(1) and 82(2) of the Pensions Act 2004. Onward disclosure of restricted information other than in accordance with the Pensions Act 2004 is a criminal offence.

TPR is a data controller for the purposes of the General Data Protection Regulations (GDPR) and the Data Protection Act 2018 (DPA). For further information on how we use data please see our privacy notice at: www.tpr.gov.uk/help