Department for Work & Pensions

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The use of Liability Driven Investment strategies by pension funds

Thank you for your letter dated 7 February 2023 setting out the findings of the Industry and Regulators Committee consideration of the use of Liability Driven Investment (LDI) strategies by pension funds.

We have set out below our initial response to the recommendations made and look forward to discussing with you in more detail at the hybrid formal meeting of the Work and Pensions Committee and Industry and Regulators Committee session on Wednesday 22 March 2023.

With regard to the recommendation of the Industry and Regulators Committee that: –

"The Government and the UK Endorsement Board should review the system of pensions accounting to see whether a less volatile, longer-term asset-led approach would be more appropriate for schemes that still have some time left to run."

Companies who sponsor DB pension schemes are required to calculate their pension liabilities, for the purposes of reporting in their annual reports and accounts, in accordance with international accounting standards.

DB pension schemes themselves are subject to different valuation requirements. Legislation (the Pensions Act 2004 and associated regulations) sets a statutory funding objective for schemes to have sufficient assets to cover their "technical provisions" i.e., the amount required, on an actuarial calculation, to make provision for the scheme's liabilities. These arrangements should not prevent schemes from investing in illiquid long-term return seeking assets. If it is appropriate to their scheme's circumstances, trustees can recognise the potential upside from investments that could be expected to have a higher return over the long term, provided the trustees judge the risks are supportable.

Alternative valuation approaches which seek to avoid volatility necessarily rely on some assessment of how investments are predicted to perform over time. This approach has its own risks in that any such assessment may be overly optimistic, and this could result in significant additional costs or risks to members' benefits in the future. Therefore, while there may be lessons we can learn on how we express the ability for schemes to take investment risk in the upcoming scheme funding regulations, we are not currently persuaded that there needs to be a wholesale change of approach to the basis of funding valuations.

With regard to the recommendation that: –

"The Government should review whether the use of leverage and derivatives by pension schemes should be more tightly controlled in the future. If schemes are to continue to use leveraged LDI, there should be far stricter limits and reporting on the amount of leverage allowed in LDI funds and greater liquidity buffers introduced for leveraged exposures."

It is important to recognise that LDI funds did hold liquidity buffers in anticipation of collateral calls, and these buffers had previously proved resilient. The scale and speed of movements in gilt yields during the LDI episode in September 2022 was unprecedented. The Bank of England stated that "measured over a four day period, the increase in 30 year gilt yields was more than twice as large as the largest move since 2000".

Government recognises important lessons need to be learned to ensure LDI can be used effectively and to minimise risks.

We therefore support the work of the regulators and the Bank of England's Financial Policy Committee (FPC) on the increased level of resilience that LDI funds are now holding to shield against future shocks. This is looking both at the resilience to shocks required as well as improvements that can be made to operational processes to mitigate financial stability risks.

We also recognise however, the need to ensure that the response is proportionate and recognises the costs that higher buffers create for DB pension schemes and will be taking this into consideration. We look forward to seeing further work from the regulators in these areas.

With regard to the recommendation that: –

"The Government should ensure that investment consultants are brought within the regulatory perimeter as a matter of urgency."

In response to the Competition and Markets Authority's (CMA) 2018 final report on investment consultancy and fiduciary management services, the Government committed to consult in due course on the issue of bringing investment consultants within the Financial Conduct Authority's (FCA) regulatory perimeter.

The principal finding of the CMA's 2018 report was that there were issues with competition in the investment consultancy and fiduciary management market. They therefore recommended that the FCA's regulatory perimeter be extended to cover activities of investment consultants.

At present some, but not all, activities conducted by investment consultancy firms are subject to regulation by the FCA or designated professional bodies such as the Institute and Faculty of Actuaries. There have been a number of other significant changes to the investment consultants market following the CMA's report – such as mandatory tendering for pension schemes, which was introduced in October 2022.

We recognise that the LDI episode has brought this issue to the fore once again but in relation to the strategies used by pension funds, which in many cases may have been advised on by investment consultants.

We note the support from the Committee for bringing investment consultants into FCA regulation, and will be taking these views and other work on lessons learned into account when determining next steps.

With regard to the recommendations that: –

Regulators should ensure they have more information on the leverage present within pension scheme finances and that stress tests are conducted. The more bank-like strategies and instruments that are used by pension schemes, the more bank-like its supervision should be, and the Government should consider giving the Prudential Regulation Authority a role in overseeing pension schemes.

Meanwhile, The Pensions Regulator should be given a statutory duty or ministerial direction to consider the impacts of the pensions sector on the wider financial system. The Financial Policy Committee should continue to take the lead on systemic risks to financial stability and should be given the power to direct action by regulators in the pensions sector if they fail to take sufficient action to address risks.

The FCA, the Pensions Regulator (TPR) and the Bank of England - through the FPC and Prudential Regulation Authority (PRA) - all have core roles to play in monitoring risks around the use of LDI. We agree with the Committee that good data, and information-sharing between regulators is critical. The regulators are already working together to investigate how this can be improved.

The FPC is responsible for monitoring and addressing systemic risks to promote financial stability in the UK. The FPC already has broad powers of recommendation as set out in primary legislation. It can make recommendations to the PRA and FCA on a “comply or explain basis” and can also make recommendations to any “other persons” it deems necessary to fulfil its objectives, including TPR.

We agree with the Committee on the importance of effective mechanisms to monitor and address systemic risks that may arise from the pensions sector. The Government will be considering the Committee’s recommendations alongside any proposals from other key stakeholders, such as the FPC, including how these relate to the overall regulatory architecture and regulators’ existing powers and objectives.

We agree with the Committee’s findings on the need for better information and are working with TPR to consider how they can best support the FPC in monitoring systemic risk. One means of support will come through data sharing. TPR is currently working with the FCA and the Bank of England to look at what data on systemic financial risk might be available and how this could be shared.

We would like to thank you and the members of the Committee for this very helpful and comprehensive report and look forward to an in-depth discussion of the findings and recommendations.

Yours sincerely,

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