Written evidence from the Pensions Regulator LDI0047

Introduction:

We welcome the committee's inquiry into defined benefit pensions with liability driven investments (LDI), and the lessons it is seeking to learn from the recent experience in the gilt market. Our written evidence supplements the information we sent the Committee on October 10 in relation to the impact on defined benefit pension (DB) schemes of movements in financial markets.

Reflecting the key focus areas of the Committee's inquiry, the below addresses our and trustees' role in relation to investments by DB pension schemes, and explores the fundamental issues surrounding the evolving situation for DB schemes that used LDI strategies.

We are acutely aware that economic uncertainty, and challenging headlines about pensions, have the potential to undermine saver confidence. It is right, therefore, that we seek to reassure savers that pension schemes were not, and are not, at risk of collapse due to rapid movements in the price of gilts, and we urge savers not to make any hasty decisions with their pension pot.

Hedging tools such as LDI can be an appropriate way to mitigate risk for DB pension schemes and their sponsoring employers. It is important to note that LDI has been used effectively as a hedging tool by trustees for around 20 years.

We will engage with a scheme if we feel the level of downside risk is not appropriate given the scheme's maturity and the covenant of the sponsoring employer. As such, we have consistently reminded pension scheme trustees to have robust liquidity plans in place, particularly given the possibility of interest rate rises.

We continue to work closely with the Bank of England, other regulators and government to understand where lessons can be learned from the recent gilt market volatility so that savers remain protected.

Our role

TPR is a non-departmental public body established under the Pensions Act 2004. Our sponsoring body is the Department for Work and Pensions (DWP) and Parliament sets the legal framework within which we operate.

TPR regulates DB pension schemes. We do not regulate the funds that schemes invest in or the fund managers that they engage. Trustees are the first line of defence for pension savers and have a duty to act in members' best interests. They are responsible for setting their scheme's investment strategy and for carrying it out.

Four of our statutory objectives are relevant to DB pension schemes:

- to protect the benefits of members of DB schemes
- to reduce the risk of calls on the Pension Protection Fund (PPF)
- to promote, and to improve understanding of, the good administration of schemes
- to minimise any adverse impact on the sustainable growth of an employer (in relation to

the exercise of our functions under Part 3 of the Pensions Act 2004 only).

TPR and FCA roles regarding LDI

DB pension schemes, regulated by TPR, that invest in LDI generally either use a pooled fund, typically if they are small to medium sized schemes, or a more bespoke solution called segregated LDI, which larger schemes tend to use. A LDI pooled fund is a type of investment vehicle. The pooled funds are regulated by authorities in the jurisdictions in which they are established, typically the Republic of Ireland or Luxembourg, with fund management activities delegated to a UK-based FCA authorised manager.

In DB schemes which use segregated LDI, they will usually appoint an LDI fund manager who will be authorised by the FCA. These LDI fund managers will enter into derivative contracts and manage collateral on behalf of the schemes.

Most of the professionals involved in advising on LDI will be regulated by the FCA, and must be authorised by the FCA if they are carrying out any regulated activities as set out in FSMA and the perimeter guidance issued by the FCA.

How we regulate and monitor investment governance and ensure good governance of DB schemes

Generally speaking, in relation to investments, our focus for DB schemes relates to governance and risk, ensuring that trustees are complying with pensions legislation.

The DB funding system was designed to give schemes flexibility over the way they invest; to find the right strategy that enables them, within an acceptable level of risk, to generate the returns they need, in combination with employer contributions, to deliver the pensions that savers expect.

We support the use of hedging to manage downside risks, notably for mature schemes and those with weaker covenants. As mentioned, LDI has been used effectively as a hedging tool by trustees for 20 years to lessen the impact of falling or volatile interest rates.

It is for trustees to decide what investment strategy is right for their scheme. We do not take a prescriptive approach to how schemes invest their assets, and we have limited powers in this regard. (See later section.)

We expect DB trustees to take an integrated approach to managing risk around three key pillars for their scheme: funding, investment and covenant. Trustees should consider the risk they are carrying and whether the employer covenant supports that risk.

In relation to monitoring DB investments, including LDI, we provided details of the steps we have taken in our letter of October 10. I will recap briefly on the key points and provide some extra detail.

In 2019, we produced a leverage and liquidity study with the Bank of England to gain a clearer picture of industry behaviour and this has informed how we assess and alert trustees to risk. We have consistently reminded schemes to have contingency plans in place, particularly given the likelihood of interest rate rises. In our 2022 Annual Funding Statement, we said:

Since the start of the year, long-term interest rates have risen and gilt yields continue to be volatile. The impact on scheme funding will vary depending on scheme investment and funding strategies, and the level of hedging in place. There could be collateral calls for schemes with substantial levels of geared hedging, and liquidity issues for investments remain as important as ever. (Our views on these can be found in the ***AFS 2021****.)*

Our detailed investment guidance, first published in March 2017, provides guidance to trustees on LDI approaches to help them manage the risks. The guidance sets out how: "*LDI typically enables pension schemes to achieve an improved balance between investment risk and return, but it does introduce additional risks, e.g. around the use of leverage and in relation to operational risks around the management of collateral."*

The guidance underlines the importance that trustees understand the risks of their matching assets including the additional risks that derivative instruments introduce as interest rates rise, necessitating schemes to have robust collateral management plans in place and to address associated liquidity and operational risks. We emphasise the importance of trustees working with their investment advisers to address these risks.

As mentioned above, we have used our Annual Funding Statement (AFS) for many years to update schemes on emerging risks, such as rising interest rates, and to set out our expectations, noting we will consider intervening if those expectations are not met.

We have sought to amplify our messages in our guidance and AFS, and though our supervision work, e-mails and social media activity.

We take an intelligence-gathering approach to understanding the amount of leverage in schemes' LDI arrangements. In particular:

- We have good market information from our routine interactions with schemes and pensions investment professionals
- We add to this understanding from interactions with schemes as part of our frontline regulation work
- We undertake scheme surveys, and in particular worked with the BoE to carry out a survey in 2019 to help TPR and the BoE to assess the potential for systemic risks to arise due to the use of leverage in DB pension schemes.

Through our engagement with industry earlier this year, we were aware that a small number of schemes were facing challenges with collateral calls in the run up to the fiscal event but that broadly, schemes were coping despite difficult economic conditions.

To build on our understanding of the LDI landscape, our investment consultants and actuaries have conducted some new analysis, which includes issuing data requests to a number of schemes. Our supervision team is also reviewing information gained from previous engagements to help clarify the picture we have. As the committee is aware, we issued a regulatory guidance statement to trustees (12 Oct) to update on our expectations regarding LDI: *Managing investment and liquidity risk in the current economic climate* and we will continue to communicate our expectations clearly and effectively to trustees and update our guidance accordingly.

TPR's powers to intervene

TPR's powers in relation to investment are limited. We have no legislative remit or powers to prescribe what investments pension trustees should make, or (subject to the limits on investments in the sponsoring employer) what investments they may not make.

However, we can take action if the investment risks being taken by trustees are not consistent with the funding or other support which the scheme is receiving from the employer, or if there are specific breaches of legislation. We can take action where there is evidence that trustees have insufficient levels of knowledge and understanding for the decisions they are making, or if they have failed to use that knowledge in managing the pension scheme. And we may also intervene where there is a weak funding basis, associated with a high level of investment risk, leading to low or nil contributions, but where affordability is not constrained.

We have powers to issue 'improvement notices' (requiring persons to take action to rectify breaches of pensions legislation), financial penalties in certain circumstances, and to suspend or prohibit a person from acting as a trustee and to appoint independent trustees where necessary.

However, we initially seek to resolve issues and change the behaviour of trustees by engaging with them. While our powers underpin our regulatory work, we do not normally need to initiate their use to put things right, noting the deterrent effect of our powers is often enough. In the context of DB funding and investment we have only looked to use our powers on very rare occasions.

Trustee duties in relation to investment

Trustees are responsible for determining a scheme's investment strategy and for its investment governance framework. Where they fail to follow the requirements imposed by legislation or by general trust law principles, they can be held personally liable.

Trustees typically make strategic decisions and delegate implementation of these decisions to an FCA authorised investment manager. Trustees are required to follow legislation on investment set out in the Pensions Act 1995 and the 2005 investment regulations. The legislation reflects and supplements established trust law principles. Trustees are required to develop and follow a set of investment principles, having taken expert advice and consulted with the employer. Scheme assets must be invested in members' best interests and in a way which ensures the security, quality, liquidity and profitability of the portfolio.

Use of derivative instruments is permitted if they contribute to a reduction of risks or facilitate efficient portfolio management (including the reduction of cost or the generation of additional capital or income with an acceptable level of risk). Where pension schemes use derivative instruments, TPR's guidance has made clear the need for trustees to consider their collateral needs in changing market conditions and to ensure the scheme has suitable assets available to meet them.

Before setting an investment strategy or making an investment (including investing in an LDI fund), trustees are required under pensions legislation to take expert advice. Advising on a decision to invest in an LDI fund is a regulated activity, so the adviser would have to be authorised by the FCA. The fund managers who oversee the funds which DB schemes invest in are required to be authorised by the FCA if they are based in the UK (noting points above about regulation in overseas jurisdictions).

TPR's role is not to tell trustees what investments they should make, but to hold trustees to the principles of good governance and administration set out in pensions legislation and our codes of practice and guidance.

Impact on DB schemes:

The longer-term funding position of the majority of DB schemes has improved as a result of the recent increase in gilt yields, with the value of scheme liabilities falling by up to 50% depending on the scheme's circumstances, based on the gilt yields change from the beginning of the year to 27 September. It is estimated that 20%-40% of schemes are ready to buy out in terms of funding levels although there are practical issues, including the capacity of the buy out market, that will mean that this is not an immediate option for many schemes.

At the beginning of November, gilt yields were 1% to 1.5% below the level seen at 27 September. Liabilities would have increased approximately 15% during this period of reduction in gilt yields depending on the scheme's circumstances.

The majority of the schemes have maintained their LDI hedging. Some have reduced hedging positions given liquidity constraints, and a small number have reduced a large amount to reflect tactical views. Across the board, schemes have increased their collateral buffer to allow for future market volatility. Trustees are working with advisors and managers to update their current funding positions, review their long-term strategies (return seeking vs liability matching, liquid vs illiquid), and rebalancing assets to reflect the long-term strategy in their portfolios.

In general terms, hedging assets works to move the value of assets to be more in line with the liabilities, up or down. So, if a scheme was fully hedged during this period of reduction in gilt yield from 27 September to the beginning of November, LDI assets would have moved in line with liabilities to maintain the funding position. If a scheme was partially hedged, it would have seen assets increase less than liabilities and therefore a deterioration of funding position.

As yields are currently still higher compared to the beginning of the year, provided the hedge has been maintained during the year, the long-term funding position will have improved.

Some schemes' liability hedging was reduced as a result of lowering leverage at the height of the yields spike, and for these schemes the funding position may have deteriorated. Depending on the amount of the hedge that was reduced, and the timing of that reduction, the scheme could see either a better or worse funding position compared to the beginning of the year.

Trustees are currently collecting data from the LDI managers and working with their advisors to obtain an update to their funding position.

Impact on DC schemes:

While changes in underlying bond prices are having an effect on DC savings, the issues around LDI have not had a direct impact. Furthermore, the impact on DC savers will be felt differently depending upon where they are in their retirement journey and how they plan to access their pension pot.

For younger savers, with some way to go before they can draw down their pension or purchase an annuity, the current volatility in the markets is less of a significant issue.

For those approaching retirement, it is a challenging time due to factors such as inflation and market volatility. It remains important that decisions are not made by savers in haste.

Different schemes have different approaches within their default funds for their asset mix as an individual approaches retirement (usually called 'lifestyle strategy'). It is important that the saver understands what that is, and that it is consistent with how they are looking to access their retirement benefits.

It is also worth noting that savers approaching retirement today typically have a mix of DB and DC benefits. With their state pension and potentially some DB benefits, savers might have more flexibility with how they use their DC savings. In time, how they use their DC savings and the nature of any 'lifestyle strategy' will become increasingly important.

In circumstances where a saver is concerned, they should seek guidance from MoneyHelper or seek regulated financial advice. It is vital that they do not make rushed or poorly informed decisions, which could leave them more vulnerable to scammers. We, the FCA and MaPS have issued a warning to pension scheme trustees and savers of a potential increased risk from scammers seeking to cash in on economic uncertainty.

We are examining what the longer-term impact on DC savers may be and how best to communicate with the industry and savers concerning next steps.

<u>The role of LDI and whether changes are required:</u>

As we highlighted in our letter to the Committee on 10 October, it is important to reiterate that the circumstances which led to the issue with LDIs were completely unprecedented. In his letter to the Economic Affairs Committee and the Industry and Regulators Committee, Bank of England Governor Andrew Bailey pointed out that the scale and speed of repricing leading up to 28 September far exceeded historical moves, and therefore exceeded price moves that are likely to have been part of risk management practices or regulatory stress tests.

In light of the speed and scale of the market shifts, we are again reminding trustees of their governance requirements, and of our expectations.

While we do not take a prescriptive approach to how schemes invest their assets, we do expect trustees to consider the risk they are carrying and whether the employer sponsor covenant supports that risk. We have encouraged schemes to consider how they manage risk through the use of hedging strategies to help deliver on their pension promises. We stand by this approach.

LDI is one tool that trustees can use to hedge their risks and match asset and liability movements and it has been used successfully for around 20 years. Schemes that have used LDI have been impacted less by previous market shocks such as the 2008 financial crisis and the Covid-19 pandemic.

In 2022, schemes with high levels of LDI are likely to have seen more stable funding levels alongside collateral calls. The strong funding position of DB schemes means that the returns required to achieve full funding have declined significantly.

In part due to our work with the FCA and the Bank of England, leverage in LDI products has reduced over the period since the Bank's intervention. For example, for LDI funds of 20-30 year duration, generally leverage has gone down from around three times to under two times.

In terms of whether changes are needed, we remain committed to working with our key stakeholders, including the Bank, FCA, government, and within the occupational pensions sector that we regulate to ensure that lessons are learned.
We continue to work with the Bank and FCA to consider issues such as what level of collateral DB pension schemes and LDI funds should hold to increase their resilience and ability to deal with future economic shocks. We are considering with FCA the best mechanism to get this message out which may include a guidance statement setting our expectations for trustees and LDI funds.

We are also examining how we can update our guidance for DB schemes and ensure that in light of the current economic conditions, our frontline regulatory teams are setting out very clearly our expectations on managing liquidity. Our guidance emphasises the need for robust governance and operational readiness to deal with fast-moving situations. The events of September and October tested the ability of smaller and medium DB schemes, in particular, to respond to the hitherto unprecedented levels of market volatility.

The speed of decision-making and executing those decisions was a concern in the smaller end of the DB sector. We know that around one in three DB schemes has fewer than 100 members. While we see good governance in schemes of all sizes, we know that larger schemes coped better. This is consistent with our data and regulatory experience that larger schemes display higher governance standards. We believe this underlines the case for consolidation in the market, noting we now have a system of authorised master trusts for DC, and a regime for DB superfunds, which deliver high standards of governance and administration. We also support the drive to have professional trustees in place in more schemes.

As we have said, we are clear that trustees must make their own decisions about how to invest and must be aware of, and plan for, any risks. We do think that hedging has played an important role in helping to improve the chances of savers getting full benefits and we believe that hedging approaches are appropriate going forward.

Next steps on gathering data:

At the heart of our Corporate Strategy is a commitment to become a more digitally enabled and data-led organisation. We have created a new Digital, Data and Technology Directorate to help us to drive forward our agenda to be data led.

We believe we need to gather more granular information on pension scheme investments. While we need to take into account the costs and regulatory burden upon schemes of requesting more data, we consulted jointly with the PPF in 2021 on proposals to better capture data on investment risk through the annual DB scheme return without resulting in an excessive administrative burden on schemes. We are considering carefully whether to extend our annual DB scheme data return to include information on schemes' leverage positions.
As part of this process, we plan to increase the amount of information we gather on a range of asset allocations including LDI.

However, it is not possible to remove all risks from the pensions landscape and we need to target our resources in a proportionate and risk-based way. Even with significantly more data available to us, there may not have been a different outcome. As we emphasise above, it was the unprecedented speed and magnitude of market movements that had an impact which went beyond what was previously considered reasonably plausible.

Nevertheless, these extreme market movements did happen, and the lessons need to be learned.

Conclusion:

Based on intelligence from the investment industry, and our engagement and analysis, we believe that DB schemes are not, and were not, at risk. To summarise our evidence:

- We believe that many trustees of DB schemes, their investment advisers, and LDI managers are taking the right steps to consider the appropriate collateral requirements for their LDI funds, given the risk of gilt yields increasing. We are looking at ways to reinforce this message to all schemes.
- We also know that standards of governance and administration in smaller schemes often

do not meet our expectations, which can lead to operational issues and slow decision making.

- We believe there is a need for more professional trustees on those schemes and consolidation where trustees cannot meet our expectations.
- We continue to call on trustees of schemes and their advisers to review the resilience and liquidity of their investments, risk management and funding arrangements, and plan accordingly to protect the interest of scheme members.
- Trustees will also need to consider, with their advisers, whether any rebalancing of their portfolios needs to be implemented.
- Lessons need to be learned and action taken to mitigate against a repeat of the high levels of volatility witnessed in the bond markets in September this year. We continue to work with the BoE, FCA and government to focus on what changes should be put in place.[i]

We hope the above provides useful insight for the Committee's inquiry.

November 2022

[i] 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.

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