Written evidence from the Financial Conduct Authority FCA LDI0054

Defined benefit pensions with liability driven investments

Thank you for the opportunity to participate in the Work and Pensions Select Committee's inquiry into defined benefit (DB) pensions with liability driven investments (LDI).

The FCA has written to the Chairs of House of Lords Industry and Regulators Committee and Economic Affairs Committee on this matter,[1] and my colleague Simon Walls (Director in our Supervision, Policy and Competition Division) and I gave oral evidence to the former.[2]

Role of LDI, and the remit and role of the FCA

Typical LDI arrangements

As you will be aware, DB pension schemes pay an income to their members when they retire. These payments are the liabilities of the scheme. For many DB pension schemes, liabilities stretch into the future, representing the payments that the scheme must meet over the lifetime of the membership. DB schemes' liabilities and how they are reflected on sponsoring employers' balance sheet, are significantly impacted by changes in interest rates and inflation. These changes have a material effect on the funding level of a scheme, which represents whether a scheme's assets are adequate to meet these future liability payments. To protect against these risks DB pension schemes have used LDI strategies to hedge their exposures.

There are two ways in which DB schemes generally achieves such hedges. Firstly, some schemes, typically larger schemes, buy into such strategies via segregated mandates (or a single client fund), where a portfolio manager executes the investment strategy on the scheme's behalf and to the scheme's instruction. Secondly, other DB pension schemes, typically smaller schemes, invest via a pooled fund structure, where the fund is managed by an alternative investment fund manager (AIFM) who is approved by the regulator of the fund and manages to a specified investment policy set out in the fund documentation. That AIFM often delegates day to day management of the fund to a portfolio manager, often in the same group of firms. To execute LDI strategies, pension schemes invested (directly or indirectly) in derivatives.

Our role and the role of other regulators

As you are aware, The Pensions Regulator (TPR) is the regulator of pension schemes and trustees who make the ultimate investment decisions - whether that be setting the investment guidelines for a segregated mandate or selecting which fund - with clearly labelled duration targets- to buy. LDI funds and their AIFMs are typically located overseas, in an EEA jurisdiction, under the oversight of the local regulator. The funds can be freely offered in the UK to professional clients under the national private placement regime. Funds' risk management is overseen by the AIFM. The portfolio manager is responsible for executing day to day investment decisions. We are responsible for regulating AIFMs and portfolio managers where they undertake a regulated activity in the UK. In the context of LDI strategies, typically onlythe portfolio manager is located in the UK and would come under our regulatory remit. The UK banks which lend to LDI funds or their derivative counterparties are regulated also by the FCA for conduct issues, and by the PRA for prudential matters. The Bank of England and, in particular the Financial Policy Committee, have an overarching mandate in relation to financial stability.

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[1] https://committees.parliament.uk/publications/30475/documents/175861/default/
[2] https://committees.parliament.uk/oralevidence/11544/html/

Our supervisory approach, work in relation to LDIs prior to September 2022 events

We are the conduct regulator for around 51,000 firms and we prudentially supervise around 49,000 firms. We supervise against a framework of principles and rules that represent the minimum standards of conduct we expect from firms and individuals. We dedicate specific supervision teams to the firms with the greatest potential impact on consumers and markets.

All five of the largest LDI providers have some dedicated supervisory resource. This meant that we had a good understanding of firms' business models going into this crisis. We had also carried out some proactive supervision work on the LDI sector, and these firms' LDI risk management, at various points over the preceding five years. That enabled us to start from a position of understanding their potential exposures and potential vulnerabilities. Our Fund Supervision team also carried out proactive monitoring and engagement on non-LDI assets, such as Money Market Funds (MMFs) and Property Funds, which we foresaw would likely be impacted.

There had been work specifically in relation to LDI strategies and their impact on the market, given the known size of the LDI market. For example, in 2018 the FPC carried out an assessment of the risks from leverage in the non-bank financial system and highlighted the need to monitor risks associated with the use of leverage by pension schemes. That work was followed up with firm-specific engagement, where LDI and associated risks continued to be a part of the focus of our general supervision, including with action and enhanced oversight on specific firms.

Pension schemes, in particular those invested in LDI strategies are also users of MMFs. The impact of Covid-19 related market stress on MMFs in March 2020 led us to carry out additional LDI-focussed activities at that time, with a focus on the interaction of LDI strategies and MMFs, as we were aware of the extent to which LDI clients relied on MMFs as a liquidity source. We were also aware that the MMF withdrawals that the pension funds that invest in LDI funds were making to build their liquidity were adding to the difficulties MMFs were facing.

We were aware of the potential impact rising rates could have on LDI strategies. As a result of the rising yield environment, we carried out a further review of LDI and MMFs in Spring 2022.

Our work prior to the events in the gilt market had provided an understanding of the leverage being deployed and the buffers being targeted by market participants. We did not anticipate a rise of the magnitude that occurred at the speed that it did (a matter of days).

Market events in September 2022

As set out in our letter to Lord Hollick and Lord Bridges, the velocity of the market reaction to the 23 September statement was unprecedented.[3] Against the rising yield environment, the large funding additions in May and June 2022, were completed without material incident.

In September there were two daily increases in 30-year gilt yields of more than 44 basis points, while the biggest daily increase since 2000 prior to this was 29 basis points. LDI strategies had largely absorbed the shift in yields and successfully recapitalised until 23rd of September. Structurally, until that time, LDI markets were operating as expected even under some level of stress. Funds were able to absorb the historic moves on the day of the fiscal event on 23 September.

As noted by the Bank of England, the five largest daily moves in the 30 year inflation-linked gilt since 2000 have all been since 23 September.[4] The rapid yield changes triggered significant collateral and margin calls on the instruments that underpinned LDI strategies. As previously described, the risk of collateral or margin calls was not new. However, we understand, the speed of changes was a critical factor in the difficulty clients had in replenishing funding. Data collected from firms indicates that for some LDI managers, the capitalisation events since 23 September alone represent half of the capitalisation events that occurred throughout the whole year to date. Pension schemes invested through segregated mandates would have been directly responsible for meeting margin calls and had to consider how to meet these. Pension schemes invested through fund structures generally had to make a choice about whether to replenish the fund's

capital and maintain their exposure, or whether to see their exposure to the fund (and thereby their hedge) reduced. Fund structures are limited liability structures, so there was no risk of recourse to the pension schemes' collateral or from margin calls in excess of their investment in the fund. Asset managers have indicated to us that most clients preferred to keep their hedges intact, and provided funding to do so, even when notice periods were reduced significantly. This is consistent with the data on sales that we collected through the period of the Bank's intervention.

The situation was further compounded by illiquidity in the index linked gilt market, due to its concentrated nature and limited pool of natural buyers (DB schemes hold an estimated 90% of long-dated linkers). The selling pressure came collectively not individually and the stress-testing by individual funds assumed a level of liquidity that the market could not support. This is reflected in the data: it is our best estimate that recapitalisation calls or the period of 30 September to 21 October amounted to at least £64.5bn. For the same period, we estimate there were sales of at least £39bn conventional and index linked gilts.

The unusual situation caused significant operational stress for firms across the investment chain, including custodians who were processing heightened volume of settlement and collateral management requests.

We worked closely throughout the market events with TPR and the Bank of England and overseas counterparts to respond to events as they unfolded. We also held daily calls with all of the significant LDI managers as well as regular engagement with participants across other sectors of the market, to understand the impact of the interventions and other market developments, and identify areas of strain or risk.

Further work

Since the events that occurred in the gilt market, the FCA has been working closely with our regulatory partners in the UK and across Europe. This includes ongoing contact with UK based LDI fund managers as well as the Bank of England, the PRA, which regulates bank counterparties to LDI funds and TPR, which regulates the defined benefit pension schemes that typically use these funds. We issued a statement today[5] welcoming the announcements made by TPR, the Central Bank of Ireland and Commission de Surveillance du Secteur Financier in Luxembourg on the resilience of LDI portfolios and the governance of pensions schemes using LDI strategies. We acknowledge the importance of calibrating liquidity buffers appropriately but – accepting that these come at a cost to pension schemes, and that in any event, extreme events may always occur that exceed a given level – we call attention to the importance of managers stress testing the operational consequences and their needs in these tail events. We give some examples in our statement. There are lessons to be learned here in LDI and we intend to publish a further statement on good practice towards the end of Q1. A more general point, that what may be considered 'extreme but plausible' now includes a wider horizon of events than may have been the case in the recent past, should be reflected on by all market participants performing stress and scenario testing.

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[3] https://committees.parliament.uk/publications/30475/documents/175861/default/
[4] https://committees.parliament.uk/publications/30347/documents/175455/default/

Our letter to Lord Bridges and Lord Hollick sets out some of our wider work on non-bank financial institutions going forward in more depth. With respect to the legislative framework, we would welcome the inclusion of investment consultants in our regulatory perimeter as recommended by the Competition and Markets Authority in 2018[6] and in our perimeter report in 2020/21 to support the delivery of our regulatory objectives.[7]

I hope the Committee finds this evidence useful and I look forward to providing further evidence with colleagues to the Committee on 14th December 2022.

November 2022

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5 https://www.fca.org.uk/news/statements/statement-liability-driven-investment-ldi
6 https://www.gov.uk/government/news/cma-sets-out-investment-consultants-reforms
7 https://www.fca.org.uk/publication/annual-reports/perimeter-report-2020-21.pdf