Work and Pensions Committee Inquiry into DB pensions with LDIs

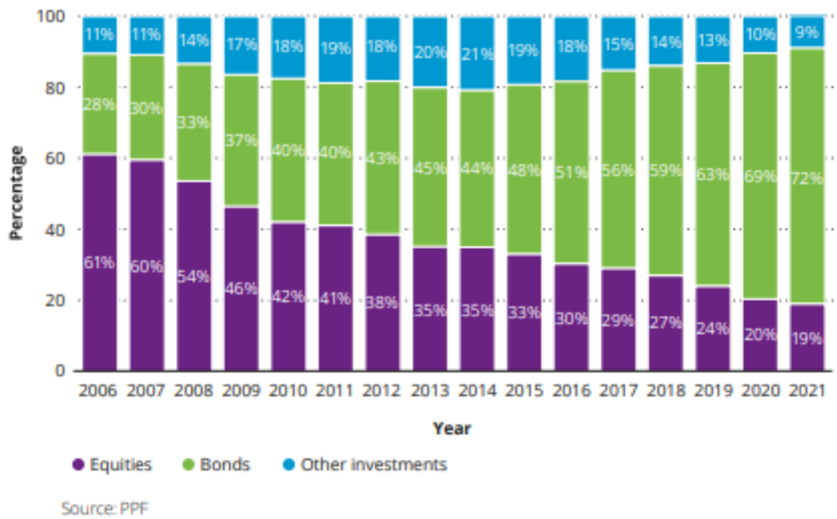
Call for evidence

1. The impact on DB schemes of the rise in gilt yields in late September and early October

There are about 5300 private sector Defined benefit pension schemes in the UK. These schemes have 10 million members and manage around £1.5 trillion in assets and have liabilities of c. £1.1 trillion[1]. The majority of these schemes are maturing and closed to new accrual.

To manage their assets and liabilities schemes use a variety of investment strategies. The long-term trend for maturing schemes has been to de-risk their portfolios; this has been supported by regulatory nudges, including the DB funding regime, overseen by the Pensions Regulator. As a result, schemes hold a significant amount of government and corporate bonds, or derivatives that deliver the same economic exposure. Generally, less well funded schemes needed to provide a greater amount of this liability matching through leveraged derivatives, so that they could retain a significant proportion of return-seeking assets to allow them to reach full funding. Better funded schemes generally had less need for leverage. The detail of this shift can be seen in data from the PPF Purple Book[2].

Weighted average asset allocation in total assets



Across this period, Liability Driven Investments (LDI) strategies have been increasingly adopted by pension funds, as well as other institutional investors e.g. insurers. TPR estimates that around 60% of DB schemes use LDI strategies. A key element of this strategy, has been to help schemes and employers, avoid significant balance sheet volatility, and "match" their assets and liabilities. This typically means that whilst assets under management may alter, movements in the markets to do not significantly impact funding levels for such schemes, whilst the strategy is maintained. It also provides certainty for scheme sponsors so they can plan any funding commitments to the scheme in an orderly way, alongside other corporate commitments.

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[1] https://www.ppf.co.uk/ppf-7800-index

[2] PPF_PurpleBook_2021.pdf

As part of LDI strategies schemes typically provide collateral which is used to balance the strategy when there are market movements. Levels of collateral can be increased or decreased depending on the scale of movements and schemes will have 'waterfalls' in place which trigger changes to collateral buffers. In typical market conditions, adjustments to levels of collateral will usually happen over several weeks or months and are modest in terms of overall change.

Following the mini-budget, there were however significant moves in the gilt market. As stated by Sir Jon Cunliffe in his letter to the Treasury Select Committee3, there was more movement in 4 days than had been seen in twenty years, and the level of movement was beyond the levels considered previously by regulatory stress-tests for 'market shocks'. The UK gilt market experienced unprecedented turmoil. Prior to this, pension funds had successfully used LDI strategies for the last 20 years and they have helped contribute to the current, historically high, levels of funding.

A consequence of the loss of market confidence and gilt movements, fed directly through to many schemes LDI strategies - with large and sudden collateral calls for many pension funds to maintain their positions.

Our research indicates that prior to the mini-budget schemes typically held 200-249bps as a capital buffer. Levels typically commensurate with managing risk prudently.

Due to the rapid changes in the gilt market, in some instances, pension funds used up existing collateral buffers, which forced them to sell other assets to maintain them. This resulted in significant sales of government gilts, driving down their value and increasing gilt yields. The gilt market was at risk of no longer functioning properly, at which stage the Bank of England made its first intervention to restore market stability. Further interventions followed over the following weeks.

Impact on pension funds

All things being equal, increases in gilt yields are good for Defined Benefit pension schemes – improving funding positions.

However, rapid movements during this window did present significant operational and liquidity challenges, and will have had knock-on consequences for some schemes running leveraged LDI investment strategies, as well as those who do not.

For example, as a result of rapid increases in gilt yields these schemes had to post more collateral at faster rates than usual, meaning some had to sell assets quickly – and in some cases taking a 'haircut' on the value of assets they would typically expect.

For affected schemes this period will have caused a great deal of disruption to normal activity and their portfolios which they will need to re-balance. Pension funds were not, as mis-reported, at risk of going insolvent, but there were short-term liquidity requirements, which, for some, were difficult to meet.

Our research indicates that the vast majority of schemes were able to maintain their 'hedge' and that c70% schemes were able to make the majority of these changes by the 14th October, however for some re-balancing of portfolios will have to take place over the weeks and months ahead. This will be dependent on the assets they hold in their portfolios e.g. illiquid assets are likely to now form a much higher percentage of the asset allocation, and will have a longer exit periods.

[3] https://committees.parliament.uk/publications/30136/documents/174584/default/

The wider impact of recent events on the gilt market will also result in schemes holding greater levels of collateral, and for some reductions in the levels of leverage in their strategy. It is expected that this collateral buffer will reduce as long-term confidence returns to markets. For such funds, this may also result in a change in their funding strategy and also increased expectations for support from sponsoring employers. For others, the improvement in gilt yields will have accelerated their 'end game' options to buy-out.

Our data indicates that in early October, most schemes had a leverage of 3x or less (70%), with 5% being full matched. Less than one in ten had a leverage of 4x (4%), 5x (2%) or greater than 5x (2%).

By the end of October, most had a leverage of 3x or less (83%), with 11% fully matched and two in five (43%) with a leverage of 2x. Only 3% had a leverage of 4x or more.

It is, however, worth noting that leverage can be measured in a variety of ways, and like for like comparisons are difficult to ascertain at this level and without a consistent regulatory definition.

Half said they had a LDI collateral buffer of less than 200-249bps before the mini-budget on 23 September 2022 (48%), with one in five (18%) saying they had a buffer of more than 300bps. In early October, more than half said they intended to make their collateral buffer more than 300bps by October 14th (56%), while one in ten say they intended to make their buffer 250bps.

2. The impact on pension savers, whether in DB or defined contribution pension arrangements

The recent market turmoil will have no direct impact on the benefits of DB members. The long-term provision of benefits being reliant on a combination of employer support and solvency, as well as scheme funding. As noted above, rising gilt yields have generally improved scheme funding for all but fully hedged schemes.

The impact of market movements will have had differing impacts for different ages of DC member e.g. younger savers contributions could have obtained more assets at a lower price. For most DC members, however, short-term movements in markets will have limited impact on their long-term outcomes.

In the immediate period many savers checking their pension statements will have seen changes in the value of their pension 'pots'.

Changes in value for some DC members approaching or at retirement may have been significant. This is because most DC schemes will include life-styling as part of their strategy for members approaching retirement. This means de-risking and purchasing traditionally stable assets such as gilts to maintain value. The movement in value of such assets due to large changes in gilt pricing and yields will have led to changes to pension entitlements for some savers. This would have been particularly volatile during the gilt crisis but will have recovered to a some extent in recent weeks.

Although the majority of members reaching retirement with DC savings now choose to enter drawdown, it should be noted that rising gilt yields have positively impacted annuity prices, resulting in resulting in £7,288 availability for £100,000 pension on 10 November 2022 in comparison to £5,134 on 11 November 2021[4].

[4] https://www.hl.co.uk/retirement/annuities/best-buy-rates

3. Given its responsibility for regulating workplace pensions, whether the Pensions Regulator has taken the right approach to regulating the use of LDI and had the right monitoring arrangements.

The Pensions Regulator does not have a direct role in the regulation of LDI products or financial stability. These functions are carried out by the Financial Conduct Authority and the Bank of England respectively.

We understand, during the recent crisis, that the regulatory bodies worked closely with one another to share information and respond to emerging issues and identify appropriate solutions.

Early indications from all parties indicate that there is appetite to understand 'lessons learnt' from events and also whether monitoring arrangements, perhaps particularly in relation to liquidity risks need to be better understood. There has also been recognition that events exceeded past stress tests, which may be need to be examined further. On this particular point, we would however note the highly unusual political and economic circumstances around the mini-budget which contributed to the severe market reaction have since subsided.

We believe it is important that regulators assess lessons learnt carefully, and proportionate and risk based in their response.

The Pensions Regulator, through its oversight of DB schemes and the DB funding regime does however an important influence on how schemes seek to manage their risks and secure members benefits. This has included a regime that encourages integrated risk management and a general trend towards de-risking as schemes mature. For many schemes the use of LDI strategies has worked within this regulatory regime very well. At a macro level it has helped strengthen the overall scheme funding level across the pensions sector.

It is worth highlighting the counterfactual - that without this approach, over the last decade, schemes and their employers would most probably have seen further periods of volatility on their balance sheets – risks that would typically need to be borne by sponsors, and sometimes members through higher and less predictable contribution rates. Such volatility, would have had wider consequences for the UK economy. It is also likely that greater volatility would have led to higher levels of DB scheme closure, than has been the case, with corresponding reduction in DB benefit provision for many members.

In future we would encourage the Pensions Regulator to consider the risk management framework that the schemes it regulates should have in place for liquidity risks vs accrued liability risks. In our view this is one of the key lessons of the crisis, and strengthening its guidance in these areas would be appropriate. We also believe the regulator should further consider its approach to the "Own Risk Assessment" obligations on pension funds.

4. Whether DB schemes had adequate governance arrangements in place. For example, did trustees sufficiently understand the risks involved?

PLSA research indicates that nearly all schemes believe that they had a strong understanding of risks within LDI strategies. It is also evident that various measures, put in place following the financial crisis, worked as intended i.e. collateral calls were made, and met. As the Bank of England has recently acknowledged some of these measures, in certain crisis, like the one we have just faced, did however act to feed the storm.

Despite the extreme circumstances, our data indicates that majority of schemes feel that their governance measures coped with the stressed conditions. Nonetheless, there are clearly lessons to be learnt, as this was not a universal experience, and even for those that coped very well there will be areas for improvement. The areas most commonly identified by schemes in our surveys were: further scenario testing, enhanced liquidity reviews, adaptions to scheme governance to act quickly in crisis, and reviewing the capacity and skills of their investment advisors and asset managers.

5. Whether LDI is still essentially 'fit for purpose' for use by DB schemes. Are changes needed?

The vast majority of schemes believe LDI remains 'fit for purpose' and has an important role to play in securing members benefits – for the reasons set out above. This view remains consistent even accounting for potential changes to reflect recent events – for example holding more collateral or reduced leverage within strategies.

6. Does the experience suggest other policy or governance changes needed, for example to DB funding rules?

We believe it is important that the Pensions Regulator considers the 'lessons learnt' from the recent gilts crisis before finalising its DB Funding Code. We set out some of concerns around this issue, in particular the risk of encouraging herding behaviour, which could exacerbate systemic risks, in our response to the accompanying DWP regulations here.

Following the CMA, which started in 2018, we supported the extension of the regulatory perimeter to include the activity of investment consultants given their important role in the investment chain. Progress between various regulators and government departments has however been slower than hoped. In light of recent events we would like to see progress to develop a suitable regime to address the concerns previously identified and any fresh learnings from recent events.

Finally, one of the key components of the liquidity squeeze during recent events has been the limited options that schemes have when posting collateral, as well as some of the obligations of clearing houses (which require cash only). We would encourage regulators to assess whether greater flexibility or optionality around margin requirements would have reduced market volatility and could be introduced in the future. This should include an assessment of whether the UK makes the 'on-shored' temporary exemption from the European Market Infrastructure Regulation, permanent for UK pension funds, and associated bank capital rules which makes this practically feasible.

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