

EVIDENCE FROM THE ASSOCIATION OF CONSULTING ACTUARIES

15 November 2022

Online Submission
UK Parliament
Work and Pensions Select Committee

Subject: Call for Evidence: Defined Benefit pensions with liability driven investments

I am writing on behalf of the **Association of Consulting Actuaries (ACA)** in response to the above call for evidence issued by the Work and Pensions Select Committee. Our members work for a wide range of pension and investment consultancy firms and advise sponsors and trustees of defined benefit and defined contribution schemes. In preparing our response, we have summarized the typical perspectives of our client base.

Our key points are:

- In our view, LDI has overall significantly benefited defined benefit pension schemes (and their sponsors and members) including during the long period of falling yields driven by quantitative easing and during the pandemic.
- We believe LDI remains fit for purpose although, given recent experiences, we anticipate there will be some changes in standard market practice in the operation of LDI arrangements, such as standard minimum levels of collateral.
- Recent market events highlighted issues of liquidity rather than solvency. Most DB trustees will have had well established, formal plans to source additional cash when needed to help support their hedging arrangements (e.g. through a collateral waterfall framework). However, in some cases the pace with which liquid assets could be disinvested and transferred to an LDI arrangement will have caused challenges given the unprecedented speed in which gilt yields rose over a short period of time. This reflects the unprecedented gilt market uncertainty at that time in response to recent policy announcements. Trustee governance models have also been tested. In particular, recent events have required often daily management and decision making. Whilst most Trustee boards have responded well to these circumstances, some will have been challenged during the period.
- Our view is the proposed legislative changes for defined benefit schemes that are currently in the pipeline risk exacerbating some of the issues discussed in this response. Our **response** to the DWP's recent consultation on the draft Occupational Pension Scheme (Funding and Investment Strategy and Amendment) Regulations 2023, on 13 October 2022 covers these points in more detail.

We hope you find the contents of the letter of assistance. We would be happy to discuss them further if that is helpful. In that event, please contact me at steven.taylor@lcp.uk.com (or on 07785 907425), or vanessa.hodge@mercer.com (or on 07920 261 321).

Yours sincerely
Steven Taylor
Chair, Association of Consulting Actuaries Limited

Vanessa Hodge
Chair, Investment Committee

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

Most DB schemes measure the value of their liabilities with reference to gilts. For these schemes the value of liabilities will have reduced significantly when gilt yields rose, relative to levels at the start of the year. The impact on DB schemes' funding position will have been scheme specific and will have depended, in part, on the following factors:

- The target level of hedging in an LDI arrangement. The high-level aim of an LDI arrangement is to reduce the sensitivity of interest rate and inflation movements on the funding ratio or funding deficit of a scheme. All else equal, a scheme with a high level of liability (interest rate and inflation) hedging would see the value of the assets move broadly in line with the movement of its liabilities. These schemes will have been protected during the previous falling yield environment (such as during the pandemic) where the growth in the value of the liabilities will have broadly matched growth in the liability hedging assets.

In late September and early October, gilt yields rose rapidly. In a rising yield environment, schemes with high levels of hedging will have seen neutral or marginal positive impacts on funding levels as the fall in the value of the liability hedging assets would have broadly kept pace with the fall in the value of liabilities. Schemes with lower levels of hedging will have benefitted from the rise in yields as the value of their liabilities would have fallen by significantly more than the value of their liability hedging assets, which, all else equal, would have improved funding (but leaving the schemes exposed to the risk of future falling yields).

- The wider investment strategy and the exposure to non-UK gilts. During the period in question, the performance of global equities and credit was negative, which would have provided headwinds to any improvement in funding.
- Access to liquid assets – Most trustees will have a collateral waterfall or similar framework. If additional collateral is required in the liability hedging arrangement in order to maintain the target hedging levels, the framework sets out where the additional cash will be sourced. This will be through the sale of other assets and typically start with the most liquid assets. Given the speed of the gilt yield rises in late September/early October, collateral calls for some schemes were large, frequent and were required at short notice. In practice this also meant that some investment funds that would usually be considered to be liquid in normal market conditions may have faced challenges trading quickly enough to meet the collateral requests, allowing for notice periods, settlement periods and trading frequency of the funds (including the receiving LDI manager).

In some cases where additional cash could not be raised quickly, target hedge levels may have had to be reduced until the additional cash payment was received by the LDI manager. The timing of when hedge levels were reduced will have impacted some schemes more than others. For example, some trustees may have needed to sell assets at a time when the valuations were low; others may have experienced difficulties if trying to efficiently call quickly on illiquid assets in order to access additional cash to maintain their hedging position.

- Leverage levels before late September. Schemes with higher levels of leverage in their LDI portfolio before the rapid rise in yields during late September and early October will have felt a greater operational

challenge than those with lower leverage. This is because they will have moved through their collateral waterfall frameworks more quickly than those with lower leverage.

- Market Timing. The timing of when hedge levels changed will have driven the actual impact felt by schemes. For example, some schemes will have been negatively impacted by the whipsawing of gilt yields experienced on 28 September 2022 when the Bank of England intervened, others positively.

For example, some trustees may have made a conscious decision to reduce the target hedge level of their LDI arrangement in order to reduce leverage levels and improve collateral sufficiency. The timing of when those adjustments were made will have determined the relative impact to a scheme. At the time, there was concern that gilt market volatility would continue to be high once the Bank of England withdrew its support at the close of business on 14th October. Trustees that either made a decision to reduce target hedging levels or found the levels of hedging in the LDI arrangement had been reduced by the asset manager, will have been exposed to falling gilt yields experienced since 17th October.

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

For the majority of DB schemes, we believe the impact on pension savers of the gilt yield rises in late September and early October will be minimal. The overall impact will be driven by the overall level of risk being run in the investment strategy and the impact on the overall funding level of the scheme (which in many cases will have improved). We also note that our understanding is that the majority of schemes maintained their hedge through the period.

For pension savers in defined contribution arrangements, those members investing in UK gilt funds will have seen a significant reduction in the value of those assets during the period in question (although much, if not all of this impact has since reverted). The potential impact will be most material for those members who are close to retirement and are invested in a lifestyle arrangement, which moves some of the members' assets into a gilt based fund during the lifestyle-phasing period.

The potential impact to these savers will depend on how they intend to use their savings in retirement. For example for those intending to purchase an annuity, the impact of gilt movements to lifestyle fund values will likely have been broadly offset by movements in annuity 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.

We believe the Pensions Regulator has historically taken an appropriate and proportionate to regulating the use of LDI and investment in general for individual schemes. In particular, aggregate funding levels have improved significantly in recent years as schemes have sought to manage exposure to interest and inflation risks.

However, systemic risk is a separate point, including whether the cumulative effects of hedging activities from individual schemes were being sufficiently closely monitored by wider regulators. Our response to question 6 sets out further related comments.

In particular, our understanding is that many of the broader regulatory and operational requirements associated with LDI will fall outside of the remit of TPR and are overseen by other regulators, such as the FCA and similar overseas regulators. The Bank of England has overall regulatory oversight of the UK market and the DMO determines the levels of gilt issuance.

To more closely monitor individual scheme hedging arrangements, the Pensions Regulator would likely need a more detailed amount of information for each scheme. In particular, the overall operational framework around an LDI arrangement will be bespoke to a scheme (and for example, as noted in our response to point 1 above, each scheme will use different LDI vehicles and have different target hedge ratios, leverage levels and access to liquid assets for additional collateral).

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

Generally, yes, although degrees of understanding across schemes and within boards inevitably varies. A key challenge during the recent period was the need for trustee boards to respond quickly to market stresses as they emerged and our experience is that most trustee boards coped with this well, in incredibly challenging circumstances.

LDI arrangements are complex and many trustees will review the purpose and operation of the arrangement when receiving a monitoring report or a presentation from the asset manager. Typical LDI monitoring reports include information such as actual hedging levels against target levels; collateral sufficiency; counterparty exposure; and leverage levels.

The main governance challenge during the period in question was the speed in which trustees needed to make decisions and take action. This required many ad hoc meetings between trustees and their advisors, or sub-group of trustee committees, as well as availability of trustees to sign instruction letters at short notice.

Trustees that have delegated the management of their LDI arrangements (including allowing their manager to source cash for collateral from non-LDI assets), or their wider investment arrangements, may have found the operational governance easier to support during the fast changing and volatile market conditions.

One industry-level challenge during this period was the ability of trustees and their advisors to obtain real-time information about their LDI portfolio. Lags in data and updates from investment managers required many trustees to make quick investment decisions based on limited data. Trustees will have looked to their investment advisors to provide clear and concise advice in order to help understand the implications of the decisions they needed to make. It was also challenging for trustees to be able to track the progress of their funding level during this period.

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

We believe that LDI remains fit for purpose as a strategic risk management tool. Not using LDI arrangements would expose pension schemes to significant interest rate and inflation risks. In particular, if leveraged LDI were not available, then schemes would likely be exposed to significantly more volatile funding requirements (from

unhedged yield exposure) and/or sponsors could face significantly higher contribution requests to fund physical allocations to hedging assets.

The letter from the Bank of England to the Work and Pensions Select Committee on 5 October 2022 stated: *"...it should also be recognised that the scale and speed of repricing leading up to Wednesday 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."*

General market practice before late September will have been to review the collateral sufficiency of an LDI arrangement to market stress of around 150-200bps (and, for reference, historical bank of England analysis suggested that a 100bps movements during a month would reflect a 1 in 1000 event.) Following recent experiences, we expect it will become the norm for LDI arrangements to now hold collateral to support at least 300bps or more of yield rises and there is evidence of this already having been put in place.

In practice, this may constrain some pension schemes that still need to generate additional returns over gilts as assets that could be allocated to growth assets may now be required to support an LDI arrangement. Depending on the level of funding of a scheme and the required return needed in order to continue to meet the trustees' funding objective, there may be opportunities to de-risk the strategic asset allocation and continue to support the level of hedging. Other schemes may be required to review the scheme's target hedge ratios if the requirement to hold greater collateral now constrains the ability to invest in other assets and to meet the strategic funding target. This may put a greater reliance on scheme sponsors.

The need for trustees to be able to access cash at relatively short notice will require trustees to review the level of illiquid assets in the portfolio. Trustees of schemes with strong funding levels may decide it is appropriate to reduce their strategic allocation to illiquid assets and market movements over the year has likely made many schemes overweight to illiquid assets. A challenge for trustees will be the ability to sell these assets efficiently.

We also expect the provision of information from LDI asset managers will need to improve in terms of the content and the speed of providing the data. This will come with a cost in terms of systems development and technology solutions. Many LDI arrangements have been priced as commodity services and the fees for segregated and pooled accounts may need to be increased to support an increase in data provision.

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

Our view is the proposed legislative changes for defined benefit schemes that are currently in the pipeline risk exacerbating some of the issues discussed above. Our comments below reiterate points we made in our response to the DWP's recent consultation on the draft Occupational Pension Scheme (Funding and Investment Strategy and Amendment) Regulations 2023, on 13 October 2022.

The financial market developments over recent few weeks have brought systemic risks into sharp focus. The draft regulations would require schemes to aim for a tightly prescribed low dependency investment allocation as they become more mature – and to have a low dependency on the employer once they reach 'significant maturity'. A typical way for schemes to achieve this would be greater use of LDI approaches. This standardisation therefore has potential unintended consequences, such as increasing systemic risks in future by encouraging all DB schemes to invest in very similar ways.

We also have broader concerns that the proposed changes in legislation are insufficiently flexible and would reduce the 'scheme specific' element of the current funding regime – replacing it with an industry standard approach, only permitting limited variation in how schemes plan their journeys towards maturity and set their ultimate destination. Based on the draft regulations, our view is that all schemes would be required to adopt fairly similar plans.

Overall, our view is that the proposed changes in regulations would have a detrimental impact on the scheme specific funding regime. In particular, we believe the opportunity should now be taken to reflect on these dynamics to ensure that investment decisions schemes are encouraged to make as they mature do not contribute to an increase in systemic risks when viewed across the whole industry.

This 'paper/document' is intended to provide general information and guidance only. It does not constitute legal or business advice and should not be relied upon as such. Responding to or acting upon information or guidance in this 'paper/document' does not constitute or imply any client /advisor relationship between the Association of Consulting Actuaries and/or the Association of Consulting Actuaries Limited and any party, nor does the Association accept any liability to any person or organisation relating to the use of such information or guidance.