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# LDI – Call for evidence


## ACA's written and oral response

Steven Taylor, Chair of ACA
Vanessa Hodge, Chair of ACA Investment Committee

24 November 2022

A business of Marsh McLennan

# Overview

1. LDI has overall significantly benefited defined benefit pension schemes (and their sponsors and members)
2. LDI remains fit for purpose
3. There will be some changes in standard market practice in the operation of LDI arrangements
4. Recent market events highlighted issues of liquidity rather than solvency
5. Trustee governance models have also been tested
6. Proposed legislative changes for defined benefit schemes risk exacerbating some of the issues discussed today

# Why the mini-budget created a UK gilt market crisis

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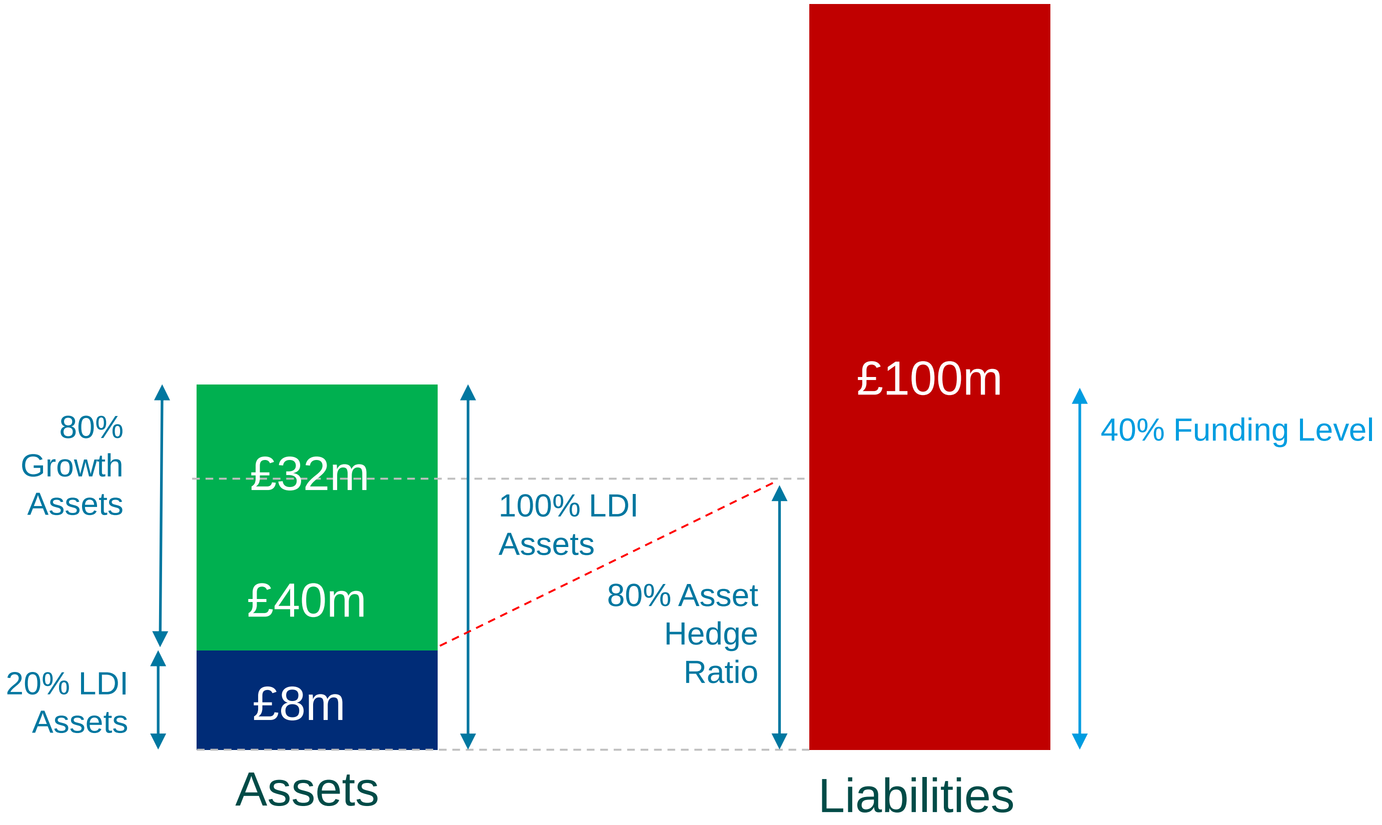
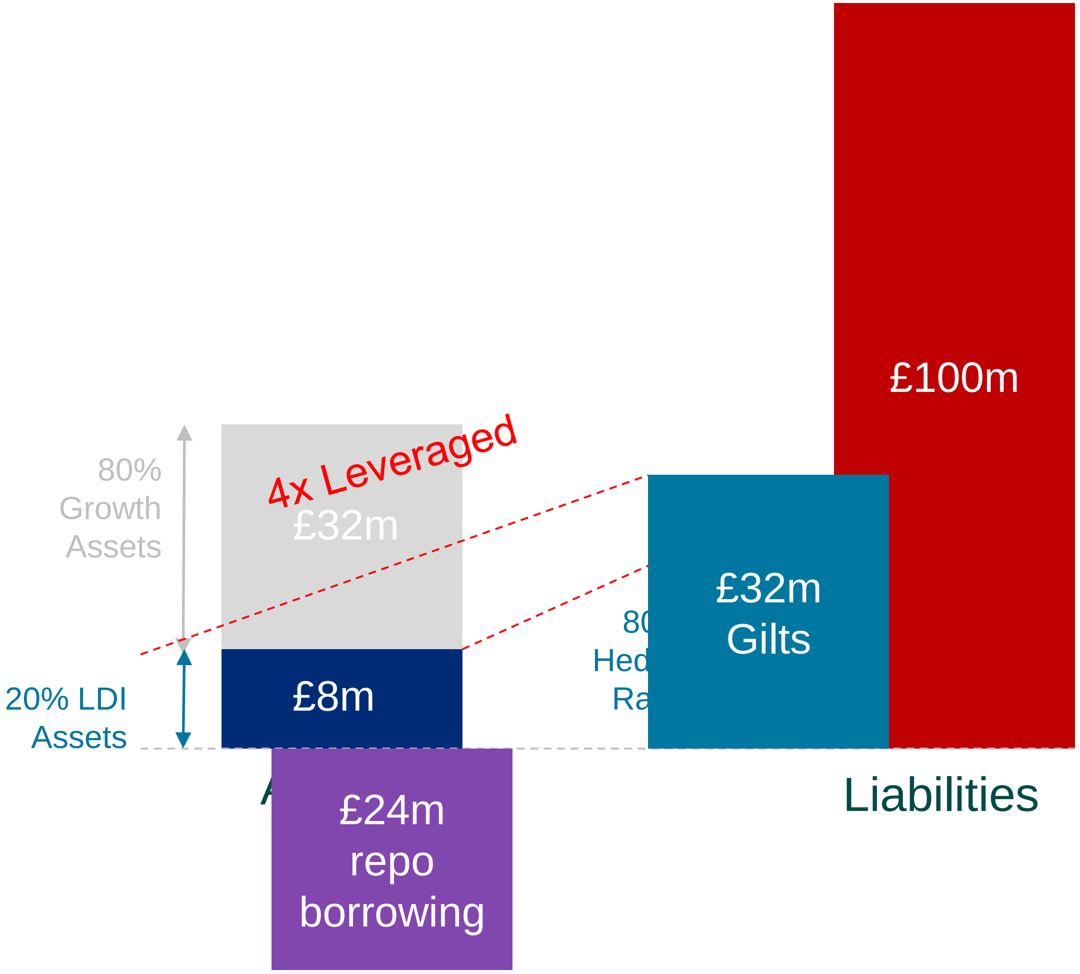
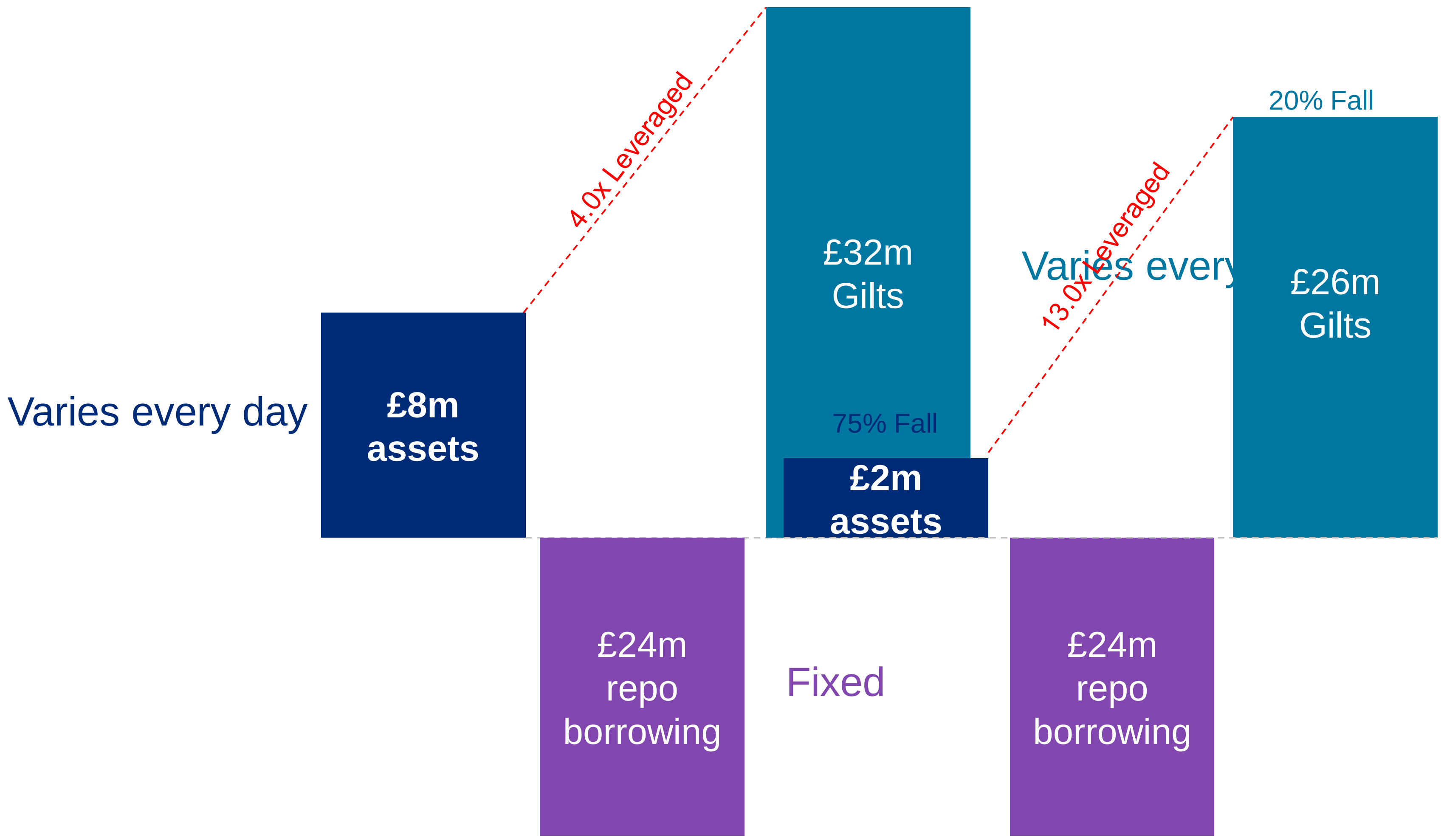
# What is the purpose of LDI?



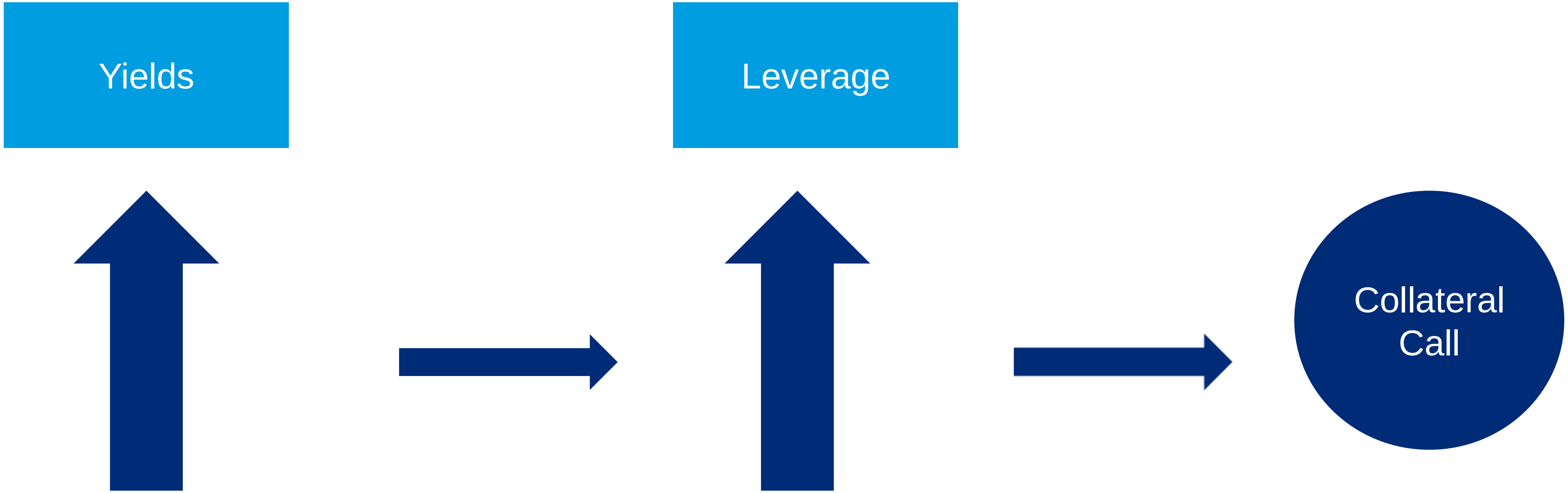
# Why is leveraged LDI is used?



# Leverage risk and collateral



# What caused the “doom loop”….

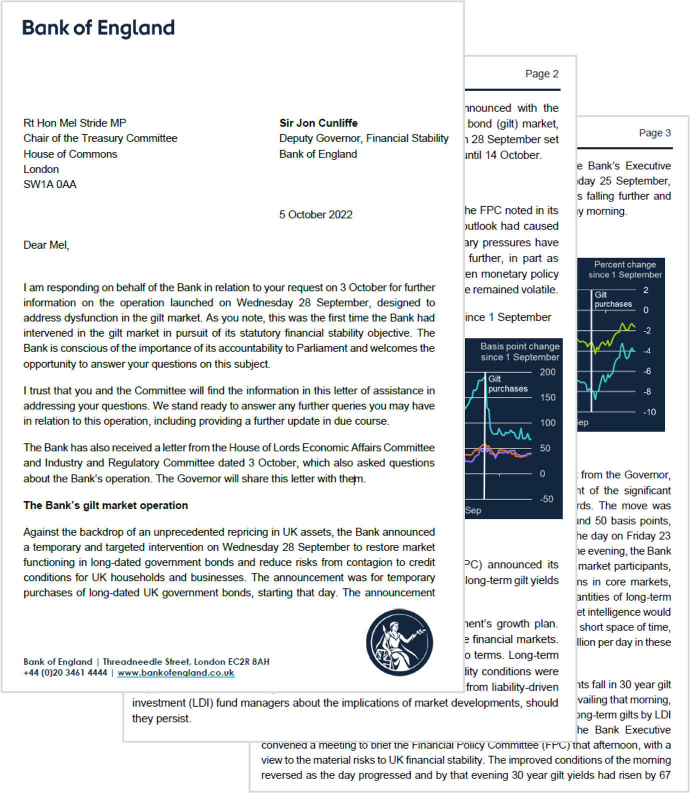



**REPEAT** **REPEAT** **REPEAT**

# Bank of England steps in


Source: Bloomberg

# Bank of England letter on why the intervention was needed



Bank of England

Rt Hon Mel Stride MP
Chair of the Treasury Committee
House of Commons
London
SW1A 0AA

Sir Jon Cunliffe
Deputy Governor, Financial Stability
Bank of England

5 October 2022

Dear Mel,

I am responding on behalf of the Bank in relation to your request on 3 October for further information on the operation launched on Wednesday 28 September, designed to address dysfunction in the gilt market. As you note, this was the first time the Bank had intervened in the gilt market in pursuit of its statutory financial stability objective. The Bank is conscious of the importance of its accountability to Parliament and welcomes the opportunity to answer your questions on this subject.

I trust that you and the Committee will find the information in this letter of assistance in addressing your questions. We stand ready to answer any further queries you may have in relation to this operation, including providing a further update in due course.

The Bank has also received a letter from the House of Lords Economic Affairs Committee and Industry and Regulatory Committee dated 3 October, which also asked questions about the Bank's operation. The Governor will share this letter with them.

**The Bank's gilt market operation**

Against the backdrop of an unprecedented repricing in UK assets, the Bank announced a temporary and targeted intervention on Wednesday 28 September to restore market functioning in long-dated government bonds and reduce risks from contagion to credit conditions for UK households and businesses. The announcement was for temporary purchases of long-dated UK government bonds, starting that day. The announcement

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

*The 30 year nominal gilt yield rose by 160 basis points in just a few days, having only had a yield of around 1.2% at the start of the year. On Wednesday 28 September the intraday range of the yield on 30 year gilts of 127 basis points was higher than the annual range for 30 year gilts in all but 4 of the last 27 years.*

*It is important that we ensure that non-banks, particularly those that use leverage, are resilient to shocks. However, 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.*

Extracts taken from the letter from the Bank of England to Rt Hon Mel Stride MP on 5 October 2022

# ACA’s written evidence

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

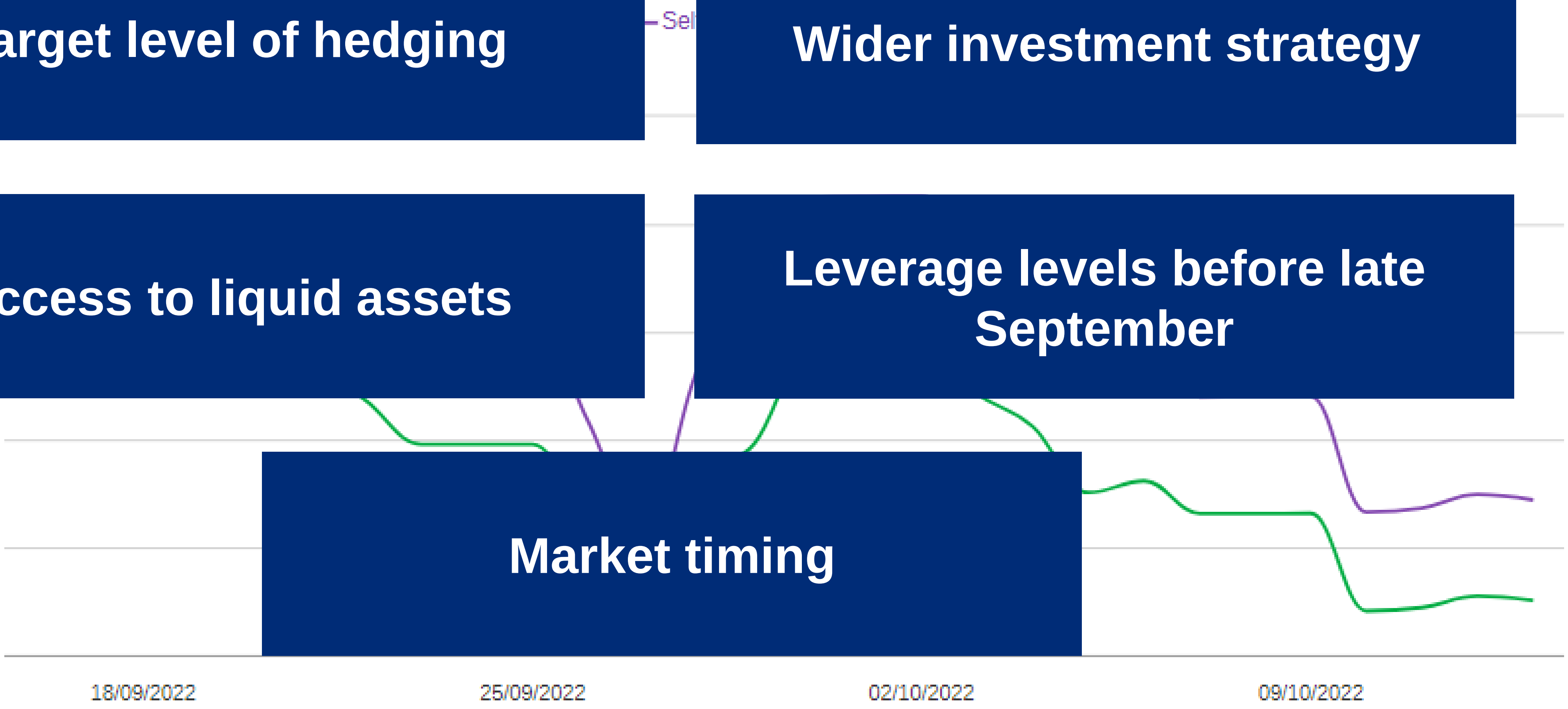
Target level of hedging

Wider investment strategy

Access to liquid assets

Leverage levels before late September

Market timing



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

## Defined Benefit

- Minimal impact
- Impact driven by overall level of risk run in investment strategy
- Majority of schemes maintained their hedging

## Defined Contribution

- UK gilts investments fell in value
- Material for members close to retirement
- Impact depends on how members intend to use their savings in retirement

# 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

✗ Systemic risks

The Pensions Regulator

✓ Proportionate

FCA Financial Conduct Authority

Bank of England

United Kingdom Debt Management Office

# Whether DB schemes had adequate governance arrangements in place

Degrees of understanding across schemes and within boards inevitably varies

Need for trustee boards to respond quickly to market stresses

Delegation of the management of LDI arrangements beneficial

Limited real-time information

Challenging to track funding level

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

## LDI REMAINS FIT FOR PURPOSE AS A STRATEGIC RISK MANAGEMENT TOOL

Higher levels of collateral sufficiency and lower leverage

Potential constraints on growth asset return

Greater reliance on scheme sponsors

Review allocation to illiquid assets

Data provision

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

- Draft Occupational Pension Scheme (Funding and Investment Strategy and Amendment) Regulations 2023 could exacerbate systemic risks
  - Encourages all Defined Benefit Schemes to invest in very similar ways
  - Greater use of LDI approaches
  - Industry standard approach to funding

# ACA’s oral evidence

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# Q&A

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