Broadstone

Resilience of Liability Driven Investment (LDI) Strategies

December 2022

Introduction

On 30 November 2022, the Pensions Regulator (TPR) issued a guidance statement concerning the resilience of LDI strategies, which were tested in the stressed gilt market conditions of late September 2022 and early October 2022. This followed an initial statement from TPR on 12 October 2022.

This briefing note considers the recommendations from TPR, and what actions pension scheme trustees should consider if they hold LDI within their investment strategy.

Background

Since the start of the year, long-dated UK government bond (gilt) yields have increased materially, peaking in late September 2022 following the 'mini-budget' when volatility rose sharply. The sharp rise in gilt yields led to many defined benefit (DB) pension schemes with LDI strategies needing to meet significant capital calls in order to reduce leverage and maintain the hedging provided by the LDI strategies.

The sale of gilts, either to meet such calls or by LDI managers who were not able to raise collateral from their investors, meant the situation became self-reinforcing in late September 2022. Yields continued to rise rapidly with prices falling, and liquidity in the UK government bond (gilt) market effectively dried up. This resulted in the Bank of England launching a temporary government bond buying programme as part of its remit to prevent material risk to UK financial stability.

Whilst many DB pension schemes were able to meet all or some of the capital calls made by LDI managers, the requests were often made with little notice. In some instances, pension schemes were either required to sell growth assets at an inopportune time, or sell any liquid assets available, leading to a concentration of illiquid assets within the remaining investment strategy. For those pension schemes that were unable to sell assets to meet the capital calls made, the hedging from LDI solutions was reduced, requiring the hedging to be restored at a later date. In many cases, depending on timing and whether hedging has been fully restored, the loss of liability hedging will have cost schemes in funding level terms.

TPR has now issued a statement providing guidance to DB pension scheme trustees who use LDI solutions, to ensure the overall investment strategy is resilient to any future market shocks. However, before covering this, let us firstly consider the response from LDI managers and the main authorities that oversee their regulation.

Response from LDI managers and regulatory authorities

The latest TPR statement was preceded by a statement issued by the Central Bank of Ireland (CBI) on 30 November 2022, following interactions it has had with the Commission de Surveillance du Secteur Financier (CSSF) Luxembourg and the European Securities and Markets Authority (ESMA) directly in relation to the operation of LDI funds.

The CBI and the CSSF, referred to as the National Competent Authorities (NCAs), are two regulators of LDI funds used by UK pension schemes. The CBI statement acknowledged that managers of LDI funds have recently taken steps to increase resilience within LDI funds, reducing overall leverage and increasing their ability to withstand a large increase in yields (around 3% p.a. on average).

The CBI statement also made clear that LDI managers would need to inform the relevant NCA in advance of any proposal to reduce an individual LDI fund's resilience. In such cases, they would be expected to prepare detailed analysis to justify the proposal, including a risk assessment to demonstrate the LDI fund's resilience in current and stressed environments.

The NCAs also require LDI funds to have procedures in place to recapitalise and/or de-risk portfolios in exceptional market circumstances, including consideration of wider market impacts.

TPR Recommendations

In its latest statement, TPR welcomed the comments made by the NCAs. In addition, to ensure that DB pension schemes using LDI strategies are resilient and run with the appropriate level of operational governance, TPR has recommended that trustees consider a broad range of issues which we have summarised as follows:

- **Liquidity:** Pension schemes should ensure they have sufficient access to liquid assets to meet LDI capital calls at short notice, either held directly with the LDI manager or which could be called on if held externally. The amount of liquid assets to act as collateral for LDI solutions will vary based on the underlying LDI approaches used.

- **Risk assessment:** Pension schemes are encouraged to consider and assess the risks of holding LDI solutions. In particular, it is recommended that trustees assess how their LDI solution and the wider investment strategy (including other asset classes such as equities, property and corporate bonds) would be expected to behave in a stressed market scenario. This scenario analysis can also help identify any risk mitigation that is needed.

- **Action plan:** Pension schemes are encouraged to develop an action plan, including setting out what steps would need to be taken in a stressed market scenario. For example, if a pension scheme cannot meet LDI capital calls in full, the action plan should set out steps that need to be taken to restore any hedging levels lost, and how to restore the overall resilience of the investment strategy.

- **Hedging levels:** Subject to the above, TPR also recommends trustees consider whether the levels of hedging provided by the LDI solution remain appropriate, with recognition of the risks and liquidity requirements associated with the LDI solution. For those trustees that are not comfortable with the risks, or cannot put sufficient liquid assets in place, the levels of hedging should be reviewed.

- **Investment manager authorised signatories:** TPR recommends that investment authorities in place with investment managers are maintained and kept up to date. This will ensure that any switches of assets needed to maintain the hedging provided by LDI solutions can be authorised at short notice.

- **LDI collateral arrangements:** Trustees are recommended to review their LDI collateral arrangements in light of recent market stress, and consider putting in place alternative arrangements where necessary. For example, this could include the introduction or extension of liquidity waterfalls, where liquid assets are called on in the first instance, but where other assets can be used as a reserve source of collateral if needed. Furthermore, trustees are recommended to consider the settlement times of dealing in any assets held externally to the LDI investment manager, to ensure capital calls can be met promptly, including in a stressed market environment.

- **LDI leverage reduction:** Investment managers have also implemented steps in recent months to improve the resilience of their LDI approaches, with many LDI approaches now holding higher levels of capital to withstand short-term market shocks. This has reduced the levels of leverage of these LDI approaches, thereby reducing the sensitivity of the LDI approaches to changes in market conditions. Trustees are encouraged to ask their LDI investment manager what steps they have taken to improve the resilience of their LDI approaches.

TPR also notes that the recommendations provided above should be reviewed on a regular basis, to ensure the resilience of an LDI-based strategy is monitored and remains appropriate over time.

Employer Support

TPR notes that some trustees may wish to establish an agreement with the sponsoring employer to provide short-term liquidity in stressed market conditions. Where this is used, TPR recommends that trustees document and legally review any agreements, and ensure these agreements are only used for the provision of short-term liquidity to the pension scheme.

Broadstone's View

We remain of the view that LDI can be a useful component of a scheme's investment strategy, but it is important for trustees to understand and put in place appropriate measures to support LDI solutions. Therefore, in our view the steps recommended by TPR are sensible and provide a logical framework for trustees to build into the ongoing monitoring of LDI solutions.

We believe that carrying out the review process suggested by TPR is essential for schemes to demonstrate good governance. However, the reality of lower leverage within LDI funds and the implications of necessary changes to asset portfolios to increase overall resilience, will change how LDI is used and whether it is an attractive option for some schemes. This will need to be considered at a strategic level for each scheme based on their specific circumstances.

For example, achieving the desired level of liability hedging will likely require proportionately more of a scheme's assets to be deployed in LDI solutions and highly liquid assets, which may impact a scheme's ability to achieve its target level of expected return. The appropriate balance of risk and return may need to be reassessed considering a scheme's longer term strategic funding and investment targets, allowing for the revised current position and the compromises now needed.

Some schemes may also want to look at alternatives to LDI, and again they will need to consider the pros and cons of different approaches. which will depend on a scheme's particular circumstances.

Finally, although we have already seen LDI managers take steps to improve the resilience within their LDI funds, there are further steps that will need to be considered to improve resilience and the efficiency of LDI solutions. We are engaging with LDI managers, and we expect further enhancements to be made in the coming weeks. Assessing the level of confidence in a scheme's LDI manager and the overall resilience to support the LDI solution should be a key output of the process that we will be working on with our clients over the coming months.

Summary of Actions

In light of TPR's statement, there are a number of immediate actions we believe trustees of DB pension schemes with LDI should be considering:

Carry out a resilience assessment based on TPR's recommended steps

We suggest using the recommended steps set out in TPR's statement as the basis of an assessment of a scheme's resilience and ability to support any LDI solution in place. This would focus on the following key areas:

- Review current authorised signatory lists and processes for carrying out any asset switches that may be required;
- Carry out stress tests and analysis of LDI and non-LDI assets, including collateral adequacy and liquidity profile in normal and stressed conditions;
- Determine whether any changes in liquidity profile are necessary and establish/expand collateral waterfalls, if necessary;
- Establish a plan for restoring portfolio resilience in the event of market stress; and
- Document the arrangements and review them regularly.

Review wider investment strategy and funding objectives

Some schemes will need a more comprehensive reassessment to fully understand and review the impact that any changes in asset allocation may have on a scheme's existing strategic objectives. This may require schemes to revisit existing objectives and journey plans, and may lead to the investigation of alternative Investment arrangements.

Understand what changes your LDI manager has made and the resilience of their LDI funds

We are working closely with LDI managers to discuss and review changes that have been made and will be considered to ensure greater resilience within LDI funds and across the processes that are currently used to support them. We would encourage trustees to engage with their LDI managers where appropriate to understand the actions that they have taken.

Please speak to your investment consultant if you wish to discuss any of the recommendations set out in this briefing note.

Find out more

For more information on how Broadstone can help you, please contact your Broadstone consultant

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