Broadstone

Latest guidance from the Pensions Regulator on LDI

May 2023

On 24 April 2023, the Pensions Regulator ('TPR') issued guidance in relation to using leveraged Liability Driven investments ('LDI'). This note provides a summary of the guidance, and our suggested action points for trustees who are using, or considering using, LDI in their investment strategies.

Introduction and background

During September and October 2022, government bond ("gilt") yields rose sharply and quickly, causing a sell-off in LDI investments, and significant liquidity challenges for managers of leveraged LDI strategies and the pension schemes who invested in them. Since then, several governing bodies have released statements and guidance on how to improve LDI financial resilience in response to market events. These include:

- For pension scheme trustees: TPR's statement issued in October 2022 and LDI guidance issued in November 2022; and

- For LDI managers and LDI funds: Guidance from the Financial Conduct Authority and the "National Competent Authorities" (the Central Bank of Ireland and the Commission de Surveillance du Secteur Financier of Luxemburg).

TPR's latest guidance for trustees supersedes its statement and guidance from October and November 2022, although many of the previously suggested steps remain relevant. The guidance is concerned primarily with leveraged LDI, though trustees may wish to apply its principles to non-leveraged LDI, where appropriate.

Summary of the guidance

The guidance is designed as a supplement to TPR's general guidance on Defined Benefit (DB) investment. It sets out specific considerations for trustees who are using or considering the use of leveraged LDI, and covers four categories:

1) Investment strategy

2) Collateral resilience

3) Governance

4) Monitoring

1) Investment strategy

Following recent changes that LDI managers have made in order to make their strategies more resilient, schemes may not be able to target the same level of hedging without increasing their LDI allocations. As a result, they may need to accept a lower level of hedging or reduce their expected investment return. Trustees should review their strategies in light of this to ensure the level of risk and return remains appropriate.

Trustees should specifically review the risks and benefits of using leveraged LDI in their strategy. Whilst LDI can be useful in helping trustees to manage funding level and deficit risks, it does introduce other risks including the need to hold sufficient liquid assets to meet collateral calls (if their LDI investments fall in value). There are lots of different types of LDI and they differ in terms of the investment exposures they provide, when collateral is required, and the types of assets that can be held as collateral.

Trustees should obtain written advice specifically on the suitability of using LDI, the benefits and risks of using LDI, and the processes in place to manage LDI liquidity risks.

Trustees should then document the results of their strategy review and any changes to their investment strategy. Trustees should record their strategy's expected return and risks; the assets invested in; the target levels of interest rate and inflation hedging; plans for providing collateral for LDI if required; and how the strategy meets the new 'resilience standards' (see the next section).

Action points: investment strategy
- Review the investment strategy following recent changes in LDI strategies and document the key strategic outcomes.
- Obtain written advice on the use of LDI, its benefits and risks, and the processes in place to manage liquidity risks.

2) Collateral resilience

Leveraged LDI investments need supporting assets (or collateral) that can be drawn on when the investments fall in value. Trustees should review the resilience of their supporting collateral arrangements.

Collateral sufficiency: firstly, trustees should ensure that they hold enough assets in a suitable buffer to cover both day-to-day moves (an 'operational buffer'), and more extreme market moves (a 'market stress buffer'). In the case of LDI pooled funds, where the buffer is set by the pooled fund manager, trustees should review its level to determine whether they are comfortable with it and understand how resilient it is to market stress. A smaller buffer ties up less assets but may need to be topped up more frequently; a larger buffer should mean fewer top-up calls but ties up more capital.

Collateral management policy: Trustees should understand the circumstances in which additional assets will be called, have a plan for meeting these calls, and record these processes.

- Trustees may wish to agree in advance which assets should be used to meet calls. This could include selling one fund or portfolio, or a 'waterfall' arrangement setting out the order in which assets should be sold. Trustees should understand the risks associated with their plan, including the time taken to sell the assets, the costs and complexity of the sales process, and the impact of selling these assets in potentially stressed market conditions.

- Trustees should ensure they are able to sell assets quickly where required. This includes making it clear who is authorised to sign instructions and what the investment manager requirements are regarding sale instructions. In some cases, trustees may wish to delegate the selling of assets to an investment manager or another third party in a pre-agreed manner.

- Where trustees wish to retain the responsibility of deciding how to source top up assets, they should ensure that they are able to make decisions and act quickly.

Resilience testing: trustees should test the resilience of their LDI investments and processes. These tests may be designed by your LDI manager or adviser, but trustees need to be comfortable that the tests are sufficiently robust and give them enough information to understand the risks. Tests might include:

Scenario testing to understand how the investment strategy would perform under specific scenarios. The scenarios should be specific to your scheme's risks and vulnerabilities and should cover a wide range of different circumstances. Trustees should understand the full consequences including the impact on the LDI investments and the collateral buffer, the sale of supporting assets including time taken to top up, and the overall impact on the investments. The scenario testing should also consider any impact of other parties acting at the same time under stressed conditions.

- Understanding the size of movement that is required before a specific event occurs. For example, understanding the size of market movement before additional collateral is called, and the size of movement before all supporting assets are used up.

Action points: collateral resilience
- Ensure the LDI strategy holds enough supporting assets for both an 'operational buffer' and a 'market stress buffer'.
- Record the agreed processes to top up the buffer in a 'collateral management policy'.
- Carry out resilience testing of the LDI arrangements and collateral management policy.

3) Governance

Trustees should be clear who is responsible for each part of their LDI investment strategy, at each step in the process from specifying the liabilities to be hedged and determining the target hedging level, through to overseeing and implementing the cashflow management of the scheme.

Trustees must be satisfied that the responsibilities, and any delegation of those responsibilities, is appropriate to the governance of their scheme and is clearly set out in adviser and manager agreements.

Trustees should periodically review the responsibilities and delegations in their scheme, and their operational processes.

4) Monitoring

Trustees should have in place adequate processes for monitoring their LDI arrangements. Trustees should ensure they receive enough information from their LDI providers and their advisers to monitor their arrangements in a timely manner. TPR provides examples of the types of information that may be useful, such as:

- the dates of past collateral top-up calls and the time and costs of selling assets to meet them,
- metrics to assess the sufficiency of the collateral buffer and supporting top-up assets, and
- any instances of the LDI hedge being reduced and the implications for the scheme.

Action points: governance and monitoring
- Ensure the responsibilities and delegation in your arrangements are appropriate for your scheme.
- Review your LDI reporting to ensure you receive enough information to monitor your LDI arrangements and processes in a timely manner.

Summary

TPR's new trustee guidance provides a comprehensive list of considerations and actions for trustees to work through when considering their use of LDI in their wider investment strategy. For further assistance with any of the topics mentioned in this note, please contact your regular Broadstone adviser.

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Find out more.

For more information on how Broadstone can help you, please contact your Broadstone consultant or use the details below.

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