New TPR guidance on Liability-Driven Investment May 2023

The Pensions Regulator (TPR) has published guidance on Liability-Driven Investment (LDI). In this briefing we explain what this means for LDI fund managers and trustees.

Key points

- TPR has recently published guidance aimed at ensuring greater resilience of LDI funds
- The guidance sets out expectations for LDI providers and trustees
- All the pooled LDI funds used by our clients comply with the new requirements
- Most trustees should also find that they comply. But if you don't regularly monitor your scheme's LDI arrangements, you should consider putting such an arrangement in place.

Guidance for LDI managers

The guidance considers the collateral that should be held within an LDI fund. Collateral is used to ensure that a fund's leverage is controlled as market conditions fluctuate.

The guidance refers to *operational* and *market stress buffers*. These are intended to identify minimum collateral levels.

TPR's reference to buffers is directed at LDI fund managers, who should be taking these requirements into account when setting their funds' leverage levels and limits. For their part, trustees should ensure that the LDI manager they choose is operating in line with the guidance.

We have checked the position for the LDI funds used by our clients and, in every case, pooled LDI funds are being managed in accordance with TPR's guidance. Further details of our assessment are provided in our FAQs at the back of this briefing.

Guidance for trustees

The guidance also considers appropriate actions for trustees and their advisers, to make LDI as robust as possible. TPR states that trustees must:

> *"...ensure that you have the right controls and governance around LDI. You need to be confident that, particularly in a crisis, you have in place ways of working with your advisers and managers, so you can act quickly and effectively"*

We wholeheartedly support this message. Indeed, our understanding is that the main cause of the forced selling of gilt exposure in autumn 2022 was not a lack of collateral within pooled funds. Instead, it was a consequence of some trustees being unable to meet LDI fund managers' calls for more money.

The consultant and fiduciary management industry had, in our view, understated the risk of holding sizeable allocations to illiquid assets alongside LDI. Many preferred not to actively consider how best to source an LDI capital call until it was actually made.

The result was that many pension schemes:

- Held too few assets that were sufficiently liquid to support LDI capital calls
- Relied too heavily on overwhelmed consultancies to prepare the critical instructions
- Had no one available to sign the required instructions in time.

An alternative approach – which has always been our preference – is to establish an automated process, under which responsibility for processing LDI capital calls is delegated to the LDI fund manager or an investment platform.

In its latest guidance, TPR identifies ways in which trustees can make their LDI recapitalisation processes robust. In our view, this is achieved by the approach already adopted by most of our clients, namely:

- Delegate responsibility for processing LDI capital calls to the LDI fund manager or platform provider
- Provide the LDI fund manager with direct access to sufficient liquid assets to meet the worst-case for capital calls from the LDI funds
- Provide and maintain clear instruction as to which assets should be sold, and in what order, to meet LDI capital calls
- Undertake regular monitoring so the arrangements for meeting LDI capital calls remain appropriate over time.

What action is required from trustees?

If, like the majority of our clients, you:

- Delegate responsibility for meeting LDI capital calls to your LDI manager or platform provider,
- Have established automatic, pre-agreed instructions for meeting these calls, and
- Receive our quarterly monitoring reports, which assess whether your arrangements are sufficient to ensure the LDI will be robustly supported in the event of extreme market conditions,

… then you satisfy TPR's expectations and there is no need for any further action.

If you don't think your current arrangement satisfies all the above bullet points, do get in touch with your usual First Actuarial consultant or a member of the investment team to discuss your options.

FAQs

1. Why has TPR issued this guidance?

TPR's guidance has been issued in response to statements issued by the Bank of England's Financial Policy Committee (FPC), aiming to "ensure the UK financial system is prepared for, and resilient to, the wide range of risks it could face".

The FPC stated in March that:

> *"LDI funds should be able to: withstand severe but plausible stresses in the gilt market; meet margin and collateral calls without engaging in asset sales that could trigger feedback loops; and improve their operational processes to meet margin and collateral calls swiftly when needed."*

And that:

> *"LDI funds should be resilient to a yield shock of around 250 basis points, at a minimum, in addition to the resilience required to manage other risks and day-to-day movements in yields."*

The guidance issued by TPR aims to make sure that the LDI arrangements used by schemes satisfy FPC requirements.

2. What is a market stress buffer?

The reference to a *market stress buffer* in the guidance is a requirement for LDI fund managers to establish a minimum level of capital within an LDI fund to survive a market shock. In practical terms, the buffer establishes an upper limit on leverage which, if reached, means the LDI manager must request a collateral call (i.e. ask investors to add cash to the fund).

The guidance states that if fund managers can get hold of additional cash within five business days, they must have enough capital to survive a 250 bps (2.5%) rise in yields. In terms of an upper limit on leverage, this depends on the duration of the fund, with examples shown in this table:

Fund duration (years) **(and duration of the liabilities being matched)**	**5**	**10**	**20**	**30**
Maximum leverage	4.6x	3.2x	2.6x	1.9x

If a fund takes longer than five business days to receive additional cash, that fund will need to survive a larger rise in yields – which equates to a requirement to operate with lower leverage. This places a capital cost on a slow recapitalisation structure. The consensus across LDI managers seems to be that if a fund is set up with a 10 business-day recapitalisation period, it will need to survive an additional 50 bps (0.5%) yield movement. This means the LDI allocation will need to be about 15% higher than can be achieved using funds with a shorter recapitalisation period.

We are supportive of this requirement as it encourages quick de-leveraging.

3. What is an operational buffer?

Most LDI fund managers won't want to maintain leverage within a tight range around the upper limit, as such a structure would require the manager to call for, or distribute, cash very frequently. Instead, most will leave room for some yield fluctuation before being required to take action. TPR's guidance refers to this practice as "establishing an operational buffer".

TPR does not quantify an appropriate size for an operational buffer, noting that this is a judgement call. A small buffer means leverage can be kept relatively high, reducing the amount that needs to be invested in LDI, whereas a high buffer means lower leverage on average, but with an expectation of less frequent trading and therefore lower costs.

4. What does the FPC mean by feedback loops?

When gilts fall in value (along with scheme liabilities), an LDI fund's leverage will increase. If the leverage reaches the fund's upper limit, a recapitalisation payment will be required to reduce the leverage back to target.

To make a recapitalisation payment, trustees will need to release cash from another part of their portfolio. If LDI recapitalisation payments are funded by a large number of schemes selling gilts (or potentially UK corporate bonds whose values are related to gilt prices), there is a risk that the combined action could depress gilt prices. The further fall in gilt prices increases LDI leverage and may trigger further requests for recapitalisation payments, causing a feedback loop.

Our advice has always been that gilts or UK corporate bonds should not be used as the source funds for LDI recapitalisation payments[1]. In addition to the systemic risk of a feedback loop, it does not seem sensible to disinvest from these asset classes to support LDI – since such disinvestments will disrupt a scheme's overall liability-matching position.

5. Are LDI providers complying with the new guidance?

TPR's guidance is broadly in line with the operational procedures established by LDI fund managers in the wake of the LDI crisis. This is unsurprising since the guidance builds on the requirements that central banks placed on LDI arrangements towards the end of 2022.

We asked LDI managers to confirm the recapitalisation details of their funds. We present this information in the table below. In our view, all the listed LDI managers comply with TPR's guidance.

Fund manager	Timeframe to de-leverage in extreme markets	Survivable yield rise at point of de-leveraging	Aligns with TPR guidance?
Abrdn	3 business days	300 bps	Yes
BlackRock	6 business days	270 bps	Yes
Columbia Threadneedle	Typically 10 business days but can be quicker if investing directly	300 bps	Yes
Insight[2]	5 business days or fewer	250 bps	Yes
LGIM[3]	5 business days or fewer	250 bps	Yes
Schroders[4]	5 or 6 business days	275 bps	Yes
State Street	5 business days	250 bps	Yes

[1] Except if the fund manager is mandated to maintain the overall exposure to the bond market by timing trades to ensure any exposure lost from the sale of gilts or corporate bonds is simultaneously replaced through an increase in matching via LDI.

[2] In extreme circumstances, Insight can implement a de-leveraging of its LDI funds with just two business days' notice. Investors then have a further four days to get cash to Insight.

[3] Legal & General Investment Management (LGIM) has flexibility to implement an extraordinary dealing date in extreme circumstances. This happened in September 2022 when a dealing date was announced with two days' notice (only one of which was a business day). LGIM will implement the de-risking in advance of the additional cash being received from investors in the fund. However, LGIM will only offer this flexibility to investors who have sufficient non-LDI assets with LGIM and where the correct instructions are in place.

[4] Schroders' timeframe may be quicker for those investing in non-LDI funds with shorter settlement periods.

Important Notes

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