LDI – new regulator guidance is just the beginning

Matthew Swynnerton looks at the regulator's expectations in relation to LDI following the 2022 crisis

In the six months following the 2022 mini-Budget, much has been written about DB pension schemes' use of liability-driven investment (LDI) strategies. Questions have been raised over the continued relevance of LDI, whether it ought to be more heavily regulated and how, six months on, we only have some, but not all, the answers.

LDI has played a central role in DB schemes' investment strategies over recent years, with over 60 per cent of schemes reporting that they use it. Under the Pensions Act 2004, schemes must invest in accordance with their statutory funding objective, which means that they must have sufficient assets to cover their liabilities. This isn't always straightforward. Scheme liabilities are sensitive to fluctuations in inflation, interest rates and longevity and, therefore, trustees need to 'hedge' their risk against such variables. An LDI strategy aims to match schemes' assets to their liabilities whilst protecting against those risks.

So, what went wrong in September 2022? One element of LDI is collateral, which ensures that leverage levels remain within pre-agreed ranges. The steep increase in gilt yields following the mini-Budget meant that schemes needed to provide their LDI managers with significant amounts of collateral at short notice, which forced schemes to sell gilts into an illiquid market, reinforcing downward pressure on gilt prices. This ended only with the intervention of the Bank of England.

The crisis led to sustained scrutiny from various industry experts and commentators, as well as from parliament, the Bank of England, the FCA and The Pensions Regulator (regulator), all of whom have focused on what regulatory action might be taken to avoid a similar LDI crisis in the future.

In March, the Bank of England's Financial Policy Committee published a statement directing that the regulator acts as soon as possible to set minimum levels of resilience for LDI funds used by DB schemes. In response, the regulator has published new guidance containing the practical steps that trustees should take to manage risks when using LDI. More particularly, the regulator expects trustees only to invest in leveraged LDI arrangements that have in place an appropriately sized buffer. This must include (i) an operational buffer specific to the LDI arrangement to manage day-to-day changes and (ii) a market stress buffer to be set at a minimum of 250 basis points to provide resilience in times of market stress. The guidance also directs trustees to look at: Where LDI fits within a scheme's overall investment strategy; setting, operating and maintaining a collateral buffer; testing for resilience, in particular, where there are changes in market conditions; making sure schemes have the right governance and operational processes in place; and monitoring LDI.

The regulator urges trustees to work with their investment consultants, LDI managers and other advisers to ensure crucial safeguards are in place to protect their members from potential risks. Whilst the FCA has also introduced guidance for LDI managers to help them manage their funds' resilience, the regulator reminds trustees that they are ultimately responsible for how their scheme assets are invested.

Many schemes will already have in place appropriate levels of resilience, as well as adequate governance processes so the guidance will not necessarily have a significant impact on them. Nevertheless, all schemes should review their processes to see what, if anything, needs to be updated to ensure compliance with the guidance.

Finally, schemes should note that the guidance is unlikely to be the last word on LDI regulation. Minister for Pensions, Laura Trott, has confirmed that the draft Funding and Investment Strategy Regulations and the draft DB Funding Code will take into account the recommendations made by the Work and Pensions Committee and the House of Lords' Industry and Regulators Committee following their investigations into the LDI crisis. Furthermore, the government is working with the regulator to improve the regulator's ability to gather information in relation to LDI: An LDI-related notifiable event has been mooted. We await further news.

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