Institute and Faculty of Actuaries

Regulatory Board

Noting report

Subject	Actuarial issues arising out of Liability Driven Investments (LDI)
Regulatory Board meeting	16 November 2022
Previous Board Update/Steer/Approval	None
International issues considered?	Yes
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Reviewer	Emma Gilpin, Head of Regulatory Policy
Purpose	Noting

A: Executive summary

1. This Paper provides an update to the Regulatory Board ('the Board') on the actuarial perspective in relation to recent public scrutiny of the use of Liability Driven Investment (LDI) strategies.

2. It provides a briefing on the issues that arose as well as the wider position the IFoA has taken on those. It also sets out various steps that have, or will be, taken in response by the IFoA and seeks the Board's steer on any other steps that should be taken from a public interest regulatory perspective.

B: Background

3. As Board members are likely to be aware, there was significant fallout from the impact of the UK Government's 'mini budget' on 23 September, which included volatility in the gilt markets, an impact on UK pensions funds and a subsequent debate arising on the use of Liability Driven Investment ("LDI") strategies.

   What are LDIs?

4. LDI strategies use complex investment tools which aim to reduce the risk of liabilities increasing faster than assets at times of falling interest rates. These strategies are typically seen in the context of defined benefit pension schemes where there is an imperative to balance long-term obligations with a need to protect short-term funding.

5. Every defined benefit pension scheme has promised to provide retirement income for its members. To do so, a scheme aims to have sufficient assets to cover its liabilities. The

funding position of a scheme can be affected by changes in the value of the liabilities, and it is this risk that 'Liability Driven Investment' (LDI) seeks to address.

6. An LDI driven solution invests some of the pension scheme's assets to help manage liability risks. In this approach, a portion of a pension scheme's assets are invested to match the sensitivity of its liabilities to interest rates and inflation (where relevant). This means that if interest rates or inflation expectations change, asset and liability values rise or fall together, and the funding level of the pension scheme should be less volatile. In principle.

7. In other words, the pension scheme's unwanted or unrewarded liability risks are hedged.

Why has this come under scrutiny in recent weeks?

8. The market instability that followed the Government's mini-budget/fiscal event led to a plummet in the value of the pound and sent the interest rate on government debts to a 12-year high. The Bank of England (BoE), recognising the danger of impending financial instability, took emergency action to calm turmoil in financial markets amid this collapse in the pound and resultant increase in government borrowing costs.

9. Much of this was focused in on government bonds, or gilts, a type of bond issued by the UK government to finance public spending. Financial markets rely on the buying and selling of these normally stable and uneventful government bonds to manage risk over the long run. This is part of the plumbing which allows money to flow from savers to borrowers. It is especially important for the pensions industry, where funds are particularly reliant on long dated bonds (those dated over 20 years).

10. After the mini-budget, and the (then) Chancellor's borrowing plans had been announced, gilt yields spiked higher as markets took fright and the investment banks that write the derivatives contract that underpin an LDI approach sought more money from the pension funds to reflect the fact that gilt prices were falling (the yield and the price move in opposite directions).

What was the impact on pension schemes?

11. Pensions schemes, and specifically LDI strategies were placed under strain, not directly because of the levels of yields, but the speed of their change.

12. Ordinarily, pension schemes, which are the largest purchasers of government gilts, would liquidise these assets to satisfy such a request. However, on this occasion, the sector-wide request resulted in a flooding of the gilt market, which further lowered gilt prices. This reduction in the value of gilts threatened the ability of schemes to satisfy the calls for collateral.

13. While there was speculation that pension schemes were close to becoming insolvent, this was not the case.

14. For most schemes, funding levels have improved. What happened was a severe liquidity squeeze. Assets had to be sold to fund the capital required to support LDI strategies, with demand for collateral making yields rise still further in a self-fulfilling circle.

15. This flurry of activity raised questions over the use of LDI strategies by UK pension funds, and the level of instability that they might be subject to. Moreover, pension schemes have been required to make large capital injections into their collateral buffers. It may mean that for many, liquid capital is scarce or has completely run dry. To recapitalise and replenish these supplies, schemes are being forced to sell longer-term assets, which in a falling market, can be perilous.

What is the actuarial involvement?

16. While actuaries are not usually making investment decisions around pensions schemes and LDIs, often they will be involved in advising on aspects of that decision-making process.

17. There may also be questions that merit further consideration relating to: (1) the extent to which Trustees sufficiently understood the benefits and risks of LDI (including whether there are potential issues here around miscommunication); (2) whether it was reasonable to expect schemes to have stress tested such a scenario and what could have been done (if anything) to mitigate or avoid the liquidity issues that arose; and (3) whether there were issues relating to market concentration/aggregation (and possibly group think) that triggered a systemic crisis requiring intervention by the Bank of England.

What further steps and actions have been taken?

18. There have been two parliamentary inquiries/investigations announced so far: the Parliamentary Work and Pensions Select Committee has opened an inquiry on 'Defined benefit pensions with liability driven investments'; and a House of Lords Industry and Regulators Select Committee 'Non-Inquiry' session.

C: IFoA action

19. The IFoA has taken a number of steps in relation to responding to some of these issues:

    - The IFoA published a brief press release responding to media request for comment (Included at Appendix 1)

    - The IFoA is preparing a response to the Select Committee inquiry (due by 15 November). This response will be approved by the IFoA's Public Affairs Group which includes the Regulatory Board Chair as a member.

    - There have been calls with the Pensions Regulator and the Financial Reporting Council (FRC) to understand their perspective and position.

20. In recognising the public interest issues that arise, the Board considered in September whether a Risk Alert should be issued and concluded, following input from the relevant Practice Boards, not to do so at this time.

21. There will be discussion at the Joint Forum on Actuarial Regulation to understand the different regulators perspectives and to explore the opportunity for cross-regulator collaboration on any next steps.

22. Once the JFAR discussion has taken place, the IFoA's regulatory Executive will explore further potential steps that the IFoA might take to address any issues and support members working in this area.

E: CONCLUSIONS

23. The Board is asked to note this paper and provide any initial thoughts on steps to consider.

Appendix 1 IFoA Press Release

Appendix 1

FOA press release

Matt Saker, President at the Institute and Faculty of Actuaries, said:

"We believe the recent turbulence in the gilt market and resulting impact on LDIs can be a catalyst for open discussion for possible thematic or wider learnings. It is too early to draw any hard and fast conclusions, but we believe the pensions sector and regulators need to consider whether adjustments or improvements can be made to schemes' approaches to their risk management and investment strategies, while ensuring public confidence and trust is maintained for consumers. We expect these discussions to be primarily in relation to governance and the amount of leverage used rather than necessarily moving away from LDI.

In keeping with its public interest mandate, the IFoA is committed to contributing to the LDI debate and, given its systemic nature, we are asking the Joint Forum on Actuarial Regulation (JFAR) to consider the subject; the JFAR group comprises many of the regulators who have an interest in or are impacted by recent events in this area."