Leverage and Liquidity in DB Pension Schemes

This note summarises results of The Pension Regulator's (TPR's) Defined Benefit (DB) pension scheme leverage and liquidity survey, which was published in December 2019, and sets out our views on this.

Background

Over the past year, TPR and the Bank of England have been considering how the use of leverage by DB pension schemes and the investment by some DB pension schemes in illiquid assets could lead to systemic market risks. In addition to the use of leverage, factors that they looked at included:

- the increasing maturity profile of pension schemes, with some schemes starting to become significantly cashflow negative;
- the "search for yield" especially in credit markets;
- greater investment in illiquid assets; and
- increased use of leverage through the use of Liability Driven Investment (LDI).

Therefore, in cooperation with the Bank of England, TPR commissioned a survey of the largest DB pension schemes to gain a clearer understanding of the potential for systemic risks to emerge.

Its conclusion was that "the use of leverage by non-bank financial institutions could support financial market functioning but it could also expose these institutions – which includes pension schemes – to greater losses and sudden demands for liquidity, which could give rise to financial stability risks."

Key findings of the survey

The survey, which covered 137 pension schemes and £697bn of assets, was conducted during Q4 2019. The asset size of the individual schemes that participated in the survey ranged from £500m to over £10bn, i.e. many of the largest DB pension schemes in the UK.

We believe that many of the key findings are pertinent and instructive to DB schemes of all sizes. We summarise several of the most interesting findings and our comments on them below:

- **85% of assets belong to schemes that are paying out 2-4% of their liabilities annually:** This is an indication of increasing maturity of DB schemes. It points to a need to generate income to meet pension obligations in order to avoid having to sell assets at an inopportune time, as many of these schemes will be cashflow negative.

- **Bonds accounted for 60% of all scheme assets:** This is not surprising given the finding above and given the de-risking journey many schemes have been on, with a focus on protecting funding levels against interest rate and inflation risk.

- **The notional principal (i.e. the agreed amount on which cashflows are exchanged or the transaction is based) of outstanding derivatives was over £520bn:** The significant scale of derivative exposure is not unexpected given the de-risking that has been taking place and the widespread adoption of LDI strategies to hedge interest rate and inflation risk.

- **Almost half of the schemes surveyed had increased leverage in the past 5 years and almost a quarter had done so in the past year:** In light of the increasing levels of interest rate and inflation hedging, given that many schemes still have funding shortfalls, this increase in the use of leverage is not surprising. While the use of leverage can give rise to various issues, it is encouraging that most schemes hold sufficient liquid assets and closely monitor their collateral needs.

- **Only 4% of assets are invested in private markets:** Despite TPR and the Bank of England's concerns about greater investment in illiquid assets, the survey found that private market investments only amounted to c. £27bn, less than 4% of the total assets of the schemes in the survey. Furthermore, around 2/3rds of this amount was held by the largest schemes.

Conclusions and Cartwright views

There has been a meaningful increase in the use of leverage by DB pension schemes in recent years, many of which are already or will soon become cashflow negative, and allocations to illiquid investments have increased. This means that good collateral and liquidity management are important to DB pension schemes. It is also clear why TPR and the Bank of England are taking a keen interest in the situation.

Leverage is largely being used for risk reduction or efficient portfolio management purposes – not to enhance returns – and most schemes (or their LDI managers on their behalf) are actively monitoring and managing their collateral requirements. This includes conducting stress tests to ascertain the market movements that the scheme could withstand before their collateral would run out. The TPR survey found that the average market movement before collateral would be exhausted was 2.9% for interest rates and 3.3% for inflation, i.e. significant moves in each case.

The majority of UK DB schemes, including some of the larger ones that took part in TPR's survey, access LDI via pooled funds. Collateral monitoring and management within such pooled funds is delegated to the appointed LDI fund manager. In addition, many schemes that invest in leveraged LDI funds will have a pre-agreed policy to deal with any cash calls (in the case of a recapitalisation event) or cash distributions (where funds need to re-leverage).

Another important point to bear in mind is that pension schemes' derivative transactions are increasingly being centrally cleared, which will serve to restrict the maximum amount of leverage that can be used.

There are various ways that schemes can manage and meet their cashflow requirements; such as by investing a portion of their assets in distributing share classes of funds, investing in assets that produce contractual income or even implementing a full Cashflow Driven Investment strategy.

While returns remain low, DB pension schemes increasingly invest in illiquid assets in a quest for higher yields. TPR's concerns about liquidity are understandable but, in our experience, most DB pension schemes run greater amounts of liquidity than they will usually need. Consequently, there is frequently scope for schemes to allocate a greater proportion of assets to illiquid investments.

Finally, we are supportive of initiatives aimed at enabling DC scheme members to benefit from the illiquidity premium, provided that appropriate controls and safeguards are in place and that trustees and members are presented with the necessary information to make informed choices.

If you would like to discuss this further, please get in touch with your usual contact at Cartwright.

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