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What you need to know about the new Pensions Regulator guidance on liability-driven investment

Background

Following the volatility in the gilts markets in September and October last year, the Pensions Regulator (TPR) issued new guidance on 24 April 2023. It relates to the use of leveraged liability-driven investment (LDI) funds and offers recommendations on ways to improve the resilience of LDI to financial market events and volatility.

The guidance sets out practical steps to manage risks when using LDI. Trustees are urged to work with their advisers in considering and implementing this guidance. TPR's guidance can be found at Using leveraged liability-driven investment | The Pensions Regulator.

What do you need to do?

LDI and your investment strategy

The Regulator urges Trustees to consider the benefits and risks of LDI in the context of the scheme's holistic investment strategy. They highlight the potential conflict between using LDI to manage funding level volatility, versus the need to hold a certain amount of liquid assets to meet collateral calls when gilt yields rise. The guidance mentions the following issues that form part of those considerations:

- How much do you want to hedge movements in the value of your liabilities to limit funding level volatility?
- What's the scheme's net cashflow position and are you confident that you can meet obligations, even if LDI arrangements are put under stress?
- How much operational risk are you willing to tolerate with respect to using LDI in order to be able to target a certain level of expected return for your strategy?
- Do you have enough liquid assets to meet the cash call requirements of LDI arrangements?
- Which assets might increase the risks associated with using LDI (such as illiquid assets, which cannot be quickly be sold to raise additional cash to meet the cash call requirements of LDI)?

The guidance goes on to say that you should ensure you have the following documented for your strategy:

- Expected returns and risks.
- The assets the scheme is invested in.
- Target levels of interest rate and inflation hedging.
- How to provide collateral for LDI and how long it would take to do so.
- How the strategy meets TPR's expected resilience standards (see below).

TPR's resilience standards

The guidance then states that LDI arrangements need to be resilient to changes in market conditions. It introduces the notion of an asset buffer, which has two parts: an operational buffer and a market stress buffer.

For pooled funds, LDI managers will define the operational buffer themselves and trustees will need to satisfy themselves that it is sufficient. A smaller operational buffer will mean you may be called upon more frequently to provide additional capital to replenish the buffer. A larger operational buffer will reduce how

often capital will be called for, but will tie up more of your assets in collateral, with implications for your scheme's investment returns.

For the market stress buffer the Regulator says schemes should hold additional liquidity. This additional liquidity can then be used to provide capital to the LDI manager within five days if there were a further 250 bps adverse movement in yields over and above what is already allowed for by the operational buffer.

The guidance doesn't specify exactly what kind of assets the buffers can be comprised of. However, it states that trustees should ensure they are liquid enough so that additional capital can be provided to the LDI manager within five days.

There is also guidance on how to conduct resilience/stress testing, in conjunction with your advisers. They suggest that this can be done in one of two ways:

1. By exploring different scenarios that are relevant to the investment strategy and its vulnerabilities.
2. By calculating the size of market movement required before a call to replenish the buffer would be made, and before the assets earmarked for buffer replenishment are exhausted.

The outcome of the stress test should be recorded and any shortcomings addressed. The Regulator expects the resilience tests to be done either annually or triennially, or when there are significant changes in funding, investment or market conditions.

Monitoring

The Regulator says you should regularly monitor the resilience of LDI arrangements and that Trustees need to understand what monitoring their advisers or the LDI managers perform routinely.

Trustees need to ensure that they receive sufficient information to be able to understand and react to risks but the Regulator leaves it to trustees to decide the frequency of such regular reporting.

The guidance provides examples of data that may be useful in monitoring LDI resilience and suggests certain metrics that could be reported. The Regulator also suggests that trustees may want to make sure they can request information outside the agreed reporting cycle if certain triggers are met e.g. if the buffer drops beneath a certain level or to increase the frequency of reporting in extreme market conditions.

What assistance can Cartwright provide to trustees in order to comply with these regulations?

- We can perform the stress tests required and provide you with a certified report.

- We can provide LDI monitoring reports with a choice of which metrics to include (see suggestions in the guidance) at a frequency determined by you.

- We can set up default cashflow policies (including waterfall arrangements) so that meeting LDI capital calls is largely automated (these are already in place for many of our clients).

If you would like to discuss any of these matters further, please get in touch with your usual contact at Cartwright.

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