XPS Investment

# News Alert

June 2023

# Parliamentary Report into LDI: Key insights for pension scheme trustees

**The Work and Pensions Committee launched an investigation on 24 October 2022 following the crisis that engulfed the gilts market in September 2022. On Friday 23 June 2023 the Committee published its latest finding and recommendations.**

## Key Insights

The report is primarily focused on the actions that the Committee wants regulators to take, which will then flow down to trustees, consultants and fund managers. We have summarised the findings of the report into three broad areas:

### 1. Improving governance and understanding of risk

The report notes two lines of defence to manage the risk from LDI – trustees and The Pensions Regulator (TPR) – and suggests that the gilts crisis revealed 'significant weakness' in both. It questioned whether TPR understood the potential for forced asset sales leading to 'doom loop' risks. It criticises the Bank of England and TPR for failing to follow up on issues with LDI that had been identified in 2018.

The Committee noted the requirement for improved governance, particularly in some small and medium sized schemes. It stated that TPR should work with the Department for Work and Pensions (DWP) as a priority to improve standards of governance. The Committee recommends that the DWP publishes its response to a 2018 consultation on scheme consolidation, which it considers offers scope to address potential governance shortcomings for smaller schemes.

In the meantime the Committee suggests the DWP considers whether the use of LDI could be restricted perhaps based on a test related to trustees' ability to understand and manage the risks involved. It noted the likely practical limitations of this however.

### 2. Better industry data and visibility

The report makes a number of references to insufficient data being collected on schemes' use of LDI. The Committee recommends that TPR considers requiring schemes to report regularly on their use of LDI and for TPR to develop a strategy to engage with schemes on the results, potentially through the annual scheme return.

It also noted the lack of information on what the impact of the gilt crisis had actually been on pension scheme funding levels. It recommends that DWP work with TPR and the Pension Protection Fund (PPF) to produce a detailed account of the impact of the gilts crisis by the end of 2023 including impact on funding levels based on the different types of LDI strategy employed.

### 3. Changes to regulatory remits and objectives

The report supports the Bank of England's Financial Policy Committee's (FPC) recommendations that TPR specify the minimum levels of resilience for LDI and calls for DWP and TPR to explain how they intend to deliver on this.

The report concluded that in some cases investment consultants were giving standardised advice rather than what was best for each pension scheme. It therefore recommends that the Government bring forward plans for investment advice around LDI to be brought 'within the FCA's regulatory perimeter', in addition to existing regulation around investment advice connected with investing in funds.

The Committee raised its concern of the potential impact of the new funding and investment strategy regime and the potential for it to lead to increased 'herding' in pension scheme investments, referencing XPS's concerns raised in our submission to the Committee. It recommends that the new regime be delayed until DWP and TPR have produced a full impact assessment including the impact on wider financial stability and open pension schemes.

## Key dates and deadlines

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| **31 October 2023** | • DWP to respond to its 2018 consultation on the consolidation of DB schemes.<br>• DWP and TPR to report on how they plan to monitor whether LDI resilience is being maintained, as well as set out a timeline for TPR's commitment to become a more digitally enabled and data led organisation, with plans to resource it.<br>• DWP and TPR to report on how they will ensure that better data is collected on LDI and how they will ensure that they, the FCA and the Bank of England will work together to analyse the implications of the data. |
| **31 December 2023** | • DWP to work with TPR and the PPF to produce a detailed account of the impact on pension schemes of the gilts crisis. |
| **31 January 2024** | • DWP to report on how it proposes to take forward the FPC's recommendation that TPR be given a remit to take account of financial stability considerations and how it plans to ensure that TPR has the capacity and capability to deliver on this. |
| **April 2024** | • Previously announced date for the new funding and investment strategy regime to come into effect – now likely to be postponed to make way for a full impact assessment of the new regime by DWP and TPR. |
| **End of current parliament (no later than 17 December 2024)** | • Government to bring forward plans for certain additional work of investment consultants to be brought within the FCA's regulatory perimeter. |
| **No deadline given** | • DWP to consider whether the use of LDI could be restricted in the meantime, given it will take time to legislate on measures to improve pension scheme governance.<br>• TPR to work with the FCA to review whether the April 2023 FCA guidance issued to LDI funds has been implemented effectively and provides trustees with a simple mechanism for monitoring LDI.<br>• DWP and TPR to put in place mechanisms to provide real-time warning of reductions in LDI resilience.<br>• DWP and TPR to consult on whether introducing disclosure requirements on pension schemes regarding LDI through the annual report would improve governance. If they conclude this would place undue burden on schemes they should explain the basis for allowing such schemes to continue to use leveraged LDI. |

## XPS Viewpoint

**The Committee took evidence from a wide range of individuals and organisations, including XPS, covering the full spectrum of views on LDI. In our view, the report reflects a range of differing, and in some cases quite extreme views, but the recommendations in the main represent an objective assessment of what needs to change.**

**The report is critical of poorly run schemes and draws a loose link to small and medium sized schemes. However, we would note that in our experience many small and medium sized schemes are extremely well run.**

**We note that the changes that have been made in the industry already, including reduced leverage, more robust operational procedures and a heightened level of general understanding, has already contributed to a substantial improvement.**

**Widening TPR's mandate to include taking into account financial stability issues means DWP and TPR will likely need to consider reviewing the central tenets of the new funding and investment strategy regime. This may well include revisiting the requirement for mature schemes to ultimately 'cashflow match' a high proportion of their benefit payments. Given the complexity, we suspect this could lead to a significant rewrite and material further delay to the new Funding Code and also possibly the more high-level draft regulations.**

**The proposed broadening of the FCA's regulatory perimeter in relation to investment consultants is a continuation of recommendations from the Competition and Markets Authority's report in 2018. It provides scope for improved minimum standards of investment advice, which we are supportive of. We note that advice relating to investment in LDI funds and managers was already a regulated activity.**

**The Committee recommends legislating to improve pension scheme governance and potentially restricting the use of LDI in the meantime. Our view is that any direct restriction is likely to be detrimental.**

**There are a number of references to improving the data collected on LDI. This has been a shortcoming in the LDI industry, with some investment managers unwilling to publicly disclose liabilities hedged under management. Better disclosure can only lead to a better understanding of the industry for all participants.**

## Key actions for trustees

**As set out above, the report's recommendations are directed at regulators rather than trustees. Given this, trustees should continue to focus on meeting the new guidance on LDI.**

### This includes:

- **Ensuring** you have an appropriate collateral management strategy including a plan for realising additional collateral (possibly at short notice) if needed;
- **Undertaking** stress testing to ensure robustness; and
- **Reviewing** your own operational procedures to make sure you can react quickly if needed.

XPS offers an **LDI oversight service** to help trustees review their LDI arrangements, catering for existing XPS clients or as a stand-alone service alongside advice from an incumbent investment consultant.

Further, given the movements in gilt yields, many schemes find themselves in a much-improved funding position, compared to where they expected to be, so it's important to ensure you understand your current funding position and, if necessary, review your investment strategy accordingly.

For further information, please get in touch with **Simeon Willis** or **Adam Rouledge** or speak to your usual XPS Pensions contact.


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