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Dear DB Funding Code Team,

RE: Investment Association Response to TPR consultation on the draft DB Funding Code of Practice – systemic risk considerations (Q53-54)

The Investment Association[1] (IA) welcomes the opportunity to respond to TPR's consultation on the draft DB Funding Code, which we consider provides important detailed guidance for trustees under the legal framework of the forthcoming Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2023.

While detailed commentary on the Code is best provided by practitioners, we note that the draft regulations and Code enshrine the existing approach of DB schemes to asset-liability management, which we regard as positive, given the benefits this approach has brought to scheme members and their sponsors. At the same time, there is sufficient flexibility within the regime for less mature schemes to take more investment risk where this can be supported by the corporate sponsor.

We welcome the discussions in the Code related to the expected characteristics of a mature DB scheme's investment portfolio, namely the need for cashflow matching, resilience of the funding ratio to short term adverse market movements and the need for good liquidity management policies. We note that in relation to the latter, further material for trustees may follow in light of the ongoing work by the Bank of England's Financial

[1] The Investment Association represents the asset management industry operating in the UK. Our members are responsible for the management of around £10 trillion of assets in the UK on behalf of domestic and overseas investors, including £2.6 trillion for corporate pension funds. For DB pension schemes our members collectively manage Liability Driven Investment (LDI) mandates that hedge £1.6 trillion of UK pension liabilities.

Policy Committee (FPC) on enhancing the steady state resilience of Liability Driven Investment (LDI) strategies[2].

In light of the autumn 2022 stresses in the LDI market, we are grateful for the opportunity to comment on the broader systemic risk issues raised by the requirement in the draft regulations to adopt a 'Low Dependency Investment Allocation' for the purposes of the funding and investment strategy by the time a scheme reaches significant maturity.

Risks in relation to use of LDI

In our view, the issues seen in the LDI market in autumn 2022 were about the implementation of LDI strategies in extremely stressed markets rather than the theoretical underpinning of these strategies, of which the current DB funding framework is a core part. Rather, in the context of an unprecedented market shock emanating from outside the pension system, the lessons to be learned are more on the side of governance and operational issues in the context of significant systemic stress. We have discussed these at length in our submissions to the Work and Pensions Select Committee Inquiry on LDI[3].

We share TPR's analysis of the episode and agree with the comments around the need for enhanced stress-testing, more robust collateral buffers to support schemes' derivative and repo exposures, better liquidity management and operational processes for ensuring additional collateral calls are met promptly. Addressing these points, as pension schemes and investment managers are already working to do, will reduce the risk of a repeat of last year's events in the LDI market.

Furthermore, we agree with TPR that as schemes become better funded and the duration of their liabilities reduces, the need for leverage will naturally reduce[4], making it easier to manage that leverage, in turn further reducing any systemic risks arising from the DB sector.

Accordingly, we do not see that the continued emphasis in the Code on the need for trustees to manage their interest rate and inflation risks increases the possibility of systemic risks: the Code merely formalises what is standard practice today.

The herding of DB investment strategies and systemic risk

Some commentators have questioned whether the introduction of a 'low dependency investment allocation' will create the risk of herding in investment strategies by DB schemes seeking to comply with the regulations as they mature. In this context herding refers to schemes investing in the same way. The concern is that the potential for systemic risks increases when large numbers of DB schemes invest in a similar fashion.

[2] Financial Stability Report – December 2022, Bank of England Financial Policy Committee.

[3] IA written evidence to the WPC Inquiry on DB pensions with Liability Driven Investments, November 2022 and March 2023.

[4] The combination of improved funding and shorter liability duration will increasingly allow schemes to match liabilities using physical assets, thereby reducing both financial and synthetic leverage, arising from the use of repos and swaps respectively.

The herding dynamic was undoubtedly seen in the autumn 2022 turbulence in the LDI market. With large numbers of schemes simultaneously reducing hedging levels, selling long-dated and index-linked gilts in order to do so, conditions were created under which there were large numbers of sellers, with no buyers. This had the effect of leading to falling prices, further collateral calls, more deleveraging and ultimately, a negative price spiral. It was only the intervention of the Bank of England as buyer of last resort that stopped these market dynamics.

Corporate DB schemes do tend to follow similar investment strategies that focus on matching assets and liabilities, with regulation and scheme maturity incentivising them to do so. At the micro level this has worked well for individual schemes, and the principles behind these strategies remain valid. Accordingly, we do not expect the guidance in the draft Code to change the risks posed by any herding, at least in the gilt market: if there are any such risks, they already exist. In contrast, the cashflow matching requirement in the Code and draft regulations does open the possibility of creating additional herding risks, although this can be mitigated by appropriate regulatory signalling. We discuss both issues below. More generally, we also discuss how the potential systemic risks in the DB sector that arise from herding can be mitigated through an increased focus on global diversification of DB asset allocation.

Systemic risk and concentration of DB ownership in the gilt market

In general, the different maturities of schemes (influencing the timing of their gilt purchases) and the steady flow of schemes transacting with an insurer in the risk transfer market (which can often create sales of gilts, particularly if the insurer is using alternative assets to back their portfolio) has helped to spread the supply and demand of gilts in practice, albeit with pension schemes still being a very significant part of the gilt market.

There is a risk that the new Code places heightened short-term pressure on gilts as schemes seek to comply (by causing large numbers of schemes to reassess their portfolios with additional constraints/encouragement to buy gilts, within a window of a few years), whilst quantitative tightening and/or a significant increase in buyout insurance transactions could also place new strains on the market. The Bank of England should therefore be mindful of these issues when managing its quantitative tightening policy.

Notwithstanding these comments, it is not clear what the alternative for DB schemes is, given the maturity profile of the UK DB universe and the existing policy, accounting and regulatory regime, which has established a clear and arguably irreversible direction of travel. With most DB schemes already heavily invested in matching assets and seeking a similar end-game, it is natural that they will end up investing in a similar fashion. Indeed, artificially seeking to reverse this shift may itself trigger systemic events if schemes change investment strategies and exit their matching exposures en masse.

It is important to emphasise again the exceptional nature of the September 2022 shock, rather than the DB funding regime being a root cause. It took an unprecedented spike in gilt yields, resulting from an event exogenous to the pension system, to trigger a systemic event in a part of the gilt market that otherwise behaves in a generally stable and orderly fashion. At that point, the Bank stepped in to reduce the risks to financial stability in the UK. In any financial system, a Central Bank will always have a role to play in protecting financial stability and it is impossible to create a system where Central Bank intervention will never be required. Rather, the focus should be on reducing the likelihood of Central Bank intervention in the first place.

The financial stability concerns arising from the concentration of DB schemes' ownership of long-dated and index-linked gilts need to be weighed against the benefits of such an ownership profile: the UK government has benefitted from a steady and robust demand for its long-term and index-linked debt from pension schemes and insurance companies. Data from the DMO shows that pension funds and insurance companies owned around a quarter of the stock of gilts by market value in the third quarter of 2021[5]. More recent data from the ONS shows that by the summer of 2022, corporate DB schemes had long-dated (25+ years) and index-linked gilt holdings of just under £400 billion[6]. The influence of the DB and insurance sectors can be further seen when comparing the average maturity of the UK debt stock to other countries: for the UK, this is just over 14 years, compared to 8 years for France and Japan and just under 6 years for the US . A long average maturity of debt significantly reduces the UK government's exposure to refinancing risk, by enabling gilt issuance to be spread along the maturity spectrum.

We also encourage policymakers to consider if it is the characteristics of the underlying market that are also causing a problem here, rather than the behaviour of DB pension schemes per se. The concentration of ownership in parts of the gilt market does appear to be a factor in the recent crisis, with one solution being greater emphasis on encouraging a more diversified group of buyers. Concerns over gilt ownership should not prevent DB schemes from using instruments and investment strategies that help them manage their risks effectively and efficiently.

In the longer term, there may be a significant reduction in demand from DB pension schemes for further gilt purchases as these schemes mature and wind-up or transfer their assets and liabilities to insurers. Furthermore, insurers are subject to a different prudential regulatory environment in the form of Solvency II and are expected to have access to a wider range of assets in their portfolios i.e. they will not be solely restricted to UK gilts and corporate bonds. This may reduce the potential risks emanating from concentrated ownership of parts of the gilt market.

Systemic risk and the requirement for cashflow-matching

One area where we do see the potential for the draft Code and regulations to create additional herding risk relates to the requirements for schemes to seek broad cashflow matching in the low dependency investment allocation.

The delivery of cash to pay pensions and cover unexpected cashflow requirements can be facilitated with several different credit management approaches. The traditional approach has been to create a longer dated cashflow matching portfolio whereby bonds are selected to mature coincident with the scheme's expected cash outflows. An alternative approach is to use short-dated credit, which whilst not explicitly targeting the scheme's cash payment dates, does generate significant amounts of cash due to the high annual maturity rate of the asset class. Indeed, this approach typically generates sufficient cash to cover both required and unexpected outgoings, as well as surplus amounts which can be reinvested in

[5] Source: Debt Management Report 2022-23, HM Treasury, 2022. Given the timing of this data, it obviously does not reflect the impact of the events of September/October 2022.
[6] Source: Financial Survey of Pension Schemes, ONS, 2022. As with the DMO data, this data point does not capture the impact of the events following the September 23rd, 2022, fiscal event.

credit as required. For some schemes, short-dated credit may a better solution as it is more liquid, better diversified and less volatile than longer dated credit, therefore delivering on the scheme's cash requirements whilst also offering flexibility and supporting funding ratio stability.

Whilst we see both approaches as permissible within the draft funding code and regulations, there is a risk that the repeated references to cashflow matching cause trustees to gravitate towards longer dated sterling credit portfolios alongside their existing long-dated gilt holdings.

This has the potential to create a herding risk in the long-dated sterling credit market, which is small in relation to the equivalent Euro and Dollar markets and is concentrated on the supply side, with limited issuance that tends to be dominated by energy and utility companies. If the funding code were to cause a large number of schemes to compete for issuance in this market, there is a risk of market (and pricing) distortions arising.

In summary, we are concerned that the references to cashflow matching may have some unintended consequences in terms of herding schemes into the relatively small long-dated sterling credit market, as well as causing some schemes to overlook what may be more appropriate short dated credit solutions. To address this point, we recommend that TPR should consider referring to 'cash generative strategies' (or similar) rather than cashflow matching strategies, or at least provide some clarity that they are not solely prescribing longer dated sterling biased credit allocations for DB pension schemes.

The importance of global diversification in reducing systemic risks

As a final comment, we note that an important way to address the potential systemic risks in the DB pension sector is to encourage greater diversity of scheme investment portfolios within the overarching funding framework. While we have identified one specific example above in relation to short and long-dated sterling credit, the more general point is that schemes could benefit by thinking more globally about asset allocation when implementing their investment strategies.

We have heard feedback from members that for generating cashflows and matching liabilities, UK DB schemes prefer holding sterling assets. While this is understandable given that UK DB liabilities are also sterling-denominated, it does create the potential for herding in UK assets that we have described above. Seeking more global investment exposures can mitigate this risk at the scheme level, and, if this principle is followed widely, can reduce systemic risks by introducing more diversity into DB investment strategies.

I hope this response is helpful and I would be delighted to discuss these comments further if useful.

Yours Sincerely,

Imran Razvi
Senior Policy Adviser, Pensions & Institutional Market