Recent market activity Q&A

Last updated - 27 October 2022

New or updated questions since our last update on 12th Oct are shown in purple

What happened in gilt markets last month?

- Yields on long-dated UK government bonds (gilts) are an indicator of long-term interest rates. Since the start of the year yields had been rising steadily from just above 1% to 3% at the end of August, pushing down the value of gilts (values move in the opposite direction to yields)
- These rises were being attributed to various economic headwinds, including continued Brexit challenges, the war in Ukraine and increased inflationary pressures
- A number of further announcements were made towards the end of September, starting with the business energy cap on the 21st, the rise in Bank of England base rates to 2.25% on the 22nd and the Chancellor's mini-budget on the 23rd
- Over the week from the 20th to 27th September we witnessed a staggering rise in yields by over 1% (there have only been a couple of times since 1970 where there has been such a large increase seen over a whole month)
- They peaked at close to 5% before quickly falling back to around 4% at the end of the month

What does this mean for DB pension schemes?

- Most pension schemes value their liabilities with reference to gilt yields
- The increases over the past year - plus the spike in September – have driven significant falls of around 30% in typical DB scheme liabilities
- The falls in liabilities, have been accompanied by asset value falls for most schemes
- This is particularly true of any assets that are held to act as a hedge against interest rates and inflation, including LDI (Liability Driven Investment) assets
- If you were using LDI the recent interest rate increases resulted in lots of demand from the LDI asset managers for additional assets to act as collateral to support the hedge (see below), which has been at the heart of most of the recent headlines
- However, most schemes will have seen overall improvements in their funding levels, with the biggest improvements seen against longer term targets (i.e. self-sufficiency or buyout) as these targets were not fully hedged

How does LDI work?

- LDI strategies involve holding assets, usually gilts and cash, alongside derivatives to allow you to generate greater exposure to yields (interest rate) and/or inflation movements than the assets could do on their own
- The level of sensitivity of the overall LDI assets' value to movements in interest rates compared with the sensitivity of the physical gilt and cash holdings is known as leverage – in simple terms, the greater the leverage the more sensitive you will be to movements
- Leverage allows schemes to protect or hedge themselves against movements in their liabilities due to changes in interest rates and inflation using only a proportion of their assets
- Schemes can adopt more efficient investment strategies as a result, because they can achieve a significant hedge while also investing non-LDI assets to generate returns

Why are there collateral calls?

- When yields rise, the values of the derivatives fall and can become negative (helping overall scheme assets to match the movement in liabilities)
- So LDI managers have to ensure that funds are clearly set aside to cover these losses – if more funds are needed, this is known as "collateral call"

How did this all contribute to the increasing interest rate cycle at the end of September?

- As rates started to rise quickly following the mini-budget, derivative values fell and became more negative, so LDI managers started to make collateral calls
- Schemes had to sell assets to meet these calls, which in most cases meant ones that could be traded easily and quickly - like gilts
- Selling gilts results in prices falling and yields rising further, which results in more collateral calls, etc
- The process has in the past been manageable, but the pace and size of the yield increases in September made it increasingly difficult for schemes to sell assets to meet increasing collateral calls
- This resulted in a severe lack of liquidity in the market and the unprecedented movements in daily gilt yields

What stopped the cycle of increasing yields?

- On 28th September the Bank of England announced it would step into the market to buy gilts
- The Bank said it would buy up to £5bn a day until 14 October – up to £65bn in total
- In reality, the Bank's level of purchase was relatively low – with only c£3.5bn out of a potential £15bn bought over the first 3 days.
- However, this announcement not only stopped the increases in yields, but saw a significant fall back down to c4%

What happened at the start of October?

- On Monday 10th October the Bank of England confirmed that it would increase daily capacity to £10bn
- This was a doubling of the potential daily liquidity on offer, although not an increase in the overall £65bn level off support
- There was a subsequent widening of the support on 11th October to include index-linked gilts within the Bank's purchasing options
- These additional announcements do not seem to have seem to have resulted in a significant reduction in bond prices (and the resulting market yields)

What happens after 14th October?

- The Bank has told schemes to use the period to sort out their hedging and collateral buffers
- So schemes only have a short timeframe to sell assets to top-up the collateral for their hedge or move to adopt a lower level of hedge
- Concerns remain that with the Bank ceasing its support on a fixed date, significant yield increases could recommence, and the vicious cycle could start again

Why were pension schemes investing in LDI in the first place?

- Derivatives are commonly associated with financial speculation or "risk" investments
- However, in the situation schemes were not using LDI to speculate, it was a risk manage tool to reduce a scheme's exposure to movements in interest rates and inflation
- Without derivatives, schemes would need to rely on gilts to manage these risks, but the gilt market is not deep enough to provide the required level of protection for all UK schemes
- LDI has been used by UK pension schemes for over 15 years, during which time it has helped to efficiently protect them from falling yields which had been increasing the size of their liabilities
- Up until September, the system had been coping with the large increases over the first half of the year, which were already large by historic standards – the problems arose following a large sudden shift

I read that some schemes had become insolvent. Is that true?

- Pension schemes are there to build up the assets needed to meet their liabilities to scheme members, with a key measure being the "funding level" (value of all their assets relative to the value of their liabilities)
- Most schemes will be in the best funding position that they have ever been, so it isn't true
- However, it is true that a number of schemes had significant liquidity issues as they tried to sell assets to meet their collateral calls
- Some schemes may have had their hedges compromised if they were not able to meet their collateral calls – which could have been painful if this happened before the Bank of England stepped in and yields fell

- As monthly pension payments make up a small percentage of actual scheme assets, we expect that all pensioners will have continued to be been paid in full and on time

So the Bank of England effectively bailed out pension schemes?

- Not really – it just offered to be a buyer to introduce liquidity into the market
- This provided pension schemes with the opportunity to sell their gilts, it didn't provide them with any free money

Are schemes going to have to get rid of their LDI and derivatives?

- No, as schemes will still need to use them to manage their risks in an efficient manner and there aren't enough physical assets for all schemes
- However, we expect LDI managers will look to, or may be forced to, run lower levels of leverage and hold more collateral (at least in short term)
- This might lead to schemes being less well hedged against interest rate or inflation movements, or less able to invest in higher returning long-term assets that are difficult to sell quickly

Sounds like there is lots to do in the short term?

- Correct, particularly in the period up to 14th October, or whenever the BoE decides it will fully step back
- Schemes should be looking to understand their actual hedging positions and what they can be done to shore up collateral – this could be disinvesting from other assets, could the sponsor providing accelerated contributions (or even loaning the scheme money to avoid disorderly sales)
- Schemes should also be avoiding any actions that will soak up liquidity (e.g. bulk transfer exercise)
- We have also seen schemes pausing quoting transfer values as the current volatility is resulting in large movements in values between one day and the next

What has The Pensions Regulator ("TPR") said about all of this?

- TPR issued a statement on 12th October
- The statement provides a helpful explanation to the use of LDI by pension schemes, the recent challenges (for DB and DC schemes), and their expectations around trustees and the actions they should be considering
- Overall, it is fairly balanced on the decision between reviewing (i.e. reducing) existing high hedging levels and minimising a fire sale of assets (particularly illiquid assets).
- TPR continues to actively monitor market movements, particularly as the Bank of England steps back from 14th October, and are liaising directly with trustees, other regulators and industry bodies.
- They accept that the situation will be reviewed in the fullness of time, whilst reiterating that it would not have been a reasonable expectation that schemes should have been run to insure against market movements as extreme as those recently experienced.

What has happened post 14th Oct?

- The Bank of England did cease buying gilts from 14th October. Of the potential £65bn potentially available it actually purchased c£19bn of gilts (split roughly two-thirds / one-third between nominal / index-linked gilts)
- The period coincided with historic political turbulence, with the replacement of the Chancellor, the unwinding of most of the mini-budget announcements, the resignation of the Prime Minister and the selection process to find a replacement.
- Long dated gilt yields have continued to see lots of volatility. From falling from a peak of c5% to c4% on the Bank of England's initial intervention at the end of September they continued to steadily rise back to c5% by the middle of October. The political changes and rowing back of the mini-budget has then seen yields fall back to c4% as we get to the end of the month.
- The roller-coaster of yield movements over last 6 weeks will have caused potential challenges for schemes that were unable to maintain their hedging levels across the peaks and troughs.
- As well as the large volume of media coverage, and TPR's statement there have also been further publications worth noting. This includes a further letter from the Bank of England to the Treasury Committee, a statement from the Institute and Faculty of Actuaries and a blog from the Government Actuaries Department.
- The Work and Pension Committee has issued a call for evidence on DB pensions with using LDI. The deadline for submission is 15th November.
- Potentially significant events remain on the horizon with the next Monetary Policy Committee meeting on 3rd November and the Chancellor's autumn budget on 17th November (after this was delayed from 31st October)

What impact will this have on schemes' longer term planning?

- This will depend on where yields settle down at the end of this period of volatility and how each individual scheme manages to navigate this period
- Schemes will need to consider whether they want to lock in any funding gains and move to lower risk/return investment strategies
- Some schemes considering insured "buy-ins" on the journey to a fully insured solution may also need to delay things a little
- But in general schemes should be in a better position – with funding deficits reduced or eliminated and timescales to longer term targets significantly reduced
- This may well accelerate work on preparing schemes for transferring to an insurer and, potentially, start sponsors thinking seriously about the pros/cons of retaining schemes to target a refund of surplus
- There will be a range of other issues to deal with, including transfer value quotations and reviewing the settling of scheme factors, in light of the increases in interest rates and ongoing volatility

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