# The Pension Regulator's ('TPR') report on trustees' preparedness on LDI risks

## Background

Based on data collected from the annual scheme return, TPR recently published a report setting out their views on the progress pension schemes and the investment industry have made to improve operational resiliency. This report builds on TPR's April 2023 guidance for trustees on managing risks when using leveraged Liability Driven Investment ('LDI').

Since this guidance was released, UK DB pension funding levels have improved, prompting a shift in investment strategy away from growth assets and into matching assets, with a general reduction in leverage within LDI mandates. This, coupled with the general rise in long term interest rates, has reduced the LDI market size from c£1.5 trillion to £0.7 trillion (TPR estimates).

TPR's latest report reviews how well trustees are following the core principles of the guidance, which is that trustees should confirm and document that they have robust and effective operational processes in place. This is to ensure the resilience of their pension scheme to market shocks (particularly related to LDI) and to reduce the risks to their scheme to an acceptable level given the scheme's specific circumstances. We have set out more details on the findings and our views below.

## How well trustees are meeting the guidelines

**Compliance to interest rate buffers** – in its 2023 guidance, TPR set out the requirement for schemes to hold a market stress buffer (a minimum of 250bps of yield headroom) and an operational buffer to manage day-to-day volatility. In line with our own experience, TPR concludes that trustees are complying with these explicit collateral guidelines.

**Compliance to recapitalisation processes** – TPR set out that it expects trustees to i) understand the thresholds or conditions under which 'collateral calls' will take place, ii) put in place processes for meeting these calls and promptly restoring depleted buffers within five days, and iii) document these processes. TPR notes in its report that LDI recapitalisation processes have been strengthened, with many schemes operating with pre-agreed cash call arrangements – we note that the majority of schemes we advise will have this type of arrangement in pace and will have documented this (either through their Statement of Investment Principles or a specific collateral management policy).

**Focus on liquidity by trustees, LDI managers and fiduciary managers** – TPR notes that LDI and fiduciary managers are placing a greater emphasis on liquidity management to ensure enough liquid assets are available to meet capital calls, in line with their expectations.

## TPR are encouraging trustees to:

**Review** and **stress test** your collateral arrangements.

**Diversify** your collateral assets.

Consider adding **flexibility** to collateral arrangements.

## Areas for improvement

**Resilience testing** – TPR's guidance expects that trustees robustly test the resilience of their LDI investments and processes from time to time, with the outcome documented and any areas for concern noted and addressed. This includes testing processes for replenishing collateral buffers within five days, per their guidance on setting and topping up the market stress buffer.

As an example, TPR notes that schemes could test how quickly, following a capital call, transactions will need to be made, and how well the scheme's operational processes and those of the scheme's advisers and/or providers (e.g. LDI manager, administrator) are positioned to be able to meet this. This would include the time taken to receive information on a collateral event, time taken to make a decision and instruct collateral payments, and should take into account the trading frequency and settlement periods of assets.

**Diversification of collateral assets** – TPR notes that trustees need to be more aware of the concentration risks associated with the assets earmarked for sale during stress events. In particular, it is likely that many schemes will invest in similar funds or asset classes and specify these in their collateral waterfalls. Therefore, there exists a risk that a large number of pension schemes attempt to sell similar types of assets at the same time, resulting in valuations for collateral assets falling and / or it being difficult to find liquidity.

**TPR suggests that trustees can mitigate this risk in two ways:**

1. Trustees can consider diversifying collateral assets. This could reduce liquidity bottlenecks in specific markets and diversify sources of cash to replenish LDI assets.
2. Trustees can consider developing flexibility in liquidity frameworks such that a more dynamic approach can be taken which reflects market conditions for those assets being sold.

## TPR stats on LDI

On average, LDI mandate headrooms have increased from 150 basis points to 300 basis points, reducing the impact of further yield rises and improving day-to-day liquidity management.

Around half of pension schemes use no LDI, c40% use pooled LDI funds and c10% use segregated LDI.

Nearly 300 schemes have not reviewed their Authorised Signatory List since 2021.

85% of schemes with LDI have a pre-agreed asset sale plan (and c75% of schemes have given their LDI manager discretion to sell these assets). Bonds would be the first asset sold in such as a scenario for around half of schemes.

Around 30% of schemes in TPR's reports would use DGFs or equities as the first asset they would sell in a capital call scenario.

## Key takeaways for trustees

Trustees and the investment industry have made significant improvements since TPR publishing their guidance in 2023, though areas for enhancement exist.

Whilst most trustees will have a well-documented process for meeting LDI capital calls and monitor this on a regular basis, TPR believes trustees should be going further by:

- Robustly testing the resilience of their LDI investments and processes to market shocks on a periodic basis;
- Reviewing and understanding whether there may be issues with selling assets earmarked for collateral calls due to concentration risks – e.g. if a large portion of an investment fund is from other DB schemes that may be disinvesting at a similar time to meet LDI capital calls;
- Reviewing whether a diversified pool of collateral assets and / or a more flexible approach to generating cash would be prudent in times of market stress.

We know of examples of TPR contacting trustee boards to request evidence of regular monitoring and resilience stress testing and therefore recommend trustees ensure they are comfortable they could provide evidence of this, and the above suggested areas of improvement, if requested.