

# Association of Professional Pension Trustees

## Response to Work and Pensions Select Committee inquiry on defined benefit pensions with liability driven investments

### About the Association of Professional Pension Trustees

The Association of Professional Pension Trustees (APPT) is pleased to respond to this call for evidence by the Commons Select Committee on Work and Pensions.

Pension scheme trustees play an important role in the UK pensions system, governing and overseeing occupational pension schemes, with the objective of achieving good outcomes for scheme members and working with the organisations that sponsor the schemes in order to do so.

Most pension scheme trustees are either:

- individuals employed or formerly employed by the organisation to which the scheme relates, or otherwise connected to it, or
- professional independent trustees

As the representative body for professional trustees of UK occupational pension schemes we maintain a set of standards for professional trustees to improve and promote the quality of the service provided by professional pension trustees. We also oversee an accreditation process to uphold these standards which requires professional pension trustees to evidence essential skills and experience and continue to upskill by undertaking a minimum of 25 hours of relevant continuous professional development activity each year.

We act as the collective voice for professional trustees and provide opportunities for member training, feedback and discussion. We also operate a dedicated discussion forum for our members from smaller trustee firms (firms with five or fewer accredited trustees), to provide opportunities for professional trustees with smaller support networks within their own firm or business to connect with a larger group of professional trustees.



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We estimate that APPT members work as trustees on over 2,000 defined benefit (DB) schemes. Our members also sit on a large number of trustee boards for defined contribution (DC) schemes including DC master trusts. APPT members each typically work on multiple appointments and in total are responsible for managing schemes with assets of over £800bn.

## Executive Summary

In responding to this inquiry, we sought views from APPT members on the Committee's questions, and our submission therefore reflects the experiences of trustees of a wide range of different types of DB (and DC) schemes. Schemes vary in terms of size, in terms of the nature of the sponsoring company or organisation, in terms of their funding position, and in terms of the number of members already drawing benefits: schemes with a large proportion of retirees are generally referred to as "mature".

- Over the last 20 or so years, most defined benefit schemes have had funding deficits on an ongoing basis. While funding positions have typically improved over that period, most schemes have had a long time horizon to reach full funding on a low dependency basis (i.e. having a low dependency on the sponsoring organisation for further contributions to eliminate those funding deficits) and many may not become fully funded on that basis for a significant period of time.
- A key part of the role of trustees has been, and remains, to seek to improve or maintain funding positions through an appropriate balance of funding from the sponsoring entity and investment returns, and to do so in a risk-controlled way. In particular, trustees are required by a combination of law, regulation, regulatory codes of practice and guidance and their own scheme rules to:
  - take advice on their investment strategy and to consult with the scheme sponsor in setting that strategy and making any changes to it
  - agree or consult on a funding plan with the scheme sponsor to meet any deficit
  - assess and monitor the sponsor's covenant, i.e. its ability to fund the scheme and underwrite investment risk
- Trustees manage the associated risks in a holistic way, exercising their judgment appropriately based on expert advice. Trustees have to manage a wide range of potential risks, often over a long time horizon, and in relation to investment risk this is done by taking into account the advice from investment professionals as part of reviewing and monitoring the performance of their pension schemes' investment strategies.
- LDI using leverage is one such strategy that many pension schemes have adopted to manage exposure to changing interest rates and inflation. The objective is to align asset valuations with liability valuations whilst continuing to enable trustees to invest other areas of the portfolio for overall growth in order to meet long-term pension obligations to members.



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- LDI strategies are well established and have worked well for the past 20 years in furthering the above objective. Trustees typically work with their investment advisers to ensure that schemes routinely stress-test scenarios including rising yield environments, and that they have collateral to withstand shocks. The speed and scale of the market reaction to September's "mini-budget" exceeded the sensitivity of risk modelling, including the Bank of England's own 2018 stress tests.
- As has been well-commented upon, this situation provided an extreme test for leveraged LDI strategies and, whilst it seems clear to us that most trustees and schemes managed the challenges, many trustees are now considering their future investment strategies in a less time-pressured environment.
- One theme emerging strongly from our members was the diversity of experience during the market turmoil of September and October 2022, depending on scheme specific characteristics.
- The experiences of trustees have also underscored the need to make sure governance and investment processes are reviewed and, where necessary, adapted so speedy action can be taken should there be any repetition of such a sudden market shock.

Our response now considers in turn the questions posed by the Committee.

## **1. The impact on DB schemes of the rise in gilt yields in late September and early October**

*In the short term, some schemes experienced liquidity issues. Overall, however, the cost of pension scheme liabilities reduced and for many schemes funding, positions improved. Beyond this, the impact depended on specific scheme characteristics.*

Negative market reaction to the September 2022 "mini-budget" and statements by the then-Chancellor promising further tax cuts caused a rapid rise in gilt yields, the scale and the speed of which exceeded risk modelling. The Bank of England's stress test in 2018 had tested a maximum rise in gilt yields of 100 basis points<sup>1</sup>, whereas the increases over just a few days in September were substantially higher than that.

In order to meet collateral calls, a large number of pension schemes had to sell gilts at the same time, which created "self-reinforcing spiral" conditions and ultimately resulted in a significant Bank of England intervention to stabilise gilt markets.

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<sup>1</sup> Evidence to Treasury Select Committee, 19 October 2022, <https://committees.parliament.uk/oralevidence/11373/pdf/>



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Whilst for some schemes (not all) this created short term liquidity issues, this did not mean that schemes or members' benefits were at risk. In fact, pension scheme liabilities reduced and for many schemes we saw funding positions improve considerably. The precise impact on DB pension schemes depended on the circumstances of the scheme, and the specific impact on funding positions, hedging ratios and asset allocation is still being worked through in detail. The initial indications we have received from APPT members are that:

- Generally, schemes with segregated LDI mandates (which tend to be the larger schemes) fared better, with LDI managers better able to manage collateral requirements
- Pooled LDI funds proved more difficult to manage, but most schemes were able to continue to meet requests for collateral
- Some schemes were not able to meet all collateral requests over the period and experienced a reduction in hedging levels as a result
- In some cases, trustees were able to agree temporary lines of credit from sponsors which helped to manage actual and potential future collateral requirements, and in other cases employers advanced scheme contributions due in the future to provide the immediate support required
- The situation highlighted the importance of having appropriate resource and structures in place to enable trustees to get timely information from investment managers and advisers during this period of extremely rapid movement
- The recent changes to the levels of collateral headroom and leverage required by LDI managers will have consequences for residual asset allocation, including in some cases greater allocation to illiquid assets, and lower expected returns. Many schemes are now therefore undertaking investment strategy reviews in the context of trustees' long-term objectives to meet long-term pension obligations to members.

## **2. The impact on pension savers, whether in defined benefit or defined contribution pension arrangements**

***For defined benefit pension schemes, benefits have not changed and pensioners continue to receive their pensions. The longer-term impact on scheme members will depend on the specific circumstances of the scheme.***

Some trustees said they expected no impact on scheme members, and many are considering communications aimed at explaining the recent events and reassuring scheme members that the “mini-budget” and the Bank of England’s market intervention would not affect benefits.



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For defined benefit schemes, trustees pointed out that in future, some schemes may hold a lower proportion of growth assets (which is the implication of deploying less leverage in the LDI portfolio), which could be unhelpful to their funding positions in the longer term. This could be an issue for immature, less well-funded schemes. The actuarial factors used to determine some scheme benefits, which are calculated by reference to market interest rates, could be affected as a result of generally higher interest rates. An example is the cash commutation rate used for converting a pension into a lump sum at retirement. Transfer values are also affected by higher interest rates.

Where defined benefit schemes had improved their funding positions, progression towards settling scheme benefits through a buy-out from an insurance company was now more likely, which would be a positive outcome for both members and the sponsoring employer. In contrast, some schemes experiencing a deterioration in funding positions said that they were considering whether they might need to re-introduce contributions from employers.

For defined contribution schemes, members who were invested in bond funds, or any other funds where the assets are impacted by changes in interest rates will have seen their fund values fall as interest rates rose. The extent of the fall depends upon a number of factors, including the duration of the bonds, with longer duration associated with a greater fall. Members who were in the transition to retirement phase of lifestyle funds which transition into (inter alia) longer duration bonds to hedge against annuity rates will have seen significant falls in fund values. We note that as annuity rates tend to increase with falling gilt yields, members intending to use their pension pot to buy an annuity would not necessarily have seen a fall in the level of retirement income they could secure with an annuity. It should be noted that the ultimate impact on members is determined by fund levels and interest and annuity rates at the time their benefits are crystallised.

### **3. Given its responsibility for regulating workplace pensions, whether the Pensions Regulator has taken the right approach to regulating the use of LDI and had the right monitoring arrangements**

*As mentioned above, LDI strategies are a valuable tool in protecting defined benefit pension schemes from adverse interest rate and inflation movements. LDI is a well-established strategy which helps to align asset valuations with liability valuations whilst continuing to enable trustees to invest other parts of the portfolio for overall growth as part of meeting long-term pension obligations to members. The Pensions Regulator is not responsible for regulating LDI products. It is responsible for developing and*



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***maintaining codes of practice for Trustees, including those relating to knowledge and understanding and establishing internal controls. It is also now responsible for ensuring that the Trustees of all schemes have set objectives for their investment consultants and have reviewed the performance of their investment consultants in relation to the objectives set.***

The prime responsibility for the design of a scheme's investment strategy lies with the Trustees of that scheme. The role of the Pensions Regulator should be to satisfy itself that Trustees are suitably equipped and advised in order to discharge this responsibility, and this includes having adequate levels of knowledge and understanding and following a proper process, and to take appropriate steps to the extent that there are any general failings, or specific failings of which it becomes aware. The Regulator has adopted a consistent, and in our view, correct approach.

To the extent that the recent experience has changed the assessment and quantification of risk inherent in the gilts market (which it has done), it is the Regulator's responsibility to satisfy itself that there is an appropriate awareness and response, and to take appropriate steps to ensure this.

#### **4. Whether DB schemes had adequate governance arrangements in place. For example, did trustees sufficiently understand the risks involved?**

***In the experience of APPT members, most schemes had good governance arrangements in place and the risks were understood by trustees. Many schemes and advisers had anticipated the potential for rising gilts and ensured that arrangements were in place to meet collateral calls. Trustees have risk management processes in place to manage a range of potential risks, but none of the models – including the Bank of England's – tested a market movement at the scale and speed of that which followed the September "mini-budget".***

Some comments from professional trustees indicated that while more emphasis could have been given to the risk of extreme events, such as we saw following the September "mini-budget", basing investment decisions on more remote risks could have created other more immediate impacts - for instance putting more pressure on the sponsoring organisation through increased contribution requirements, with adverse consequences for employees and for the UK economy. There was a general sense that in this case, economic policy developments had meant that risks previously thought by all parties to be too remote to take into account had



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materialised, and that trustees could learn from this experience and recalibrate their stress testing in relation to possible LDI collateral requirements.

Although trustees reasonably did not base investment strategies around unfeasibly remote outcomes, and most schemes were able to respond well through the market turmoil, some schemes could adapt their processes to be able to respond more quickly to raise cash to meet margin calls in light of extreme events.

Value at Risk (VaR) has been a common approach to the measurement of risk within investment strategies. This may have led to advisers and trustees focusing more on mark-to-market risk at the expense of liquidity or counterparty risks, both of which re-emerged during the period following the “mini-budget”. Real world scenario analyses will become a frequent tool in risk management going forward.

It is important to note that the trustee role has become increasingly professionalised in recent years, and the APPT continues to work to promote and maintain the highest possible standards across the professional trustee industry.

The professional pension trustee standards, overseen by the APPT, was put in place in 2019 and designed to promote and maintain the highest possible standards across the professional trustee industry. This was supplemented in 2020 when an accreditation process for professional trustees was introduced - 450 professional trustees have since then achieved accreditation. In order to become fully accredited, professional trustees need to demonstrate their competency through passing exams covering technical and soft skills, as well as fulfilling fit and proper checks.

## **5. Whether LDI is still essentially ‘fit for purpose’ for use by DB schemes. Are changes needed?**

***LDI strategies are well established and have worked well for the past 20 years. They are important as a risk management strategy to secure members’ benefits whilst allowing trustees to invest other parts of the portfolio for overall growth as part of meeting long-term pension obligations to members.***

The role of pension scheme trustees is to deliver and protect the benefits of pension scheme members and beneficiaries, whilst also considering their scheme’s sponsoring company. In doing so, trustees are required by law to take advice on their investment strategy and to consult with the scheme sponsor in setting that strategy and making any changes to it. Trustees have to



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manage potential risks and this is done by taking into account the advice from investment professionals as part of a regular review of pension schemes investment strategies.

LDI has an important place within investment strategies, and trustees, their investment consultants and LDI managers are already adapting by taking steps to reduce leverage within their LDI strategies and review investment strategies.

The strategy continues to be appropriate, but certain aspects of it could be improved: for instance, moves from weekly to daily liquidity for LDI dealing funds; and LDI managers and investment advisers increasing capacity to reduce dealing time. Many schemes are taking steps in response to the recent situation, for example reviewing their targeted hedging levels, collateral buffers, LDI leverage, and their liquidity waterfall, within their overall asset allocation.

Better information flows and real-time analysis from LDI fund managers would also help trustees respond during periods of extreme market volatility.

There was also a view that, in order to reach a “low-reliance” target, leveraged LDI will continue to be necessary in order to deliver the return required and stay within the desired risk tolerance, particularly where affordability of additional contributions from the employer is more of an issue.

## **6. Does the experience suggest other policy or governance changes needed, for example to DB funding rules?**

***The APPT generally welcomes the new DB funding rules. In response to the recent events, overly reactive or prescriptive regulatory changes could have unintended consequences in other parts of the pensions sector.***

Pension schemes are heavily regulated, and whilst this can reduce certain governance risks, there is a danger that regulation designed to limit investment risks would increase the cost to sponsors of running pension arrangements through ultimately requiring higher contributions should deficits not be able to be funded through investment returns to the same extent.

The APPT generally welcomes the new DB funding rules. In response to the impact of the recent experience on the new DB funding rules there was a range of different views, suggesting that a “one size fits all” approach would not be appropriate. Some trustees pointed out that for immature, underfunded schemes, forcing rapid fixing of deficits would lead to significant strain on sponsoring businesses. Others said that the imposition of ‘low reliance’ funding rules at a



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time when schemes are dealing with the recent problems could be problematic for some schemes.

Many trustees are carrying out exercises to review their investment strategies and operational processes, and are looking closely at continuing professional development (CPD) and at Trustee knowledge and understanding (TKU) to reflect lessons from the events of September and October.

## Conclusion

The pensions system as a whole has developed to be flexible and adaptive given the very different types of schemes that characterise the UK pensions market.

While there are clear lessons to be learned from the period following the “mini-budget” of 2022 and how the political environment can cause extreme risks to materialise, it is important to stress that trustees’ responsibility is to deliver and protect the benefits of pension scheme members and beneficiaries, whilst also considering their scheme’s sponsoring employer. Basing investment strategies solely on the materialisation of any extremely low likelihood but high impact risk may not be compatible with those obligations, could have unforeseen consequences elsewhere, and could be damaging for the UK economy.

While trustees and schemes managed the challenges presented, it is likely schemes will want to consider carefully in a less time-pressured environment their investment strategies. Trustees have, and will continue to reflect on their experience, and views of plausible risks have changed. We believe that Trustees and their advisers, working with the sponsoring companies, are best placed to work out the right conclusions for their circumstances.

The APPT is supporting our members as they continue to ensure schemes and sponsors are responding appropriately to the current market conditions to ensure that risks are managed in the most effective way.