CFA Society United Kingdom

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DB Funding Code Team
Regulatory Policy
Advice and Analysis Directorate
The Pensions Regulator
Napier House
Trafalgar Place
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Submitted by e-mail to: DB.Consultation@tpr.gov.uk

Dear DB Funding Code Team,

CFA UK response to the TPR's Second consultation on the Defined Benefit Funding Code of Practice

The CFA Society of the UK (CFA UK) welcomes the opportunity to respond to TPR's second consultation on this topic. CFA UK responded to TPR's first consultation on the DB Funding Code back in September, 2020[1] and are pleased that many of our recommendations in that response have been taken forward.

We provide more detailed responses to some of the specific questions in the consultation in Appendix II. On this occasion we have chosen to respond only to a sub-set of questions relating directly to investment matters.

CFA UK supports the proposed 1-in-6 year 4.5% stress test. Importantly it will still permit schemes to achieve diversified cashflow matching asset allocations, however, we recommend the following amendments be made to the proposed more specific requirements:

- We do not believe it is necessary to effectively mandate a required minimum interest rate hedging level (which is proposed at 90%). This proposal exacerbates the risks of herding schemes into gilt, swap and corporate bond markets and inflating the prices of these assets.
- We do not believe that cashflow matching assets should be limited to those that are fixed and inflation-linked in nature. Allowing a broader, more diverse and potentially more stable asset allocations taking in wider assets (such as infrastructure, loans, securitised, property and other cashflow matching assets)

[1] CFA UK response to The Pension Regulator's ("TPR") Consultation on the DB Funding Code (Sep 2020): https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/cfa-uk-response-to-the-pension-regulators-tpr-consultation-on-the-db-funding-code.pdf

would enable well-governed trustees the flexibility, investment freedom and the efficient allocation of capital to meet their beneficiaries' needs.
- We believe managing liquidity risks (for instance, through minimum collateral requirements) should form an important part of managing pension scheme risk on an ongoing basis and should therefore also be included in the Code of Practice.

In line with our Society's purpose, we aim to highlight relevant issues to help the investment community to serve its stakeholders well and to build a more sustainable future.

We appreciate the opportunity to respond to this consultation and thank TPR for its ongoing engagement with this important project.

Yours sincerely,

Will Goodhart
Chief Executive
CFA Society of the UK

Andrew Burton
Professionalism Adviser
CFA Society of the UK

With thanks to contributions from:
Alistair Jones (Chair of the Working Group)
Alex Beecraft, CFA (Chair of the Pensions Expert Panel)
Natalie Winterfrost, CFA, APT
David Rae, CFA

and the oversight of both the Pensions Expert Panel and the Professionalism Steering Committee.

APPENDIX I: About CFA UK and CFA Institute

CFA UK serves nearly twelve thousand leading members of the UK investment profession. Many of our members work with pension funds, either managing investment portfolios, advising on investments, or as in-house employees responsible for pension investment oversight.

The mission of CFA UK is to build a better investment profession and to do this through the promotion of the highest standards of ethics, education and professional excellence in order to serve society's best interests.

Founded in 1955, CFA UK is one of the largest member societies of CFA Institute and provides continuing education, advocacy, information and career support on behalf of its members.

Most CFA UK members have earned the Chartered Financial Analyst® (CFA®) designation or are candidates registered in CFA Institute's CFA Program. Both members and candidates attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.

For more information, visit www.cfauk.org or follow us on Twitter @cfauk and on LinkedIn.com/company/cfa-uk/.

CFA Institute is the global association for investment professionals that sets the standard for professional excellence and credentials.

The organisation is a champion of ethical behavior in investment markets and a respected source of knowledge in the global financial community. Our aim is to create an environment where investors' interests come first, markets function at their best, and economies grow.

It awards the Chartered Financial Analyst® (CFA) and Certificate in Investment Performance Measurement® (CIPM) designations worldwide, publishes research, conducts professional development programs, and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry.

CFA Institute has members in 162 markets, of which more than 170,000 hold the Chartered Financial Analyst® (CFA) designation. CFA Institute has nine offices worldwide and there are 158 local member societies.

For more information, visit www.cfainstitute.org.

APPENDIX II: Responses to questions

1. ***Are there any areas of the summary you disagree with or would like more/less detail? If yes, what areas and why?***

   No

2. ***Do you agree with the principles for defining a matching asset that i) the income and capital payments are stable and predictable; and ii) they provide either fixed cash flows or cash flows linked to inflationary indices? If not, why not and what do you think is a more appropriate definition?***

   We agree with the concept of DB pension schemes allocating more to cashflow matching assets as they mature. However, we do not agree that matching assets should be limited to only those that produce cashflows that are either fixed or linked to inflationary indices. The consultation paper indeed states that it does not wish to limit the cashflows used for cashflow matching purposes.

   Whilst much of the gilt and UK corporate bond markets are fixed or inflation-linked in nature many other markets such as loans, private credit, infrastructure, securitised credit, real estate debt, CLOs, ILS, etc. are floating rate in nature. We believe that excluding floating rate investments from being recognised as cashflow producing assets would significantly limit pension schemes' asset allocation. Most of these cashflow assets have 1-in-6 year downside VaRs of 4.5% or less as required under Fast Track requirements for low dependency asset allocations. LDI instruments are also commonly used to swap the floating rate exposures of these types of assets to fixed and inflation-linked exposures to match pension scheme liabilities.

   CFA UK's preference is for regulations not to encourage further herding into UK gilt and corporate bond markets. We would therefore like to see the requirements for matching assets to include floating rate assets.

3. ***Do you agree with our approach for defining broad cash flow matching? If not, why not and what would you prefer?***

   CFA UK agrees with the definition for broad cashflow matching, although we believe that the requirement for assets to have a 'contractual obligation' to produce cashflows requires further definition. Holders of equities have an expectation to receive dividend cashflows in most scenarios, but the overriding point is that issuers do not have an obligation to pay dividends and Equities should be called out as an asset that does not have a contractual obligation to pay cashflows.

4. ***Do you think the draft adequately describes the process of assessing cashflow matching? What else would be appropriate to include in the code on this aspect?***

   The draft describes the process of matching the interest and inflation sensitivities of pension scheme liabilities associated with yield curves. CFA UK therefore believes that a broad range of cashflow producing assets should be permitted in DB pension scheme asset allocations as the precise swapping to achieve an immunisation of a scheme's liability exposures can be achieved using LDI techniques.

5. ***Should the code set out a list of the categories of investments into which assets can be grouped for the purposes of the funding and investment strategy? If so, what would you suggest as being appropriate?***

   The code should not contain a list for the purposes of funding and investment strategy. This should encourage schemes to use a diversity of assets to achieve the requirement for 1-in-6 year VaR to be less than 4.5% in low dependency asset allocations rather than to herd schemes into UK gilt markets. This should encourage diversification and the appropriate use of other assets such as high yield debt, property, long lease property, infrastructure, loans, private credit, securitised credit, real estate debt, CLOs, ILS, etc in low dependency asset allocations.

   That said, we note that a table of eligible assets is listed in the section on Fast Track along with the stress tests that should be applied for each of these assets. We therefore strongly advocate for this table to be expanded to also include the assets listed above such as infrastructure (equity and debt) in particular.

6. ***Do you agree that 90% is a reasonable benchmark for the sensitivity of the assets to the interest rate and inflation risk of the liabilities?***

   CFA UK does not believe that a specific and separate benchmark is required in this respect for the following reasons:

   - We believe that other stated requirements, specifically the requirements (i) to be invested in broadly matching assets and (ii) the maximum stress requirements are sufficient to determine an appropriate investment strategy. It is not clear to CFA UK why interest rate risk (and not other risks) warrants a separate and specific requirement.

   - Inclusion of the benchmark also presupposes a need for pension schemes continuing to pay benefits on an ongoing basis to maintain funding levels by reference to fixed income asset returns (as opposed to having them transferred to an insurer, for instance). While this is an entirely reasonable approach for many schemes to take, we do not believe it is the policy intent to be this prescriptive on scheme strategies (nor should it be necessary).

- This specific requirement risks exacerbating the herding into UK gilt, swap and corporate bond markets, covered in our answer to question 2 above, thus unnecessarily heightening undesirable systemic risks in these markets.

- Given that the low dependency funding target is significantly higher than the measurement of pension liabilities under accounting standards, the setting of a minimum [90%] interest rate hedging ratio will result in all schemes being over-hedged on a corporate accounting basis. This could result in significant volatility for the balance sheets of scheme sponsors in response to the impact of material interest rate changes on their pension scheme valuations. In turn, this could materially impact scheme sponsors' accounting reserves and distributions policy. While sponsors' balance sheets are not a direct concern in the TPR's objectives, we would like to draw the TPR's attention to and highlight this unwelcome consequence of what we regard to be an unnecessary additional restriction.

CFA UK also recognise that historically Value-at-Risk models have not always accurately calculated the significance of risk events when they have occurred in practice. Hence the 1-in-6 year stress of 4.5% could be complemented by hard ranges on low dependency investment allocation such as 85% cashflow matching / 15% growth +/-X% where X% could be 15% for example.

Notwithstanding our comments above, should TPR decide to proceed with a specific benchmark in this area, it should recognise that, after allowing for suitable buffers to avoid falling beneath this benchmark, many schemes will likely choose to target nearly full hedging ratios – that is, in setting it's minimum requirement, TPR should recognise many schemes will aim higher for prudence, so TPR should ensure this minimum requirement truly represents what it regards as the lowest acceptable.

7. ***Should we, and how would we, make this approach to broad cash flow matching more proportionate to different scheme circumstances (e.g. large vs small)?***

For cashflow matching requirements to be proportionate they should be implementable for small schemes who typically use pooled funds. Investments in LDI funds as well as typical income distributing share classes in other asset classes should be permitted to meet small DB schemes' needs when they reach low dependency.

8. ***Do you agree with our approach that a stress test is the most reasonable way to assess high resilience?***

A stress test is a simple method for assessing resilience that all pension schemes should be able to implement, especially with stresses for each asset class set out under Fast Track. All asset classes should be set out under the stresses specified including assets such as infrastructure. DB schemes taking a Bespoke approach, as opposed to Fast Track, should be free to use more powerful models if they have them - such as those that use stochastic yield curve projections.

9. ***Do you agree that setting the limit of a 4.5% maximum stress based on a one year 1-in-6 approach is reasonable? If not, why not and what would you suggest as an alternative?***

   CFA UK agrees that a 4.5% maximum stress test based on a 1-in-6 year approach is reasonable.

   This level of risk should allow a diverse range of assets to be used in low dependency investment strategies including high yield debt, property, long lease property, infrastructure, loans, private credit, securitised credit, real estate debt, CLOs, ILS, etc.

   CFA UK also recognise that historically Value-at-Risk models have not always accurately calculated the significance of risk events when they have occurred in practice. Hence the 1-in-6 year stress of 4.5% could be complemented hard ranges on low dependency investment allocation such as 85% cashflow matching / 15% growth +/-X% where X% could be 15% for example.

10. ***Do you agree that we should not set specifications for the stress test but leave this to trustees to justify their approach? If not, what would you suggest as an alternative?***

    Stress tests are specified for each type of asset under a Fast Track approach. Trustees taking a Bespoke approach should have the ability to specify the 1-in-6 year VaR stresses that are most appropriate for their particular assets. Trustees taking a Bespoke approach may have the ability to use more sophisticated models than the stresses applied under fast track.

11. ***Do you agree with our approach for not expecting a detailed assessment of liquidity for the low dependency investment allocation (LDIA) since we have set out detailed expectations in relation to schemes' actual asset portfolios?***

    CFA UK agrees with TPR's approach for not expecting a detailed assessment of liquidity for the LDIA. Pension schemes should have some investment freedoms to invest efficiently and opportunistically, particularly compared to insurers.

12. ***Do you agree with our approach for not expecting a stochastic analysis for each assumption to demonstrate that further employer contributions would not be expected to be required for accrued rights, but rather focussing on them being chosen prudently? If not, what would you suggest as an alternative?***

    Yes.

13. ***Do you agree that the two approaches we have set out for the discount rate for the low dependency discount rate (LDFB) are the main ones most schemes will adopt? Should we expand or amend these descriptions, if so, how?***

Yes. CFA UK agrees with the two approaches set out for the discount rate. Trustees are encouraged to use market-based, risk-free rates and yields on cashflow matching assets. When setting a prudent longer-term return for the low dependency investment allocation, Trustees could be encourage to also base these on observable market-based yields such as credit spreads, rental yields, dividend yields, earnings yields, etc.

14. Should we provide guidance for any other methodologies?

No.

15. Do you agree with the guidance and principles set out in Appendix 3 and 4? Are there any specific assumptions here you would prefer a different approach? If so, which ones, why and how would you prefer we approached it?

CFA UK agrees. After the discount rate another significant assumption when calculating pension scheme liabilities is that of future expected inflation. It is good to see that this is also specified as being based on market observable yields (like the discount rate) reflecting the characteristics of matching assets.

The yields used when setting assumptions should be net of the costs and charges that are representative of the investment that a scheme invests in.

16. Do you agree that a simplified approach to calculating duration for small schemes is appropriate?

Yes.

17. Do you agree with the above considerations? If not, please explain.

We agree with the above considerations.

However, we believe that the risk of herding should not only be mitigated by analysing if DB schemes may cause more flows into UK gilts and corporate bonds but by also giving DB schemes enough freedom to invest across a more diverse range of cashflow matching assets. As explained in our response to question 2 above, the range of eligible assets should include global corporate bonds, securitised credit, high yield debt, property, long lease property, infrastructure, loans, private credit, real estate debt, CLOs, ILS, etc. CFA UK believes that there is sufficient freedom within the drafted DB funding code to allow this.

The ability of DB pension schemes to invest in diverse asset classes including infrastructure also aligns with recent consultations in the DC pensions space encouraging investment in private and productive assets.

These themes were consulted on in the following UK government consultations:

- Enabling investment in productive finance (Nov 2021): https://www.gov.uk/government/consultations/enabling-investment-in-productive-finance
- Facilitating Investments in illiquid assets (June 2022): https://www.gov.uk/government/consultations/facilitating-investment-in-illiquid-assets-by-defined-contribution-pension-schemes/facilitating-investment-in-illiquid-assets [2]
- Broadening the investment opportunities of defined contribution pension schemes (Nov 2022): https://www.gov.uk/government/consultations/broadening-the-investment-opportunities-of-defined-contribution-pension-schemes/consultation-broadening-the-investment-opportunities-of-defined-contribution-pension-schemes [3]

53. Do you think there are any areas of systemic risk that should be considered further in light of our draft code? If yes, please explain.

The consultation states that LDI risks have now been reduced by the requirement that LDI mandates now hold larger buffers sufficient to withstand yield increases of up to 300-400bp. This is an important consideration because the consultation proposes 90% liability matching at the point of low dependency.

Segregated LDI mandates tended to perform as anticipated though the significant yield movements in the period immediately following the 2022 mini-budget. However, some of the LDI mandates of smaller DB schemes, which typically use LDI pooled funds, did not perform as anticipated.

This can be partly explained by the fact that collateral was not being posted to pooled funds within the timescales required by funds. However, risks to pension funds' funding positions were mitigated in cases where LDI fund managers had the authority to act on behalf of pension trustees.

Given that the consultation proposes liability matching at levels of at least 90% in low dependency, this widening of the authority to act, which successfully mitigated risks in some schemes in the period immediately following the 2022 mini-budget, could be encouraged by TPR more universally.

[2] See CFA UK Response to the DWP regarding the open consultation on 'Facilitating investment in illiquid assets' (July 2022): https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/cfa-uk-response-to-the-dwp-regarding-the-open-consultation-on-facilitating-investment-in-illiquid-as.pdf

[3] See CFA UK's Response to the DWP regarding the open consultation on 'Broadening the investment opportunities of defined contribution pension schemes' (November 2022): https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/response-to-dwp-v5-final-to-dwp.pdf