Draft defined benefit (DB) funding code of practice and regulatory approach consultation

Insight Investment response

March 2023

Insight INVESTMENT

BNY MELLON | INVESTMENT MANAGEMENT

Executive summary

Insight Investment is one of the UK's largest investment managers, managing £654bn in assets, primarily for UK defined benefit pension funds, as well as insurers, sovereign wealth funds and financial institutions[1]. Most of Insight's assets under management are in risk management (including liability-driven investment, or LDI) solutions and fixed income.

In our 2020 response to the first DB funding code consultation, we highlighted that at any point in time, "pension schemes should seek to minimise liability, asset and forced selling risks, as doing so will minimise the dependency on additional future contributions…[but] the extent to which they are able to achieve this will depend on their current funding position and trustees should be encouraged to consider the trade-offs in managing each risk"[2].

We are pleased to provide this response to the second consultation on this topic[3]. We confirm that we are in support of most of the principles outlined in the new draft code, with only a few points of clarification that we think may be worthy of further consideration. We highlight the following themes in our response:

- **A prescriptive focus only on market values, when measuring pension scheme's progress and when stress testing pension scheme resilience, can have unintended consequences:** If a pension scheme has contractually secured cashflows from maturing bond holdings to achieve its targeted funding goals by the relevant date, these cashflows will not be affected by changes in short-term asset values relative to liability values. Therefore, while a market-value based stress test may be reasonable in many circumstances, it is not the most relevant test when assessing risk relative to a pension scheme's long-term objective. This point also supports the code's current approach in avoiding a prescriptive journey plan for pension schemes. We would therefore propose that the code makes it clear that a forward cashflow-based approach to stress testing (i.e., reflecting the cashflows needed for success by the relevant date, relative to the cashflows expected to be delivered by assets held by the pension scheme) is also deemed acceptable and can be assessed through the bespoke route.
- **Clarification around the use of floating-rate assets (including asset-backed securities) and shorter-dated contractual instruments would be helpful:** Both asset classes can play an important role in prudent risk management. For example, using short-dated instruments alongside appropriate liability-hedging arrangements can often support appropriate cashflow matching, deliver greater efficiency and increase resilience over time.
- **A prescribed inflation hedge ratio for pension schemes could undermine appropriate risk management:** Slightly counterintuitively, prescribing a minimum hedge ratio of 90% could in fact increase risk for pension schemes, particularly when it comes to inflation hedging. Where a minimum hedge ratio is set, this effectively means that the limited price indexation (LPI) linkages embedded in pension benefit increases could force pension schemes to buy and sell index-linked gilts at the same time in response to changes in inflation expectations. This could also be unhelpful when it comes to maintaining ongoing collateral resilience. To this end, adoption of the 'principle' of sound liability risk management may be preferable to the 'rule' of minimum hedge ratios.

We appreciate this opportunity to provide our input on these important topics and would welcome any questions that arise from this response.

Insight Investment

March 2023

[1] As at 31 December 2022. Assets under management (AUM) are represented by the value of cash securities and other economic exposure managed for clients. Figures shown in GBP. Reflects the AUM of Insight, the corporate brand for certain companies operated by Insight Investment Management Limited (IIML). Insight includes, among others, Insight Investment Management (Global) Limited (IIMG), Insight Investment International Limited (IIIL), Insight Investment Management (Europe) Limited (IIMEL) and Insight North America LLC (INA), each of which provides asset management services.
[2] Defined benefit funding code of practice consultation response, September 2020, Insight Investment.
[3] Draft defined benefit (DB) funding code of practice and regulatory approach consultation, 16 December 2022, The Pensions Regulator.

Questions and answers

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

We agree with and are broadly supportive of the principles outlined in Chapter 2 of the draft code. We offer the following high-level observations:

- **Paragraph 28.** We believe the current definition of "broadly matched" (explained in paragraphs 61 to 74) can be further refined and have offered more details in our responses to Questions 2 and 3.
- **Paragraph 28.** We disagree with the focus on the resilience of "the value of assets relative to the value of the scheme's liabilities…[during] short-term adverse changes in market conditions". This could be construed as detracting from the message that the true goal is to not have to rely on the sponsor for additional financial support. If a pension scheme has contractually secured cashflows from maturing bond holdings to achieve its targeted funding goals by the relevant date, these cashflows will not be affected by changes in short-term asset values relative to liability values. As such, we believe a sole focus on an asset value-focused approach could detract from the goals of taking "supportable risk" and achieving "low dependency" on the sponsor. A focus on the future cashflows required and the ability to generate these cashflows should also be permitted, if not encouraged.
- **Paragraphs 29. and 30.** These are helpful clarifications relative to the above points in Paragraph 28, but may appear to contradict their use of the terms "broadly matched", "value of assets" and "short term".

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 believe these principles are incomplete and would propose the following amendments for your consideration.

We believe that matching assets should include all assets capable of offering a contractually defined outcome in line with a pension scheme's objective (meaning they can be used to match liability cashflows), as opposed to growth assets which rely on mark-to-market pricing to deliver the required investment outcome.

To this end, while we are supportive that fixed interest assets (such as government and investment grade corporate bonds) and inflation linked bonds should be captured as matching assets, we do not think the definition should exclude instruments such as floating-rate assets, which seem to be precluded by point (ii) above. This is because floating-rate instruments, when paired with an appropriate derivative overlay, are equally capable of matching a pension scheme's liabilities.

Taking asset-backed securities (ABS) as an example, these assets are contractual, meaning they deliver reliable return profiles on a hold-to-maturity basis despite being floating-rate instruments. Where such floating rate returns are paired with an appropriate derivative overlay (e.g., interest rate/inflation swaps), such a package could mature into creating a fixed rate or inflation linked cashflow. To this end, we believe floating-rate contractual instruments should be captured under the definition of matching assets.

We believe floating-rate assets play a very important role in reducing risk and should not be categorised as a 'growth' asset by default. We believe the definition of matching asset could reasonably be extended to cover all investment grade assets with contractually defined returns.

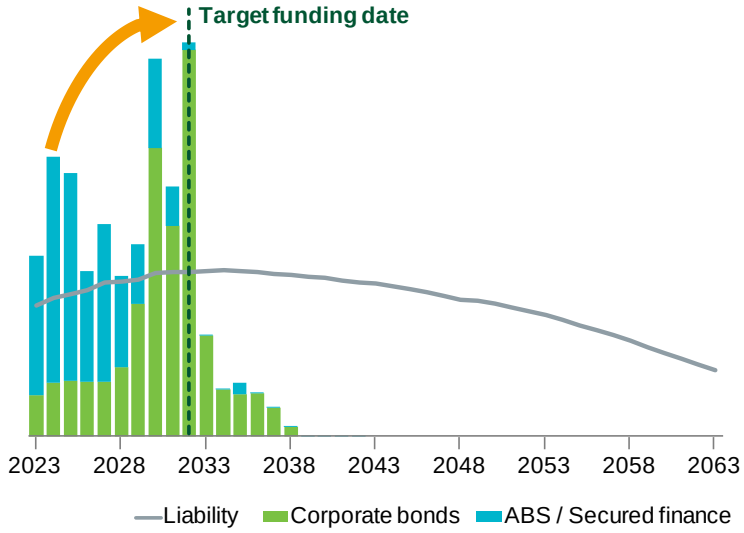
Furthermore, we do not believe that the application of point (i) should preclude the use of contractual assets with potential prepayment/extension options included, as these risks are generally well understood and can be addressed through appropriate portfolio construction. For example, securing more cashflows to mature than needed to meet liability payments can mean that despite prepayment/extension risk, the ability to meet liability payments is maintained without being a forced seller.

Indeed, securing more cashflows than required to meet liability payments in early years can deliver greater resilience in investment solutions than a fully cashflow-matched solution, as the excess liquidity provides additional flexibility and protection against potential forced-selling risk arising from unexpected benefit payments (e.g., commutation or transfers), as well as the potential need to top up collateral pools in a rising yield environment. We cover these considerations in greater detail our response to Question 3.

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

We support the principle of broad cashflow matching, subject to the usage of floating-rate instruments being permitted (see Question 2), and a further scenario of 'broad' matching being allowable, as explained below.

Specifically, we believe it may be helpful for the code to include an explicit clarification around the use of shorter-dated contractual instruments to deliver more liquidity than needed to meet liability payments. This should not be seen as contravening the requirements of broad cashflow matching, as any excess liquidity can be combined with the appropriate liability-hedging arrangements to allow appropriate cashflow matching over time. For example, a 10-year fixed cashflow can be secured using year-on-year floating-rate instruments (i.e. receive SONIA plus X each year), plus a 10-year interest rate hedge (which receives the fixed cashflow required, in return for a payment linked to realised SONIA over the 10 years). We show an example of such a potential portfolio below.



This illustrates that while the cashflows from corporate bonds and ABS are 'mismatched' against the liability profile, liability hedging can be used to address any shortfalls in fixed-rate or inflation-linked exposures at both the shorter end (as ABS are floating rate in nature), and the longer end (where collateral held, and reinvested excess liquidity, can cover the pay legs of any hedges established).

We highlight this specific case because excess liquidity can deliver greater efficiency and resilience for pension schemes for several reasons, as outlined below.

- Ability to top up collateral over time without giving rise to forced-selling risk
- Ability to meet unexpected liability payments (e.g., commutation and transfers), without giving rise to forced-selling risk
- If more liquidity through sales is needed in order to meet cashflow requirements than expected, then shorter-dated matching assets will be less sensitive to movements in credit spreads than long-dated matching assets
- Avoidance of 'forced' cashflow matching where opportunities are lacking (e.g., very low opportunity set and expensive assets at the long end)

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?

We believe the code can benefit from further clarifications, for reasons we explain in our response to Question 2 and 3.

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?

Overall, we are agnostic as to whether assets should be listed, but if so, this list should not exclude floating-rate assets, for reasons we explain in our response to Question 2.

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?

While we believe pension schemes should manage liability-related risks, there are good reasons why pension schemes may want or need to adopt hedge ratios less than 90% (particularly in relation to inflation risk), in the interest of robust risk management. To this end, we would discourage a fixed minimum hedge ratio rule, in favour of the principle of sound liability-risk management.

We have outlined two such scenarios below.

A. Limited price indexation (LPI) hedging

The inflation sensitivities of pension schemes' liabilities are typically derived from an 'option delta' (i.e. the sensitivity of LPI liabilities to changes in underlying Retail Price Index) approach to considering LPI-linked liabilities. One implication is that as inflation expectations move, pension schemes periodically recalibrate their inflation deltas, resulting in the purchase or sale of inflation-linked instruments (e.g., index-linked gilts).

As demonstrated in the recent gilt crisis, liquidity in the index-linked gilt market can be challenged by very little selling from pension schemes. It may therefore not be beneficial for pension schemes to be forced into buying or selling index-linked gilts with the aim of targeting a specific regulatory minimum hedge ratio.

In fact, there are alternative approaches to inflation hedges which may be more beneficial from a risk-management perspective. Schemes that are already well funded and well hedged may benefit from choosing a static inflation-hedging portfolio, which results in a tolerable outcome (profit or loss) across a very wide range of inflation scenarios. For example, the best hedge against LPI (0,5) is to be able to afford to pay fixed 5% increases – meaning an inflation delta of zero, despite the inflation sensitivity of the liabilities. Ultimately, sound liability-risk management is about having the certainty of being able to meet liability payments irrespective of the level of inflation, and this may not require a high inflation hedge ratio at high levels of funding.

This approach can ensure schemes are able to withstand a broad range of inflation scenarios, without the need to adjust their inflation hedges over time. Given the inflation-hedging portfolio would be static under this approach, the inflation hedge ratio would change in response to changes in inflation expectations. This is because the assumed inflation sensitivity of the liabilities would change, following LPI recalibration, but the sensitivity of the portfolio would remain unchanged, influenced by market conditions only. It may therefore be the case under this approach that the inflation hedge falls below 90%, but regardless, the scheme retains its ability to achieve the long-term objective in a risk-controlled manner.

B. Collateral management

Following the gilt crisis, pension schemes have a heightened awareness of the need for stronger collateral resilience.

In a scenario where a scheme does not have plentiful access to liquid assets that can be readily converted into eligible collateral, it may be more prudent to adopt a lower hedge ratio to ensure greater collateral resilience.

Schemes should not be forced to adopt a minimum hedge ratio to the extent it compromises collateral resilience. That said, as scheme funding levels improve, we would expect portfolio liquidity to increase and hence supportable hedge ratios to rise.

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

A market-value based stress test may be reasonable in many circumstances, but it is not the most relevant test when assessing risk relative to a pension scheme's long-term objective.

For example, as explained in our response to Question 1, if a pension scheme has contractually secured cashflows from maturing bond holdings to achieve its targeted funding goals by the relevant date, these cashflows will not be affected by changes in short-term asset values relative to liability values. If credit spreads widen (market values fall), the scheme may appear to be underfunded from a 'present value' point of view. But to the extent the scheme's assets have not defaulted, and therefore not compromised its ability to meet the required cashflows, the scheme should not be viewed as being worse off relative to its long-term objective.

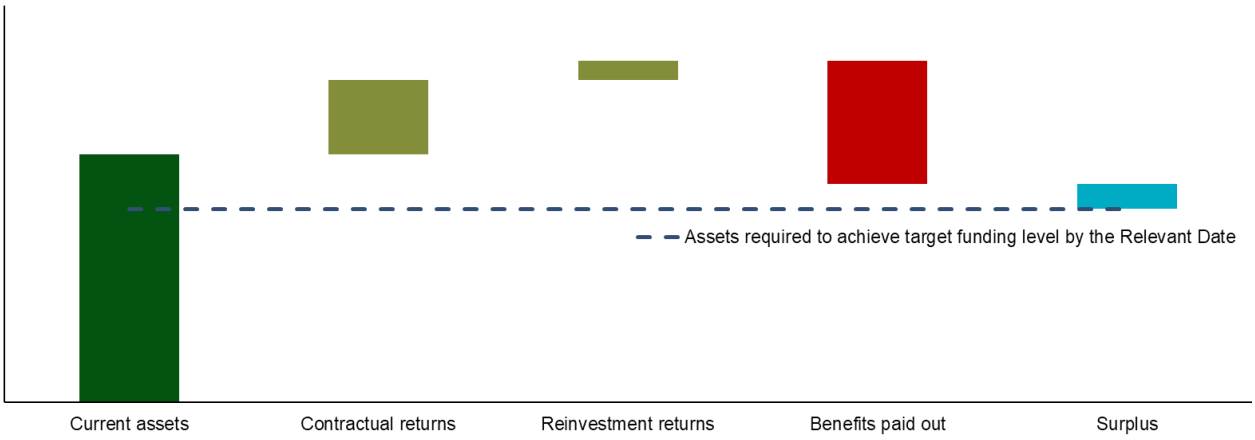
Market-value based stress tests fail to allow for this, meaning that if a scheme fails such as test, it may lead to unintended and sub-optimal investment decisions. There are remedies to this which we outline below:

i. Allow schemes to substitute the proposed market-value based stress test for a forward-looking cashflow-based stress test. We outline what this could look like below.

ii. Enable schemes to conduct stress tests relative to liabilities on a dynamic discount rate basis. Our understanding from the code is that this is permissible, but given the complexities, it may be the case that few pension schemes are able to conduct the stress test on this basis.

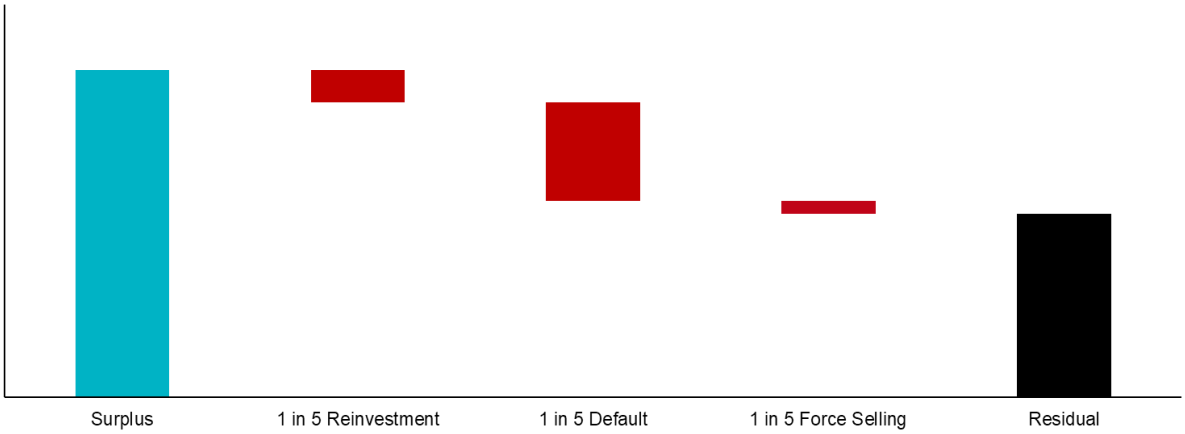
iii. Set the maximum permitted stress test large enough such that the impact of large credit-spread movements would not be expected to breach the limit.

Schemes that have adopted cashflow-based strategies may be able to project their outcome relative to the target funding position, based on the cashflows they have contractually secured. Such a projection is illustrated below.



Under this forward-looking approach, the risks focus not on present market values but on factors that can impair the pension scheme's ability to meet the required cashflows and undermine their target funding objective (such as defaults, reinvestment and forced-selling risks).

A more relevant stress test for schemes focusing on achieving a long-term objective may be to individually stress these default, reinvestment, and forced-selling risks. An example is illustrated below.



Therefore, we propose that schemes that could potentially fail the market-value based stress test should not be precluded from following a cashflow-based strategy. For such cases a forward-looking cashflow-based stress test may be more appropriate (submitted through the Bespoke route). We would propose that the code clarify this is an acceptable approach.

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?

As we explain in our response to Question 8, while we understand the practical attractions of market-value based stress tests, we do not believe they are necessarily fit for purpose in cases where the focus is on “broad matching” of cash flows. To this end, we would encourage the code to permit a risk framework that accommodates cashflow-based strategies.

Furthermore, we would point out that a strict 4.5% maximum stress test may be unnecessarily restrictive for schemes with a funding surplus. For example, a scheme that is 120% funded on its long-term objective basis may have chosen to run the scheme on in the interest of improving its surplus to build additional resilience and consider potential additional benefits to members and sponsors; if the scheme adopts a strategy that is highly resilient for assets equal to 100% of the liabilities, it may have a strong case for being able to run a higher risk with its surplus.

Potential alternatives could include:

- for the stress test to only be applied to a portfolio of assets equal to 100% of the liabilities, and for trustees to retain greater freedom in the investment of surplus assets (over the low dependency funding basis);
- to focus on whether the 1-in-6 VaR approach would bring funding levels below a given funding threshold (e.g., 95%); and
- an independent scenario-based assessment for schemes targeting a cashflow-based strategy as outlined above – for example, considering a strategy to be appropriate if the projected stressed or unstressed surplus relative to a prudent liability goal remains positive.

We would further note that any stress test focused on resilience in the face of a potential monetary shock risks failing to capture qualitative risks, such as illiquidity. Such an approach should therefore not be used in isolation, and we would encourage a broad range of considerations when evaluating risk.

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, we would agree.

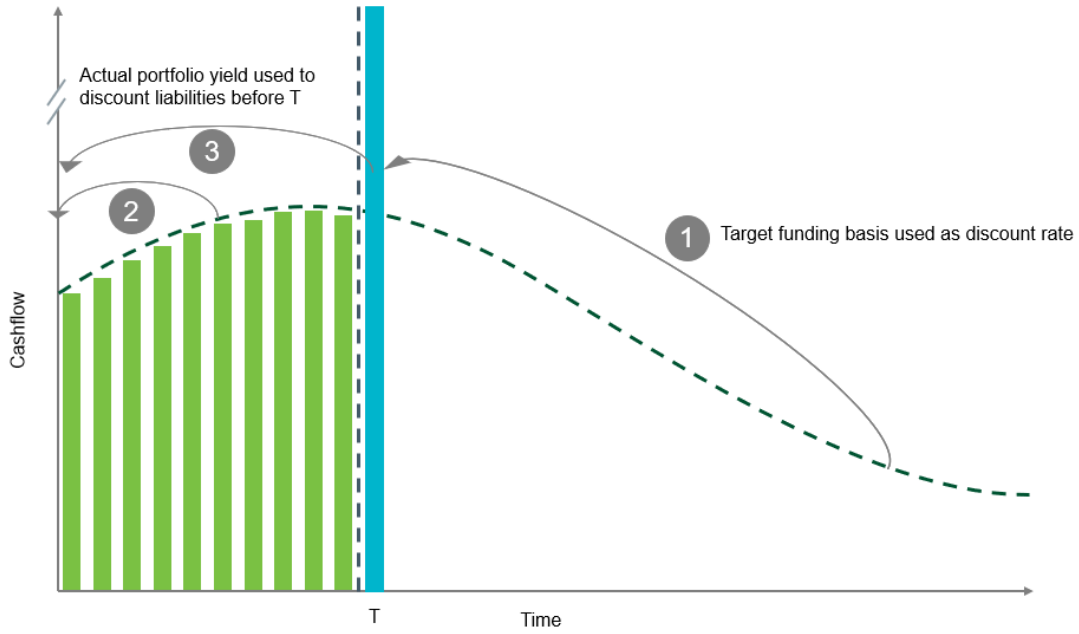
While stochastic analysis has served trustees well during the 'accumulation' phase of pension schemes, it suffers from its dependence on capital-market assumptions, and an ever-expanding funnel of doubt when it comes to investment strategy outcomes.

The requirement for "broad matching" means that over time, most schemes will no longer need to rely on these assumptions and can evolve to more prudent ways of managing risk. We believe a scenario-analysis based approach to risk management, based on the returns secured contractually, will become increasingly appropriate as pension schemes approach full funding on their low dependency funding basis.

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?

We agree with the two approaches set out. However, we would also propose a further clarification to paragraph 105 of the code, which we believe is relevant not only at the relevant date, but also to help schemes on their journey towards the long-term objective.

For schemes which match cashflows to the long-term objective/relevant date, there is a natural way to select the discount rate, illustrated below.



For all cashflows maturing beyond the target date, it is appropriate to adopt a discount rate consistent with the long-term objective discount rate. For cashflows due to be paid before the target date, and assets that mature on the target date, we suggest using the actual portfolio yields.

This approach provides an objective means of valuing the liabilities, while directly linking the scheme's investment strategy to the Technical Provisions basis, using returns that have been contractually secured.

Additional prudence could be introduced, as deemed necessary by the relevant scheme actuary, through the application of haircuts (reflecting an assumed level of defaults) to the cashflows or via a deduction to the portfolio yield.

17. Do you think setting an earlier point for significant maturity within Fast Track as compared to the code (as described in option 3 in this section of the consultation document) would be helpful for managing the volatility risk of using duration? If yes, where would you set it and why?

It is unhelpful for trustees to be working to a timeframe that can change materially due to yield changes. To this end, we would suggest that option 1 (calculating duration based on a fixed yield) may be a preferable way to determine significant maturity. Unfortunately, option 3 does not address this fundamental challenge, and can give rise to unintended and unnecessary 'forced' actions for schemes that need to make use of the time they have remaining.

28. Do you agree that trustees should, as a minimum, look at a one year 1-in-6 stress test and assess this against the sponsors ability to support that risk?

We agree that it makes sense for the investment stress test to be assessed against the sponsor's ability to support the risk.

However, as we note in our response to Question 8, we believe trustees should be able to use a forward-looking cashflow-based stress test that supersedes a market-value based stressed test. This is more aligned to the risks associated with achieving the long-term objective.

If a scheme has constructed an investment portfolio aligned to paying the cashflows required by the long-term objective, but

i. would fail the prescribed market-value based test, and

ii. would pass an equally prudent forward-looking cashflow-based stress test,

we believe the scheme should be permitted to continue to run the investment strategy, and not be forced into making sub-optimal changes. This should be clarified in the code.

32. Do you agree with our approach of not being prescriptive regarding the journey plan shape?

Yes – prescriptive journey plan shapes could have the unintended consequence of reducing a scheme's ability to meet the long-term objective.

For example, as explained in our response to Question 1, if a pension scheme has contractually secured cashflows from maturing bond holdings to achieve its targeted funding goals by the relevant date, to the extent the scheme's assets have not defaulted (in excess of prudence margins built into the strategy design), it will achieve its objective.

However, a prescriptive journey could result in a scheme needing to sell some of its assets to carry out forced rebalancing, which could compromise the scheme's ability to achieve its long-term objective. For example, if credit spreads were to tighten significantly and the market value of contractual assets (such as high-quality bonds) increased, under a prescriptive journey plan, a scheme could be deemed to be overweight these assets leading to forced disinvestment – meaning the scheme might no longer be able to generate the cashflows need to meet the objective.

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

We believe there are two areas worthy of further consideration in light of the draft code.

1 LPI hedging

As discussed in our response to Question 6, we believe it would be sensible for the code to not impose a specified inflation hedge ratio requirement on schemes, to the extent that it would result in a requirement for all schemes to buy and sell index-linked gilts at the same time in response to changes in inflation expectations.

Such behaviour could result in increased pressure on the index-linked gilt market, leading to a similar scenario to the recent gilt crisis.

2 Collective action risk

While we are very supportive of the principles set out in the code, it is worth remembering the potential implications of herd behaviour on markets.

For example, if all schemes are encouraged to adopt portfolios which are allocated to long-dated credit (i.e. to achieve cashflow matching), they may be collectively forced to sell these allocations at some point due to unforeseen circumstances (e.g. losses on inflation hedging). Similarly, if schemes are encouraged to concentrate into the insurance sector, these risks could be exacerbated further.

To this end, we would prefer cashflow-driven strategies that are intended to mature into required outcomes over shorter time frames, as opposed to encouraging long-dated cashflow matching using credit risky instruments. It is worth noting that this does not mean that schemes cannot continue taking credit risk over time, but the key principle is that there are regular checkpoints which allow a reassessment of the situation without needing to become forced sellers at the same time.

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