Financial Services Regulatory Insights

Regulators issue guidance on Liability Driven Investment funds

AT A GLANCE

April 2023

What's new?

- Following volatility in the gilt markets in pooled, leveraged Liability Driven Investment (LDI) funds, new guidance was issued by the FCA on 24 April 2023 (aimed at managers of LDI funds) and by The Pensions Regulator (TPR) for trustees of Defined Benefit (DB) pension schemes.
- The regulators set out their expectations on how the risks associated with LDI investment strategies should be managed, covering risk management strategies, operational matters, governance and communications.
- The FCA notes that its recommendations should also be considered by other firms facing similar risks.

What does this mean?

- The FCA has identified vulnerabilities in some LDI investment strategies: management of risk, including stress testing, communications and client servicing, and operational arrangements. It expects all firms to manage services and products in a way that is compatible with their stated objectives and the stability of UK financial markets.
- It advises special consideration is given to operational arrangements (including critical third parties), liquidity risk, the profile and capability of investors, liquidity requirements in different conditions (including severe conditions), and other systemic factors.
- It suggests managers should also consider issues such as asset and exposure concentration, client liquidity waterfalls, the extent of leverage and impact of different market conditions, strategy concentration, client concentration, macroeconomic developments, and potential regulatory developments.
- In many cases, existing operations were not able to respond at speed in 2022; the FCA notes firms should review product operations, including in stress scenarios, and take steps to ensure clients can deliver collateral within five days.
- Verification of arrangements with key stakeholders (such as counterparty banks) and critical suppliers should take place to ensure essential activities that the fund is dependent on can continue during market stress.
- The FCA also notes client relationships are a potential vulnerability and sets out its expectations, including ensuring appropriate guidance is given on products, and clearly setting out requirements of clients in stress scenarios.
- Full consideration should be given to conflicts of interest between different categories of clients, and between the firm and clients.
- Finally, it notes strong governance is essential during periods of heightened uncertainty, and governing bodies should have sufficient expertise and understanding of the exposure of the firm.

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- TPR also published guidance on LDI, for DB scheme trustees. It emphasises that trustees are ultimately in control of how the scheme's assets are invested, and need to have the right governance and controls in place and an understanding of the risks associated with their strategies.
- The guidance states that a cash, or cash equivalent, buffer of 250bps for market stress should be held. This should be in addition to the operational buffer held. Firms must balance LDI funding, hedging and liquidity.
- The guidance states that trustees should model cash calls being made by managers - for example, the ease with which assets can be sold, who can instruct sales, and the process for doing so. This should also be stress tested to consider the impact of cumulative cash calls on the processes in place.
- Finally, it notes resilience testing should be carried out regularly and governance arrangements should be clearly mapped out, so that each party understands their role in relation to the LDI investments held.

What do firms need to do?

- Managers must urgently complete and embed improvements to address any deficiencies identified, addressing each issue raised by the regulator.
- Firms should also be cognisant of other guidance on LDI, such as that set out for pension funds by the TPR on April 2023 and the Financial Policy Committee's publication issued in March 2023.
- Firms should note the occasions when the FCA expects to be notified of developments that pose a risk of harm to consumers or to market function.
- Firms should work with clients - particularly DB pension schemes and their advisers - to ensure that robust processes and communication procedures are in place during instances of market stress.

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Next steps

Though no formal future activities are confirmed, the FCA notes it will be working with firms to assess progress in addressing vulnerabilities, and will be working with other authorities to ensure implementation of, and compliance with, the guidance issued.