THE SOCIETY OF PENSION PROFESSIONALS
making pensions work

Submitted via a standardised online form

TPR / PPF Joint Consultation
Proposals to update the asset information collected from defined benefit pension schemes

8 June 2021

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• Do you agree that bonds will continue to be a focus for pension plans?

Yes. There has been a significant rise in the use of bonds and fixed income assets by pension funds, and we believe that this will continue to be the case as schemes mature.

This increase has been partly driven by pension funds using a Liability Driven Investment (LDI) approach, for which bonds and bond-related instruments (including swaps and repo contracts) are important tools.

• Are there other market developments we need to consider?

As mentioned above, one clear trend over recent years has been the increase in the number of schemes investing in Liability Driven Investment (LDI) portfolios to reduce investment risk.

Whilst it is possible to allocate LDI portfolios under the proposed framework, the current guidance lacks clarity around how to do so and, as a result, there is a variety in practice across the industry when allocating LDI portfolios. A specific concern is the treatment of swaps under the current approach. Pension funds who use swaps as part of their LDI portfolio could be penalised, for example, when compared to funds who use gilts.

We strongly recommend that TPR/PPF provide greater clarity in relation to the allocation of LDI portfolios by updating the asset allocation guidance. We provide further details on a potential approach, which is commonly used, later in this document.

It may also want to consider collecting further information in relation to LDI portfolios (such as PV01/IE01 values, as standard) to allow an accurate assessment of risk. However, we recognise that there is a need to balance information detail with simplicity.

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• Do you agree with our proposals for new bond categories under Tier 1?

Yes, we generally agree with the proposals for new categories. As discussed above, a broader consideration needs to be given to how LDI is captured as part of this categorisation – smaller funds must not be penalised for use of swaps.

• Do you agree with our proposals for more granular detail under Tier 2?

Yes, we generally agree with the proposals for more granular detail under Tier 2. As above, greater consideration for how LDI is captured as part of this categorisation is needed in order to ensure clarity and consistency across the industry.

• Do you agree that private debt should be included for Tiers 2 and 3?

• If so, do you agree that a single sub-asset class is appropriate?

SPP makes no comment

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• Do you agree with our proposal for having a dedicated category for UK Government inflation-linked bonds given the implications for US TIPS?

Yes, although we note that the use of US TIPS is low and so this issue is perhaps not as pressing. A larger question about how LDI is treated needs to be addressed, with consideration to ensure that that smaller funds and funds using swaps are not unduly penalised.

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• Do you agree with our proposals for leaving the equity split unchanged for Tier 1?

• Do you agree with the proposal for Tier 2 to split overseas equities into developed and emerging markets?

SPP makes no comment

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• Do you agree with including a category for DGFs for all tiers?

Whilst we understand the rationale for proposing a broad DGF category, there are a very wide range of DGFs available to pension schemes in the UK, and the risk/return characteristics of the different funds can vary significantly. We therefore expect there may be winners and losers from a broad classification. For some schemes, allocations can make up a significant proportion of their overall growth asset holdings. If such schemes were invested in DGFs at the “low risk” end of the offerings, then this might have a material impact on their levy versus a “look-through” to the underlying asset class splits.

It may therefore be worth allowing pension scheme to continue to adopt a “look through” approach if they feel that this more accurately represents the risk/return characteristics of the specific DGFs which they use.

• Do you agree with our proposals to add absolute return strategies for Tier 2 and above?

As noted above, there are a large number of DGFs available to pension schemes, and these range from "long only" or "core" offerings (where the underlying holdings might be split mainly between equities and bonds), to more sophisticated offerings which might be predominantly invested in derivatives. We therefore feel that an "absolute return" category would be useful, but we note that the definition should be well defined to avoid ambiguity. We agree that the use of "cash+" benchmarks is often associated with such funds, but this type of benchmark is sometimes adopted by more "core" DGF offerings. Extensive use of derivatives is therefore likely to be another key distinguisher.

Given the relatively high use of DGFs and absolute return funds, particularly amongst small and medium sized schemes, there may be merit in allowing the category of "absolute return" to be available to all tiers.

• Given our proposals for DGFs and absolute return strategies, do you agree that the hedge fund category can be removed?

Given the findings in the consultation document highlighted that the average allocation to hedge funds is only 7%, and that the majority of this allocation is in respect of DGFs, then it seems reasonable to remove the hedge fund category and direct schemes to use the "absolute return" category, where appropriate. The fall-back to "other" for different types of hedge funds seems a reasonable approach given likely allocation sizes.

• Do you agree with our proposals to remove the commodities and insurance categories?

This seems reasonable to us. Some smaller schemes have allocations to legacy with profits funds, and so we are supportive of those schemes being able to continue to "look through" to the underlying holdings of such policies.

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• Do you agree with our proposal for multi-asset credit funds to be broken down into the constituent parts for the scheme return?

As with DGFs, there are now a wide range of multi-asset credit funds available to pension schemes. Many of these funds have broadly similar underlying asset class exposures, but the overall risk and target returns can vary significantly. A look-through approach to the different constituents should therefore help here. For example a fund which has a significant allocation to defensive areas of credit, will benefit compared to a fund which has more speculative areas of sub-investment grade.

• Are there any other changes we should consider for asset class categories?

As noted above, we strongly recommend that TPR/PPF consider the allocation of LDI portfolios.

A common approach to allocating LDI is the "leveraged gilts and negative cash" approach, which provides a coherent measure of the economic exposure of the portfolio. Under this approach the value of the liabilities hedged by gilt exposure are provided, along with a negative cash offset that brings the total value back down to the amount of capital invested in the LDI portfolio by the scheme. For example, if a pension scheme had £30m capital in an LDI portfolio that hedged £100m of liabilities, this would be recorded as £100m in a UK government bond (of appropriate duration) and -£70m in cash.

If this is the preferred method for allocating LDI, this should be made clear in the guidance.

It should also be made clear that this approach is acceptable for both gilt-based LDI and swap-based LDI, as there is no material difference in risk characteristics between these portfolios. This would protect funds from being penalised for the use of swaps in their LDI portfolios.

Additionally, it is worth noting that whilst undertaking a bespoke stress for an LDI portfolio does provide a more accurate assessment of risk, this does not remove the requirement to have a coherent method to allocate the LDI portfolio in the Scheme Return (as the "smoothing" element of the levy calculation continues to rely on this allocation, even if a bespoke stress has been carried out).

We note that some multi-asset credit funds make use of derivatives to control the overall level of risk within a portfolio, sometimes using such instruments to introduce hedging or tail risk protection. A look-through will therefore lead to some winners and losers, but a solution to capture such intricacies would involve a level of detail in the breakdowns and inputs which would likely be impractical, so we are broadly supportive of the proposed approach.

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- **Do you agree with our proposals to measure scheme size by submitted s179 liabilities?**

Yes

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- **Do you agree with the proposal to set the tier at £20m?**

See following question.

- **Do you believe there is a case for a higher initial threshold for Tier 1? If so where should this be set?**

We are comfortable with the proposed boundary, though would also be happy with a boundary up to £50m.

- **Do you support our proposal to allow schemes to voluntarily provide more asset information?**

Yes.

- **Could it become more difficult for schemes in Tier 1 to complete the standard asset return, if industry reporting moves to provide more granular information in Tier 2?**

No

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- Do you believe that there is a need for TPR to collect more detailed information on derivatives for a larger proportion of schemes?

- Do you agree that the boundary for Tier 3 should be £1.5 billion of s179 liabilities?

SPP makes no comment

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• Do you agree that maintaining a simplified roll-forward approach is appropriate given the relative costs and benefits (rather than establishing a more sophisticated approach using a wider range of indices as described below)?

Overall this seems sensible given the points around relative costs and benefits. In practice a simplified method will lead to winners and losers on an individual basis.

We note that for the first three categories of assets class in the table on page 29 that the reference index is "FTSE UK Gilts All Stocks TRI" in each instance. We assume this is a typo and that the indices for the two credit categories will reference relevant investment grade and sub-investment grade indices.

• Do you agree that the index proposals set out above are appropriate, in particular the approach to roll forward 'Other' holdings, diversified growth funds and absolute return funds?

For the DGF category, this seems broadly reasonable, but as per our earlier comment, there may be benefit in allowing schemes to continue to use a "look through" approach for "core" DGF funds, if they feel this more accurately reflects the DGF they use. For example, some DGFs may have materially more or materially less than 60% invested in equities. This should also make the roll-forward more representative of their holdings.

We also note that equity exposures (direct and through DGFs) are typically currency hedged, at least to some extent. There may be merit therefore in considering currency hedged benchmarks as the basis for (at least part of) the roll-forward indices.

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• Do you agree that if a more sophisticated set of indices is applied then those set out above would be appropriate?

This seems a reasonable suggestion. Depending on the approach adopted for splitting out multi-asset credit funds, it will be important to ensure there are appropriate indices available for those assets classes (e.g. if the look-through approach includes other asset classes such as loans or emerging market debt, would there be additional roll-forward indices or would these be aggregate into other categories?).

• If you favour an intermediate approach between the two approaches we have outlined, for which of the proposed asset classes would separate indices be beneficial??

Including indices to more accurately roll-forward the bond exposures is likely to have most significant impact, given the de-risking of pension scheme which is highlighted.

Some of the indices you have included in the more sophisticated option are readily available – in particular the short/medium/long term gilt indices. We would suggest where the index is readily available then a more granular breakdown should be used, but where it is not a simplified approach should be maintained.