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**DB Funding Code Team  
Regulatory Policy Advice and Analysis Directorate  
The Pensions Regulator  
Napier House  
Trafalgar Place  
Brighton BN1 4DW**

Submitted via email to: [db.consultation@tpr.gov.uk](mailto:db.consultation@tpr.gov.uk)

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

BlackRock<sup>1</sup> is pleased to have the opportunity to respond to the consultation on the DB Funding Code, issued by the Pensions Regulator ('TPR').

BlackRock manages the pension savings of over 11 million people in the UK. Our investment approach is rooted in our fiduciary duty: we start with our client's objectives, we seek the best risk adjusted returns, and we underpin our work with research, data, and analytics.

We welcome the opportunity to comment on the issues raised by this consultation paper and will continue to contribute to the thinking of TPR on this and other topics.

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BlackRock welcomes TPR's work on the DB Funding Code. We support the principles of the Code, the practicality of its aims and objectives, and the choice it offers to schemes.

We also agree that TPR's proposed 'twin-track' of offering both a Bespoke and Fast Track approach will help smaller DB schemes comply efficiently, while allowing other schemes the flexibility to decide what is most appropriate for them.

Most notably, we welcome the flexibility offered by the Bespoke approach, especially in regard to the discount rate; how investment risk is measured; and how the risk budget is spent. These factors allow for fully bespoke asset-liability management and we believe this approach will be welcomed across industry.

However, while we are broadly supportive of the aims and principles of the Code, there are a number of areas that we believe need further consideration, in order to make the Code most useful for schemes.

**Relevant date and significant maturity**

We note that, in line with the Department for Work and Pensions consultation on the draft regulations, maturity is being defined in the draft code as the point at which a DB scheme reaches a duration of liabilities of 12 years.

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<sup>1</sup> BlackRock is a leading provider of investment, advisory and risk management solutions, and has been active in the UK for over 50 years. Our purpose is to help more and more people experience financial well-being.

While we take no specific issue with setting the duration at 12, we believe that market sensitivities should be removed from the duration calculation. Failure to do so may result in big changes in duration based on changes in interest rates, this is unhelpful for planning purposes and could put pressure on schemes in a rising rate environment by requiring an accelerated derisking plan.

We would highlight that, fixing the maturity gate at 12, while allowing liability duration to vary with market conditions, may end up rewarding schemes based on their hedge position. It is likely that the schemes who would find it easiest to accelerate derisking plans would be the unhedged who experience rising funding levels, and those that would find it most difficult would be those that had hedged and therefore do not see a rise in funding level.

In other words, TPR could end up creating winners and losers based on schemes' decision whether to hedge, which may in some cases be due to a lack of effective governance, rather than design. This in turn, may disincentive the hedging of liability risk prudently.

With this in mind, we are supportive of the removal of the market yield curve from calculations of duration in the new Code. One way this could be done is through an undiscounted weighted average term to payment approach. Another possible solution could be that TPR publish a fixed discount rate as of the date the updated Code is published (for example, the gilt component of this discount rate could be based on a historical average of the 20-year yield, this would similarly remove the market sensitivity).

We would also suggest that TPR consider building in some form of transitional measure when the Code comes into force. Wherever the maturity gate is set, it is likely that some schemes may end up closer than they had expected or planned for. We therefore suggest that TPR builds in a transitional measure when the Code first comes into force to help schemes manage this change. This could be time limited, if TPR felt that was appropriate.

## **Ensuring alignment**

From our perspective, in order to ensure alignment across the Code, there is need to consider the interaction between the set of questions on cashflow matching, categorising assets and minimum hedge ratios versus the later points on risk management and liquidity management.

The consultation states that a scheme with 10% in growth assets will need leveraged duration to achieve the 90% goal. While this is true, we believe there are other ways to achieve the same outcome. For example, holding corporate bonds seems to meet the cashflow points under questions 3 and 4, however, this would then require a significant amount of overlay, as corporate bonds are generally substantially shorter in duration than gilts, and nominal in nature.

In addition to this, the Code does not provide much specification around how the cashflow and foreign exchange risks associated with overseas corporate bonds should be managed. Under an insurance framework there are very clear guidelines, but in this context the restrictions on cashflow matching are quite restrictive. Once a scheme moves outside of UK bonds, it would naturally introduce a number of other risks and liquidity drains which may not be immediately obvious and may be spread across different managers in the portfolio, for example if credit managers are having to do foreign exchange rate hedging.

In practical terms, this may push some fund strategies into corporate bonds plus inflation swaps, likely including a high proportion of overseas corporate bonds. There is hence a need to ensure that stress tests and liquidity tests are aligned with this setup and that schemes have good risk management and governance in place to deal with the potential stresses across the different parts of the portfolio.

## **Systemic risk considerations**

The consultation notes that LDI buffers have grown to 300-400 BPs. While this may allow a scheme to better weather future market events, this level of buffer will have an impact on returns from assets, which may increase the costs to the sponsor of funding the scheme.

We note that the schemes who are most likely to feel this impact may be those schemes with longer horizons to full funding who are more reliant on leverage. Removing leverage is not a costless decision, given the increased funding costs or increased interest rate / inflation risk that would arise for some sponsors. This is especially true for schemes with a deficit who will need to make up the shortfall through some combination of: taking increasing costs through sponsor contributions; increasing risk through reduced hedge ratios; and/or extending journey plans.

As such, if an upper limit in the region of or higher than the current market levels were to be introduced, the outcome for many schemes – in terms of increased costs to the sponsor, ability to achieve returns from other assets, and decrease funding levels – would be suboptimal, and therefore detrimental to end investors.

As a more general point, we believe that focusing on leverage alone is too narrow and that leverage, liquidity, and wider investment goals must be examined in the round. However, we agree the UK pension fund industry needs protection from excessive leverage taking and are supportive of more focus on the issue.

While we note that the issue that was observed last autumn is not the only tail risk pension schemes manage against (e.g. excessive equity falls, counterparty credit risk), we believe that it is worth having an explicit plan for managing LDI leverage, given the potential for pension actions to perpetuate a sell-off in rates.

At BlackRock, we believe our clients are best placed to make the decisions about what is most appropriate them and their beneficiaries. In line with this, we think clients should assess what portion of their notional LDI exposure should be covered by their liquid assets to protect against tail risks. For some, that may be 100% – but scheme circumstances are diverse, and so a one-size-fits-all approach would be inappropriate.

Finally, we would highlight the stress testing suggested in the consultation omits the type of leverage and liquidity stress tests that the TPR suggested in November of 2022 as a mechanism for schemes to test resilience against this tail risk. In order to ensure alignment, we would suggest that all of this stress testing is brought together under the Code, rather than having the guidance from November sit separately.

## **Fast Track Approach**

We welcome the introduction of the Fast Track approach and believe this is something that many schemes will want to make use of. With this in mind, it is crucial that the framework is most useful to schemes.

For Fast Track, the discount rate is stipulated as Gilts+0.5%, it is our view that a dynamic asset-based approach should also be permissible.

We note the need for the Fast Track to be prescriptive to aid efficiency and so cannot offer the same flexibility on discount rate as in Bespoke. To allow for this, we suggest TPR sets return assumptions per asset class, that can be used to generate an overall expected return / dynamic discount rate for a strategy that has been mapped onto TPR's asset class definitions. These could be updated quarterly, with pension funds aggregating to get the right blended rate for the scheme.

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This approach, coupled with the risk test applied to the investment strategy, would form an appropriate overall assessment of whether the scheme risk is within tolerance. For example, it would prevent schemes having a high discount rate, as that may mean they fail the investment risk test.

## **Conclusion**

We are supportive of TPR's work on the DB Funding Code and welcome the Code's aims and principles. However, it is crucial that a number of amendments are considered in order to make the Code most useful for schemes.

We welcome the opportunity to comment on the issues raised by this consultation paper and will continue to contribute to the thinking of TPR on any issues that may assist in the final outcome. We welcome further discussion on any of the points that we have raised.

Yours faithfully,

**Gavin Lewis**  
Managing Director  
Head of UK Institutional Client  
Business  
[gavin.lewis@blackrock.com](mailto:gavin.lewis@blackrock.com)

**Muirinn O'Neill**  
Vice President  
Global Public Policy Group  
[muirinn.oneill@blackrock.com](mailto:muirinn.oneill@blackrock.com)