HOUSE OF LORDS

Industry and Regulators Committee

Corrected oral evidence: The use of LDI by pension funds

Tuesday 15 November 2022

10.35 am

Watch the meeting

Members present: Lord Hollick (The Chair); Lord Agnew of Oulton; Lord Blackwell; Baroness Bowles of Berkhamsted; Lord Burns; Lord Cromwell; Baroness Donaghy; Lord Eatwell; Baroness McGregor-Smith; Lord Reay; Lord Sharkey; Baroness Taylor of Bolton.

Evidence Session No. 1 Heard in Public Questions 1 - 17

Witnesses

I: Nikhil Rathi, Chief Executive, FCA; Simon Walls, Wholesale Director—Sell Side, FCA; Charles Counsell, Chief Executive, The Pensions Regulator; Neil Bull, Investment Specialist, The Pensions Regulator.

Examination of witnesses

Nikhil Rathi, Simon Walls, Charles Counsell and Neil Bull.

Q1 **The Chair:** Good morning and welcome to this meeting to discuss LDI, an acronym that few of us knew about but many of us have now read about. I am delighted to welcome two of the key regulators in the space: Nikhil Rathi and Simon Walls from the FCA, and Charles Counsell and Neil Bull from the Pensions Regulator. I think the third leg of the stool is the Bank of England, which will shortly appear in front of the Economic Affairs Committee. I thank you all for your responses to the letter that Lord Bridges and I sent you; they have been very helpful.

It would be helpful if you could just set the scene because, as it says in the title of our committee, obviously we are particularly interested in the regulation of the pension market, including where the strengths of, and possibly gaps in, that regulation lie. I invite Nikhil to start. Could you explain what part of the pension market you regulate and how you go about that regulation? As a secondary question to you both, how do you liaise with one another to ensure that there are no gaps through which things can fall? Nikhil, over to you.

Nikhil Rathi: Thank you for the invitation to engage with the committee this morning. From the FCA's perspective, specifically with respect to pensions, our regulatory focus is defined contribution pensions; Charles can talk about the broader role of the Pensions Regulator.

Looking at the LDI chain, there are various parties in that chain, which we covered in our letter to you. Specifically, we supervise investment managers who were delegated investment management responsibility from the funds, which are typically domiciled in overseas jurisdictions—most prominently Ireland and Luxembourg—with their management delegated back to managers based in the UK.

We also supervise, jointly with the PRA, bank counterparties. The PRA looks after solvency and liquidity while we look after conduct risk. Bank counterparties were obviously central to this, not just in terms of those that were providing leverage but also the custodians. When we come to talk about the episode in September, we can talk about some of the stresses and strains seen in that part of the market as well.

The Chair: On liaison, who are you most hand in glove with, or is it shared between the three of you?

Nikhil Rathi: For nearly all the major issues, we deal with them in partnership with a range of different regulatory partners. We have a common framework with the Pensions Regulator for the regulation of the pensions industry; we have worked together on issues such as fair value and tackling scams, for example. We also work with the PRA and the Bank of England more generally through the FPC. Then, of course, there is international co-operation through the MoUs with our European counterparts, which evolved as we left the European Union.

Charles Counsell: Thank you for inviting me this morning. Our role is to regulate DB and DC pension schemes that are trust-based. The DB universe is, in effect, regulated by us. We do that by regulating the trustees of the schemes, and the trustees, if you like, act as the first line of defence. And they have a fiduciary duty on behalf of the members of the scheme. Our focus is typically around governance, it's around risk and ensuring that trustees comply with relevant legislation.

In terms of our objectives, what we are trying to do is ensure that DB schemes are fully funded so that, when the members of the DB schemes come to retire, that they get the full benefits that have been promised by the employer to that scheme. Equally, as part of our statutory objectives, we have an objective to protect the Pension Protection Fund. It is an important part of the framework because, where an employer does not survive the full course or a scheme is not fully funded, it provides a lifeboat and benefits up to a certain level—a pretty good level. That framework was put in place through the 2004 Pension Schemes Act.

On investments, we do not direct trustees about where to invest and where not to invest. What we do expect trustees to do, particularly in schemes that are above a certain size, is to have a statement of investment principles, which they should agree with their sponsoring employer. And then they would engage investment managers to advise them on their investment strategy and, indeed, what to invest in, in line with that statement of investment principles.

I think it is worth just saying for a moment that, just talking about LDIs which clearly form part of the investments that DB schemes have had and we think that about 60% of DB schemes have invested in LDIs in one form or another. What has happened over the course of the period that LDIs have been in existence is an improvement in funding levels. What LDIs have done is they have helped pension schemes get through things such as the financial crisis and the Covid crisis. If you look at the overall figures, you will see that funding levels between 2012 and 2021 rose from 83% on aggregate to 108%. Since then, to September this year, they rose again on aggregate to 135%.

The Chair: Is that as a result of the much higher discount rate that is being applied?

Charles Counsell: That's because of bond yield rises, that is right. I should say that LDIs form a part of that; I am not for one moment suggesting that LDIs are the only thing that have contributed to that.

On the second part of your question, as Nikhil has said, we work closely together. Collaboration is really important to us as a regulator, and we recognise that we need to collaborate with other members of the regulatory community. Nikhil has used some examples, on which I absolutely agree with him on those examples.

We also work with other regulators as part of what is called the wider implications framework, and the purpose of that is to ensure that, where

we see things happening where there might be implications for other parts of the financial regulatory community, we discuss and agree approaches to how we will address those wider implications.

The Chair: Between the two of you, you cover pension fund advisers, pension fund trustees, and those who run LDIs and other pools that pensions invest in. Which of you—perhaps it is both of you—engages with the sponsoring company? The ultimate guarantor of meeting a pension promise lies with the company. As long as the company is solvent, that is a liability that it must honour. How do you liaise with the companies, which are the ultimate underwriters of these schemes?

Charles Counsell: Broadly that's our role, to do that. We do that typically through trustees, who act as a first line of defence. We would expect trustees to be having the relevant conversations with the sponsoring employer.

We engage directly where we feel we have a need to engage directly , and, in particular, there are a few circumstances in where we will do that. For example, if a company is in difficulty—it may be going insolvent or there may be a takeover—we would want to work with the trustees, sometimes directly, to ensure that the pension scheme is protected through the insolvency or takeover. Using the example of a takeover, if a third party is coming in to take over the employer that is the sponsor of that pension scheme, we would want to ensure that the funding levels or funding guarantees stay in place through that, and that the cash is not syphoned off into the new employer.

The Chair: The pension trustees are an independent body, separate from the company, so do you liaise with the company through the trustees or also with the company itself?

Charles Counsell: Typically it is through the trustees, sometimes it is direct with the company itself. Clearly one of the things that we are alive to is the potential risk of conflicts of interest, because it is sometimes true that the trustees will have been, or are, employees of the company. That is typically not the case, so we typically liaise directly with the trustees.

The Chair: When you look at a pension fund and assess its solvency, strength and ability to withstand fluctuations in the market, do you also look at the company's balance sheet to see whether it has the financial strength to stand behind it and honour those pension promises in a very volatile market?

Charles Counsell: We can do, and we occasionally do, but we would typically expect the trustees to focus on it.

The Chair: You have explained how you work together. One comment that rather surprised us, which came almost immediately after the events of 23 and 24 September, was attributed in the papers to the Bank of England. It said that Threadneedle Street—the Bank—suggested that the

FCA and the Pensions Regulator had "failed to crack down on risky investment strategies". That does not sound like a happy group of regulators. Were you surprised at this criticism?

Charles Counsell: It is worth going back to the events that happened at the end of September. What we had collectively looked at is the degree to which pension schemes and LDI funds would be able to withstand a shock be able to withstand increases in bond yields. Typically, that meant testing it to something like 100 basis points. What happened was an increase in bond yields much greater than that; it was about 150 basis points in less than three days, which was an extraordinary shock. It was much broader than anything that we had expected, beyond what we thought was reasonably plausible.

Lord Agnew of Oulton: Is that credible? We have known for at least a year that interest rates were going to rise dramatically; we have watched the Fed pushing them up at the most aggressive rate in 40 years. I know it is easy to sit here with hindsight, but why were you so complacent about the very small rise that you anticipated?

Charles Counsell: It is the speed of rise that sits at the heart of this. You are quite right, bond yields had been going up—by something like 200 basis points—through the year, and we were clearly aware of that. But it was not the fact that they were going up that caused the liquidity problems that sat within the funds; it was the speed at which they did so over that very short period of time. That was the real difference between what we had seen in the lead-up and what actually happened.

The Chair: I return to the Bank of England's criticism, which must have come as a bit of a surprise. Have the two of you and the Bank sat down to discuss quite what lay behind its very public criticism?

Nikhil Rathi: In the article you mentioned, there is a difference between the headline and what was said in the note of the Financial Policy Committee, on which I sit on. The note talked about the need for regulators to work together on increased standards in the future. I am not sure that the text of that particular headline was actually in the statement of the FPC.

Weekly meetings are going on at the moment across the regulators and with the Treasury. I am happy to talk through what we were doing on the investment manager side of things, since March this year. As Lord Agnew said, the timing cycle started—

The Chair: We will come to that.

Lord Burns: What was the result of that stress test of the rise of 100 basis points, and what did it tell you about the position? Why do another 50 basis points make so much difference?

Charles Counsell: In the guidance we give to pension schemes, we expect them to carry out relevant stress tests. The 2018 report from the Bank of England asked for further detail of what was going on within

pension schemes. We then carried out a survey of pension schemes in 2019, and our conclusion was that schemes were well diversified and actively monitoring the risks with respect to leverage and liquidity. Given what we thought was plausibly foreseeable that seemed right.

Lord Burns: Just to be clear, are you saying that you felt comfortable with the stress test of a very rapid rise of 100 basis points?

Charles Counsell: I think that is right. It may be worth asking Neil to talk about the mechanics of why the speed makes such a difference.

Neil Bull: Before I do, I will introduce myself. I am the investment consultant at the regulator. Prior to that, I was at a multinational, working on LDI, not only in the UK but in the US and Europe. Perhaps we could come back to that later.

Charles is right: creating a liquidity buffer, which is what this is about, is about making sure that schemes have sufficient liquidity to withstand a sharp increase in bond yields. What actually happened was that we almost got the worst of both worlds: bond yields had already been going up quite substantially—you referenced that in your question—and, on top of that, there was an additional very short, sharp increase as well. As Charles said, it was outside the realms of plausibility. It did not help that this was on the back of an existing increase in bond yields. I think the schemes would have been able to deal with those increases in bond yields, even the sharp ones, had they happened over a period of months; it is just that they happened in a matter of days.

Baroness Bowles of Berkhamsted: You talked about the stress tests, but when did they start? Did they start only in 2018, after the Financial Stability Board flagged up that there were issues? Were those stress tests of the base line plus spikes? Why did you stress test only to what was plausible? When I have done things with banks and other places, they have stress tested to destruction, at least internally. Did you know what the destruction point was?

Charles Counsell: As for when the stress tests were started, we issued our investment guidance in 2017 and we referred to stress tests in that guidance. I should be clear that what we were asking was that pension schemes carried out stress tests; it was not a stress test that we carried out but one that we expected pension schemes to carry out.

To the point about reasonable plausibility, it is sometimes difficult as a regulator the degree to which you can put a burden on your regulated community. The more that we ask them to do, the more the burden rises. So there is always a balance of risks, and we believe that that was the right balance.

Despite the fact that, as I said, it was beyond reasonable plausibility, clearly it happened—there is no getting away from that—and now we need to look at what lessons need to be learned and what we need to change as a consequence of that.

Nikhil Rathi: To add to that, when the interest rate cycle starts to turn—Simon might want to come in on this—obviously the pension funds are the ultimate consumers of these products. We were working on looking at how the managers would cope with rises. We looked at that through March to September, and 150 basis points seemed fine.

You have heard what has been described about the speed of the movement but, on your point about the lessons coming out of this, what we did not do as a system—and there are many different players in the system, both here and overseas—was think about what the reverse stress test is and how the system would cope if we saw something very dramatic, which in the end we did, beyond any historical precedent. There are definitely things that we will want to take away for the future regarding how we think about that.

There is always going to be a judgment about what buffer to take. Now there are some funds that have 300 to 400 basis point buffers, and they are worried about the cash drag that comes from holding that much cash in an inflationary environment. There is always going to be a judgment about that, and there is a trade-off between the amount of cash that you hold versus what is available to invest in other assets and growth.

The more fundamental point coming out of this is the resilience of the system when events like this happen. In the banking sector we have a stress test, but then we have a resolution regime. We require detailed planning: if you blow through the stress test, how would the system cope and how would you fail? That work needs to be done in the non-banking space, not just by pension funds but across the non-bank arena, as leverage has moved since 2008 from the banking system into the non-banking system. How do we cope with failures?

That is the context that we are dealing with right now, where government bond markets—not just ours but other government bond markets around the world—are much less liquid, particularly at the long end of the curve. Assumptions that may have existed 15 years ago about the ability to sell collateral at scale, whether gilts or US Treasuries, do not necessarily hold in the same way today, and monetary policy is also unwinding.

We saw in the episode in September that not all parts of the system performed as we would have wanted them to. There were clearly gaps in capability and competence among some of the investors and there were clearly gaps among some of the investment consultants. We believe they should be regulated, which they are not at the moment. Some of the custodians were struggling through manual processing with the majority of the volume of transactions that they were having to deal with. All of these are issues that we will want to take forward for the future, recognising that the scale and speed of what happened was extraordinary.

Baroness Bowles of Berkhamsted: So in fact stress on things further down the chain was not actually part of the stress testing for 100 basis points. You did not stress test the custodians.

Nikhil Rathi: I think it is correct to say that. We also need to look at the structures of some of these funds. A lot of pooled funds, which are typically used by smaller pension funds, perhaps do not have the financial acumen to understand what is happening here, particularly when it is overlaid with derivatives. If you are buying a product like that then you need to have the governance and decision-making in place to move very quickly when the markets move incredibly fast. Some of them have terms that would allow for cash to be called, but in 10 days. That does not work in an environment where things are moving very fast intra-day. On 28 September we had an intra-day movement of gilts of 127 basis points—a staggeringly large intra-day range of movement. There is a question there. I think some of the managers are doing some soul-searching now as to whether that is a product that they think is going to be available in future in the way that it has been historically.

Q2 **Lord Eatwell:** I must say that listening to this reminds me of John Meriwether saying, "Nobody told us this could happen", after Long-Term Capital Management collapsed. What you seem to be saying is, "Nobody told us this could happen".

Ever since 2007-08, we have been very much aware that systemic risk is something quite different from ensuring that individual units are safe. This was obviously a systemic event. I was struck by the fact that, when referring to the chain, Mr Rathi said, "Of course there is liquidity and insolvency risk but we do not do that; we do conduct risk". When Mr Counsell told us what the Pensions Regulator did, there was no mention of systemic risk. If you look at your statutory responsibilities, you will find that it does not come into it at all. So was it after the *Financial Stability Report November 2018* that that actually fell through the cracks? It was not the FCA's perceived responsibility or the Pension Regulator's to deal with systemic risk, while the PRA, for whatever reason, was not focused on the systemic risks arising in the pensions sector. Is that what happened?

Nikhil Rathi: I would say that we all have a responsibility to contribute to the management of systemic risk. Obviously the Financial Policy Committee has oversight of that in our system but we should all be contributing data and contributing to those discussions. Extensive work was going on in the regulatory space on non-bank finance.

To your question, which I think is a fair one, this particular risk, this vulnerability, did not receive the attention that other systemic risks did. The systemic risks that we have been focused on in the last year or 18 months are energy markets, cyber resilience and sanctions risk. Sanctions risk has occupied a huge amount of our resource; we put the biggest regulatory burden on the financial services industry for a very long time because of the speed and pace at which we implemented sanctions, which caused all kinds of disturbances.

It is correct to say that, although it is not that this issue was not on the radar, the particular scenario of a 250-basis-point move in the space of five days in index-linked gilts—which has just never happened in our

history—was not tested for. We are dealing with a situation where markets are really fragile right now; there are black swan events, or once-in-100-year events, happening every few months. It is important for us to test, across the system, how, if something crystallises that we just have not thought of, the system would cope. We are testing for failure. The point about resolution regimes is a really important one coming out of this for all of us.

Lord Eatwell: Could you sketch the work that is going to be done? Is any work going to be done on this by the Pensions Regulator, or are you essentially providing data to the FCA and the PRA?

Charles Counsell: For all of us, there is work to be done to look at the regime. The immediate work, and Nikhil has referred to this, needs to focus on the degree to which there is sufficient collateral in the system to be able to support shocks such as this. We are working alongside the FCA to consider whether we should make a statement to the LDI funds and to pension schemes that operate segregated arrangements about the level of collateral that we expect them to keep, which would mean that there is a stronger buffer in the event of very sharp bond yield movements than there was before this event happened. That is one change that we will make.

The second is that, on reflection, we did not have as much data on this as perhaps we would like to have. In the last two or three years, the organisation has been very focused on improving the data that we have and the data that we collect from pension schemes and others. This is clearly an area of real focus.

We have already started that. We had already started that. We conducted a consultation last year alongside the PPF to look at asset breakdown from pension schemes in much more detail than we have ever looked at it before. That new data collection will be coming in during 2023, and we will look at whether we need to go further with data collection, so that we can work on the systematic risks together.

Lord Eatwell: I was struck that you prefaced your remarks by saying you would look at the amount of collateral that must be held. Are you even considering whether the instrument is suitable at all? I am reminded of 2007-08 and the role of credit derivatives. Blythe Masters said she designed a Ferrari and they gave it to people without a driving licence. Is this instrument a Ferrari that is being given to people without a driving licence?

Charles Counsell: We need to look at the whole regulatory system. Nikhil has already referred to the regulation of investment managers. To expand on something else he said, there is a question around the governance of pension schemes themselves. We need to remember that about a third of all DB pension schemes have fewer than 100 members, so there was an issue with the speed of decision-making. The majority of those, if they are in LDIs at all, will be in pooled funds.

That said, I would not like to say that that is true across the pension system. Many pension schemes are being run by incredibly capable trustees, which was evident during the Bank of England's intervention from the conversations that I was having with some of the larger pension schemes and the professional trustees who were dealing with this across multiple schemes.

Lord Cromwell: Can I just get this clear? Is it the two regulators' view that LDI is fine and not the problem but that cash is the only acceptable collateral?

Charles Counsell: Let me start on that. It would worry me if we removed schemes' ability to hedge interest rates and inflation. LDIs have been a useful vehicle in schemes' ability to hedge. If you take out LDIs, that vehicle has gone, and that is not without cost. Without hedges, you are at risk of interest rates falling and, equally, the reverse. Hedges serve a purpose.

Equally, LDIs themselves need collateral as support when there is a call on a scheme. The more schemes put as collateral, the more collateral they have, but that again has a cost in the ability of the scheme to be fully funded, which is ultimately what we want. To go back to the question, the ability of a scheme to hedge is really important.

Lord Cromwell: Just to be clear, the basic point is that LDI is not the problem and limited types of collateral are acceptable. If we started using gilts or equities as collateral, would that solve the problem?

Nikhil Rathi: Building on the previous question, I would split the work we need to do now into short-term work and more medium-term reflections. We have to be careful when making judgments in the heat of the moment, but there is something in your question that requires deeper examination.

Charles talked about data, and there is a huge amount of work we have to do on data reporting and data gathering. We are dealing with funds that are domiciled overseas and we have residual EU law. We get the data on a one-month lag and, as the legislation comes through Parliament, we look to adjust our templates. We can make ad hoc data requests, but they can be quite burdensome on the industry. Our principles of fund supervision are principles of deference so, if we believe an overseas domicile is broadly equivalent, those funds can come into our market, unless the Treasury imposes additional rules on top.

I think Baroness Bowles will be familiar with the framework that has been established there, but we are now in a world in which we will want more data, on a consistent basis, but in a way that works appropriately for the industry. The banking supervisors will do the same because, at the height of this, if it had gone wrong, the banks and counterparties that were providing the leverage would have been left with gilts and, potentially, losses of tens of billions of pounds. The way they monitor concentration, liquidity and margin is going to be incredibly important.

I have talked about the pipes. On your point about different collateral, some funds were not able to move quickly enough to provide different types of collateral to their counterparties because the technicalities—governance and decision-making—were just not working quickly enough.

That brings us to the more medium term and whether the particular structure of these funds will be right in the future. There is an inability to move assets that are outside the LDI mandate into the LDI mandate to manage the risk. That is one question that we will have to look at carefully.

This is more TPR's territory than ours, but there is clearly a conversation going on about insurance buyouts and whether they are for a portion of funds or whether smaller funds are more appropriate. The professionalisation of the industry, in terms of professional trustees and consolidation, also needs to be put on the table. I do not want to jump to a conclusion on that, because there is a cost to it. If pension funds are not able to invest as much in growth and other assets—equities and other alternative assets—the deficit will ultimately have to be funded by the corporate sponsor. That needs a bit more reflection as we work through it in the coming months.

Q3 **Lord Sharkey:** I should declare an interest as a member of the council at UCL, which is the largest employer in the UK's largest DB scheme. My question has to do with the regulatory architecture. Is the tripartite structure that we are talking about here the best approach to handle this kind of issue or problem? Is there not a case for one of the regulators taking direct oversight of the systemic risk that lies within the sector?

Charles Counsell: There are a lot of strengths in the regulatory architecture as it stands. It allows us, TPR, to have a really strong focus on DB schemes and trust-based DC schemes. In many ways, the architecture that was put in place in 2004 has delivered really quite good results. I talked about aggregate funding earlier and, in reality, aggregate funding has improved substantially over that period. I also referred earlier to the PPF, which is the lifeboat that did not exist before the 2004 Act.

We continue to look at ways that we can improve, and the Pension Schemes Act 2021 is another example of how we are improving the architecture and the powers that The Pensions Regulator has, as well as introducing the new changes with which you will be familiar, such as collective defined contribution schemes.

In that respect, the role that The Pensions Regulator plays is important. We work very closely with the FCA. Nikhil and I meet regularly and there are meetings throughout the organisation to discuss the issues that we think are most important. I also meet with the PRA, and I know Nikhil does too.

I am not sure that what happened is a case for changing the regulatory architecture. Clearly improvements can be made—both Nikhil and I have

talked about some of them already—but I am not sure that this is an argument to change the regulatory architecture.

Nikhil Rathi: To add to that, we in the FCA intersect on so many issues with so many different partners. There is a parallel debate going on about fraud and whether there should be a lead fraud regulator, where we are contributing to the work of the police and other crime agencies. My perspective is that it is our role to roll up our sleeves and contribute to solutions for the future, because nearly every complex public policy problem we are dealing with requires us to work with multiple different parties. That is why I alluded to the work we do on the FPC because, ultimately, that is where all this intelligence and analysis should be corralled to document where we think the biggest vulnerabilities and risks are.

Ultimately, this did not come right to the top of the radar. We were really focusing our energy on many other systemic risks, as has been documented. There has not been a shortage of systemic risks in the last year to 18 months, and we clearly need to think about that to make sure we capture some of these issues more systematically in the future.

Lord Sharkey: Is it not the case that, in the 2018 stress test, the Bank noted that there was more work to be done here? It is not clear whose responsibility it is to drive that.

Charles Counsell: We picked up on that report and did a number of things as a consequence. The first was to carry out research to look at the degree to which there were risks here. As I said earlier, the conclusion of that work was that schemes were monitoring the risks that were apparent.

Since then, we have done a number of other things. We updated our investment guidance to trustees in 2019 and we issued two annual funding statements, in 2021 and 2022. Those are a big deal for us, because they set out our expectations for funding across the DB scheme universe. On both of those occasions, we talked about liquidity and leverage risks. We used a variety of other mechanisms to get the message out to trustees, including social media. As I said earlier, a lot of DB pension schemes are small, and it is therefore important to find accessible ways for them to hear the same messages.

Lord Sharkey: Nikhil, do you have anything to add to that?

Nikhil Rathi: May I pass that to Simon?

Simon Walls: Good morning to the committee. I am the director of wholesale sell-side at the FCA but, more relevantly to the committee, I was also the interim director of wholesale buy-side during this period.

We certainly participated and were involved in the work following the *Financial Stability Report*. We were involved in the discussions with LDI managers seeking to assess the size of the buffers they used. The 100 basis points came from the buffers that they were using at that time.

In 2018, we also picked up some idiosyncratic issues with some of the larger managers regarding some of their operational issues. This included direct supervisory work and adding firms to our watch-list to draw attention to some of the operational challenges they were having. Generally, they were making errors because of processing issues and then compensating the fund. We said that this could cause problems.

In March this year, as the macro environment changed, we could see a high likelihood of rate expectations rising. We went out again and spoke to funds about how they had been coping while that was occurring. Generally, funds had been managing it well. As we spoke about earlier, the vulnerabilities in these strategies are to do with size of move and speed. In March, and we followed this up in July, although we had the size, there was no speed for those moves, so the buffers were generally maintained or increased. We were seeing buffers of around 125 to 150 basis points at that time.

However, we continued to probe on both size and speed. During that work, we oversaw some improvements in some of the bigger funds in their ability to call money from the underlying pension funds at short notice. That was helpful in this period, but there are a lot more lessons to learn, because we did this on a sample basis. This episode has given us a lot of operational areas to look at in trying to reduce the lag.

Generally, these funds were designed for calm times. They gave pension trustees a week or, in some extreme cases, two weeks to provide money in the event of fast moves. This would generally be okay, but was proven wanting here. We saw a number of funds make emergency changes, which we want to make sure are embedded in the future.

Nikhil Rathi: Since 2018, we and the Bank have been working very intensively with our international counterparts on the international regulatory reform of non-bank finance. In 2020, we saw issues with money market funds and property funds. We do not supervise most of these funds; they do not have leverage caps or leverage rules, and they are supervised in other jurisdictions. We have been working very intensively to secure international agreement, so that there is a cross-border strengthening of resilience here, through the Financial Stability Board and the G20. That is hard-going; it is taking time to get agreement and get it executed in all the different jurisdictions.

Lord Sharkey: I hear the list of things that you have done and are doing, but cannot help wonder whether a guiding mind behind all this would be a useful addition to the architecture.

Charles Counsell: As with everything, it is something to consider.

Q4 **Lord Burns:** Some of the experts we have spoken to are clear that TPR has encouraged DB pension schemes to use LDIs. How do you respond to that view?

Charles Counsell: First, we do not dictate to pension schemes what their investment strategies should be. We do not believe that is the right

thing to do; they should be scheme specific. That said, we have encouraged schemes to understand the risks, particularly to their funding, and to consider ways to improve their funding. That includes the use of hedging against interest rates and inflation. The degree to which we are concerned about the risk in investment strategies depends on the strength of the underlying employer and the employer covenant. We have encouraged schemes to manage that risk very carefully.

As I said earlier, we expect all schemes to have a statement of investment principles in place and to agree it with their sponsoring employer, and then to take advice on their investment strategy and the investments they make through that strategy, making sure that at all times it plays back to the statement of investment principles.

Lord Burns: Given that so many pension funds went down this route, everyone must have gained the very strong impression that you were very happy with this strategy and their ways of dealing with these risks. Are you quite happy that you encouraged the use of LDIs?

Charles Counsell: I think we absolutely encouraged the use of hedging strategies, and LDIs are a key part of that.

Lord Burns: They were so widespread. I have been involved in the regulatory business and one knows when the regulators are content for certain strategies and activities to be pursued. That you had been watching this and seeing it happen could easily have been interpreted as you being quite content with this.

Charles Counsell: I think that is fair. It is also fair that we were encouraging pension schemes to consider the associated risks of LDIs. Neil, do you want to add anything to that?

Neil Bull: Perhaps I will reflect on my experience. I teed myself up earlier when I talked about my previous work in a multinational, looking at LDI not only in the UK but in other countries. Two good examples are the US and the Netherlands, both of which clearly have different regulatory regimes and different nuances to their liabilities. But, at their heart, they are both exposed to the risks of inflation and interest rates. In both regimes, when I worked on this, using LDI in the pension funds was a useful tool to help with that risk, hedging a degree of the interest rate and inflation exposure. I wanted to give that international flavour to the LDI concept.

Lord Burns: I will go further and ask to what extent the FCA oversees the investment strategies used by the asset managers. Do you get involved in this space?

Nikhil Rathi: We generally do not seek to micromanage investment strategies that are provided by investment managers because, as I said, they are delegated from funds that are domiciled elsewhere. There is an important point here, which comes up in a number of debates, on the level of protection for different investors. Typically, pension funds and

institutional investors are treated as professionals—they have access to advice and resources to make investment decisions. We have typically not sought to put effectively retail-style investor protection measures into the institutional and wholesale market.

Having said that, this experience has shown us that, where a number of investment managers are offering a particular investment strategy, they need to make sure that they understand the operational issues that may arise, in terms of both the intermediaries that they use and their customers. I referred earlier to soul-searching on the part of some investment managers. Notwithstanding that they may have been professional investors, it is not obvious that they had the financial acumen to manage some of the products that were ultimately sold to them. The documents, and I have read some of them, all clearly said, "You could lose 100% of your money in a time of stress"; people were signing up to that. The question is: did they understand what would actually happen in a time of stress, and were they prepared for it? We are all reflecting on that.

Simon Walls: I will introduce one more point. People normally use two different types of structures for LDI. Segregated mandates cover about 85% of the assets under management, where the pension trustee and their consultants say what they want the pool to do and it is just for them. Here, the fund manager's job is just to do that. The remaining 15% of the market has pooled structures, where there is no possibility of that level of dialogue because there are many different investors. So the manager says, "This is my model portfolio, and you can choose how much leverage you want for it". Some pooled funds have no leverage and some have two times leverage—they do not use the term "leverage" but instead talk about duration—and the trustees are able to choose from among them. Because that is so clearly stated, and because the UK manager in this case just gets given the instruction from the Luxembourg, Irish or other overseas fund, our principal intention in supervising and overseeing them is seeing whether they can deliver what they say they will.

Although we look at the MiFID manager's governance, conflicts of interest or operational side, when we get down to the fund level we are really asking, "Are they set up to deliver what they say they will?" We are not second-guessing what they say they will do, just as we would not for Mexican equities, US small cap or whatever it is that they tell their customers they will invest in.

Lord Burns: On the extent to which LDI funds escape your oversight because they are domiciled overseas, you implied earlier that this has not been an issue. Do you think that it is?

Nikhil Rathi: We have a deference or equivalence regime where, once a jurisdiction is deemed equivalent, its funds can be marketed into our jurisdiction. Certainly, in the approach that we will take in the future—because of not just this experience but others—the intensity of the supervision of UK-domiciled funds will increase, in terms of the data that

we collect and so on. Time will tell whether that approach will be the same in some of the other major fund domiciles around the world. We certainly co-operate, but there is probably a more reactive rather than proactive approach to fund supervision. That is why I alluded to the non-bank finance work that we are doing through the G20. Because these markets are so interconnected around the world, we need everyone—all the major jurisdictions—to move together as far as possible in order to move forward on this. On fund domicile, we in the UK are a pretty small part of the overall global pie.

Simon Walls: We take more things as given for an overseas fund. Technically, the alternative investment fund manager is also based overseas and delegates to the UK manager. We will generally ask the UK manager what they have been asked to do, and those prior elements, including the duration, leverage and intention of the fund, will already have been agreed and stated in the fund prospectus overseen overseas.

Lord Burns: We talked to some investment managers and asked the advisers to the trustees whether they had given any notion to the trustees about some of the systemic risks that were involved in what they were up to. To what extent do you think that those advisers have not quite served the purpose that was hoped?

Nikhil Rathi: We have been very clear on the record, in 2018 and again in 2020 and 2021, that investment consultants should be brought into the regulatory perimeter. The Competition and Markets Authority published a study at the end of 2018, and we supported its recommendations. The perimeter is a matter for government and Parliament, but we have made our position on it clear.

Why have we been concerned about it? First, we do not believe that pension funds have necessarily had the ability to compare performance or qualities of disclosures; how can they assess fees? There has also been a nagging concern about conflicts of interest within the investment consultancy model. To what extent are they using their privileged position with pension schemes to potentially steer them towards other services that they may provide? We therefore thought that the regulatory umbrella would be valuable; it is a core part of the chain. Parts of groups may be regulated, but that activity is not subject to regulatory oversight at the moment.

Lord Blackwell: I challenge your underlying proposition that LDI, particularly leveraged LDI, is in the interests of pension funds and their pensioners. In some of our discussions it has been put to us that it is effectively a one-way bet on interest rates falling. If they do, you are protected against that, but if they rise, as they have done, the pension fund suffers a real loss. The way that you, pension trustees and companies look at it, that is offset by the reduction in the value of the liabilities from a higher interest rate. But that does not avoid the fact that the absolute value of the pension fund has lost money, and the pensioners are losing out.

Charles Counsell: I will pass that to Neil.

Neil Bull: If you invest in a matching asset, such as bonds—we will get on to LDI in a second—that tries to match the cash flow. Increasingly, a number of pension schemes are doing that because they are mature and closed, so they want to create some investments that mirror their liability cash flows. Bonds are an ideal investment for that.

In a market rate of discount, when bond yields go up, the value of bonds goes down, but, as you correctly say, the value of liabilities goes down as well. For our scheme funding arrangements and regime in the UK, and in the other countries that I mentioned, the important point is to invest in a way that means that the assets and liabilities move in lockstep. LDI is a tool that helps pension schemes to do that, perhaps on top of investment in regular bonds.

So the fact that your assets may have fallen or increased is, I would argue, less relevant than whether the funding level of the pension scheme—or the deficit or surplus, I suppose—has changed. That is really what matters. Ultimately, that is important for saver and member protection, because it is important that schemes do not have a deficit or create a deficit through investment returns. Being able to protect against that happening from market movements is really important.

If I may, I will address your other question about the one-way bet on LDI. I would not characterise it as that. As I say, I think LDI is a useful tool to provide for assets moving in line with liabilities. When bond yields fall, assets and liabilities go up. It is true to say that when bond yields increase, assets and liabilities go down. It is about trying to create that lockstep movement and focusing on the funding gap.

Q5 **Baroness McGregor-Smith:** From what you are saying, LDI and leveraged LDI will still be a big part of the regulatory oversight going forward, but what does that really mean? Nikhil, you talk about gathering more data, and Charles, you say that we may have to have more cash in pension schemes. What does that really mean for pension deficits or surpluses in the future? What is your thinking on that?

What does that really mean for companies? We are about to hit a period of potentially prolonged recession. Corporates are not going to have the money and will push back, quite rightly, on funding strategies and what may well change from your regulatory oversight. You talk about LDIs and leveraged LDIs still being okay, but what is this really going to mean? If I am a trustee, what is the Pensions Regulator going to say to me? Are you going to say that you do or do not like leveraged LDI for this amount? What is going to change, really?

Charles Counsell: There are a few things. Over the last few months we have seen improvements in the overall funding levels of all schemes in aggregate. That means that the funding of individual schemes has risen, in effect. That means that some schemes are now in a position, which they were not before, to potentially buy out. Other schemes will be fully

funded, that were not before. From an employer perspective, that is good news.

There is a question that we need to work our way through around the degree to which we wish to encourage schemes to lock those benefits in. It is not always absolutely the right thing to do but in many cases it is the right thing to do. In terms of the employer burden, that is positive.

There is a higher level of collateral sitting available for the LDI arrangements. That means that schemes are less able to invest in other things. That is a risk. In the end, this is a balance of risks. There is no risk-free system that will enable us to create fully funded pension schemes. Risk needs to be taken. The question is where you place that risk.

Ultimately, it is the employer who has made the promises and so the employer must pay the contributions. However, what we are trying to do is create a system that puts a fair amount of burden on the employer and creates the right levels of investment returns in order to ultimately get to a place where the schemes are fully funded.

Baroness McGregor-Smith: On your point that more schemes are in a better position today, how quickly can that change? We are basing everything on what we see today, but that could change again quite rapidly, could it not?

Neil Bull: You are quite right that it could. An increase in bond yields generally pushes the value of liabilities down. If that is pushed down by more than the value of assets, you are in a better position for funding. If bond yields were now to go back to where they were at the beginning of the year—a much lower level—and nothing else had changed, you might go back to the funding level position of the schemes then, which was not in a bad place but was not as good as it is now, as Charles said.

That raises an interesting point. During the time of the Bank's intervention, I saw commentators questioning whether we need to have hedging and whether it is a good idea. Of course, immediately after that we saw a fall in bond yields from nearly 5% to, I think, at the 20-year point today, around 3.7%. That is a significant fall. If you had removed your hedging at the very time you needed it, you might well have suffered. Maintaining the level of hedging was really important to a number of schemes.

On your other point, as Charles mentioned, there is no free lunch here. If you require people to have more cash and collateral, they will generally take that from their growth assets and that will lead to lower returns.

You mentioned the sponsoring employer; the final point I would make is that LDI is a very useful tool in that way. If a pension scheme wanted to remove all its interest rate and inflation risk, and LDI was not a tool it was allowed to use, it would have to invest entirely in bonds. It would not really have any available growth assets to provide those extra returns

and lessen the load on the sponsoring employer. LDIs are a useful tool for trying to maintain some growth assets in the portfolio and, at the same time, deal with the interest rate and inflation risk. As I say, that is why they have been popular not only here but in other countries with market rates of discount.

Baroness McGregor-Smith: If that is the case, will anything actually change? We are still going to encourage hedging and using the different tools. Companies will not want to put more money in unless they have to, so they will be very encouraging of strategies that can reduce risk for them. You will do some more regulatory oversight, but what is really going to change?

Nikhil Rathi: I will make one point here. Obviously, I defer to colleagues from the Pensions Regulator on pension scheme funding and the leverage that is permitted, but I think what we are going to see, and have already started to see, is that the real costs of managing liquidity and leverage will go up, in a world and an environment where, particularly in some of the major markets, liquidity is much lower than it has been historically. That will start to surface through the different parts of the chain.

I will give an example on repo haircuts for gilts. Bilateral repo counterparties may have accepted gilts as collateral with no haircut. That has been very common for sovereign debt around the world, particularly in G7 markets. During the September episode, haircuts started being applied when gilts were provided as collateral, because of the perceived risk in capital value. Sometimes haircuts of 2.5% to 8% were applied when gilts were posted as collateral. That means that the overall costs of managing collateral, liquidity and leverage will go up. Therefore, the end-users, in not just pension funds but investment funds of all types in the landscape, will need to think about how much of that hedging they want to undertake.

As I understand it, one distinction with the Netherlands is that typically its pension funds will manage around 50% of their interest rate risk through hedging; ours have typically been significantly higher than that. These are all choices that the end investors are having to make.

Q6 **Lord Reay:** In December 2019, TPR produced a leverage and liquidity survey. It looked at DB pension funds and what they were doing as far as leverage is concerned. One table showed gilts versus funding via repos with a medium leverage of over four times. Do you recognise that as representative of what was going on? Did it raise any questions for TPR, and is there an acceptance that the level may have been too high?

Neil Bull: Perhaps I can answer that one. Forgive me, because this might get a little technical, but I will try my best. On the leverage side, to give a very simple example, a very short-dated bond leveraged four times might have a much lower risk than a very long-dated bond—say, a 30-year bond—leveraged two times. It is not the leverage number per se, although people talk about leverage ratios on aggregate across the board. What is more important, I would argue, is the degree of collateral

or liquidity available to withstand a certain level of interest rate moves or increases. The parts of the report that talk about that are more useful than just a particular leverage number in isolation.

Lord Reay: In your oversight of pension schemes, do you look for information on leverage, liquidity and buffers in LDI exposures, or is that something you will do going forward?

Charles Counsell: We have not historically collected that data systematically. We are certainly considering whether we need to do so going forward. That said, we have pretty good intelligence about what is going on across schemes through our discussions with our supervisors and other means. So although we have not systematically captured it, we have pretty good intelligence about what is going on. But we need to think about whether we need to look at it systematically.

Lord Reay: Do you look at leverage in the same way as TPR? Is there a leverage rate beyond which you just do not think it is acceptable to be held in some of these funds?

Simon Walls: I agree with the way that Neil is characterising it. Looking at the duration and the buffers is probably better than looking at leverage, bluntly, because that gives you the number of basis-point moves that they can handle. It incorporates the sensitivity of the portfolio to moves and how much cash they have. We have done that on a periodic basis. In the reviews that I referred to, we have gone out to approximately 90% of the market and asked those sorts of questions.

We are doing that now. We were doing it on an intra-day basis at the height, during September. Now we are asking for systematic data weekly, but I do not think that will necessarily be a steady state. We have tens of thousands of funds and other pockets of concern to look at. As we discussed earlier, it is not the FCA's practice to second-guess the risk management of the managers. So we are looking at it weekly now, and we are looking at the buffers. It is perhaps too crude to set a buffer number that is right. We have shown that the previous buffer number was wrong, or was insufficiently prudent for the extreme events that occurred.

As Charles and Neil have set out, there is clearly a balance in setting the buffer number. There are difficult but more obvious wins on the operational side—the various mechanisms, which we referred to earlier, to reduce the time the manager of a pooled fund needs in order to call extra money from the pension trustees. There are a number of steps there. We have seen some managers manage that better through this period and we have seen managers introduce particular measures, so there is some fruitful ground there to try to reduce the vulnerability to a sharp move that happens quickly, allowing them bring money in more quickly.

We have talked about the rest of the system. There are lots of lessons for the banks and other market participants to learn. More generally, what is

extreme but plausible has changed, in this market but also anywhere else. We have expected people to risk-manage to extreme but plausible events, but there is a much wider range of things that fit into that category now—energy markets, metals markets, whatever markets. So we are horizon-scanning at other pockets that may have similar characteristics to these, where there is leverage, concentration—either within the market or in the number of players—or a lack of transparency. Although we are continuing to monitor this issue on a regular and at least weekly basis, we are also looking for the next one.

Lord Reay: Obviously there are thousands of funds out there, but I understand there are about half a dozen fund managers who control the majority of the funds. It does not seem unreasonable to get information from them on a regular basis to keep an eye on any potential systemic issues.

Nikhil Rathi: We are doing that now. We are getting information on leverage on a fairly intense and frequent basis. The leverage has been managed down fairly materially over the last few weeks.

To broaden the question out to leverage in the non-bank system more broadly, we have been working through not just the traditional visible leverage but synthetic and hidden leverage. As we have seen in some of the episodes, such as Archegos, which failed a year or so ago, or the nickel episode at the London Metal Exchange, it is often the synthetic or more opaque leverage that comes to light only after the event. It is positions that are held not just in one jurisdiction but OTC in other jurisdictions and the mixed reporting requirements that exist in other jurisdictions.

I do not want to suggest that data is the panacea, but we as an international regulatory community have to get far better at least at tracking what is going on, so that we can understand better where these big concentrations of leverage and concentrated counterparty exposures are building up. That is another phenomenon that we saw here, and you are right to point it out: the small number of concentrated managers and counterparties that were playing a role here.

Simon Walls: Perhaps I could give a little more comfort. In those weekly data, we have seen the buffers being maintained at the higher level—essentially, money not being returned as interest rates have fallen. The median buffers are between 340 and 400 basis points. Although you are quite right to talk about the concentration of firms, they manage a number of different vehicles that will have a range of different buffers within that. Buffers are materially higher than they were before this episode. Target buffers are at around 250 basis points. So a lot of resilience has been built has been built into the system through the episode, but of course the comments that TPR has introduced about those having costs are right, so we may not be at a steady state now.

Q7 **The Chair:** Your responsibility is for the resilience of the system today, tomorrow and over the next 30 years. The choice to put high leverage in

these funds has been made over the last decade or so, and there was significant surprise that there was leverage of up to nine times. It follows from this that there are some very aggressive investment management strategies out there. On the upside, they can look very attractive, but obviously on the downside they are very unattractive and put at risk the underlying stability of the pension fund.

Would it not be sensible—as you say, it is not your job to run these funds—to point out to the people who are responsible for running them, including the sponsoring company, that if they want to run a very highly leveraged capital fund, they should put capital in, so that in the event that it goes wrong the fund members are protected? Surely a responsible regulator should be looking at that as a key intervention in the event of very high leverage.

Nikhil Rathi: All these things are on the table in the discussion, including leverage caps, higher buffers, higher capital requirements—

The Chair: With respect, they have been on the table for the last 10 years.

Nikhil Rathi: We have a regulatory structure where we do not set leverage caps for funds. As I have said, those funds are authorised overseas and then they come into the market. But it is correct for us now to be thinking about whether there should be greater safeguards against leverage. I repeat: we have to get that measurement of leverage right and get into the data, because it is not just absolute leverage but synthetic and other forms of leverage obtained through derivatives and other structures that we need to make sure are captured using any tools that we—

The Chair: So it is firmly on the agenda, then?

Nikhil Rathi: It is very firmly on the agenda. The Financial Stability Board's work is very clear about this. It will be most effective if we can secure cross-border agreement and cross-border implementation.

Simon Walls: Perhaps I could make one more comment. Your example of a nine-times-levered fund allows us to illustrate the point that the very simplest pooled funds simply have gilts that they repo out and buy more gilts. They do not have anything else. Other liquid assets are, hopefully, in the pension fund itself, and at the moment they are not introduced into those simple LDI funds. So the nine times leverage will be slightly misleading, because it does not include the broad denominator that is in the pension fund.

The other point of detail is that these are limited liability funds. If we entertain a nine-times-leveraged fund, although I think that is a real outlier now, in the worst case for the pension fund—absent the systemic issues that we have been talking about today—it could actually walk away, although the money that it had put in would be lost; the prospectus says that you could easily lose 100% in the year. The knock-on consequence would be on the banks that provided the repo

arrangement. That was one of the dynamics that we were particularly concerned about in this episode, because we were worried that the banks would take the collateral and quickly seek to sell it, to add to the selling pressure.

So there is a little comfort there. In the worst case for those limited liability funds, it is not necessarily the pension fund that ends up holding the baby but the provider of the leverage. We would say that the provider of the leverage should also learn lessons from this and learn to stress-test in a much deeper way.

Q8 **Lord Agnew of Oulton:** You have made a defence for LDIs, but you did not really differentiate between vanilla LDIs and leveraged LDIs, and you have admitted that you have no data to know which funds are using leveraged LDIs. I hear the comments that nine-times leverage does not matter, but, to Lord Eatwell's point, that is a Ferrari in the hands of people, and you do not know who is driving these things or how capable they are. What is your sense of trustees' awareness of these potentially very toxic instruments, and what are you going to do about it?

Charles Counsell: To be honest, the degree to which trustees were aware of what they were investing in, I think, does vary. Broadly, we have a lot of extremely good trustees who will have been very aware and will have known exactly the right questions to ask of the LDI fund. More likely, there will have been segregated arrangements, so they will have been managing it through those arrangements.

However, the universe of pension schemes is quite broad. There are a number of very large schemes. Equally, there are a very big number of rather small ones. The degree to which the trustees of those small schemes were fully aware of what they were in is a good question. There is a broader question about the quality of the overall governance that we see in small schemes. Frankly, that has been giving us concern for many years, and that is as true in the DC world as in the DB world.

We have been pushing for a consolidation of smaller schemes, because we really worry about the degree to which the smaller schemes are sufficiently well run. We have quite a lot of evidence demonstrating that they are less likely to be well run than larger schemes. That is not to say that there are not some schemes that are well run—there are—but on balance it is true that the governance of small schemes is not as strong as that of larger schemes.

What does that mean in practice? There are two issues. First, we would like to move to a point where all schemes have got a professional trustee on their trustee board. At the moment, the reality is that"s not practical, because there are too many schemes and not enough professional trustees. So we cannot get there at the moment, but we think that has to be the right direction of travel. In order to get there, we have to have consolidation and reduce the number of schemes out there.

In the DC market, which I recognise is not really the focus today, we now have master trusts, which are well-run schemes that we have authorised so that we can have confidence that consolidation in master trusts is as safe as it can be. In the DB world, we have set up a framework for what are called superfunds, which are consolidation vehicles into which DB pension schemes can consolidate. At the moment, although we think that framework is robust, none the less it is on a voluntary basis and, frankly, that makes us nervous. For some time we have called for superfunds to be put on a statutory basis, just as master trusts are in the DC market.

Lord Agnew of Oulton: Thank you. Mr Rathi, I am slightly puzzled or even worried that twice you have referred to the leverage issue as being a global problem and therefore slightly, "Not my problem, guv". We in this country have to get our own act together. It is about transparency and about you understanding where that leverage is sitting. Let us be honest about it: leverage is essentially greed. We have all done it; we buy a house on a 5% deposit because that is how you make money, or because you cannot afford to do it otherwise. I would like your assurance that you are going to get the UK system clean and visible on this issue. Although you can have your international conferences, that will take you years.

Nikhil Rathi: I would not want to leave you with the impression that we are not very focused on this issue in the UK. We will take the steps that we need to within the UK framework, secure the visibility that we need and sensitise the market to the risks. I am simply drawing your attention to the fact that some of the products in the non-bank space more generally are global products and are marketed across jurisdictions, and we do not decide whether they are allowed in the UK. We can explain and warn about risks, but we do not take that decision.

You can see in other areas where we have taken quite robust decisions. I do not want to divert the committee too much, but we prohibited crypto derivatives in the UK, including leveraged products. We have taken quite a bit of heat for doing that—this is an interesting conversation about the secondary competitiveness objective coming into play in the regulatory framework—from people saying that we are allowing this innovative activity to move to other jurisdictions, and that other jurisdictions are stealing a march on the UK and are able to manufacture and distribute products that should be centred here.

We stand behind that decision, along with the decision about prohibiting platforms where we were concerned about money laundering that have gone to other jurisdictions. That also requires us to have parliamentary and political support when we take those robust decisions, because we will get criticised for taking a tougher line than some of our colleagues in other jurisdictions.

Lord Agnew of Oulton: That is fine, but, on the situation of leverage here, you can issue a warning notice and trustee can then minute why they are deciding not to listen to that notice. The responsibility must go back to the trustees, but you have an obligation to flag up some of these

toxic international instruments that are leaking into the system. As you say, you cannot stop them, but you can at least warn the system about them, because you will have knowledge way beyond the average pension fund trustee.

Nikhil Rathi: The responsibility for trustees is obviously with Charles, but where we see significant systemic risks, we want to call them out. At the same time—and this is an important conversation to have—what level of protection is Parliament seeking from the regulator in the institutional and wholesale investment space? To go half way in between, we have been having a debate with the Treasury about high risk investments in retail. At the moment, if you have £250,000 of assets, you can self-certify that you are sophisticated. We have been uncomfortable with that for many years, but obviously that is a legislative choice. At that point, the regulatory protections get switched off. That is in high net worth retail, before you even get to professional and institutional investors.

Lord Agnew of Oulton: Why are you uncomfortable with that? I fill those forms in on a weekly basis. I know that I am taking a risk, and I know that if it all goes wrong, I cannot come weeping to you. That is how life should be. Why do you not like that?

Nikhil Rathi: Because the revealed behaviour of mis-selling situations in mini-bonds and other markets is that many people who signed that form did not quite understand the risks they were taking. They do come back and raise concerns; often, vulnerable consumers have been coached into signing off that they are sophisticated. In the context of where assets on household balance sheets are in the UK, £250,000 would not buy you a very big pension. The suggestion that that is high net worth is something that we have suggested needs to be looked at quite carefully.

Lord Agnew of Oulton: I do not think that you are here to look after the lowest common denominator of stupidity. If you sign a letter like that, you know what you are signing; otherwise, you do not get involved.

Coming back to the whole pensions industry, I do not want to see massive overregulation of the system as a knee-jerk reaction to the past few weeks, but I do think that you are in an unrivalled position to provide transparency on this complex international financial plumbing, which they are not going to have. If you can produce warning notes for them—they have to address those as part of the minuted decisions in investment—you will be doing a much more useful job than trying just to overregulate everything. I will shut up.

The Chair: Baroness Donaghy, would you like to ask your question?

Baroness Donaghy: Am I queue-jumping?

Baroness Taylor of Bolton: You are, actually.

The Chair: You are queue-jumping, but I am conscious that Baroness Taylor has some time limits.

Q9 **Baroness Taylor of Bolton:** It is fine. I am okay for the moment, thank you. Lord Agnew mentioned overregulation. Can we perhaps mention underregulation and investment consultants? Mr Rathi mentioned them earlier, but when you, Mr Counsell, were talking about the governance of small schemes and the problems there, you hinted at the lack of financial acumen. Does that not drive people into the hands of investment consultants, who are not regulated? Perhaps there is underregulation that we should be thinking about. Mr Rathi, you implied that you would like to see some form of regulation, but you passed the buck back to Parliament and the Government to decide, rather than give us your ideas. Could you both tell us what you think should happen?

Charles Counsell: Frankly, the answer to your question is yes. Trustees must take advice on both their investment strategy and the investments they then make. Giving advice on an investment strategy is not a regulated activity. If I may be blunt, where trustees do not know the right questions to ask—there is only so much prompting you as a regulator can do—there is a risk for them.

Nikhil made the point about the regulation of the investment consultancy industry, but I go back to the point that in due course I want to see a smaller number of schemes and that they have at least one professional trustee who sits on those boards. We cannot get there yet, but that is where we need to get to, in my view.

Nikhil Rathi: I hope I have not simply passed the buck to the Government and Parliament. What I said was that we published our recommendations on investment consultants and set them out very clearly. We laid that report before Parliament and, obviously, sent it to the Government as well. I touched on some of the issues that we think could be regulated, such as quality of disclosure, comparability of fees and management of conflicts of interest. The point I was making is a factual one: the extension of our perimeter is a statutory matter and it is ultimately for the Government and Parliament, not us, to make a decision on that.

Baroness Taylor of Bolton: What vibes have you been getting back from Ministers and officials about moving in that direction?

Nikhil Rathi: My sense is that there is a significant bandwidth issue at the moment, given the volume of other issues on the agenda. There is a big piece of financial services legislation coming through, so this is not a conversation that has advanced significantly since we made our most recent recommendation.

Baroness Taylor of Bolton: Would the Pensions Regulator be willing to put more weight behind moves in this direction?

Charles Counsell: Certainly, but I agree with the comments that Nikhil has just made.

Baroness Taylor of Bolton: It is a bit depressing.

The Chair: As an independent regulator, you can say what you think is the right way of fulfilling your responsibilities, and go ahead and do it.

Nikhil Rathi: We cannot act outside the perimeter that Parliament has established for us. This point also comes up in the debate very clearly. We have heard about the overreach of regulators. We have powers to gather information from regulated entities. The scope of regulated entities is determined by Parliament. Investment consultants are formally outside that scope. There is also a question about the appropriateness of spending our money on an activity that we have not been asked to regulate, until Parliament makes a decision along those lines.

We always have that tension. We are seeing it right now with buy now, pay later services, for example. Very serious issues are arising during the cost of living crisis. We have gone a long way in trying to get data and making sure that they are protecting consumers, but it has not yet been decided formally that this comes within our perimeter.

The Chair: Do you think that you get the right level of support from the Treasury in these matters?

Nikhil Rathi: We have a healthy dialogue.

Baroness Taylor of Bolton: How far does the Pensions Regulator go in warning trustees, who you say do not have the financial acumen, that they should be very careful about using some of these investment consultants? One description is that some were verging on thuggery. If people do not have the expertise, they are very vulnerable, and if somebody comes along and says, "We can solve your problems", that is very attractive. As a regulator, what precautions do you ask people to take?

Charles Counsell: We do that by setting out guidance for trustees, and we expect them to follow it. Clearly, we cannot and would not want to stop trustees taking advice from investment consultants. They need to do that. What we can do is set out guidance, and that is what we do.

Q10 **Baroness Donaghy:** To what extent has LDI come to prominence because of changes in how current estimates of liabilities are measured rather than changes in long-term liabilities themselves? Should pension accounting move away from market-based discount rates, given that there is no interest-rate risk to actual liabilities, only estimates of their present value?

Neil Bull: Perhaps I can answer that one. There are a few strands to it. First, I go back to the fact that an awful lot of pension schemes are closed or maturing. They are moving quite rapidly towards a situation where the bulk of their membership is pensioners and they have a series of cash flows that they want to mirror in terms of the assets that they hold. That means they are moving more into bonds, as a lower-risk position, just to match those cash flows. That does not have to be just gilts; corporate bonds or indeed illiquids could form part of that. It is

right that those schemes look to a bond-market rate of discount in measuring their risk position.

Just because a scheme is measuring its risk in that way does not mean that it has to invest in that way. As we discussed earlier, schemes that are open and that have strong employer covenants might want to take quite a lot of investment risk, but the appropriate way to measure it in that scheme is with reference to those market-rate bond yields.

To set up a counterexample, if a closed, mature scheme was to invest in equities and equities had a poor run over a number of years, that scheme could get into quite a lot of difficulty, because it is paying out pensions regularly. That crystallises those losses and it is potentially difficult for the scheme to get out of that problem. That would ultimately put savers in that scheme at risk. So it is important to look at it with reference to market bond yields in this case.

Separate to that, I want to make two external points, if I may. First, many pension schemes are looking to secure their liabilities with an insurance company through a buyout. Again, buyout pricing is outside our jurisdiction, as it is set by the insurance rules, but they also use a bond yield market-driven approach. So if you are very close to achieving that goal, it makes sense to look at your liabilities through that lens as well.

Finally, there is the accounting side, which you referenced in your question. The accounting rules fall outside our remit, but it is true that many sponsoring employers, in many cases, are happy for a pension scheme to move to more bonds to help protect it against the volatility of that accountancy number, which they ultimately have to disclose to their investors.

I have tried to talk about the economic reasons and a couple of external factors as well. I close with the comment I made before that a number of other countries use market discount rates and, where they do, we have seen the use of LDIs there to hedge the appropriate level of risk.

Q11 **Baroness Donaghy:** The smaller schemes or closed schemes perhaps have a lower quality of advice, less flexibility and greater vulnerability to severe changes. I am interested in what you said about the need for a statutory requirement for, I think, consolidated funds, which are voluntary at the moment. Having been a trustee myself, as both an employee and an employer at different times, I understand that schemes are sometimes fiercely independent and do not like the idea of merging with others. To what extent would you press or have you pressed for this statutory requirement, because it seems an important move to help those smaller and more vulnerable schemes?

Charles Counsell: Quite hard, is the answer to that question. We recognise that it is complex to put something like this into practice. Over the last two or three years, we have had lots of discussions across a number of parties, including with the Government, about how this might

work and what the model might look like. In that respect, I think we are moving closer to it and what the detail looks like.

To pick up on something Nikhil said, there are a lot of priorities for the Government at the moment. I recognise that, although I think it is important to get this on a statutory footing, we are up against a lot of other priorities. This is an important vehicle going forward, and I hope we get there from a statutory perspective.

Baroness Donaghy: If we look over the next few years, this is the riskiest end of the pension market. A smaller scheme would, in essence, no longer become viable unless it nestled into a more protective area.

Charles Counsell: That depends. I go back to my earlier comment that we know that, on balance, the governance of smaller schemes is not as good as the governance of bigger schemes. That clearly introduces risk, but of course standing behind any scheme is an employer. This is not to say that all smaller pension schemes are necessarily at the riskier end, as it depends on the strength of the employer, the funding levels and the governance aspects that I talked about.

Q12 **Lord Cromwell:** There is a difficulty here that has run through our whole conversation. You have made numerous references to the difficulties with trustees' variable skills and knowledge, but repeatedly come back to how they are ultimately the guardians of the scheme. You cannot have both positions at the same time. I suspect that if we had brought a random sample of trustees in before LDI and asked them to explain it to us, none of them could have done it. If we did it today, probably only a small percentage could do it convincingly.

Quite apart from what the next problem coming is—the unknown unknowns coming down the track—your solution seems to be to slam smaller pension schemes together. They might have different companies with different objectives standing behind them, which is a whole nest of issues. Being a professional trustee is a tough job to take on. Broad knowledge will be required with the head fiercely over the parapet. Who is going to regulate that person, and will they also be regulating the investment consultants?

Charles Counsell: That is a good set of questions, so I will try to break them down. To your point about asking trustees whether they understand LDI products, I am not quite as pessimistic as you are. I have spoken to a lot of them and many of them understand the product pretty well. That said, going back to my comments, I am not saying that they all do.

The specific point about professional trustees and their regulation is a good and relevant question. Professional trustees are not regulated at the moment. We expect them to be accredited and there are two mechanisms for accreditation that we encourage professional trustees to have, but we do not have regulatory powers to insist on that.

Their regulation going forward bears thinking about. We need to consider whether there are benefits from regulating professional trustees. They

are not regulated at the moment, but it is certainly something we should closely consider.

Lord Cromwell: Would you accept that they are likely to have a close relationship with the pension consultant, because they are the two people involved who speak the language?

Charles Counsell: Do you mean the pension consultant on the investments?

Lord Cromwell: The professional trustee and the advising consultant are likely to work very closely together.

Charles Counsell: Yes, they will exactly. I spoke to quite a few professional trustees through the period of the Bank of England's intervention, and it was clear that they really understood the issues they were facing and tried to sort them out.

Q13 **Baroness Bowles of Berkhamsted:** I will move on to a few other issues, but, having listened to what you said, there seem to be a lot of self-fulfilling loops here, such as in the use of net present value introducing the concept of interest rates, which are then hedged against, and then—surprise, surprise—liabilities, as measured by net present value, move in accordance with changes in the interest rates.

There also seems to be a bit of a loop in the delegation. It starts with the trustees, who can delegate to a manager. My understanding is that there are five big managers in the UK, but they may be buying funds somewhere else. Mr Walls spoke about those funds then delegating back to the managers. Where is this delegation loop going on? When Mr Walls was talking about the buffers, he said that the 100 basis points actually came from what the funds were using, but I thought it came from stress testing following the Financial Policy Committee report. Everything seems to go in a loop, and I am not exactly satisfied.

I also find it difficult to make what is happening fit either the letter or the intent of the legislation. The UK version of IORPs—given my background, I am used to IORPs more than I am to the UK stuff—says, in Regulation 5(1), "Except as provided in paragraph (2), the trustees of a trust scheme, and a fund manager to whom any discretion has been delegated under section 34 of the 1995 Act, must not borrow money or act as a guarantor in respect of the obligations of another person where the borrowing is liable to be repaid, or liability under a guarantee is liable to be satisfied, out of the assets of the scheme". Paragraph (2) says that "Paragraph (1) does not preclude borrowing made only for the purpose of providing liquidity for the scheme and on a temporary basis". I am sure you know that very well.

Repo is central to this. I have heard people use the semantic distinction that repo is not borrowing, but the Bank of England's and the FCA's letters to us freely talk about borrowing, and the Pensions Regulator freely talks about leverage. The Oxford English Dictionary defines leverage as the use of "borrowed capital for (an investment), expecting

the profits made to be greater than the interest payable". The Cambridge English Dictionary defines it as "the act of using borrowed money to buy an investment".

So there is no doubt that, economically, you are borrowing—not you personally, but the leveraged LDIs. Therefore, whether you can slide around the precise wording or not, are you not in the position of subverting the intent of the legislation?

The important words here, from the UK transposition, are: "liable to be satisfied, out of the assets of the scheme". We have just seen some 25% of scheme assets being used to discharge liabilities that have arisen as a consequence of leveraged LDIs. So are you happy in principle that, as a regulator, you have allowed subversion of the intent of the legislation?

Charles Counsell: I will ask Neil to come in on that.

The Chair: Just plead guilty or not guilty.

Lord Cromwell: Just hand him a rope.

Neil Bull: I recognise your quotations from various regulations; they are certainly correct. I will refer to some other regulations in a moment, if that is okay, and I will summarise the argument.

It is correct that pension schemes are not allowed to borrow money except for the short-term liquidity requirements that you spoke to. But the use of LDI focuses on two types of instrument: repos, which Baroness Bowles mentioned, and swaps. These are derivative instruments that are used by pension schemes. The use of derivatives is explicitly allowed in Regulation 4(8) for "efficient portfolio management" and to reduce the risk. That is our response to that question.

Lord Agnew used the word "greed" in relation to leverage. LDI has been an incredibly useful tool over 20 years. The financial crisis was referenced, but the fact remains that, during it, schemes that had LDI would have done much better than those that did not, because bond yields fell. So it actually helped with weathering through that unpleasant situation. Covid-19 is another example of a situation where bond yields fell dramatically—

Baroness Bowles of Berkhamsted: You are talking about when there is a crash. This only helps because of liabilities going down according to the accounting treatment. In the real world, the assets are not better off. If a company goes under, the value of those assets counts very much towards what, say, the Pension Protection Fund, which you are obliged to try to defend, will get. I do not think it would be happy to get 25% less than it would have done previously, because that is the hard cash out of which pensions are paid. So we are in the funny money world because of the accounting standards. I recognise that insurance companies are, of course, also living in that world and do not care, because they look at the ratio according to net values.

You happily accepted the notion that you are sliding around with a repo

being a sale and a repurchase, not borrowing, and you think that you are allowing swaps that are for risk reduction. Well, they are not; they are risk swapping. On the size of the swaps that have been going on, your guidance gives an example suggesting or saying that trustees are perhaps told by their adviser to allocate 30% of their assets to LDI and gradually increase their allocation thereafter.

Quite often, you do a third of it and leverage two times, so you have hedged the whole of the asset—so you then have swaps covering the whole of your assets. I will pray international context too: if you asked the Netherlands regulator whether it would rely on a swap for its entire asset basis, it would say no. If you asked whether it allows repos, it would say no. So it is wrong to say that this is accepted and done in other countries that are also running, fundamentally, under the IORPs directive. So you cannot escape.

Your sliding around the principle is about the most positive light that I could give this. How confident are you that, if this went to court, the court would not make a purposive interpretation? Namely, if it looks like a duck, it is a duck, even if you have called it a chicken.

Neil Bull: You have asked a range of questions there. On the challenge on borrowing, I repeat what I said: under the regulations, derivatives are explicitly allowed.

Baroness Bowles of Berkhamsted: But repo is not a derivative.

Neil Bull: There is a healthy debate about whether repos fall into the category of derivatives or money market instruments—

Baroness Bowles of Berkhamsted: Oh, come on.

Lord Eatwell: They cannot be derivatives; they do not derive their value from anything, so the word "derivative" cannot be used. They have their own internal value that is not derived from something else.

Neil Bull: I think people would argue that it is derived from the underlying gilt, in terms of the repo transaction. Derivatives are allowed under the regulation—

Baroness Bowles of Berkhamsted: Have you heard from government that it is an interpretation? I have asked some people in government, and they said, "We didn't know that borrowing wasn't allowed".

Neil Bull: I am not sure whether this is where your question is going, but the only other category that people sometimes refer to as repos is money market instruments, which are the other way that it is defined. These are explicitly allowed in other parts of the regulations as well, so we are comfortable that the use of LDI does not equate to borrowing money.

Baroness Bowles of Berkhamsted: So are you trying to tell me that repos will be listed where the annexe defines what derivatives are? I do not recall that.

Neil Bull: I do not have that information in front of me, but I am confident that LDI is—

Charles Counsell: Would it be helpful if we came back to you on this?

The Chair: That would be helpful, because it seems pretty fundamental that there is a significant gap between what the legislation says and what is being practised. Are there any opinions from leading counsel—there is nothing other than that; all of them are leading—to support the contention that repos are not borrowing?

Charles Counsell: I will come back on that.

The Chair: Please do that, because this has been raised in a number of conversations that we have had. As Baroness Bowles said, this may be a foggy issue for Ministers as well.

Baroness Bowles of Berkhamsted: Nikhil, did you know that borrowing was not allowed? You happily use the word "borrowing" in your letters, as does the Bank of England, because that is economically correct.

Nikhil Rathi: I am not in a position to comment on that specific provision; I will need to look at it. It is clear that there was leverage and, effectively, borrowing going on in the system, so I will not try to suggest otherwise to the committee. I will wait to see what the leading opinion says on the precise technicalities of the legislation.

The Chair: We look forward to receiving that. Lord Cromwell?

Q14 **Lord Cromwell:** Thank you; just as things were getting interesting, too. Perhaps we could just stand back a bit. There is this whole drive to de-risk pensions. What or who has been behind that? Is it legislation? Is it government policy? Is it how you have interpreted government policy? Where is this movement generated from, and by what?

Charles Counsell: The answer is that it is multifaceted. A whole set of drivers is behind it. As we discussed earlier, the first factor is to manage the expense and risk to the sponsoring employer. We have talked about the liabilities of pension schemes sitting on the balance sheets of employers, so that is a factor. It is also true to say that liabilities have risen over the years because of an ageing population. Again, that is a factor. The legislation put in place in 2004 and subsequently is designed ultimately to try to ensure that savers get the full benefits that have been promised to them by the employer. It is the balance of all those factors together that has taken us in the direction we have gone.

Lord Cromwell: We mentioned that the FCA's objectives, for example, are being adjusted. Do you feel that the Government give you a clear understanding of the objectives they want?

Charles Counsell: I think so. Our objectives have likewise changed over time. Our original statutory objectives were set out in the Pensions Act

2004. They were then changed just under 10 years later to include a new statutory objective that meant in effect that we have to take into account the strength of the employer. That is Parliament saying to us very specifically that it wants us to take that into account. More recently, we had the Pension Schemes Act 2021, which introduced a very wide raft of new measures. That has included new powers for the Pensions Regulator. Again, that sets out a clear direction of travel.

Lord Cromwell: Is the FCA as happy as the Pensions Regulator is?

Nikhil Rathi: Our objectives are a live conversation, with legislation before Parliament. We support the Bill as introduced by the Government. That is now making its way through Parliament.

Q15 **Lord Blackwell:** I want to end by coming back to a summary of what you see as the next steps. Before I do that, can I come back to the discussion following Baroness Donaghy's question about discount rates? You could say that all this has arisen because of the requirement on pension funds to discount at a low-return bond yield. Because it is interest rate sensitive, that has forced pension funds to match that with low-return bond assets and then, to increase the actual return, leverage that through LDI schemes so that they can invest in higher-growth assets.

You can understand that that makes sense for a scheme that is in maturity with short-term payouts, but a lot of schemes are still active and still have long-term liabilities. Common sense would say that, when you have long-term liabilities, you can accept some short-term volatility in the interests of higher long-term expected returns. Most university endowment funds are not invested in bonds but equities.

The consequence of this requirement to discount everything at short-term, low-interest-rate bonds has meant that the proportion of pension funds invested in equities has drastically reduced over the last 20 years. As opposed to all this conjuring up of ways of getting high returns while still matching low-interest-rate discount rates, would it not be sensible for the Pensions Regulator, if it has the power, to allow pension funds to discount their liabilities at a more reasonable equity rate of return, particularly where the company has a strong covenant or where there is longer-term maturity? Would that not avoid this whole business of LDI and leverage?

Charles Counsell: I will let Neil come in in a second but, broadly, we take a view that there is a difference between different types of pension scheme. That is self-evident. The level of maturity of the pension scheme is one of the critical factors in that. Whether the scheme is open or closed is also a factor. We take that into account, as well as the underlying strength of the employer covenants. Those are all really important factors, so I agree with the premise behind the question. However, there is a real difference when we are talking about very mature schemes, perhaps with weaker covenants. That is very different territory.

Neil Bull: I think it is helpful to make the distinction you made in your question about schemes that are closed and maturing. A lot of them have increased their allocation to bonds. You are quite right that schemes that are open may not mature for the foreseeable future and, if they have a strong covenant backing them, they may well decide to invest in a large amount of growth assets. We are going to consult on our scheme funding code shortly. It recognises the flexibility in the system to do exactly that.

Lord Blackwell: So are you saying that, yes, they have the capacity to do that, but if they do, they will potentially end up with much greater volatility in the observed deficit, because they are forced to discount everything at the bond yield? This may be something that you do not have authority over, in which case I am happy for you to say that. But is there not a logic in allowing schemes with longer-term liabilities or stronger covenants to use an equity rate of discount rather than a bond discount?

Neil Bull: Some pension schemes, particularly those in the category you are talking about, do use what is known as an asset-led discount rate, which reflects the assets that they actually hold rather than being anchored to the bond. So that flexibility exists in the system and is used by some schemes that would not necessarily follow the market rates of discount as opposed to bond yields. Many schemes in that mature area do that, partly because they are looking at those cash flows and that is the relevant thing they want to match.

Lord Blackwell: I am not sure why the use of different discounting rates it is not more widespread, then. The accounting rules may be the driver of that.

Charles Counsell: Clearly, the accounting rules are a driver in terms of what is reported on the employer balance sheet; that is absolutely right. Going back to something that you said earlier, no, I am afraid that this is not within our remit—full stop. That is true.

In terms of the universe of schemes, we have been talking about less mature, open schemes. Of course, they are the minority. The majority are increasingly maturing and closed. Some are very mature.

Lord Blackwell: But even if they are mature or closed, they may have liabilities stretching out 20 to 30 years or more. Common sense would say that you would accept short-term volatility in equities for higher long-term expected returns.

Neil Bull: I think that some schemes will make that decision in that context.

The other thing is that, just because it is a market rate of discount related to bond yields, it does not necessarily mean that people invest in gilts. As I said earlier, there is a large growth of investments in corporates and, indeed, illiquids. That is quite a fast-growing market. That perhaps allows pension funds to access the higher returns that they

were used to historically, from an equity point of view, and to create a structure in which they are mindful of the cash flows they have to pay out, even if they stretch for quite a long time. Some of those illiquid assets can make commitments for quite a long period of time.

Q16 **Lord Blackwell:** We heard earlier that you tended to encourage matching in bonds and using LDIs. It may be worth making some changes to that which reflect the points you just made.

To come back to next steps, I have heard the FCA and TPR mention a number of things. You talked about more information and data collection on leverage and liquidity, with the possibility of leverage caps allowing more assets to be used as collateral on liquidity. More work needs to be done on the systematic model and the potential to regulate consultants more closely. Is there anything else in your collective next steps that I have not mentioned?

Most of us would impose additional costs and restrictions on pension funds' investments, which would further lower the returns. Going back to the conversation we were just having, are you concerned that the consequence of all this will be to further damage pensioners' interests?

Charles Counsell: That is exactly what we need to think through in making any changes to the system. Ultimately, we are trying to make sure that pensioners get their full benefits. We have to make sure that, as we make any changes to this regime, we understand the potential risks. I completely agree with that point.

To your earlier question about whether we need any other changes, we feel that we need to look at the speed of decision-making in pension schemes. That is partly wrapped up in the governance issues we explored in earlier questions, but only partly. There is a point about speed of decision-making by trustees and others within the system.

Nikhil Rathi: You have captured the points well. I would add testing for failure and the operational resilience of the pipes. This is an important area of work. I also referred to the international work in which we are very engaged.

Simon Walls: Just as a point of detail on the speed of decision-making of trustees and getting assets that may exist in the pension funds to the pooled funds, there may be mechanisms that allow the asset manager more discretion and perhaps more access to the liquid funds that sit outside the pooled vehicles. Some of the fund managers are already looking at the feasibility of that.

We have not talked much about custodians. There were settlement challenges during the height of the issues in September, so there is work going on to look at the custodians and the operational consequences of that volatility, once it had occurred.

We have also not talked much about a particular pocket of the gilt market, which is inflation-linked or index-linked, and how that was affected. By the Wednesday, it started to move separately from the

conventional market. There were lessons learned there about the concentration of that. Generally, it was the DMO issuing and LDI managers buying, so there was not much of a market when the LDI managers moved the other way. There are lessons there for the system and for asset managers around the consequences once the buffer had been exhausted.

What we really saw here was a shock on the Friday, when the fiscal event occurred, but long gilts were weaker by only 20 to 25 basis points. We then had political noises over the weekend and a big move again on the Monday. It was not until the Tuesday, when cumulative moves were over 150 basis points, that you started to see the self-fulfilling element of this. They were resilient to the initial shock and partially resilient to the political news that came out over that weekend, but there was a level at which this started to become self-fulfilling. That needs to fit into the stress testing. Much of the stress testing before thought about how to make that first buffer big enough to prevent any subsequent consequences. We have discussed how that is not cost-free; the system could make the buffers higher, but it would have a cost.

It is more cost-free to assume that whatever buffer we set could be exhausted by whatever wild event is happening in the world and think about how to make the knock-on consequences less severe. That is quite fruitful, as we are not confronted by quite the same difficult balancing act on that side.

Q17 **The Chair:** Nikhil, you referenced FTX, which is another three-letter financial drama. I think I am right that, when FTX was allowed to open an exchange in Cyprus, in the EU, you made clear that you would not allow that here. Obviously, that proved to be a good call in very short order. At the same time, you also said that investors should be very wary of investing in FTX. How successful were your words of warning? When you give a clear warning, to what extent are you able to monitor that it is followed? If you have given a clear warning on something, do any repercussions fall on intermediaries who then allow UK-resident investors to invest in this sort of instrument on this sort of exchange?

Nikhil Rathi: Our remit for crypto platforms is limited to money laundering registration. We have refused applications, or they have been withdrawn, in 85% of cases, because we have not been satisfied that they would meet the standards that we believe are proportionate and reasonable. I know that this committee has looked at money laundering separately and questioned that assumption, but we certainly feel that some of the core systems and controls that we require are proportionate and reasonable. This includes sometimes turning down some of the largest players in the global market.

We will shortly receive powers around financial promotions so that we can start to tackle some of the marketing on the Tube and elsewhere promising all kinds of things.

We do not have any mandate for consumer protection, which has not come into the regulatory perimeter. We have called for it, and a vote was passed in the House of Commons a couple of weeks ago that would allow the Treasury to set a framework. That will obviously come to this House for consideration in due course. We believe that this next step is important. So, in direct response to your question, we do not have information on how many UK consumers have put their money into these platforms. If they want, they can go all around the world and deposit money by credit card, and we do not track it; we have no means of doing so.

The Chair: So, in order to fulfil what you clearly see as a responsibility to warn people and avoid that sort of exchange coming into the UK, you would need parliamentary clarity and support.

Nikhil Rathi: We would, and we would also need a point-of-consumption regime, so that if you are marketing into the United Kingdom, you must fulfil a regulatory responsibility in doing so. We would therefore have oversight of it. This is all for the discussion that should come in the future.

We see use cases for tokenisation, and we see its potential benefits in wholesale and institutional markets, so we are not against professional use cases that can make markets more efficient. But what we see here are very high-risk products—I cannot call them investments—in which consumers, often vulnerable ones who have life savings of only £1,000 or £2,000, think they should place their money.

The Chair: We will take this up with Treasury Ministers when we hopefully see them, and with a Minister from the Department for Work and Pensions, with whom we will discuss LDI. This is an important matter relating to the regulatory remit and powers to move quickly and rapidly into something that looks like a train wreck.

Thank you all very much. You have been very helpful. We will hopefully produce a report shortly, probably by way of a letter. We will look to hear from Ministers, because you have raised quite a few issues that relate to Ministers’, officials’ and Parliament’s role in helping you to do your job, as well as oversight and pointing out when you might not quite be doing the job that we hope you could do. Thank you.