HOUSE OF COMMONS

Work and Pensions Committee

Oral evidence: Defined benefit pensions with Liability Driven Investment, HC 826

Wednesday 7 December 2022

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Watch the meeting

Members present: Sir Stephen Timms (Chair); Debbie Abrahams; Steve McCabe; Selaine Saxby; Dr Ben Spencer; Chris Stephens; Sir Desmond Swayne.

Questions 65 - 122

Witnesses

I: David Fogarty, Dalriada Trustees, Harus Rai, Association of Professional Pension Trustees, and Rod Goodyer, Barnet Waddingham.

II: Abdallah Nauphal, Insight Investment, Kerrin Rosenberg, Cardano Investment, Jonathan Lipkin, Investment Association, and Charles Prideaux, Schroders.

Written evidence from witnesses:

David Fogarty, Dalriada Trustees

Harus Rai, Association of Professional Pension Trustees

Rod Goodyer, Barnet Waddingham

Abdallah Nauphal, Insight Investment

Kerrin Rosenberg, Cardano Investment

Jonathan Lipkin, Investment Association

Charles Prideaux, Schroders

House of Commons

Examination of witnesses

Witnesses: David Fogarty, Harus Rai and Rod Goodyer.

Q65 **Chair:** A warm welcome, everybody, to this meeting of the Work and Pensions Select Committee and our inquiry on defined pension schemes with liability driven investments. A very warm welcome to all three of the witnesses who have joined us for our first panel this morning. I will ask each of you to very briefly tell us who you are.

Rod Goodyer: Good morning. I am Rod Goodyer. I am head of investing consulting at Barnet Waddingham. Barnet Waddingham is a pensions consultancy firm who advise over 300 pension schemes on their investments. We have 130 investment professionals and we work primarily with DB schemes. I am a qualified actuary. I have worked in the pensions industry for 20 years, primarily in investment consulting.

David Fogarty: Good morning, everyone. I am David Fogarty. I am a director at Dalriada Trustees, which is a professional trustee firm. We have over 200 trustee appointments. My background is very similar to Rod's. I am a qualified actuary and prior to becoming a professional trustee I acted as an investment consultant for one of the large employee benefit consultancies.

Harus Rai: Good morning and thank you for inviting me here today. My name is Harus Rai. I am the Chair of the Association of Professional Pension Trustees, otherwise known as the APPT. I am also the Managing Director of Capital Cranfield, which is a professional trustee firm.

Q66 **Chair:** Thank you all very much for being with us. I will put the first question to you. Can you tell us to what extent the pension schemes you have worked with have used leveraged LDI? Do you think the position of the Pensions Regulator on LDI has been appropriate and proportionate? What is your assessment of the role of investment consultants in all of this?

Rod Goodyer: On the first question, the majority of defined benefit schemes that we work with have used leveraged LDI at some point. Ideally for a pension fund you would have liability matching within your strategy to manage the risk of contribution volatility to the investor contributions to make things more predictable for the sponsors but also to improve member security of benefits in the case of weaker employer covenants. That is why most schemes have done it and many have required to use leverage because of the funding position of the schemes.

Sorry, what was the second part of your question?

Chair: What do you think about the approach of the Pensions Regulator?

Rod Goodyer: In reality, although the Pensions Regulator has undoubtedly encouraged schemes to use LDI where it has got involved in cases, particularly with weaker covenants, I don't think that the Pensions

Regulator has been the key driver of the vast majority of schemes using liability driven investment. I think it has been more that from a risk management perspective liability driven investment has been the right approach for the scheme to use. Typically that has not come from just the investment consultants. Often the scheme actuary, the company's actuarial advisers as well, will have been involved in those discussions as to the risk management approach taken by the scheme.

Q67 **Chair:** How would you assess the role of investment consultants like yourself in the decisions that funds have made?

Rod Goodyer: A DB scheme is required by law to review its investment strategy at least every three years. Typically you would come out of each actuarial evaluation and do a full review of the strategy. The investment consultant will look at the options relative to the funding position, what assets are available, what returns are needed, and they will look at the options for how they generate the returns and manage the risk. That is normally where the risk management protection strategies will be considered and where the issue of LDI will typically be raised with the trustees.

A lot of schemes have had LDI in place for quite a long time now, so it is not a recent decision to introduce LDI. When you get to the point of the investment strategy review, you consider what changes to make to the level of what is termed the hedging, the degree of protection that is in place. Most schemes have tended to try to increase that protection over time if their funding position has improved so as to better manage the volatility. The investment consultants are the key people in driving the discussions about how that is implemented but they are certainly not the only people involved in that discussion.

David Fogarty: We see LDI commonly used across the clients we are involved in and there will be some level of leverage. The decision-making process for us is very much that LDI is a risk management tool: what is the ability of the scheme and then, after the scheme, the sponsor to withstand falls in interest rates? If we, as the trustee, view that that is not strong enough or indeed if the sponsor does not want to run the risk that a deficit will balloon—clearly we have lived through the last 15 or 20 years where interest rates have kept going down and down and deficits have kept going up and up—LDI and hedging becomes a solution to that.

Leverage is a more nuanced question because it is about how the overall investment strategy fits together. If you have a target to have a certain level of hedging and you are, for instance, very well funded, you don't need leverage. If you are less well funded and you need some of your assets to earn returns to help bridge that gap, you will need to leverage. We view leverage as not being the primary problem.

We see the primary problem as a combination of things: the understanding of the trustee board of what the actual product is and the extent of leverage and what would happen if certain events happened. On

top of that, we see a challenge, and a challenge we have experienced with the crisis, of a series of operational failures. You could have a well-advised trustee board who understood the situation but if there was failed operational procedures, between the trustees obtaining advice or between the asset managers being able to act upon the decisions that the trustees want to take, that creates real problems within a system.

At a high level, coming back to the key point, for us the most important issue is that the buck has to stop with the trustees. The trustees are the ultimate decision-makers. You can challenge whether the advice is good, bad or indifferent, but it is for the trustees to insist and ensure that they get good advice. To do that, the trustees have to be equipped, they have to have the skills and the expertise. They have, to some extent, to be able to talk the same language as the consultants. To us, that is an obvious weakness in the system.

Q68 **Chair:** Sarah Breedon of the Bank of England said in a speech last month that the root cause of the problems was "poorly managed leverage". Do you think she was right about that?

David Fogarty: There is a lot of schemes, so it is very hard to generalise and different schemes have had different experiences. We see a series of weaknesses and then question which of those weaknesses might have played out in a particular scheme's circumstance. We start with whether the trustees really understood what they were trying to achieve and what the purpose of it was, what the product was, what the liquidity was and what the risks were; did the trustees understand that? Secondly, did they have the infrastructure to engage with the consultants if a crisis happens? A lot of the trustees are working, so how do you get somebody on the phone every day for two weeks and get people up to speed with stuff? Then the investment advice—and I know we will come back to that in later questions—is not necessarily uniform.

I argue that within the industry large schemes are very well advised. They have large governance budgets and have the time to spend on these issues. As you go down the size of pension schemes, that governance budget or their ability to spend time on things shrinks and shrinks and shrinks. The per hour cost of advice is the same whether you are a large or smaller scheme, so it is hard for medium and smaller schemes to get the same quality of advice and understanding. That advice is a challenge.

Then undoubtedly there were, in our view, problems with certain products, not all products. Part of the problem was the structure of the products but as much as anything else the operational processes around the product—the frequency of dealing, their ability to access cash in other parts of the investment management organisations in a timely manner to meet collateral calls.

Q69 **Chair:** What do you make of the role of the Pensions Regulator in all of this?

David Fogarty: Against what the duties are, we see the regulator fulfilling its statutory requirements. There is a question in our minds about not what it did but the infrastructure. The industry issue is that you have a regulator issuing what we believe is reasonable guidance but it needs to be understood, and if the recipients of the guidance don't understand the nuance of the issues, that is when you have a problem. We think that there is a reasonably strong argument for trustees to be regulated to lift the bar of the capability and understanding of trustees. There will be some marvellous trustee boards. It is not all about professional trustees. We are not saying that is the solution, but it is about the skills within a trustee board that they have to be at a level where they can understand.

Q70 **Chair:** Thank you very much. Harus Rai.

Harus Rai: I may touch on some of the points that the guys have already said, so apologies now. I will go back one step and talk about what a trustee is trying to achieve.

Ultimately what we are trying to achieve is our ability to make sure that members' benefits are paid, now and in the future. The way we do that is we look at all the elements that might impact that ability, and interest rates and inflation are just two of those. LDI helps us, and they have been invaluable tools for defined benefit schemes, by allowing us to closely match our assets to our liabilities so we can manage those elements.

Where leverage comes into it is that it allows us to use fewer assets to cover the liabilities, so it frees up funds to invest elsewhere with the intention that we then erode any deficits that have been in the scheme, based on the actual assumptions that we have and how we are trying to assess those. In turn we are trying to remove the elements of the risks of sponsors' covenants. If a sponsor covenant was to weaken, we are trying to get that pension scheme into such a strong funding position that we can always pay members' benefits. That is what LDI and leverage has allowed us to do. Ultimately any trustee, a lay trustee or professional trustee, is trying to ensure that members' benefits are paid at all times in full.

The role of the regulator is to provide guidance around the risks that we as the industry will face. That is one of its roles. We welcome the work that it has done. Representing the APPT, we have regular interaction with the Pensions Regulator and the Department for Work and Pensions and it has always been constructive and helpful. There are clearly lessons to be learnt from this. The regulator itself has said that there is a need to gather more data. There is the annual return, but it needs to gather more data. The regulator is not there to regulate LDI products. As I say, it is there to ensure that we have the guidance at systemic level and scheme level to tackle the risks that we will deal with when operating pension schemes.

I think it is unreasonable to suggest—and I don't think anyone here is suggesting this—that the regulator could have foreseen the impacts of the mini budget and the sheer speed and the unprecedented rise that we saw in gilt yields, which in the past people were talking about over a matter of months and this was over a matter of days. This is where we as an industry and trustees and advisers need to come together and work with the regulator, because it is not just the regulator. These are lessons that we all need to learn about this. They are not conversations that will happen, they are happening now and the APPT is playing an active part in that process.

On investment consultants, I think that we should remember that trustees are responsible for hundreds of billions of pounds. As I mentioned before, we are trying to ensure that we can create better member outcomes and to do so we have to take appropriate advice. David has quite rightly talked about governance budgets and within the governance budgets that we have, we take the advice that is appropriate for the needs of the scheme. There is not a one-size-fits-all category when you are talking about pension schemes because every scheme will have its own specific that we need to deal with.

I want to a make a few points, if that is all right, about investment consultants. The first is that it is a legal requirement for trustees to take advice from someone who is suitably qualified. Secondly, under the Competition and Markets Authority reporting requirements, we have to set objectives for the investment consultants and we have to assess them against those at the end of each year. We set meaningful objectives, not just generic ones but very meaningful objectives, which are based on the specifics of our schemes. While not all investment consultants are regulated, a lot of the work that they do falls under regulatory requirements. You have heard at previous sessions where if it falls into regulated activity they need to be regulated and I am sure Rod can talk more about that.

The final point is that I have seen the comments from the FCA about wanting to have investment consultants authorised by them. I don't know Rod's views but personally I don't see any reason why that should not happen. Again, could I have anticipated that the investment consultancy world would have foreseen the post mini budget events? I think it is probably unreasonable to assume that they would have anticipated that.

Q71 **Sir Desmond Swayne:** Given the problems that you have drawn to our attention—the limitations of some trustees or their ability to understand consultants or even to get hold of adequate consultancy advice—to what extent do you think that trustees had a clear understanding of the downside risks of LDI that they were taking on? That is to all of you in any order.

David Fogarty: I am happy to go first. It will be very varied. It goes a little bit back to my earlier comments. I think you will find generally speaking that the larger pension funds that have vehicles such as

investment subcommittees who meet more regularly, spend more time with their advisers, get reports on the actual structure of the LDI, understand the nuances of liquidity and counterparties and all of the issues, were in a good position. If you put those schemes in a bucket, I suggest that the majority of them go through this whole crisis relatively unscathed.

There definitely are problems as you go down. When I was an adviser I experienced this as well. LDI is a complex topic and trustee meetings are two to three hours. You might start talking about interest rate risk in meeting 1. By meeting 2, which is three months later, the trustee board who have day jobs, forgets some of the things that you told them. You try to move it on and now you are into potentially what hedging is and some of the other consequences for the investment side of things, and that process goes on for a long time. I have sat with trustee boards multiple times as an adviser and what sticks is not that much. As individuals, these are very bright people in their own fields but this is not their field and I think that is a real challenge.

As I said earlier, while the buck has to stop with trustees in taking responsibility, I think that there is a significant responsibility on advisers. Not all advisers are equally good at getting their points across. For me, a big test is before you move to implementation: is the adviser confident that the person making the decision has understood the implications of the decision they are making? I suggest that in many cases where we find that there were issues now, that test was not passed.

LDI is not straightforward and there is a long series of issues to go through—the risks, the hedging, the products, the impact on the rest of the strategy—but then when it gets to products I suggest again that if you look at many of the situations where there were failures, the trustee did not appreciate that the particular pool, the LDI fund or whatever, only dealt once a week. They did not appreciate that the other assets they sold might have had that frequency or even less frequency, so they did not appreciate the challenges to get cash to support the strategic position that they had.

I think there is a lot of weaknesses. The problem with a structure where we have 5,000 pension schemes or thereabouts is that it is easy to hold up the ones that did well. Even if three-quarters of them covered it all very well, that is still an awful lot of schemes where there are problems and issues, consequences for members, consequences for employers. If there are losses that have come through this, those losses will have been aired up in some way.

Rod Goodyer: I will talk a little bit about my own experience in my career. I agree with what David said that liability driven investment is not something that you would typically be able to move a trustee board from having been introduced to it to investing into it in a single meeting. It is normally quite a long process to explain why you would be doing it, how

it works, what the pros and cons are, what the operational issues to consider are. That is quite a detailed process to go through and generally once LDI is in place, schemes in most cases receive quite detailed quarterly reports specifically on the operation of the LDI, where the hedging is, but also looking at the issues of collateral and liquidity: what would be the size of the next collateral call if the LDI calls are going to ask for more money; do you have that money in cash with the asset or where is it coming from; where is the second, third call going to come from? It is thinking about those issues and a lot of schemes are briefed on those things.

It is quite true, though, that you will have a balance of skills in most trustee boards. A lot of trustee boards now have a professional trustee on them, who may well have a lot of knowledge because their day job is sitting in trustee meetings and they hear lots of different advisers talk about LDI. They are very au fait with the operation and they are very happy to challenge the advisers and ask questions. It won't be the day job of some of the other trustees, so they may be relying more on the trustees with knowledge of finance and investment, but in some way you have a diversity of skills across the trustee board in a whole range of areas. Some of them might have legal skills, some of them might have finance skills. You don't want to lose that diversity of thought within trustee boards. There probably is a challenge that not everybody can be brought up to the same level of understanding on the most complex issues facing pension trustees, of which investment is only one.

Harus Rai: I echo the comments from David and Rod.

Q72 **Sir Desmond Swayne:** John Ralfe told us that the real villain is hidden leverage and that comes down to inadequacy as to what is reported and what is available. To what extent do you agree with that analysis?

Rod Goodyer: I don't believe that it is the case that the leverage is hidden. Hidden is a slightly emotive word because it implies that somebody has deliberately concealed it. An example was given last week of the BT pension scheme and it was highlighted that if you look at the company accounts, it was difficult to understand. For almost all pension schemes, the statement of investment principles is available online. It is a legal requirement that it is available for all schemes that have one, that you can find it on Google. I looked up the BT pension scheme statement of investment principles. The hedging target is explained and the asset allocation and from those two elements you can work out what the leverage is.

I think a fair criticism is that sometimes the leverage is not easy to understand if you are not a pensions professional, but I don't think it is correct to say that the leverage has been hidden. It is in the public domain.

Harus Rai: I will add that as well as the statement of investment principles, as trustees there is an accounting requirement enough to

ensure that we outline in the trustee report and accounts information about the pension scheme that will include who the fund managers are, how we invest with those, how much. It will include market commentary on what we have seen over the course of the year that may have affected the pension scheme. There has to be risk analysis also on what the risks are associated with those and that is a requirement that we have to have in place for the annual trustee report and accounts.

Q73 **Selaine Saxby:** Good morning. Warnings about liquidity risks for schemes using LDI started to emerge earlier this year. Were you required to meet additional collateral calls at that point, how were you able to manage this and were the stress tests sufficient?

Rod Goodyer: That is correct. I think the Pensions Regulator highlighted the issue in May, but earlier in the year yields had started to rise. It was a hot topic in the spring. Obviously inflation was rising and was a growing concern as well, but the yields might start rising and potentially more quickly than the market expected at that point, and that is really what causes the collateral calls. Most schemes hold some very liquid collateral alongside their LDI, often simply a cash fund to meet the first calls.

I would say that most LDI, certainly the pooled funds, had collateral calls during the summer well ahead of any of the events of September. That was all met via the normal process. Those collateral calls are replenished by selling other liquid assets to effectively top up your first line of defence to meet a future call. The issue that came in September was the very rapid move in yields, meaning that those processes and how quickly people could move became a lot more challenging. The process was working exactly as intended over the summer and into September.

David Fogarty: Rod’s explanation would have been experienced generally across our portfolio. I will raise the point that if you have a trustee board that meets quarterly, has strong advisers and has all this reporting, these issues are in front of them, but many trustee boards might meet only once a year. They may not employ an investment consultant to give them LDI reporting. That connects a little bit with Sir Desmond’s question. I don’t think it is a point that leverage was hidden but it was not necessarily understood. It is only understood if it is portrayed in front of you.

Harus made good observations about what is in the public domain, but one of the challenges that was exacerbated in the gilt crisis was that someone has coined the phrase “pensions time”. Pensions works on three-year, one-year and quarterly cycles. Pensions don’t work minute by minute and the data that we as trustees typically see is based on quarters, but a lot can happen between the end of one quarter and the end of the next quarter. Visibility information is not there for many schemes.

Harus Rai: We saw with the industry stress testing—you are probably bored of hearing about the Bank of England stress testing at 100 basis

points—the rapid rise of gilt yields beyond what anyone had anticipated. But beneath that, schemes were doing more focused stress testing and that would have been based on the particulars of their schemes: the funding position, strength of the sponsor covenant, the membership profile. That was always going on and that has been happening for a while.

But this comes back to the point of the lessons that we need to learn from this because there are scenarios where stress testing was not appropriate. We have already seen the regulator's guidance that came out last week, which we welcomed. You have already seen the conversation change from testing at 100 basis points over the space of a month to 300 to 400 basis point scenario testing. It just shows how far this conversation has gone in such a short period of time.

Q74 **Selaine Saxby:** Do you think that the Pensions Regulator should have done more earlier? Once you started to see a problem and that there was a forecast of rapid change, was it appropriate that the industry caried on operating on pension time or should it have perhaps caught up with politics time?

David Fogarty: Again it is a challenge. It is an unwieldy beast. The system is not set up for the regulator to engage with 5,000 schemes. It can give general guidance and it can pick, based on its own data and systems it has, cases that it is concerned about. But they are typically ones that they are concerned about because they are very large but there are a lot of schemes that are not very large, so they are not necessarily on a watchlist of there are issues.

I would approach it the other way, as I said a few times. The buck has to stop at the trustees. The trustees have to take responsibility for a particular situation that they have.

Q75 **Selaine Saxby:** Do you think there is more that they should have done in that because it feels, from what you have said, that there was an acceleration in the problem but the response from the trustees, whoever is being looked at, did not quite keep up with the rate of change of the problem.

David Fogarty: When you are deep in a crisis you just have to deal with the crisis but the reflection afterwards now is do we have the right skills on the board? How can we improve them? Do we have the right advisers? Did they support us through the process? Were the right operational procedures in place? Do we still like the product that we were invested in? Do we need to think about a different product? What about the rest of our investment strategy? How does that fit with our risk management objectives? There is a huge body of work for pension schemes to undertake now to address all of those issues.

Q76 **Steve McCabe:** You are going to have to bear with me here. The language and the technical detail of pension finance is a bit beyond me,

so I hope you will bear with me. I noticed that Barnett Waddingham said there were operational challenges for almost all LDI users, and we talk about that being a problem when gilt yields rose quickly in September and then again in early October. Rod, could you tell us what were those operational challenges?

Rod Goodyer: The operational challenge mainly centred on the sheer number of things that needed to be done for every single scheme that had LDI. Ordinarily, as David has commented on, in the world of pensions not everything has to move at breakneck speed all of the time. If every scheme with LDI needs to make similar transactions in the space of a week, that creates bottlenecks within the asset managers where they process those trades.

But also one of the key bottlenecks we found was the flow of information. Normally you can get for each pension scheme fairly good scheme-specific information from the asset managers fairly quickly. With the sheer volume of requests coming to them, that was more challenging for obvious reasons. Obviously it is symbiotic. I think that causes operational challenges for trustees because they are being asked to make not only decisions more quickly than usual but on more generic information than they would normally expect, which obviously makes decision-making feel a bit less comfortable.

Obviously people in my profession and across the industry—I was talking to professional trustees—were having to speak to five or six clients every day to keep things moving. It creates a lot of operational pressure. I think the industry coped pretty well with those issues but it was definitely a challenge and there are some learnings from that as to how things can be set up to work in a more streamlined way in future.

Q77 **Steve McCabe:** This is a system designed to move quite slowly. It anticipates moving quite slowly. Suddenly it was required to move very quickly and there is not provision for the rapid transmission of up-to-date data information. Is that the problem that people were grappling with?

Rod Goodyer: I think the system would have coped fine. If what happened in four days in September had happened over four weeks the system would have coped fine and everything would have—it was the challenge of it all happening so quickly created the operational chain. It goes back to the point about the stress testing and the movement we saw was far outside the boundaries of historical movements.

Q78 **Steve McCabe:** People making decisions without maybe as much information as they wanted. When it says that this led to schemes having to sell down assets beyond their designated highly liquid assets, that seems to me like panic selling. Is that what we are describing?

Rod Goodyer: It is not quite panic selling but—

Steve McCabe: I see David nodding, I will come to you in a second.

Rod Goodyer: Basically there are things that are very liquid that you would be happy to—things like equities are very liquid. They have very low trading costs. When you move into some areas of credit the trading costs are higher, but if lots of people are trying to sell credit the same week the trading costs go higher still. You would not necessarily want to be a more forced seller of that but some of it, if you look at the movement of dealing spreads in the data, undoubtedly there was some forced selling in the market and that will have had some frictional costs to schemes.

Q79 **Steve McCabe:** Would that have meant that some money was lost to the schemes if people were selling things in the way that I described as panic selling? Does it mean that some money was lost?

Rod Goodyer: Compared to the other systemic issues that some of the schemes experienced, the losses would be relatively small. There probably are some small losses that were crystalised as part of the process.

Q80 **Steve McCabe:** David, I noticed you nodding when I asked if it was a form of panic selling. I am trying to get my head round this. How would you describe it?

David Fogarty: Perhaps unplanned. I think having Rod's comments, data were the big challenge so there was stuff happening in the gilt market and there was perhaps a call that there would be more capital required to support the product or the hedge. But there was not so much data on what has happened to the rest of our assets? What is our overall funding level? Should we think about maybe having a lower hedge and therefore we can put less of our capital there. The time constraints meant that if you had to make a decision to get cash to an LDI manager, in some cases the same day, in some cases multiple days, you did not have the time to go through all of those issues that you would want to go through in making a strategic decision as opposed to an unplanned decision.

I think there will be losses. To our eye, there are losses in a number of places. There are losses particularly for schemes who had their hedge position reduced when gilt prices were low and then replaced when gilt prices went high again. That crystalised a loss. There will be losses from the selling of assets at distressed prices, and it depends what the asset is. The haircuts in certain assets might only be small single percentages but in some assets there might be more, 10%, 15%.

Q81 **Steve McCabe:** I do not want to overdramatise it but this sounds to me like people operating a bit blind in a very rapid-moving situation where they are having to make very quick decisions. Is there any lesson for the future about how you get better information to make it easier for people to operate? It sounds like people were taking quite a lot of risk. I do not know, I am not trying to accuse anyone of anything but if you are having to make very quick decisions and you do not know all the detail it is a bit

of a gamble, I assume. Is there a lesson you have learned? Is there something that can be done for the future?

David Fogarty: For sure. I think trustees reflecting on it now hopefully will be thinking a lot more about not just their asset allocation and percentage allocation but a clear understanding of the liquidity of those assets and the times that it might take for them to release cash. There is a concept that you may have heard about, which is fairly typically used in larger schemes, called a liquidity ladder, "This is the first assets I will sell, this is the second asset I will sell, this is the third". I think that has to work down the scheme size.

I think that there will be a strong argument, and certainly my own point of view, for co-locating of assets in a single place. Some of the challenges came from the fact that many pension schemes, if not the majority, appoint different managers for different things, and therefore there is a disconnect between where the assets are. They are not all in one place, basically. They are in different products with different asset managers. That creates problems when you want to release money, and so on.

Arguably, if you have assets in a single platform or with a single manager who perhaps has access, you can give power of attorney to investment managers to take certain decisions on your behalf that you have pre-thought through. A lot of crisis management is about thinking, "If this happened what we would do, let's game play that out, let's have a plan" and then if something happens close to that—it may not be the same event—that is the plan you look at, and so on.

Q82 **Steve McCabe:** Can I ask one bit about this that struck me when I was reading the brief, and this came from Dalriada? They talk about, "Likely confusion within trustee boards who for the first time began to fully understand what they were invested in. A significant reason for this was the failure of consultants to fully explain the nature of the products that they had advised, possibly because of a failure on their own part to fully understand the nature of the products themselves." I remember many years ago reading a book called "Liar's Poker", which is about the junk bond market. This sounds like a version of that to me, people advising folk to have things that they cannot fully explain. Is that the conclusion that Dalriada have drawn? That trustees were perhaps induced to invest in things that they did not fully comprehend, and that had not been fully explained to them by their consultants, and where the consultants themselves may not have understood exactly what they were advising people to invest in.

David Fogarty: That is our point of view but what we are not saying is that is universal. That is about certain parts—

Steve McCabe: But that was the conclusion Dalriada came to.

David Fogarty: Again I would go back to trustee boards have to be able to challenge their advisers. If you do not understand the depth of what they are talking about then you either have to upskill the board or think

about getting a better adviser. There are certainly weaknesses in that ecosystem.

We talk, and you have talked today a little bit and in other sessions, about leverage. But I would suggest that if you asked 100 trustees only 50 of them would perhaps have understood that to achieve their—they might have heard the word "leverage" before but they did not appreciate that that was holding a position of 100, backed by assets of 50. I don't think that many trustees fully understood that situation.

Q83 **Steve McCabe:** I want to finally ask about pooled funds but, Harus, is there anything you want to add to what I have asked already?

Harus Rai: On the final point, APPT has obviously spoken to its members and from our members. From my own personal experience of working with lay trustees and those that I have worked with, they had a good detailed understanding of LDI. They understood why it is being used, the risks that were involved. I can tell you n the cases where investment consultants have put these ideas forward there have always been training sessions, "What does that mean?"

Q84 **Steve McCabe:** Do you think in view of the discussion we have just had that those training sessions adequate or is there any need to improve them? It sounds as if there was a bit of a gap between what people understood they were invested in and what the reality was.

Harus Rai: You appreciate, of course, that with 5,000 defined benefit schemes—and we are talking thousands of trustees—the experiences will vary. This is in line with our legal requirement. There is a legal requirement under the Pensions Act 2004 that we have trustee knowledge and understanding. You have to maintain that whether you are a lay trustee or a professional trustee.

One of the things that a regulator has asked us to do regularly is trustee board effectiveness and that is so that we, as trustees, sit back and review the governance structures of our particular schemes and determine—David mentioned a point about upskilling—are there areas where trustee boards may need to be upskilled or is there digital support that is then needed? That could be additional advisers on certain areas. It could be bringing in a professional trustee in some capacity, a member of the board or an independent chair or, even more drastic, moving it to a professional—

Q85 **Steve McCabe:** This might be off the wall, I am not sure about this, but I am fascinated about how this works as a process. When a consultant comes and recommends this investment, what is the kind of flavour of the questions that would be put to the consultant to test how well he or she understood the product they were advising on and how well it was being grasped by the trustees? What is the exchange that takes place?

David Fogarty: There are two flavours and the flavour, probably consistent with what Harus is talking about, is a well-governed scheme.

There is an understanding of where the hedge ratio is today, the financial circumstances of the scheme, the covenant, the return that is required. In that ecosystem the decision to change the hedging ratio is an integrated decision. It is a risk management decision. That is in the well-advised world. You will see that consultants put up charts with wider stress tests than the Bank of England with 2% changes in rates or 2% changes in inflation to demonstrate the ability of the scheme to withstand movements in interest rates. That is your well-advised side of things.

But the challenge is that that is not the problem. Although that exists, and I totally concur with what Harus said, that it is a good portion of larger schemes, but it is not universal. The problem is that the other story is somebody coming to a meeting and talking about interest rate risk, how assets might move, how liabilities might move and LDI's solution to this, and this is how it works, and it protects your funding level. I would argue that if you looked back you will find very few of those presentations that say—because they are risk managing about the potential for rates to fall. They are not exploring the outcome of rates potentially rising materially.

In those circumstances you have a slightly weaker trustee board. It is less capable of challenge. It accepts the idea that this is a good idea for risk management because risk management sounds like a good thing to do so let's do this. Then the investment consultant says, "Okay, we now need to choose a product provider". "Okay, so who do you recommend? So let's go with them" and before you know it they have LDI in place. But I do not think that they have understood it at all to the level that Harus described, which is in a well-governed scheme.

Q86 **Steve McCabe:** That is fascinating, thank you. Can I finally turn to the question of pooled funds? I think it was Andrew Bailey who said there were quite significant problems when it came to pooled funds, and he made the point that because they were collective they were not at all designed for rapid decision-making. What would you say were the problems with pooled funds and what is the learning from that experience?

Rod Goodyer: In those days of severe stress in September, effectively the same liquidity and collateral challenges were faced by both pooled funds and segregated mandates. The difference was with a pooled fund they have to effectively have one fixed set of rules that apply to everybody. Whereas a segregated manager could be quite flexible on the phone with clients, saying, "When can you get money to us? What can we do? Look for options", with a segregated manager, because the largest segregated managers have hundreds of clients, they literally had to say to all the clients, "You have to give us money by Wednesday". On Monday morning they say, "Give us money by Wednesday or we will reduce your exposures". That was the operational challenge that so much had to happen and therefore they were more likely to end up being

forced sellers of gilts in the scenario where those collateral calls were being met.

In the subsequent weeks, it is worth noting that some of those large segregated mandates will also have chosen for other reasons to ultimately reduce their exposures to gilts, but the initial market turmoil had much more impact on the pooled funds because they were forced to act in a certain way because they have to move uniformly across all the clients.

Q87 **Steve McCabe:** Pooled funds do not obviously represent that big a section of the market—about 10%,15% it says here. Is the likelihood that there will be a reduction in pooled funds or will there need to be a change in the decision-making structure so that at least in emergency situations they can act more rapidly?

Rod Goodyer: Some of the changes have already happened in the last six weeks, in that the pooled funds have all massively increased the amount of collateral buffer they are carrying. Effectively, if the events of September were to occur in the next four days they have enough collateral to withstand that without getting into the trouble that they came into.

But there are still further improvements to be looked at in dealings. For example, reference was made earlier to funds that only deal once a week. I think some of that might need to change. Likewise, the visibility of where clients have collateral. I think that there may need to be improvements within the industry for LDI managers to understand where clients have access to collateral, how quickly they can raise it, all the good points that the Pensions Regulator has been raising last week, I think some of that will be a need to have every scheme using pooled LDI to have all those protections and structures much more clearly documented.

David Fogarty: To add a point, and apologies, I had not read the submission. You referred to 15%. I would imagine 15% is by size of assets because the majority of schemes probably under 200—

Steve McCabe: It says make up 10% to 15% of the market.

David Fogarty: Part of the problem is that the market is a long tail, so although there might only be 15% of assets, it could be 80% of schemes. Those schemes then are facing the operational challenge of dealing with the LDI managers and so on. Again, Rod picked it up, not all pooled funds are the same. It is quite important that the way they are structured can be different and some are structured, in a sense, better than others.

Q88 **Steve McCabe:** Can I ask one last question quickly? Did the Bank of England's decision to announce the end period in the way it did put extra pressure on the system?

Rod Goodyer: That is probably a better question to get the fund managers to talk about because they are more directly in the market. It seemed to me that if the market is on that day—and I think some of the stress within the market in the first two weeks of October is effectively you have this LDI market that is built up over 20 years and in the space of 13 working days it is told to change how it operates. That in itself causes some challenges. It is probably one that the next panel will be better placed to explain.

Chair: We are running a little bit late now.

Steve McCabe: Sorry.

Chair: No, it is all very interesting and thank you for the very interesting answers you are giving us.

Q89 **Chris Stephens:** Harus, I will start with you. In your written submission you mentioned the type of schemes that were negatively impacted in September and October. What were the characteristics of these schemes and what made them particularly vulnerable?

Harus Rai: As you appreciate, there are many schemes in the UK, as we mentioned before. As we saw gilt yields rise, we saw the liabilities reduce significantly. For many schemes we saw that funding positions had improved.

There undoubtedly will be scenarios because what it created was a call for additional liquidity, and that would have created challenges. For some schemes, and this is where we need to do the investigation into what this means, we are hearing anecdotally of cases where hedging was closed unilaterally without prior consultation, where there were issues with raising collateral. That would have had an impact on those. David quite rightly mentioned, as has Rod, about there was a collateral call, but which assets do you then use to meet that collateral call?

If you had assets that were on a weekly dealing date that would have caused issues. There is no just one type of scheme but this is part of the work that we now need to do to understand so that we can put in place robust structures, both at systematic and at scheme level, to ensure that we are better equipped going forward.

Q90 **Chris Stephens:** Was it predictable beforehand what type of schemes would have been impacted by the events, like the recent ones, and was it also predictable what degree the impact would be for each type of scheme?

Harus Rai: I think it is fair to say that no one predicted the rapid and unprecedented rise in gilt yields. That was over a matter of days, not a matter of months. Schemes were doing scenario testing. As I say, there was more focused scenario-testing done at scheme level. From that point of view, I think it was unlikely that schemes would have anticipated exactly what we saw post the mini budget.

Q91 **Chris Stephens:** Rod, in your exchange with Mr McCabe, you talked about the small number of schemes who became forced sellers of the liquid assts to make collateral calls. Were there any other alternatives that these schemes had available to them?

Rod Goodyer: The options, when you see the collateral call, are you either obviously raise capital and some money to send to the LDI manager. You could choose not to meet the collateral call and reduce your hedging but in most cases schemes would not want to do that because that would increase your risk levels, particularly in a period of market volatility, and schemes who were not able to meeting collateral calls may have suffered adversely, depending on exactly when that happened.

The third option, which I think a small number of corporates did—and it has been in the media—was to extend credit to the pension fund. I am not personally involved with any schemes that did that but I have read in the media about schemes where this has occurred. Effectively they had assets that they could sell but they simply could not do that quickly enough. Instead money was lent from the sponsor to maintain the hedging, which goes back to my point that often the sponsor has been quite involved in wanting the hedging in place because of the risk management benefit on the contributions. That would be the other option.

Q92 **Chris Stephens:** David, what changes do schemes have to make in their asset allocations and were they happy with the results?

David Fogarty: I think a lot of that work has not been done yet. The shoring up was putting the collateral in place and meeting the higher requirements of LDI managers, so for lower leverage. That is somewhat a temporary fix but what has happened—and it is hard to get one's head around—is that asset allocation tends to work on a percentage basis. If you have two assets and they are both at 50%, and one of the assets is LDI and interest rates go up a lot, then that value falls in pound terms and in percentage terms, you now suddenly overweight the other asset. One of the things that schemes will be doing is trying to rejig that and get back to a sensible long-term asset allocation.

To further complicate it, what was generally happening was people were selling the more liquid assets, which tend to be things like public equities, and they were not able to sell the less liquid assets. There has been a distortion in their investment strategy. They now need to go back and reconsider what their objectives are, how long they are going to give themselves to get there, what sort of return do they need. Do they still want the hedge ratio that they had before and what sort of asset mix are they going to have?

Using the reflections of the experience there will be a different asset mix because people will probably have a preference for more liquid assets over and above less liquid assets, depending on the sort of hedge ratio.

There is a lot of change to happen at a scheme level in reviewing those investment strategies.

Q93 **Chris Stephens:** My final question is to all three of you. It has been suggested to us by the independent financial analyst, Toby Nangle, that broadly speaking large schemes with well-resourced executive or fully delegated governance frameworks in place appear to have fared extremely well. Should we be encouraging moves to larger schemes or is that just putting all the eggs in one basket?

Harus Rai: I think it is fair to say that, as has been mentioned a few times, experiences across all the schemes will vary. There are some extremely well-governed smaller schemes but there are over 5,000 schemes. My understanding is that the majority of those are sub-£100 million, which in the industry we refer to those as potentially at the smaller end.

We have seen rises in, for example, sole trusteeship where you are moving from purely a lay trustee board to a purely professional trustee board at the smaller end. One of the reasons for that is to raise governance standards. I do not think it is a one-size-fits-all solution.

David Fogarty: I touched on this earlier. I think that there is an argument for the—you used the term "delegated" but to my mind it is partly about delegation but it is also partly about the assets existing in one place, so that there is the ability to understand values day to day and to act between the different parts of your investment strategy.

The level of delegation is not universal. Where people use a delegated approach they often have quite different rules around that delegation, and again that is a balance of discussion that has to take place at a scheme level for the comfort of the trustee board, the comfort of the sponsor, the perspective of the skills of the trustee board engaging with that party. But generally speaking, I am in favour.

Rod Goodyer: On governance, as Harus says, it is not a simple line to join because there are small schemes that came through all of this absolutely fine and managed things very well. Likewise there are some larger schemes, we have heard anecdotally, who have had more challenges because the stresses have impacted them more on their asset allocation.

I think the key is driving through good governance, and that is about quality of setup, infrastructure, trusteeship; all of those things that I think the Pensions Regulator is driving are the right things. I think that aggravating things at scheme level is one option but there are other ways to effectively drive through that good governance from better structures that can be put in place on a bulk pooled basis.

Q94 **Sir Desmond Swayne:** If it were to happen again, if we were to get those movements again that we saw in September, let's say now, how

ready would schemes be and what is your assessment of the announcement that was made on 30 November setting out the expectations for funding requirements?

Rod Goodyer: On what would happen now, the collateral buffers have been put in place. If those events were to repeat themselves the pooled funds would not come into the same crisis, although again clients would quite quickly be being asked for more collateral. I think again it would create some collateral but it would not have to be done at the same urgency and causing the operational challenges we talked about. The system is better prepared to withstand that.

I think the guidance that came from the regulator on the collateral requirements, and also the announcements that came last week from the European regulators—the pooled funds are not domiciled in the UK; they are generally domiciled in either Ireland or Luxembourg. Those announcements and the guidance that has been given looks very sensible to us, that we are now looking at a 3% to 4% collateral buffer. That seems sensible too. I think that the industry is moving in the right direction and it is probably worth saying that the larger segregated mandates they have already moved to a similar position.

But as we said in our submission, we still think there are some other points to look at, operational things. I think the industry needs to work together to look for other improvements and learnings from all of this as to how we could work more seamlessly in another period of volatility. The market was very well set up, if interest rates had simply risen 1%, for a lot of this to just happen automatically within pre-agreed mandates. It just needed a lot of interaction because it rose so much, so quickly. I think that there is more that could be put in place along the lines of some of the things that David has just touched on to help that work better in future.

Harus Rai: I am happy to add to that. I agree with Rod that we welcomed the guidance. There is some useful information in there of what they expect from trustees in conversations that should be happening and that are happening. The 300 or 400 basis points scenario testing is welcome. But it is a large amount so we need to now understand what sort of effect that will have then on pension schemes for where they can invest elsewhere. If I come back to the point I made right at the beginning, we are trying to erode deficits to ensure that the reliance on the sponsor covenant is not needed, and that is effectively the approach the regulators and the DWP want trustees to take.

We want to ensure that we can maintain and have that ability to pay full member benefits at all times. These are partner conversations—David touched on this—on where will we invest going forward. As I say, we welcome those conversations.

David Fogarty: A slight variation because, Sir Desmond, you said if it happened today. I think if it happened today there would be nearly as

much of a problem because the requirement for a LDI manager to have a higher tolerance for rate rises is there but that is only part of the infrastructure.

Like we just talked about, schemes have not had the time post-crisis to review their strategy. They have not had time to reconsider their hedging level and whether that is the one they like or want. They have not had the time to reconsider the impact on the rest of their assets. They have not had time to reconsider whether they have the right skills to take all those decisions and whether they should do more to strengthen the board.

Hopefully, in a matter of probably three to six months—and it is more like that rather than weeks—many of those things will have been gone through and they would be better prepared at that point. I am sure that there are lots of lessons on the operational side within asset managers, consultants and other advisers of being more able to cope with having to deal with all of your clients at the same time as opposed to a smaller fraction each week or each month.

Q95 **Sir Desmond Swayne:** Iain Clacher told us that the forthcoming new funding requirements were going to be LDI on steroids. I have a note here from the Railway Pensions Trustee Company that says basically it will lead to the closure of the remaining defined benefit schemes because of the additional costs that come with them, that it would increase the systemic risk because of the greater inclination for herding, and that it would be very difficult to support the Government's growth agenda. Do you agree with any of that or all of it?

David Fogarty: Probably not. What the crisis should have taught trustees to do is to be more reflective of the level of hedging that they want and the consequences for the rest of their assets. That is what it should do so that if you take a particular trustee board that then decides it wants to maintain a relatively high hedge, and it needs to have the ability to withstand a significant in rates and the capital to do that, the assets it can invest in need to be liquid and there are probably fewer of them. That means that either the sponsor will have to pay in more money or the time they will take to reach their full funding will be longer. It is not necessarily the case that everything falls over. It is just there needs to be change.

Q96 **Sir Desmond Swayne:** Are there any other future risks for which we should be preparing now?

Rod Goodyer: I think within the pension system—although obviously this session has been about LDI and it is very much a DB issue—the level of contributions going into DC pension schemes continues to be a big risk to the UK. I do not think that the alignment of the contributions and members' expectations of what they will receive particularly, compared to what their parents' generations received in pension provision, is correct. That is a big challenge coming down the line, as we get a generation

coming to retirement who have predominantly DC pensions that will give them materially less income. That is probably the biggest challenge that the industry faces.

David Fogarty: There undoubtedly are, but we do not know what they are, which is the big challenge. To my mind there are two critical issues. One is that nearly always when there is a crisis, no matter what the crisis is, the key issue is liquidity. Do you have the liquidity, whether pay pensions or meet obligations, that you have within your investment structure? I think that this crisis will have highlighted the importance of liquidity.

Then the other point is understanding. No trustee board should invest in an asset that it does not understand the opportunity for what can go well and the risk of what can go badly. That goes back to things like the global financial crises. That is the issue here: do you understand what you are investing in? If you do, and you understand the risks, you should not be knocked sideways when events happen.

Harus Rai: I echo Rod's comments on DC; 8% autorun contributions is far too low for someone to have a sustainable pension or income and retirement, not just pension but income and retirement. That can potentially put additional strain on the state for state pensions. I think you are right to talk about the funding code because we are waiting with interest to see how the events of the mini budget will have affected the funding code.

There is a desire from the regulators and from DWP, as I mentioned before, to reduce the reliance on the sponsor. That is a direct result of the fact that we have seen in the past—previous Pension Committees have looked at BHS, British Steel, Carillion—where the sponsor's covenant has weakened to the point where schemes have had to enter into the Pension Production Fund, and a result of that for certain members is that benefits will be reduced. The approach of the regulators and the Department for Work and Pensions is the correct one, to get that scheme in a position where members' benefits can be paid in full at all times.

Chair: Thank you all very much for interesting answers to our questions. We are grateful to you all. That concludes the questions we wanted to put to you, and we would be grateful if the second panel could take their places on the table.

Examination of witnesses

Witnesses: Abdallah Nauphal, Kerrin Rosenberg, Jonathan Lipkin and Charles Prideaux.

Q97 **Chair:** A warm welcome to you all. Thank you for being willing to answer some questions for us this morning. Can each of you in one sentence tell us who you are, starting with Abdallah Nauphal?

Abdallah Nauphal: I am the Chief Executive Officer of Insight Investment, one of the large LDI providers to the UK.

Kerrin Rosenberg: I am the Chief Executive of Cardano Investment. We are a fiduciary manager in the UK and we use leveraged LDI solutions as part of a fiduciary solution.

Jonathan Lipkin: Good morning. I am Director of Policy Strategy and Innovation at the Investment Association, which represents investment managers operating in the UK.

Charles Prideaux: Good morning. I am Group Head of Strategy and Solutions for Schroders. Schroders is a global asset management company headquartered in London and offers both fiduciary management with LDI in it, and LDI separately.

Q98 **Chair:** Thank you all, and welcome. I will put the first question. We heard last week from Iain Clacher and Con Keating who questioned whether it is right to focus on matching the present value of pension fund liabilities, given that in reality the fund must pay out pensions for many years, so the present value does not necessarily capture what funds are required to do. How effective do each of you think LDI is for managing the real risks that pension funds face? We will start with Mr Nauphal.

Abdallah Nauphal: Absolutely I think that is an important question, but also quite a confusing topic to talk about, because ultimately defining what future value is and how you measure it is an important question.

At the end of the day, I think one should start with the understanding that a balance sheet of a pension scheme is made up of both the asset side and the liability side of that balance sheet. On the asset side everything is present value. The price of a bond is the present value of that. The equity is the present value of what you expect from it. So the asset side of the equation is based on the present value of it. What do you compare it to when you are trying to make a decision on whether this fund is well funded or not funded and the like? When people talk about present value versus future value the question comes down to what the discount rate is you would use to apply to those future values to make a decision. The proponent of the future value would suggest that you should be using the expected return on the assets to discount these longer-term valuations. That is the way it used to be done, until about 20 years ago when there was a big swing against that, for reasons that were very important, which are important to highlight when one compares them to the LDI.

What were these issues? The first is a lack of comparability and transparency. Two companies could have the exact same assets, the exact same liabilities, but different expectation of what the returns may be. One will say it is gilt plus three, the other one gilt plus four. So even though they are exactly the same, they will have a different funding level. So how do you compare it? What is the transparency?

The second one is there is a presumption that you are able to forecast this long-term return with enough accuracy so that we are able to do that projection. The truth of the matter is that every study that I have seen that is serious about it shows that our ability to forecast long-term return is pretty close to random in accuracy. We are not good at these things, so it already introduces a bias.

That leads me to the third deficiency, which is because the liabilities are not well defined you are never really sure how well funded a scheme is, so you could leave it exposed, to a big extent, to a sponsored risk. If the sponsor goes bankrupt, you are left with a very big deficit to make up and you end up with substantially lower benefits that are paid to the members.

The community has moved away, the overwhelming majority of the accounting community, actuarial community, the regulatory community around the world and is trying to use the yield on an instrument that looks like the liability and say, "This is the best way to ultimately provide transparency and a sense of how well the funding of a target is" and this was the introduction of the present value concept, but using a discount rate that is transparent, but also a discount rate that is not transparent. This is the real difference between the two of them. The world has seriously moved on because of the issues that existed with not trying to manage the value of the liability correctly. Therefore I do believe that LDI is exactly the right tool to reduce the real risk in a plan, rather than a fictitious risk as has been presented before.

Kerrin Rosenberg: I agree with everything Abdallah Nauphal has said. I would add a couple of perspectives. For most occupational pension schemes, certainly the ones that are closed, this is part of a journey, and the journey involves a move towards becoming better funded, removing a deficit and being able to be self-reliant, to no longer be reliant on a company.

Now, most pension funds, certainly occupational ones, certainly the ones that are closed, which are the overwhelming part of the industry, are on that journey. In fact, the events of this year have accelerated that journey probably by several years. Within the next five to 10 years most of the occupational industry expects to be self-sufficient, and if that is your end point it is very important to keep score against whether you are moving closer or further away from your end point.

It is also important to remember that the role of leveraged LDI will naturally decline as pension funds become better funded or are less requiring of higher returns or able to naturally derisk. Within the next five to 10 years leveraged LDI will naturally become a smaller part of the industry due to that effect.

Jonathan Lipkin: The only thing that I would add is that when one looks at the combination of the overall funding position of the DB universe and the stability of that funding position one can see what LDI has delivered

over the past two decades. In that respect, I think Kerrin's point about the journey and when we look at the data of how that journey has progressed, we can see very clearly what the benefits have been.

Charles Prideaux: I echo what has been said and would simply add that the key thing here, the clue, is liability driven. Ultimately, defined benefit plans now in the private sector are for the most part closed to new members. The liability, therefore, in the future is very defined and what LDI does is effectively it is a funding risk protection strategy to smooth the journey towards fulfilment of that contractual liability. It is that client focus obligation that I think probably courses through all of this.

Q99 **Chair:** Mr Rosenberg, you gave us an example of leveraged LDI enabling a scheme with a weak sponsor to reduce its deficit and manage with reduced employer contributions. What would have happened in that particular case if LDI had not been available?

Kerrin Rosenberg: We looked at a couple of case studies. We have been using these strategies for about 15 years, so we wanted to examine what might have been the case, had leveraged LDI not been used. In the particular example this was a pension fund that was worth about £1.3 billion 15 years ago. They have used leveraged LDI. Their funding ratio has improved; their deficit has reduced over the last 15 years.

We did a simulation and said if they had done everything else the same but not deployed leverage, they would have been £600 million worse off today. That takes account of the yield rises that we have experienced in 2022. I would say there is nothing unique about this pension fund. The analysis, the mechanics, are the same for any other DB pension fund that would have been around over the last 15 years.

The reality is that because a leveraged LDI is protected against inflation and interest rates it stabilised their funding ratio to enable them to invest in higher returning growth assets and it meant, very importantly, that the regular payment of pensions could be met without causing the assets to diminish to a point of no return.

Had they not used leveraged LDI they would have been paying out pensions, their asset base would have collapsed and at some point they almost certainly would have had to go into the PPF and be closed down.

It is a very helpful example of why we in the industry and those of us who have been proponents of LDI see this as a very valuable tool.

Abdallah Nauphal: If I may talk about leverage a bit because that may explain a little bit the context. Leverage is mentioned in many contexts and can be used for very different reasons. You can use leverage to speculate. If you think something is going to go up 10% and you leverage it 2:1 you get 20%. Or it can be used for hedging. Hedging is a removal of the risk, for instance if I take a company that has foreign suppliers you would hedge the exchange rate that exposes through using

a swap. You use the same instrument for whether you are speculating or whether you are hedging, and both are essentially vulnerable to the same liquidity risk, but there is a very big difference. If something goes wrong, like you get a liquidity risk, when you are leveraging you are impairing the solvency of the company. It can go bankrupt. This is what LTCN did, for instance, but if you have a liquidity crisis when you are hedging, you are never impairing the solvency of an underlying instrument, because assets and the liability move in tandem and in lockstep. This is what leveraged LDI does. It never impairs the solvency of the underlying securities, because they are moving in tandem, and as such it is very different from speculation, which is the other form of leverage. One needs to make that distinction.

Q100 **Selaine Saxby:** Good morning. Warnings about liquidity risks for schemes using LDI started to emerge earlier this year. Did you have to make additional collateral calls at that point and to what extent were schemes able to meet them?

Charles Prideaux: As I think was commented in the earlier panel, we saw a sell-off in the gilt market in the early stage of the year. Speaking on Schroders's behalf, all of our collateral processes worked as normal and as expected. Yes, that scenario of rising interest rates was catered for, had been planned for, and everything happened as it should have done. What changed of course was what then happened in September where you had effectively the introduction of a disorderly market, given the combination of scale and speed of those two things together of the sell-off, which therefore put additional stress into the system.

Abdallah Nauphal: Insight managed to get all the liquidity that we needed from our clients from the beginning and during the crisis. We were never forced sellers of gilt up to the crisis, up to the Bank of England intervention or after, largely because we have generally two things: a more conservative buffer, but also the communication with the client that allowed the liquidity to come in. It was tough, and if the Bank of England had not intervened when it did, we would have been in a different position, but it worked during that phase.

Q101 **Selaine Saxby:** In hindsight, were stress tests adequate, particularly for pooled funds, and do you think the Pensions Regulator should have done more earlier?

Jonathan Lipkin: To set the context and I know this has been talked about a lot, the Bank of England's commentary on root causes has been helpful. There was an unprecedented move in gilt markets in scale and speed and Sarah Breeden said to another Select Committee inquiry that that was the lesson and therefore hindsight now would be baked into the data sets going forward. The stress tests have adjusted, and that is already reflected in the greater collateral buffers that we are seeing, which in turn implies lower leverage. Regulators in Ireland, Luxembourg and the UK have expressed approval for that adjustment. I think that is

the key message in terms in the first part of lessons learned from that episode.

Kerrin Rosenberg: It is always good to learn lessons, but if I may use this as an analogy, because this is a complicated topic, take the retail banking sector. We all know that if every single customer at Barclays Bank turns up on Monday morning and demands their money back there is not the cash to satisfy that. That is not a failure of the system or a failure of the bank; in fact, we want the bank to take that money and invest it. We do not want it sitting around in the till. There needs to be some sort of expectation about how many people might need their cash back, and there do need to be regulatory limits.

Like any part of the financial system the LDI market functions in the same way. We have an expectation of what normal volatility might be. We should remember that for the first eight months of this year interest rates rose by a full 2% and the whole industry coped absolutely fine. I echo comments made by colleagues; we were able to meet those collateral calls without any issues.

The question is what sort of an extreme event is prudent, what sort of an extreme event should you plan for? With the benefit of hindsight, I think the buffer should be larger. I think everyone has acknowledged that. I think the industry has effectively already moved to that position. That does not in the same way as my analogy invalidate the role of retail banking. In the event that one might have a run on the bank those are exactly the circumstances where the Bank of England needs to intervene to create a calming environment and to create a functioning market. Then one might reasonably need to ask whether buffers should be a bit larger and should there be other things. This is not something that in my view invalidates the tools or the process. It might mean that we need slightly larger buffers and better governance around it.

Abdallah Nauphal: May I try to describe the process we use to calibrate the collateral? That may help shed some light on how one arrives at a particular level of stress test. What is the collateral for, in the first place? Our clients are asset rich, but they do not keep a lot of cash and the problem is that you obviously need to post collateral daily, and it takes a bit of time to dispose of the assets to reliquefy your buffer. Call it a week, if it is a liquid bond and a well-developed covenant, maybe two weeks if not.

What the buffer is supposed to do is protect you for those two weeks in the time that you need to get the cash once you make a call from that client. The way we have calibrated them is we have looked at the last history of index-linked and said, "What has been the worst day ever in index-linked land in interest rate rises?" and we said, "Let us add a buffer on top of that of about 50%." That brings you to about the 1% that the regulators both in Europe and the UK have used in general.

But out of an abundance of caution we decided to add another 0.9%, making them about 2%. So basically what we have used, the worst possible period, added 50%, added another 100% on top of it, and therefore this is as conservative as one can imagine being based on the historical record.

Clearly what has happened was that the historical record was not an appropriate way to calibrate those risks, and we should have assumed that a market can be completely broken and fail to function, which is exactly what happened, and lead to something that even with 150% buffer over the worst day would not be adequate. It is a challenge in how you calibrate it ahead of the action. Now we know that the market can behave the way it has, we have doubled the buffer practically, so gone from about 2% to about 4% in everything we do, so the market yields can rise 4% before the buffers are exhausted.

Charles Prideaux: We have done exactly the same and in essence what regulators, both Luxembourg and Dublin, have come out with since has effectively validated the approach that we have taken.

Q102 **Dr Ben Spencer:** Going back to Sarah Breeden's analysis, one of the things that she said was the root cause of the problem was poorly managed leverage. Would you agree with that?

Abdallah Nauphal: Sorry if I talk too much. Please let me know, Chair and I will tone it down, but I have a view on many things.

I think only partially. I do not agree that that was the primary cause, but I think the quote has two questions. What was the contribution of leveraged LDI to the crisis, and secondly was it poorly managed? That is slightly different.

If I can focus on the causes briefly, it was only a partial contributor to the causes, not the primary catalyst. It was a confluence of factors that came together, that created this unique event and the truth of the matter is usually these kinds of events, when they happen, are not because of one thing. It is a number of things that come together unexpectedly.

By importance of ranking, the first one is we need to recognise how jittery the markets were with regard to the long-term outlook for the fiscal position of the UK. At the time, the Bank of England was ready to start unwinding QE, so you had a jittery market that turned into panic on rumours and then confirmation of the mini-Budget. That was the primary cause of the sell-off and led to an increase in risk premium across the board. It was not just gilt. The currency fell very sharply, and other assets were also hammered. It was a very much UK risk premium issue to start with.

The second issue in our opinion which was substantially relevant here was how illiquid or dysfunctional the gilt market became, especially the index-linked market. You could not do a small trade without moving the

prices very significantly. This is not the typical market you expect of a large government bond market. You expect that in a tiny little market. It was impossible to trade without seriously moving the market, and that is due to two factors: the composition of the ownership of index links being primarily pension funds, but also due to regulation post the financial crisis, which had made banks unwilling to house any risk, so they want to pass the risk and if there is no one to pass it to then they will move the price sharply enough so that they do not have to buy it from you.

The third is definitely the leverage issue that may have led to some forced selling in some part of the industry.

Two of those are being dealt with, the fiscal situation and the leverage situation. What seems to be conspicuous by its absence is any debate around the liquidity of the gilt market and the index-linked, which in my view has the worst longer-term consequences for funding.

Kerrin Rosenberg: I would add to that the complete lack of confidence, a loss of confidence in the gilt market was the cause of the crisis, and in my analogy if people lose confidence in a particular bank it causes the run on the bank. We had a run on the gilt market effectively for a few days.

On the margins, there may well have been some pension funds who were less able to manage themselves in those circumstances. It may be true that there were some poorly managed leverages among some. My experience is that was probably on the margins, probably a small number and that probably resulted in a small number of pension funds being disproportionately affected by this.

Jonathan Lipkin: If I could amplify the distinction that is being made between the proximate cause and some of the lessons that may need to be learned. We have been very struck by multiple sources of Bank of England comment on the conditions in the markets that Abdallah and Kerrin have referred to, but it does not mean that there are not lessons to learn from an operational resilience perspective. Some of our preliminary views were reflected in our evidence to this Committee, which echo comments that have been made in the previous panel, and we can go into that in more detail if you wish. It is essential to separate out why the markets were in that state of dysfunction and then what we can do to ensure that operational resilience is at its maximum for any such future dislocation.

Charles Prideaux: I agree with that. Essentially the market was the market and as I said before was during that period disorderly. If we had been talking about equities, we might have been talking about the circuit breakers that exist for equity markets when equity markets fall. The gilt market does not have such a thing, but the Bank of England through its intervention effectively fulfilled the same role as a circuit breaker.

The other element of course as Jonathan is saying is around when you have a period of intensity that puts focus on process management and governance.

Q103 **Chair:** It sounds as if you are saying the Bank of England did not really understand what was happening properly or its analysis was mistaken. Have I understood you correctly?

Jonathan Lipkin: I think we are saying the contrary. Absolutely the contrary. We are saying that the Bank of England has presented the evidence about the unprecedented nature of what happened in the context of the market dislocation, and we agree with that. We agree with Sarah Breeden's comments to the Treasury Select Committee that the lesson was the scale and speed of what took place and therefore I think that is where we are with respect to how this crisis started.

We are in the early stages still of the regulatory investigation. There is this Select Committee investigation and others. What we are indicating equally clearly is that in such situations there are operational lessons to learn and I think there again we would be aligned with some of what is being said by the Bank and regulators about how we ensure maximum resilience going forward and we want to be very considered and thoughtful and calibrate according to the evidence that we are all discussing.

Q104 **Chair:** But you are clearly disagreeing with Sarah Breeden's point that the root cause of the problems was poorly managed leverage?

Kerrin Rosenberg: Yes.

Jonathan Lipkin: Yes.

Abdallah Nauphal: I think they were different comments made.

Chair: I accept that some of Sarah Breeden's comments you do accept, but not that particular one. Okay.

Debbie Abrahams: I am not sure where we are up to. I thought I was doing Ben's questions, so which one would you like me to ask?

Chair: On our brief it is question 11.

Debbie Abrahams: Okay, which I think we have just asked.

Chair: I apologise for the confusion. In that case we come to Chris's question.

Q105 **Chris Stephens:** Abdallah, my first question is to you. To what extent were schemes unable to meet their additional collateral calls in September and October?

Abdallah Nauphal: The overwhelming majority of the schemes that we manage did. I cannot speak for the rest of the industry. I can only express the Insight experience. There are two types of clients, the segregated clients and the pool funds clients. The segregated clients

pretty much all met their collateral call. On the pool side I would say above 95% responded to the multiple calls that you have made, because it was not one call. That is where the complexity is. You made one call for new cash, but before the cash even came you had to do another call, because the markets were moving so fast. On the addition of all of those, more than 95% did, so that is a small minority that did not make that, and they had to reduce their exposure as a result.

Q106 **Chris Stephens:** Kerrin, is there any evidence of any fire sale of assets to meet urgent collateral calls and, if so, what longer-term damage might that have done to schemes?

Kerrin Rosenberg: There is certainly evidence of quick responses, and we heard that in the previous panel, that pension fund trustees and fiduciary managers were required to act at a speed that is usually not required, so there was a lot of that. There was a huge volume of assets that were sold to meet this.

To assess the longer-term impact of that we must bear in mind the rebalancing component. I think it was mentioned in the previous session that if you want to have, say, 50% LDI, 50% growth at the end of September you may have been 70:30 and you would be out of whack so even if you had the luxury of time you would want to sell growth assets to replenish your LDI. What would normally have happened is people would have spent a month or two doing the rebalancing and that rebalancing was accelerated into, in some cases, days.

I think "fire sale" is an emotive term, but there was certainly a fast reaction to do that.

Q107 **Chris Stephens:** Jonathan, in what circumstances did schemes fail to meet additional collateral calls and what was the result?

Jonathan Lipkin: We do not have the visibility at scheme levels as a trade body, so what we can do is look across the market, talk to firms and give an aggregate view. Therefore, I think probably it would be better to let some of my colleagues answer these more detailed questions.

Q108 **Chris Stephens:** Charles, I will try you then. Is there a need to increase the liquidity of assets to allow a faster response to future collateral calls or are there better ways of creating resilience?

Charles Prideaux: It is all about the aggregate strategic asset allocation that a client has. As I think has become clear, LDI is a component to an overall scheme's strategy. What is important is the context in which that LDI strategy is cast, the leverage and therefore the associated collateral buffer and what was described earlier in one of the comments, the liquidity waterfall to access available collateral, but that is all set in a way that can cope with the now revised stress test.

Q109 **Chris Stephens:** Charles, what do you think will be the overall impact of

what happened in September and October on asset allocation? Will pension companies undergo a wholesale reconsideration of where to make their investments or will they change how to make those sorts of judgments?

Charles Prideaux: Strategic asset allocation is an iterative process. Pension funds in my view correctly are very averse to violent shifts in tactical asset allocation because that does not tend to lead to success. Rather, to repeat the comments from the earlier question, the phrase that we are on a journey to fulfil member obligations, and that you set your strategic asset allocation through time with an aggregation of different exposures to risk.

What has happened, and you have seen a lot of commentary around this, is that the overall funding ratio of an enormous number of schemes has improved very significantly. We have line of sight on our internal fiduciary management book, and fiduciary is when you are the delegated asset manager and therefore have oversight of all of the assets, so that is why we are in a position to see this, and to give you an idea, from the end of May where the average funding ratio for this book of business was 78%, as at the end of October that had risen for the same equivalent book of assets to 87%. So the ramifications for that, as has been inferred by others already, is more LDI but possibly on a less leveraged basis, because it is less required. At the margin what does that mean? That means less allocation to growth assets, be they liquid ones, such as equities, or illiquid ones, such as infrastructure, real estate and so on.

The data that shows the collapse in allocation to public listed equity in the UK since the financial crisis is very stark. The "Purple Book" I think now highlights that the average allocation for a UK pension fund is down to 2%.

Chris Stephens: Abdallah, I see you nodding profusely there.

Abdallah Nauphal: I agree completely. I think one of the primary considerations that people take into account when designing an investment strategy is that funding status. If you are in surplus you clearly want a lot less risk than if you are in deficit, because you do not have to close that risk. Given the improvement that we have seen across the board in the funding there is no doubt that people are going to further derisk their portfolio in allocation to risk but also leverage. Both of these will reduce.

The only caveat in all of this, this is probably a multi-year process to reduce, what is important is to put in place the bridges that are robust enough to get us from today to where we are. That process has already started with what the regulator has mentioned for the new leverage, the governance, the stress test and so forth. There are a few other things that still need to be dealt with, primarily how you finance illiquid to prevent forced selling at the right time, if another accident of that nature happens.

I think the direction of travel is going to be towards a far safer and steadier plan. We need to help get there.

Q110 **Chris Stephens:** Kerrin, do you agree with that?

Kerrin Rosenberg: I do. There are implications for illiquids. That I think needs to be seen in the bigger picture, that as pension funds get closer to the end their tolerance for illiquids reduces naturally. The experience of this year has just accelerated that. I think that is a shame. There are lots of very good illiquids, social housing and areas that can make a real difference both to the economy and to pension funds. Regrettably, the industry has just reached a level of maturity where it is finding it harder to make longer-term commitments.

Q111 **Sir Desmond Swayne:** Can I ask the question that I asked the last panel? If those movements in the market were to happen again now, how well would the schemes fare? Secondly, what do you make of the collateral expectations that were announced on 30 November by the regulator?

Kerrin Rosenberg: If it happened again today, we would fare better, but before the Bank of England intervened there was no bottom to this market and it was difficult to see that. If we got back to a situation where one had genuinely lost all confidence in the gilt market, we would at some point get back into crisis mode. There is still leverage and it is there for good reason. Leverage levels have come down; collateral buffers have gone up. There have been process improvements, but that does not mean that one could absorb an unlimited shock.

Charles Prideaux: I agree. Of course, boards of pension fund trustees have now been through this experience and so they would be prepared in the way that possibly they had not been before.

Abdallah Nauphal: I concur in the sense that the two are linked. The fact is that you have a higher stress level that has been announced by the regulator that is intrinsically linked to making the whole situation more manageable if there is a repeat of the crisis. The interest rate buffer that we have now is 3% to 4%. The crisis led to a 2.5% type of crisis, so that would be covered by that. The risk is that the next crisis is this one times two, and then we have a bit of a repeat of the situation.

Where the risk of that becomes is the amount of illiquid assets in the portfolio. Do they have enough things that can be sold, not at a distress level, to reliquefy the buffers? That is what the industry is working on now to reduce those levels of illiquid investments.

Q112 **Sir Desmond Swayne:** What is the future of the forms that collateral might be able to take in preparation for that?

Abdallah Nauphal: Thank you for asking that question because for us it has always been a very critical one. We were always worried whenever collateral has to be in the form of cash that it creates liquidity issues to a

great extent. For instance, one of the reasons we fought very hard against forcing a pension scheme to clear all their swaps is because the collateral is in cash, and you create that potential for liquidity. Keeping the collateral in broader forms solved a lot of that problem. If you can include gilts that solves part of the problem and if you include high quality corporate bonds it solves even a bigger problem. Regulation today or at least bank regulations do not make it easy to use non-cash or non-gilt as collateral but it would go a long way to solve the liquidity challenges when that happens.

Charles Prideaux: I would echo that.

Jonathan Lipkin: I wanted to draw that together to give an answer to that. As colleagues have indicated and other panels have indicated the adjustment in collateral buffers adds very significant immediate resilience, but we will be working through some of these broader points around operational resilience that have been raised earlier this morning and today around governance, liquidity, collateral, eligibility, communication to ensure that that process is as robust as possible.

The third point that Abdallah and other colleagues have made that is also important is to look at the gilt market and some of the fragilities that have been exposed by this episode. To summarise, yes, there is a much greater degree of immediate resilience but there is a need to consider some broader lessons that can be considered relatively quickly and actioned, but that process does need to work through.

Kerrin Rosenberg: I would add that there is a trade-off between how safe one makes the collateral buffer and what return one can earn on the growth assets. The more you shore up in collateral the less you are investing in growth. At 400 basis points, at 4%, there will be some pension funds who will have to go back to the drawing board and reappraise their strategies. At 4% buffer levels they may have to pare back their growth ambitions and that will have consequences on the amount of money their sponsors will have to put in. There is a trade-off there and if one were to go to the extreme and say, "No leverage is allowed. We need to have an unlimited buffer" it would probably cost the industry about £30 billion or £40 billion a year in extra sponsor contribution. Somewhere there is a systemic trade-off.

Q113 **Sir Desmond Swayne:** Finally, is there a significant risk that is out there that we have not touched on, which we need to be preparing for now?

Charles Prideaux: I think what the world is dealing with now, not just the United Kingdom, is the reversal in global liquidity and you are seeing in the newspapers daily indications of the distress of that liquidity withdrawal, that is, going from a phase where basically you were getting zero and in some countries negative return on capital on a risk-free basis through to now where interest rates are rising, as we all know. When you have had an era where capital can be allocated against that backdrop, has there therefore been the increase in potential for misallocation of

capital? The answer must be yes. Asset managers in a sense are paid to worry, and so are we anxious about the ramifications of where things could unfold and to your point where the next stress could emerge? Yes, we are doing that every day. Sadly, none of us have a crystal ball.

As far as the pension system is concerned, I think we have been covering that in detail and I would put out there again the need, notwithstanding the environment that we are in, to do all that is possible to create a pro-saving culture within defined contribution schemes with associated long-term asset allocation as well is very important for this country's future.

Abdallah Nauphal: Talking about liquidity in a slightly nuanced version, I think the liquidity of the underlying market that we talked about in the context of index-linked and gilt has deteriorated but it has deteriorated everywhere in the bond market. Equities tend to trade on exchange. Bonds tend to trade over the counter, in a sense that you need an intermediary between them, and when the intermediary is told that they cannot hold much inventory at all, it becomes a much less liquid market.

All bond markets have become much less liquid in their ability to transact big amounts. That has potential consequences not just for this. In a broader sense it has consequences for unit trusts and so forth. If there is a lot of withdrawal you are not able to sell fast enough without moving the prices very sharply. Liquidity risk events are potentially the bigger risk in the next few years that we have not addressed.

Jonathan Lipkin: One thing that I will add is that although we do not know exactly where the next threat comes from, there is a lot of work happening between industry and regulator in the UK and elsewhere on what we call the liquidity toolkit. What is our ability to manage some of these risks as they emerge in our ability to measure liquidity, to price effectively, to have appropriate access and frequency of access to funds? That is an area, particularly the work that has taken place in the UK with the Financial Policy Committee, where we feel that the liquidity toolkit is being strengthened, which should give us the ability to be in the best position as possible when future threats emerge.

Chair: We want to backtrack a little and I apologise for the confusion that I caused earlier on, to pursue the collateral point a little bit further.

Q114 **Debbie Abrahams:** Do you think that schemes have sufficient information on which to make decisions? Dalriada has made some comments that that is not the case. Do you accept that?

Abdallah Nauphal: By law, schemes and trustees must take advice, expert advice and the primary communication channel is usually between the advisers and their client. Once they are appointed we become part of that exercise and we have at least with regard to Insight an ongoing programme of communication, training that people attend, all kinds of trustees, and raising awareness of all the issues that tend to be possible risk down the road. We never stop that process. I personally think that

especially this year we have been very explicit about the rise of interest rate risk and how people should deal with it.

Generally, our clients, and again I can speak for our experience, have been reasonably aware of the potential risk. Trustees get a slightly bad rap in all of this, because while there is a broad range in skill and training, I think they really try to learn and dedicate themselves, but they have been blindsided by this event, in the same way that we all have been. The managers were blindsided, the regulators were blindsided. It is not just the trustees that did not see it coming; it is pretty much all of us who did not see it coming. Even if they knew a lot more it would have been pretty impossible for them to use that stress.

Debbie Abrahams: Does everybody agree with that?

Charles Prideaux: I agree with that. The commitment to training is part and parcel of the role to help. The responsibility that trustees bear is huge and then it is our job to try to help equip them as best as possible to make the decisions with transparent reporting and the like. I agree and this was covered in the session earlier, interest rates we know have been rising throughout the course of the early part of this year, and so boards of trustees were already very familiar with the reality of that, and how their LDI portfolios were reacting in response.

Kerrin Rosenberg: There is the angle of trustee knowledge and data. There is also the regulatory transparency and that is where something could and should be done. At the end of the day we have a £500 billion index-linked gilt market and we had a £2 trillion defined benefit market seeking to access that to hedge. While all the firms work in the best interests of their clients, to add it up and see the big picture one needs to collect all that data so that you can understand the impact.

As Abdallah mentioned, the decline in liquidity of the index-linked gilt market is a concern, and it is not obvious that that information has been centralised and collected in a way that has facilitated monitoring of the liquidity of the index-linked gilt market. I think that is where more could be done.

Q115 **Steve McCabe:** I had a small point I was curious about. There was some reference in questions earlier to the views of Iain Clacher and Con Keating, who I think it is fair to say do not have a very positive view of LDIs. One thing I noticed that they had raised, is it right to refer to the present value of liabilities as the market value? Is it one and the same?

Abdallah Nauphal: I think we touched on that a bit earlier, but if you do not mind me repeating.

Steve McCabe: I am sorry if I missed it, Chair.

Chair: I think you may have done but do repeat the point.

Abdallah Nauphal: Every pension scheme has a balance sheet that has the assets.

Q116 **Steve McCabe:** Yes, I was here when you gave that explanation. What I was trying to understand, and I did hear that explanation, is that by calling it the market value is it giving the impression that there is some greater level of calculation being done rather than just simply stating what you stated as it being the other side of the balance sheet?

Abdallah Nauphal: At the end one can think about it slightly different rather than using the terminology of market value, in that you have a stream of cash flows that are your liability payments that you must match. You can decide to lock those values in one way or the other through a cash flow matching of a bond or through hedging those risks using those derivatives. It is about locking down the value of the liability so that your asset strategy can then know what it is attempting to target in improving the return. What that tends to do is to improve the predictability and the direction of travel between where you are now and where you want to go, which is largely the outcome that people are seeking is ultimately better funding.

The risk is that if you do not hedge those liabilities a movement in either inflation or interest rates could make your scheme less solvent or less well-funded. The reason you would hedge them is to remove that risk. Whether you want to call it market value or not is probably less the issue.

Q117 **Steve McCabe:** The reason I am pursuing this is I understand that is a perfectly valid explanation. I was trying to think about this from the point of view of the trustees and I wondered if a trustee were told this was the market value could they be induced to think that there was more scientific rationale behind this than the reality?

Kerrin Rosenberg: Where the phrase "market value" is very relevant is where you are considering a buy-out. Of course, for many trustees, maybe even the majority, that is their ultimate objective. For many now that is several years away and one is thinking about how close, so a buy-out really is a market value and that is the price you pay an insurance company to take these liabilities off your balance sheet. As soon as you have identified that as a destination you do want to keep track of whether you are getting closer or further away from that, and you will be tracking the market value of your liabilities using someone to help provide you with a monthly update. For many trustees that is a very valid way of thinking about it, and it is correct to call it a market value.

Abdallah Nauphal: Even if you are not targeting a value, it is the same concept. If you are overfunded, you have a surplus, you may decide you want only bonds that cash flow matches all of your liabilities and the relevant metric here is what is the market value, so this is the price that you would pay to do that. In that sense, it is the one metric that has a lot of relevance to what should be your benchmark from the funding perspective.

Q118 **Steve McCabe:** So you would disagree with Clacher and Keating when they say it is wrong to compare these two or suggest that they are the

same thing. You would say they are wrong?

Abdallah Nauphal: It is not just me.

Steve McCabe: No, but you are the witness.

Abdallah Nauphal: I would say the overwhelming majority of the accounting, actuarial and regulatory consensus around the world has moved on and disagrees with that.

Q119 **Chair:** A final point. You have all talked about lessons to be learned from this experience. To what extent do you think there is now a need for greater regulatory oversight of what is happening in this area around LDI, and if you think there is, and you indicated one or two things where perhaps this is appropriate, what should that oversight look like, in your view? Let us start with Mr Prideaux.

Charles Prideaux: I think what we have been talking about today is a market and the importance of that market functioning correctly. It has numerous stakeholders in it. There is the Debt Management Office, boards of trustees, advisers, with the Debt Management Office being the supplier to the gilt market and the overwhelming buyer being the pension funds. What needs to be in place is the ability for aggregate data to be visible and shared, so that the overall holistic view can be taken a view on, such, to repeat my phrase, that then an orderly market can be maintained. Certainly we would be very supportive of aiding and abetting the reporting that we do, because obviously we only see the tranche that we see, to help those with an all-seeing position to have that aggregate overview. That must be a lesson to be learned here to facilitate smooth operation.

Jonathan Lipkin: I would amplify and echo what Charles has said. There is absolutely no lack of regulation or regulators looking at the supply chain from fund managers all the way through to pension schemes. We probably do not have time to get into it now, but from the fund onwards there is an extensive set of requirements and reporting with respect to what we, as an industry, are required to tell regulators. Quite clearly from a system perspective no individual actor in that chain can see the whole picture and that is why Charles is right to talk about the lesson not being more regulation, but how these different pieces of overlapping regulation fit together such that the regulators in different capacities, whether systemic pensions or securities, can feel confident that they have the information set necessary.

Q120 **Chair:** Are you saying that the regulation is too fragmented now?

Jonathan Lipkin: I do not think it is fragmented. I think some colleagues in the industry have used the phrase "overlapping rather than underlapping" so I think it is a question and Charles put it extremely well and the regulators would be better placed to answer this, which is from our perspective we feel that we are providing an awful lot of data. The question that the regulators will answer is whether that data flows in

ways that allow them to have the full picture noting, as we have been stating throughout this session, that everyone from the central bank onwards has been saying that the exact nature of this crisis could not have been predicted.

Q121 **Chair:** Which of the regulatory players do you think should have that overview?

Jonathan Lipkin: I think that will be for the regulators to decide according to their unique needs. What we are looking at in this market, there are different priorities depending on which regulator you are. The Bank of England clearly has a financial stability imperative. The Pensions Regulator is looking a bit more narrowly at pension schemes. You have the FCA of course, who is the lead regulator for investment management and fund management in the UK. The regulators will give a view about how they see their differing responsibilities fitting together in such a way that we can ensure that that whole picture is available.

Kerrin Rosenberg: I have a slightly different perspective. Whenever you ask the question if there should be more regulation or what should one do, I think one needs to keep in mind who the injured party is. Exactly who are we trying to protect from what? My perspective is I do not think that regulation should aim to protect the system against a complete lack of confidence in the gilt market. That is too big an ask for the regulatory environment.

If we have that type of event with the lack of confidence there will be a fallout. Fallout can be contained but I do not think regulation should try to avoid that. Who might one be wishing to protect? There are a lot of anecdotes and every colleague in the industry I speak to has an example of a scheme here or a scheme there who were perhaps using too much leverage, who did not have the right governance, who have been negatively affected. It does not represent the mainstream, and I think you have heard from all of us that the vast majority of pension fund clients got through this crisis relatively well, relatively unscathed, but there are probably some schemes out there who were not abiding by sensible principles, who were perhaps using leverage a little more than they should have, and it does seem to me to be a lacuna that there are no guidelines. There is no system that tells you, "That is a safe way to use leverage and that is not a safe way to use leverage." It seems to me that the potentially injured party here might be those outliers, who are probably a relatively small number of pension funds, who have been harmed in this process. I think the Pensions Regulator could be asked to create some parameters to ensure that leverage is used sensibly.

I do not think that would affect the vast majority of the clients that we represent, but on the margins that would be useful.

Abdallah Nauphal: Two observations, if I may. First, on the various regulatory bodies, the fact that the crisis was due to a number of factors, each under the jurisdiction of a different regulator, a fiscal crisis is more

to do with Treasury or the DMO, and the stability of gilts may have more to do with the Bank and the other one around the GDPR or the FCA, and it was difficult for one to have a complete oversight of it.

I however think for regulation going forward it would be useful to clarify minimum standards for everybody. What I mean by this is for instance we were running a buffer of nearly 2%, while the industry from what I hear was 1% in general. There is an economic cost for me to have a higher economic buffer, because it is cheaper to use someone who has a lesser buffer. Having those minimum standards, which have already started to come through, through the various regulatory announcements, would help establish a minimum base of safety, which will be essential.

The second one is the monitoring of aggregate data that Charles referred to. It did not exist before. It is starting to happen and suddenly now there is a rich amount of data that one can use and hopefully see it as an early warning indicator of troubles to come.

My biggest wish, if there is one, is that once we get a bit over the crisis and we can sit and dispassionately assess what has happened rigorously, that there is a regulatory multibody assessment based on real data that we all can look at, to determine something a bit more credible. Right now, we are still all speaking out of experience and fragmented data, rather than a holistic view. I hope that at some point we will be able to do that.

Q122 **Chair:** How long is it likely to be before we are in that position?

Abdallah Nauphal: When passions die down is a difficult thing to talk about, but I would hope it is early next year, when hopefully the media have tired of it.

Chair: Thank you and thank you all for an interesting and helpful session. If any other thoughts occur to you after the session that you would like to pass on to us, please do send us an e-mail. We would be very keen to hear from you. We are most grateful to all of you. Thank you very much. That concludes our meeting.