House of Commons

Work and Pensions Committee

Oral evidence: Defined benefit pensions with liability-driven investment, HC 826

Wednesday 14 December 2022

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Watch the meeting

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

Questions 123-208

Witnesses

I: Charles Counsell, Chief Executive, The Pensions Regulator; David Fairs, Executive Director of Regulatory Policy, Analysis and Advice, TPR; Oliver Morley, Chief Executive, Pension Protection Fund; and Evan Guppy, Head of LDI and Credit, PPF.

II: Nikhil Rathi, Chief Executive, Financial Conduct Authority; and Simon Walls, Wholesale Director, Sell-side, FCA.

Written evidence from witnesses:

The Pensions Regulator

The Pension Protection Fund

Financial Conduct Authority

House of Commons

Examination of witnesses

Witnesses: Charles Counsell, David Fairs, Oliver Morley and Evan Guppy.

Q123 **Chair:** I warmly welcome everybody to this meeting of the Work and Pensions Committee in our inquiry on defined-benefit pension schemes with liability-driven investments. I welcome all those who are here for our first panel. Can I start by asking each of you to tell us very briefly who you are?

David Fairs: I am David Fairs, executive director of regulatory policy, analysis and advice at the Pensions Regulator.

Charles Counsell: I am Charles Counsell, chief executive of the Pensions Regulator.

Oliver Morley: I am Oliver Morley, chief executive of the Pension Protection Fund.

Evan Guppy: I am Evan Guppy, head of LDI at the Pension Protection Fund.

Q124 **Chair:** Thank you all very much for joining us. Can I start with a question for Charles and David? Witnesses in this inquiry have said to us that the policies of the Pensions Regulator are the main reason for pension funds switching from equities to gilts over the past couple of decades. Do you think that is correct?

Charles Counsell: May I start by talking about our role with respect to this? Then I will talk a bit about the way that we have encouraged schemes to manage risk. Our role is to regulate defined-benefit and defined-contribution trust-based schemes. In doing so, we have a number of statutory objectives, one of which is to secure the funding in DB pension schemes. The second is to protect the Pension Protection Fund. We have a role in improving the governance of all schemes, and we also have a role in ensuring that we protect the sustainability of employers.

Those are important in the context of the question, because we have been endeavouring to manage a balance of risks. We are managing the risk to employers of the contributions that they must make into their pension schemes. We also need to take into account the liabilities that the pension scheme has, and in particular to ensure that, at the point at which the members of that scheme retire, they have the best chance of getting the full benefits that they have been promised by their employer. There are also other risks that we take into account, such as the ageing of the population and, accordingly, the increase in liabilities. Of course, we are also trying to protect savers through this process.

With those things in mind, what we have done is to encourage schemes to think about the risks that they face. That means that we have encouraged

them to think about how they might hedge. In hedging, we are looking for them to be able to match the liabilities that I have just talked about, which are, in effect, the payments that members will get in the future, but also to hedge in terms of what might happen with interest rates and inflation. That is where LDIs have come in. Through the way that we have encouraged schemes to manage risk over the years, on a PPF basis the aggregate funding of schemes has moved from 83% in 2012 to 105% at the beginning of this year. At the end of November, it was 134%. There have been real improvements in the aggregate funding over the years, because of the way that we have encouraged schemes to manage the risks that sit within their schemes.

One final point is that we do not dictate to schemes what they should invest in. It is a really important principle that trustees have a fiduciary duty, and that they must manage the risks in their schemes as they see them. What we do not do is tell schemes, "You must invest in this," or "You must invest in that."

Q125 **Chair:** I think that was a yes, wasn't it? My question was whether your policies have moved people so substantially from equities to gilts over the last couple of decades.

Charles Counsell: Yes. Certainly, what has happened is that there has been a move from equities into bonds.

Q126 **Chair:** Let me just raise another point. The last point you made was that you don't dictate to people. Some funds have told us that the Pensions Regulator has placed them under what they felt was huge pressure to adopt LDI when they did not think it was appropriate, and they fear that that pressure is likely to increase with the additional powers and penalties that the TPR now has at its disposal. How do you respond to that complaint?

Charles Counsell: I am not sure I recognise the complaint, in truth. We don't put huge pressure on schemes or, indeed, on advisers. What we do do is encourage them to manage the risks that they have within their own individual scheme. It is important to state that the underlying basis is scheme specific: the circumstances of a large, open, immature scheme are very different from those of a mature, closed scheme, and perhaps there is a weak employer covenant. Those are very different situations. I do not recognise that we put them under pressure. What we do is set out clear guidance, and we expect them to take into account that guidance when they are looking at the specific circumstances within their scheme.

Q127 **Chair:** We have seen, for example, correspondence to a scheme from the regulator pretty firmly pushing them to adopt LDI, and I think what the schemes feel is that now that the penalties you have at your disposal are becoming significantly greater—that, for them, does feel like very great pressure that they are being placed under.

Charles Counsell: I think I need to repeat the answer I gave earlier, which is that what we are looking to do is to make sure that schemes prudently manage the risks that they are facing. We encourage them to do

that; we do expect them to follow the guidance that we set out. I am not sure about the correspondence that you are referring to, Sir Stephen, but if we feel that schemes are not following the guidance, we may well encourage them more strongly. But broadly, we are expecting them to take decisions that are appropriate for the particular circumstances of the scheme.

Q128 **Chair:** As you know, some witnesses have told us that they have been warning of the dangers of a death spiral here for quite some time, but that they feel that those warnings have been ignored. How do you respond to those claims?

Charles Counsell: With respect to a death spiral, you mean in terms of the collateral and the leverage that was held within the LDI funds.

Chair: Yes.

Charles Counsell: I recognise the evidence that has been given to this Committee on that. The view that we took in the lead-up to it was this. We were looking at what would be reasonable levels of bond movements, and across the regulatory system our view was—we believed—that the system would be robust to the level of a movement of 100 basis points. That was what we thought was a reasonably plausible movement, but beyond that wasn't a reasonably plausible movement. And what happened at the end of September was extraordinary movements—absolutely unprecedented movements. You will have seen that from the Bank of England's statements and their views on it. What we were trying to do was to have a system that would work to what we thought was a reasonably plausible—

Q129 **Nigel Mills:** The 1% was over what timeframe, Charles?

Charles Counsell: Well, what happened, of course, was a movement much greater than that over three days, and it was exactly that point—

Q130 **Nigel Mills:** Yes, but you said the system was robust for a movement of 100 basis points. Over what time period were you assessing that?

David Fairs: Schemes would have in place a waterfall of which assets they would realise, and pension schemes would expect that some of their equities—UK equities or overseas equities—they would be able to realise in a period of three to five days, so as long as the 1% went beyond three to five days, they would be able to sell other assets to top up their waterfall.

Q131 **Chair:** You were making some points to me about your response to the criticisms.

Charles Counsell: What we believed we had in place was a reasonably robust response across pensions schemes for what was a reasonably plausible scenario. What happened was something that was way beyond that, so obviously we have asked ourselves what lessons we have to learn from that, and it is clear that the level of collateral was not sufficient for what happened.

You have to take judgments as a regulator about how hard you push pensions schemes. Quite often we are accused of putting too much burden on our regulated community, and you have to take a view: how much is adequate, and how much is too much of a burden? Our view was that, given what had happened with movements of bond yields historically, a movement to 100 basis points over the period that David just talked about seemed reasonably plausible but pretty unlikely. As it happened, of course, something much greater happened.

Q132 **Chair:** You have told us that you did not take counsel's advice about whether leveraged LDI contravenes the restriction on borrowing in the Pensions Act 1995. Might you do so now, given recent events?

Charles Counsell: We are confident in the internal legal advice that we have, and I therefore do not think there is a need to take counsel's advice. I will let David talk a bit about the legality.

David Fairs: At the time that there was a transposition of the EU directive into UK legislation, there was a consultation by Government, and in the Government's response to that consultation, it acknowledged that there was concern that the transposition would make gilt repos, investment in pooled funds and so on not feasible. The Government said in paragraph 10 that it is not the intention to restrict the activities "in the example given above"—that is, LDI pooled funds and repos. That was the clear Government intent, and the way that it drafted the Occupational Pension Schemes (Investment) Regulations 2005 was with the specific intention of allowing those investments.

Q133 **Chair:** If there was to be a ban on leveraged LDI in pension schemes, what would the effect on schemes be?

Charles Counsell: Any change like that comes at a cost. In the end, you would then have to look at other ways of being able to secure funding, and there are probably two ways that you would do that. No. 1 is by investing in things that are riskier, but by definition, if they are riskier, you then have the risk that you might not get the returns or, indeed, you might end up with lower returns. No. 2 is that employers would have to pay more into the schemes to be able to make sure that they met the promises that had been made. It is also true that if you ban LDIs, you lose the ability to hedge in the way that we have been encouraging schemes to do.

Q134 **Chair:** I mean leveraged LDI.

Charles Counsell: That is a fair point. If you ban leveraged LDIs, you lose the ability to invest in growth assets while being able to hedge.

Q135 **Sir Desmond Swayne:** How does the PPF use LDI, and what has been the impact on funding?

Oliver Morley: We have around £30 billion of liabilities that we hedge for the most part with LDI. Our concern is there around interest rate volatility, and that obviously has been borne out with regard to recent events. We have a significant amount of risk management and strong governance

around the approach we take on LDI. It is partially leveraged for the specific reason of affording us the opportunity to invest in growth assets. However, our approach on it, as I said, is strongly managed, and certainly over this particular period we were in a position where we were well-protected in terms of buffers and availability of collateral.

Evan Guppy: In terms of our overall investment strategy, we're very much focused on running a prudent level of risk. The biggest risk that we run on our balance sheet is the interest rate and inflation sensitivity of our liabilities. So, the board takes the view—I think rightly—that that is a risk that we don't get rewarded for, so we use our LDI strategy to hedge out our interest rate and inflation exposure. That then leaves all of our risk budget to be deployed in assets where we think we generate returns. For us, LDI is about making sure that we are taking the right risks that we think we are rewarded for.

As for our specific experience through September and October, we went into the period with a relatively low level of leverage. As of this morning, we have £17 billion of assets hedging £21 billion of liabilities. So, relative to some of the leverage numbers that have been talked about more widely for schemes, that is a relatively low number. That meant we had much more room in which rates could rise before we started to run out of collateral.

I think the other point I would make about the way in which we run our strategy and the investment strategy overall is that we manage a lot of our assets in-house. We have a full-time professional investment team who look after the portfolio on a day-to-day basis. We are able to react very quickly. If we got into a situation where we did need to raise more cash for our LDI portfolio, we would have been able to do so in a matter of days.

Q136 **Sir Desmond Swayne:** You maintain a collateral buffer against the possibility of a 200 basis-point rise in gilts. What's the reasoning behind that?

Evan Guppy: I guess I differentiate between that 200 basis points. Actually, our collateral buffer is a little bit more sophisticated than that, because it has to take account of derivatives exposure we have in other places, for instance in currency. The idea of that is more of a trigger-point for action. We aim to have 200% coverage over a stressed scenario, which includes a hundred basis point shock in interest rates.

You could think about simply as being a minimum level of 200 basis points. If we were to reach that threshold, then that is the trigger for us to do something. That might be some of the things that David was talking about in terms of selling publicly traded equity, which we can realise in the course of two or three days. That 200 basis points is there to give us breathing room to do something—to act—which, as I say, because of our governance process, we can do so extremely quickly.

Q137 **Sir Desmond Swayne:** Having referred to your own in-house expertise

and flexibility—the ability to manage from within—for those pension funds that do not manage it from in-house and do not have that immediate access to expertise and flexibility, what would be the appropriate collateral buffer for them?

Evan Guppy: I am probably not in a position to give scheme-specific advice, but I would broadly echo some of the comments that the Bank of England made in their financial policy report yesterday, that schemes need to consider their financial resilience alongside their operational and governance processes.

If we have a buffer, and we had a minimum buffer of 200 basis points going into the turmoil, if a scheme has a less slick governance process, the clear implication is that they need to have a larger buffer.

Q138 **Sir Desmond Swayne:** Would it have been appropriate—with hindsight, I suppose—for the regulator and yourselves to have explained your approach more thoroughly to other pension schemes?

Oliver Morley: Obviously, I won't speak for the regulator, but we do communicate more widely our LDI approach and our investment approach generally. However, it is worth saying that in our early stages we would be using outside support to ensure we have an LDI book and so on, so it has been a transition for us, too, where we have achieved scale and where we have been able to bring LDI in-house.

We have always had strong governance and been able to respond well to significant risks. We try to give people an idea as to what we are doing in terms of the way we manage LDI, but in terms of making recommendations more specifically we would definitely leave that to the regulator.

Charles Counsell: We set out, in various forms, how a scheme should manage the risk associated with the use of LDIs. We did that through our investment strategy guidance in 2017, which we updated in 2019. We did it again through the covid guidance that we put out in the early stages of the covid crisis, and then again in our annual funding statement in 2021 and 2022. The annual funding statement is a very significant document; it is what we expect trustees to take into consideration across the breadth of the funding issues.

Since the events of late September and October, and through the Bank of England's intervention, we and the other regulators worked hard with LDI fund providers and schemes to increase the levels of buffer—the collateral levels that were in schemes—recognising that the events that had happened had changed the situation. You will have seen that the Central Bank of Ireland and its equivalent in Luxembourg issued statements expecting buffer levels—collateral levels—of between 300 and 400 basis points, which is roughly where they were at the end of the Bank of England's intervention. We welcomed that statement, and in doing so we also said to schemes that use segregated arrangements that we expect them to use the same levels of buffer going forward.

On your question, yes, we did need to make changes. We have, I suppose, been more directive in that respect. We have also set out our very clear expectations about how trustees manage those buffers, along the lines that David was talking about earlier but in more detail. There is a fair question about lessons learned and the degree to which smaller schemes really understood the implications of the investments they were taking. That is a lesson that we need to take away. We need to think about what we do about that.

Q139 **Nigel Mills:** It is a bit of a problem, isn't it, that you were suggesting that schemes needed to cover 100 basis points, the largest scheme, which is sat next to you, with sophisticated managers and presumably much more resources, thought that they needed 200 to cover it, and now you are saying that schemes should have up to 400 basis points to cover? You were way off, in reality. At a time when we were seeing central banks put up base rates by 75 basis points in a stroke, and the market was presumably guessing that that might happen at some point, it was not that unforeseeable that 100 basis points wasn't enough, was it?

Charles Counsell: I will let David come in in a moment, if I may. During the course of 2022, we obviously saw the events that were happening with interest rates and bond yields. We saw some schemes beginning to find issues with collateral levels, and we issued a statement—well, we issued a blog—in August referencing that. It is correct that we didn't foresee the speed of the rise of bond yields that happened at the end of September. It having happened, we recognised that we have to change the way the system works. I completely acknowledge that we now need to make sure we have a more robust system for the future, given that we now know the events that did happen.

Q140 **Nigel Mills:** It just seems slightly odd that you have a big, sophisticated scheme with lots of people around who can move things around quite quickly when they need to, and they were holding twice the buffer held by small, unsophisticated schemes that probably couldn't respond as quickly. Instinctively, I would think that you would have wanted the less sophisticated, rather than the more sophisticated, to have more buffer.

Charles Counsell: It is true to say that we were trying to ensure that there was a buffer of 100 basis points. It is also right to say that the buffers were higher than that in many cases. PPF has set out the buffers it had, and other schemes would have had higher buffers too. I go back to the point that, for what we thought was a reasonably plausible scenario of a 100-basis-point movement in a very short period of time, we thought that buffer would be enough.

Let me put it in some sort of context, approximately. A 100-basis-point increase may not sound very much, but it is roughly the equivalent of a stock market collapse of something like 50% or 60% in the same sort of period. At the end of the financial crisis, we saw the S&P index go down by about that amount, but it was over 20 months, not over three days. That is the sort of scenario that we are talking about

Q141 **Nigel Mills:** Okay, I think we have done that as far as we can. Can I take you back to the objectives that you say TPR had at the start, and the Chair's questions about whether, over 20-odd years, you have pushed people into gilts rather than equities? The impact over those 20 years is that we have got far fewer DB schemes and employers have moved away, yet somehow we have ended up with, as you said, 134% funding of schemes. Do you have any worry that we went too far and we have basically closed down DB in the private sector, and perhaps that need not have happened if we had taken some different decisions?

David Fairs: I would characterise it by saying that there were other things happening in the marketplace as well. Previous people have talked about the accounting approach, which effectively measures liabilities relative to bonds, and, in effect, there are financial institutions—banks, insurance companies—where their regulatory tier 1 and tier 2 capital is based off those accounting numbers. Particularly for those organisations, the ability to stabilise their funding position and their regulatory capital would be a significant driver. There are other organisations where the accounting numbers may impact on their payment of dividends, so there are those influences. There are some DB pension schemes that are looking to buy out and want to stabilise their funding level relative to buy-out prices, so that would be a significant consideration for them. So there are other influences at play; this is not just the regulator.

The approach that we have as a regulator would allow schemes to have, in a general sense, a much wider approach to investments than they actually take. We are in the position at the moment where, in aggregate, pension schemes are 72% invested in bonds. That has stayed static over the last year, but it has generally increased by 1% to 2% per annum. That is a market practice that is much narrower than is permitted under our existing funding code and, indeed, under the proposed new funding code. There are different things at play.

We do come across pension schemes that are almost 100% pensioners and the assets are almost 100% invested in equities. When we challenge the trustees and the sponsoring employer and say, "If that investment approach doesn't pay off, can you top up the funding position?" and they say, "No, we can't afford to do that," in those circumstances we would encourage the trustees to move away from that investment strategy, because we think that it is, in effect, gambling with members' retirement pots. Where we think that there is an excessive risk, yes, we do encourage schemes to take risk off the table, but schemes, for other reasons, naturally have a more prudent investment approach than would be required by our funding code.

Q142 **Nigel Mills:** That was quite a long answer, although I am not sure that it answered the question I asked. Do you not think that it is counterintuitive that we have just hit a period of economic turmoil where inflation is running at the highest level in my lifetime—or at least in my memory—interest rates are rising, the economy is in recession, we have just had a pension scheme-induced crisis that nearly sank the economy and required major intervention, yet pension schemes are 30% better funded

than they were a year ago? It seems bizarre to the ordinary person that everything has gone to rack and ruin, yet, all of a sudden, pensions are in the healthiest position for 20 years. Does it not suggest that something slightly strange is happening in the way that we measure or calculate or manage this stuff to get that perverse conclusion?

Charles Counsell: I completely accept the premise that it appears to be bizarre; it is not wrong, but it just appears to be counterintuitive. At its heart is this point that as bond prices go down, bond yields go up—they operate in reverse of each other—and that in itself is not immediately intuitive. The reality is that because bond yields have gone up by quite significant amounts—as you pointed out—during the course of this year, the consequence on schemes is that their liabilities have come down, and that is good from an overall funding point of view.

Q143 **Nigel Mills:** Except their liabilities haven't come down, have they? They have actually gone up, because future inflationary increases on pension payments presumably look to be higher than we assumed them to be a year ago. Their balance sheet value has come down, because you are now using a higher discount rate, but in the real world I presume people are now expecting slightly higher payments than they were a year ago.

David Fairs: In fact, for schemes that are fully hedged against inflation, where inflation is at 11% or 12%, typically pension schemes are passing on 2.5% to 5% of that to members. The reality is that although inflation is very high, it is higher than schemes are passing on to members by way of pension increases, so again—perhaps slightly counterintuitively—what you have seen as a result is funding levels improve because the level of inflation protection passed on to members is capped at a much lower level than inflation is actually running at.

Q144 **Nigel Mills:** What are you saying to schemes in that situation? Are you saying, "Bank this bonus for a future rainy day"? Are you saying, "Actually, your members are really struggling. Why don't you do a discretionary increase over the cap? If you are hedged and you have just made a 10% bonus, why have your members suffered with an artificially lower cap?"

Charles Counsell: I will ask David to come back in on the payment of additional amounts in a second, but overall funding levels have improved, which means that the whole cohort is in a better place. We estimate that somewhere between 20% and 40% of schemes may be in a position to buy out. That will secure members' benefits for the future. Although they will not actually all be able to buy out because the market is not big enough, none the less they are in a much better place. A number of other schemes will now be fully funded, whereas they were not before. We would encourage schemes to consider how to lock that in, so that members get the benefits and we can secure the benefits for those schemes. There will be a positive impact on the PPF because there will be schemes that were not previously fully funded on a PPF basis but now are.

On the specific point about paying additional amounts to people because of inflation going up, I think it is about scheme rules, but I will let David answer.

David Fairs: I regard that—whether to give discretionary pension increases—as something that the sponsoring employer and trustees would agree between themselves. I would not regard it as the role of the regulator to direct schemes in a particular direction.

Q145 **Nigel Mills:** You do not have a view on that, even for a scheme that, as you say, was fully hedged, so inflation is a big win for them—

David Fairs: I think that is a matter for the trustees and the sponsoring employer.

Q146 **Nigel Mills:** But you wouldn't say that would be an inappropriate thing to do in that situation, if they chose to do that.

David Fairs: It is not inappropriate, provided that it is within the rules, and the trustees and the employer agree that that may be the right thing to do.

Q147 **Nigel Mills:** Mr Morley, in previous sessions we were told that one of the main attractions for LDI was that it took away the volatility for the sponsor, because you were not getting interest rate movements hitting your balance sheet. You are on the UK plc balance sheet, aren't you? Wasn't there any pressure from your sponsor, which I guess in reality is the Treasury or something? Were they saying to you, "We don't want that volatility. Please hedge it," or were they not that engaged?

Oliver Morley: No, we are independent from that point of view. The independence of the PPF's overall strategy and the PPF board is very much enshrined in the Pensions Act 2004. Obviously we would listen and be interested in a view on that, but we have always taken this view. A lot of this discussion is around the balance between that kind of interest rate risk versus the short-term solvency issues that we saw at the time. In terms of our influence and others' influence on us, we were obviously very definitely conferring and engaging with regulators and so on, but our approach very much comes from the PPF board and our overall approach to risk management.

Q148 **Nigel Mills:** It is slightly strange that you have ended up giving the organisation that issues these gilts a kind of hedge against the movement in the value of the thing they were issuing, whereas generally the Government do not like any Department doing any kind of hedging, otherwise you end up with Departments hedging against each other. It just feels slightly odd: "I have my balance sheet hedged against my own instruments moving."

Oliver Morley: Our fundamental point is to protect the 10 million members of defined-benefit schemes more widely. Our hedge is therefore to make sure that we are able to pay them, potentially, in terms of claims, and also our existing members. What we are really doing there is hedging against, as I said, future claims—that is really important in terms of the

way we run our strategy—but also our members more widely. It isn't really that kind of hedge; it is very much focused on ensuring that we are able to pay those future claims on us. That is what we are focusing on.

Q149 **Nigel Mills:** Yes, but what has happened is that the Government now have a much bigger cost for all the borrowing that they have in place, yet the one part that owns a load of gilts that would therefore have seen a big benefit in balance sheet terms of unhedged gilt holding has hedged out that benefit, so we have all the loss. Our Government borrowing is now at a higher rate, and we have managed to hedge out the only benefit on the other side. In an ordinary organisation, that wouldn't have been a particularly clever thing to do. We had a natural hedge, in that if gilts went up, we would have lost here, so winning there was okay. If gilts went down, we would have lost on that side but won over here. We have unhedged ourselves in the worst possible way, haven't we?

Oliver Morley: I don't know whether Evan has a comment.

Evan Guppy: To Oliver's point, our intention is to be able to stand on our own two feet and not be in a scenario where perhaps investment returns are not as good as we thought because we have perhaps left interest rates or the inflation risk unhedged, and we have to turn around to the Treasury or the DWP to ask for more money to bail us out. We think of ourselves as a stand-alone lifeboat for the pensions industry, making decisions separate from the Government.

Nigel Mills: A stand-alone on-balance-sheet organisation.

Chair: I think Debbie Abrahams wants to raise an additional point.

Q150 **Debbie Abrahams:** I do, and it links to question 5—I have Steve's permission to ask it. I am trying better to understand the role of the regulator in risk assessment requirements. My background is in health, as chair of an NHS trust. We were required on an annual basis to do a local risk register and forward it to the Department of Health. The Department of Health would then review all the risk registers to identify common issues that were predicted—including pandemics, by the way. It was always a question of when, not if. As a consequence of that, different trusts were required to do different exercises to test their robustness in being able to withstand those risks.

I want to understand what your role is, at a national level, in determining the risk to different trusts. Mr Counsell, you mentioned that the events in September were unprecedented and a once-in-a-lifetime type of thing—like a pandemic. What is the role of the regulator in trying to understand and predict those potentially catastrophic risks?

Charles Counsell: We looked across the system at the degree to which we thought that it was plausible that it would be beyond 100 basis points. That was the risk that we, and indeed other parts of the regulatory system, were focused on. Clearly, that was not right. I acknowledge that. In that respect, going forwards we will be looking at this in a different way. As I said, we have already issued a statement in support of the

Central Bank of Ireland and its equivalent in Luxembourg about the levels of collateral that we expect to have in place, and we expect schemes to follow that if they are using segregated arrangements. In terms of the overall risk, we think that that has now put us in a much stronger position. We also set out, in the same statement, how trustees must follow that, and the degree to which they must stress-test their own schemes to ensure that they can manage to that level of collateral.

Q151 **Debbie Abrahams:** Will you be monitoring that? I mentioned the annual returns that had to be made by NHS trusts. Do you receive their stress-testing results and analysis? And then do you determine if there are particular concerns, whether it is a smaller trust or not?

Charles Counsell: I think it is fair to say that we were not collecting systematic data around this before this happened. In retrospect, maybe we should have; certainly, going forward, we will. The first thing to do was to put in place changes that baked in the rules after the end of the Bank of England's intervention, which we have done. Now, just as you have said, we need to work through how we monitor that. We are near the stage of thinking about how we will do that, and there is work to be done to ensure that it is done appropriately.

We will probably look at that from two different perspectives. The first is from the perspective of those using pooled funds; it may well be that we go directly to the pooled funds to collect data, rather than to the schemes. We cannot forget that about a third of all DB pension schemes have fewer than 100 members, so we have to be mindful of the degree to which they will be able to provide this data, and the burden that providing this data would place on them.

We will then look at the segregated schemes in a different way. We have not yet determined how we will do that; we are working on that at the moment. We may do it through a systematic return. We have a mechanism for getting data from pension schemes annually; we do it through something called the scheme return. To be honest, for these events, annually isn't going to cut the mustard, so we might have to find a different way of doing it. It could be a combination of doing it annually in some form or another, and by exception, whereby if schemes find that they are no longer within the bounds of what we have set out, they are obliged to report to us. It is a work in progress, but those are the sorts of things we are thinking about.

Q152 **Debbie Abrahams:** You are a small organisation and what you do is incredibly important. Do you have the resources to do that work with the speed and thoroughness that you want?

Charles Counsell: That is an interesting question. We are, as an organisation, very much changing the way that we look at data. About a year ago, I announced that we were putting in place a digital data and technology directorate, whose focus is to help us to become much more of a data-led organisation. We have a long way to go. Have I got a line of sight to all the funds that we need, if we are to be able to do that?

Honestly, no, not at the moment. How we do this is complex. In a way, to really get to where you need to, you need something in real time. There is the question of whether that would be appropriate, given the burden it would place on schemes, but we are certainly a long way away from being able to do that.

Q153 **Steve McCabe:** Good morning. I think these questions are largely for the TPR; I will come to our other witnesses later. I wanted to start with this thing about not collecting data; you said you are collecting it now, but you had not previously. In fact, in your letter to the Committee on 10 October, you said you had an intelligence-gathering approach instead. What was that intelligence gathering, and did it fail? Why are you switching now to data collection?

Charles Counsell: I do not think I would describe it as failing. Again, I go back to the point that what we believe—

Steve McCabe: Tell me what it was, first of all, just so that we can understand what you were doing.

Charles Counsell: Sure. We have a number of ways that we collect intelligence. One is that we might get whistleblowing reports that come to our intelligence team. Another is that we have supervisors who are out talking to pensions schemes, and, through that supervisory relationship, we have intelligence about what is going on. That will cover some larger schemes, but also, through events, it will cover smaller schemes as well. We also carry out periodic research. We carried out research in 2019 looking at the degree to which schemes had the collateral and were managing the risks associated with LDIs.

Q154 **Steve McCabe:** I asked if it failed because I got the impression from your answers that you did not feel you were particularly well sighted on what was happening as the crisis developed. Is that a fair assumption?

Charles Counsell: I think that, as the crisis developed, that is probably not a fair characterisation, because not only were we doing what I have just described in that period, but we were also directly in touch—

Q155 **Steve McCabe:** If I had been having this conversation with you a fortnight before it unfolded, would you have been able to tell me what schemes you were anxious about?

Charles Counsell: There are two parts to that. First, there are the pooled funds. Secondly, there are schemes. I have to re-emphasise what we said in our evidence to the Committee: the schemes were never at risk through this. Pension schemes were never at risk of collapse; we were not worried about that. What we were worried about was the degree to which there was liquidity in the funds, and, to some extent, in the schemes that were running segregated arrangements. During the crisis, we were in touch with a number of schemes and professional trustees to enable us to understand exactly what was going on and the degree to which they were able to ride through the storm.

Q156 **Steve McCabe:** I think most people will be relieved to hear that schemes

were never at risk. If I have understood correctly, the way it works is that when they need to rebalance, they draw down liquidity from the main pension fund. Had they been forced to draw down more and more, presumably they would have been at risk—is that right?

David Fairs: You probably need to separate pooled funds and segregated funds. Let's look at segregated funds first. In essence, the reason why they are posting collateral is that interest rates are rising. As interest rates rise, the liabilities fall. Although you are posting assets, overall, if you were perfectly hedged, you would still be 100% funded, if you started off 100% funded. In the case of pooled funds, it was slightly different, because they were heading to the point where they would end up with negative asset values. At the point that they have negative asset values, effectively the fund is—

Steve McCabe: It would be over to yields.

David Fairs: At that stage, the investment that the pension schemes would have had in those vehicles would have gone to zero, but the very conditions that caused those things to go to zero would mean that liabilities would have fallen substantially. Pension schemes would still be able to pay pensions to members, even though they had made a substantial investment in something that went to zero. The pooled funds may have failed, but the pension schemes were not in danger of not paying pensions—they would still have paid pensions.

Q157 **Steve McCabe:** Okay, that is helpful, I think. Help me with this because I am struggling here. When the pool funds fail, who is the casualty, or where is the casualty? A failure suggests that something has gone wrong and something really bad has happened, so there must be some effect or consequence. Who is the casualty when a pooled fund fails?

David Fairs: In essence, it is just like making an investment in an equity where the equity fails. You made an investment and you have made a loss on that investment.

Q158 **Steve McCabe:** So nobody suffers any consequences? Is that right?

David Fairs: The very conditions that caused that failure mean that interest rates would have risen—

Q159 **Steve McCabe:** No, sorry. What I am trying to ask is who suffers the consequence of that loss?

David Fairs: The counterparties would suffer.

Q160 **Steve McCabe:** Who actually suffers the consequence of the loss? At the end of the day, is it the fund?

Charles Counsell: On David's point, in the end the counterparties suffer the consequences of the loss. That is precisely why, in the end, the Bank of England stepped in. Its worry was that the counterparties, which may well have been banks, were potentially going to suffer a loss. That may have had knock-on effects elsewhere.

Q161 **Steve McCabe:** A knock-on effect on what?

Charles Counsell: Well, for instance, on interest rates and therefore the general economy. That was the risk that the Bank of England was trying to manage.

Q162 **Steve McCabe:** On something slightly different, I think you explained why you did not decide to collect systematic data. When the Bank of England issued its warning about the need to monitor the risks in 2018, you conducted a survey, but only of the large schemes. What was the rationale for looking only at the large schemes and not at the smaller schemes?

Charles Counsell: We wanted to have a reasonable view across the assets that were invested, and the majority of the investments are invested through the larger schemes. That was the rationale for doing it. We set out in the research document that we published the methodology for the way we went about it, and I think that gave us reasonable reassurance that the schemes understood the risks that they had, and the way that they were going to manage the collateral levels.

Q163 **Steve McCabe:** So when Sarah Breeden said that the problem was poorly managed leverage, was she right?

Charles Counsell: The leverage was clearly an issue; in that respect, she is absolutely right. What she said in her speech was that the original leverage and the need to sell assets—the need to sell bonds—had a spiralling effect, which increased leverage in its own right. In that respect, Sarah was absolutely right about the spiralling effect that she talked about in her speech. She also said in that speech that leverage is not in itself a bad thing—she is very clear about that—but there was a spiralling effect of the leverage.

Q164 **Steve McCabe:** I ask that for this reason. If I have got this right, it is essentially the regulator's job to have oversight of how the schemes are performing. You have explained that you have an intelligence-gathering approach, and that you are going to vary it now and collect more systematic data. You have explained some of the problems with pooled funds. I understand what you say about not wanting an excessive regulatory burden, and that it is your job to advise, rather than to tell schemes what to do, but I am left wondering if, with the knowledge and responsibilities you have in this area, you have any sense that maybe you should have spotted some of this earlier, and advised some people to move away from leveraged LDI.

Charles Counsell: In advance of the situation happening, I do not feel that—

Q165 **Steve McCabe:** I am asking with hindsight. Do you think maybe you should have been a bit more on the ball?

Charles Counsell: Clearly, with hindsight, there are significant lessons to be learned; I acknowledge that. I have talked about data as an example. By the way, the data point is broader; this is one example of data that we need to collect more systematically. There are lessons to be learned about

the governance of schemes, and while we felt that, to levels that were reasonably predictable, we had a system that worked—

Q166 **Steve McCabe:** What would be the main lessons about governance that you have learned and would want to pass on?

Charles Counsell: I will answer that slightly obliquely, but it is absolutely the answer. I go back to the point that a third of DB schemes have fewer than 100 members. We know, and have known for some time, that smaller schemes are less well managed and less well governed than larger schemes. This has demonstrated that in a whole new way that we had not anticipated, but we do know that. We have to focus on how we move to a point where we have larger schemes. I am not saying that all small schemes are badly managed or badly governed, but it is true that across the board, they are more typically badly managed.

The question, then, is how we move to consolidate the smaller schemes. For that, we need consolidation vehicles. In the DC world, we have that through master trusts. In the DB world, it would be through super-funds. You will be aware that we have an interim regime for super-funds, but we believe that should be put on a statutory footing to make them safe, because ultimately, if there is going to be consolidation, we must consolidate into safe vehicles. That is one point.

The second type of consolidation vehicle is DB master trusts. We do not authorise them, so we do not have the same level of regulatory grip as we would over a DC master trust. That is the first point around governance.

Oliver Morley: We are also a consolidation vehicle of a kind.

Charles Counsell: Yes, of course. The second point, which again was very stark in this process, is the degree to which schemes have professional trustees sitting on their boards. We have said for some time that we believe that schemes should have a professional trustee sitting on their board, but the reality is that the capacity of the professional trustee market does not match the number of schemes, so you cannot get there immediately; that goes back to consolidation. Equally, once we have got to a point where we can get professional trustees on all trustee boards, that will improve governance.

There is an open question that we need to think about. There is no authorisation regime or regulation around professional trustees, and there is the question of whether there should be. All that is designed to improve the standards of overall governance in all schemes across the board.

Q167 **Steve McCabe:** On that last point, you think that professional trustees need some kind of accreditation to show that they are—I say legit, but that is not quite what you mean—competent, reasonable people.

Charles Counsell: To be fair, there is an accreditation process. Professional trustees can undertake that accreditation process, but we cannot force trustees to do it.

Q168 **Steve McCabe:** So you want it to be compulsory?

Charles Counsell: I think I am probably going a bit further than that; I am talking about an authorisation process. These are big financial vehicles. If I were in the FCA's shoes, looking at people who run big financial vehicles, there would be an authorisation process.

Q169 **Steve McCabe:** I am pressing you because I am trying to ask whether this is a recommendation that you are making.

Charles Counsell: I am slightly cautious about going that far, because I realise there is a lot to do to get there, but there is a strong case for it.

Q170 **Selaine Saxby:** I am looking at the impact of the events of September and October. Were any schemes negatively impacted, and what was the scale of the losses?

Charles Counsell: I would put this in three buckets. The first bucket is that the majority of schemes are in a better place because of the events. We have talked about that, in terms of the aggregate funding levels and the liabilities going down. Secondly, a small number of schemes would have lost their hedge or decided not to hedge at the top of the yield market. Then, as yields came down, because they were no longer hedged against interest rate falls, they will have lost money. We know of some instances where their funding level has worsened. I do not know how broad that is. There will be some cases where that happened, but I do not think there are very many.

There is a third bucket, which is DC schemes. A lot of the focus has been around DB, rightly, but in DC—this is not to do with LDI, but has to do with the movement in bond yields—I will put that down to two parts. If you are a younger investor in DC schemes, you can still mostly ignore this, but if you are an investor approaching retirement, and you are in what is called a lifestyling scheme, which has largely de-risked, that will mean that the scheme has largely gone into bonds, and bond prices have come down. As they are approaching retirement, the value of their DC scheme may well have come down.

A strong message to members of those DC schemes is that they should take advice and not make hasty decisions around what has happened. The value will have come down. We will see annual statements go out over the course of next year, and people will start to see this, if they have not already seen it. Again, the members of those schemes should take advice, go to the Money and Pensions Service for guidance, and think carefully about what they will do about retirement planning. Again, with pensions freedoms, you do not necessarily need to take all the money out at once. You do not need to put it all into an annuity. Mind you, annuity prices have gone up, of course, but there is an impact on DC schemes as well.

Q171 **Selaine Saxby:** To the PPF, are there any schemes that are at greater risk of entering the PPF because of these events?

Oliver Morley: We think probably not. Obviously, from our point of view, the most important driver of that is insolvency in the employer, rather

than necessarily the scheme funding. That obviously determines more widely whether they come into us, but we have not seen an uptick in claims or insolvencies as a result of this particular issue.

Q172 **Selaine Saxby:** What assessment have any of you made of the estimate of Iain Clacher and Con Keating that £500 billion is missing from the asset side of pension schemes?

David Fairs: In effect, I think the way that Con has done that is to look at asset movements from the beginning of the year through to September. If you picked a different point in time—so, if you took the peak of gilts to the present day—you would have found that there was probably a counterbalancing movement. It all comes down to what your starting point and end point of measuring are. From the peak of interest rates to now, you would have a significant increase in asset values. Equally, if you take a different point in time—

Selaine Saxby: It is literally how you cut the data, in your view.

Charles Counsell: It is. It also does not take into account liabilities and movements of liabilities, and that is a really important factor.

Q173 **Chris Stephens:** Charles, the Financial Policy Committee of the Bank of England yesterday recommended that you, in co-operation with other regulators, take what they determine is regulatory action to ensure that LDI funds remain resilient. What do you plan to do in response to this recommendation?

Charles Counsell: We welcome the statement that the Financial Policy Committee made yesterday. We have put in measures that are resilient for now, but we need to think about what the longer-term measures might be. Our intent is therefore to look at what those measures might be, and to do that via a funding statement in April next year. We need to look at what happens in the longer term if interest rates go up or if interest rates go down, and at what levels of collateral should be in place. We will be looking at those medium and longer-term implications.

Q174 **Chris Stephens:** Will you be reporting back to the Bank of England, then? If so, can you undertake to share those reports with this Committee?

Charles Counsell: Yes, of course we will.

Q175 **Chris Stephens:** Thank you. There are various views on LDI. Some folk have come to this Committee—I am thinking of Con Keating and Iain Clacher, for example—and said that LDI has never been fit for purpose. They question the role that the Pensions Regulator has played in encouraging its use. What is the current thinking on LDI, and how would you respond to the criticisms that Con Keating and others have made about the regulator's role?

Charles Counsell: We welcome different views, and clearly there is a different view here. Our view—I go back to what I was saying at the beginning of the hearing—is that it is important that schemes hedge, and

it is important that they hedge against interest rate falls and inflation. We have seen the impact of that over the years. We have an improved funding position not only because of LDIs, but the improved position is partly due to LDIs. Our view is that it is right to hedge. LDIs are a form of hedging, and leveraged LDIs provide, as Sir Stephen said earlier, the opportunity to invest in other assets.

Q176 **Nigel Mills:** May I ask Mr Counsell and Mr Fairs about the new DB funding code that I think you have been working on and are about to publish another draft of? Do you have any concerns that the funding code needs to be adapted given the events of a couple of months ago, or can you just press on as you were planning to?

David Fairs: The key plank of the new funding code is that schemes set themselves a long-term objective: they understand where they are now; they set in place a journey plan of how they will get from where they are to their long-term objective; they both understand and measure the risks that are within their funding and investment plan; and the employer covenant is supportive of those risks. We see the new funding code as introducing appropriate risk management, which a lot of schemes already have, but not all schemes. This will make it a requirement for all schemes to have proper risk management in place, and that includes liquidity. The code is an important tool for us to have in place to ensure that schemes understand, measure and mitigate the risks, or that the sponsoring employer can tolerate those risks. That is an important tool.

Clearly, because of the events through September, we have had to look at some elements of the code. We have made changes to it. We have strengthened some of the guidance on governance and operational management. We have included the same buffer requirements that we set out in our statement. We have also changed the stress test that we are going to apply for schemes that go down the fast-track route. We think the code is an important tool for risk management purposes, as I said, but of course we have had to take account of the events of September and to make some amendments to ensure that some of the lessons learnt—we have further work to do—from that experience are taken into account in the code.

Q177 **Nigel Mills:** Does it make sense to press on with this process while you are still working out what lessons you need to learn? Should you not try to learn the lessons before you set the future code?

David Fairs: There are things—like having stronger governance and operational management—that we would like to have in place as soon as possible. Our challenge is that if we defer our consultation beyond Christmas this year, in effect that means an entire year’s delay before the code is operational for actuarial valuations going forward.

It is an important tool for us, and, because of the risk management, there is stronger emphasis on liquidity. We think it is important to have that in place as quickly as possible. We are having an extended consultation

period of 14 weeks, so we think there is time to take further lessons learnt into account in finalisation of the code.

Q178 **Nigel Mills:** The consultation will run until the end of March roughly. When do you expect to publish the final version in response to the consultation?

David Fairs: We will publish the final version of the code—we lay the code finally—in June, in order for it to be operational from October next year.

Q179 **Nigel Mills:** You will have time to consider any recommendations that we or our colleagues in the House of Lords make.

David Fairs: We are happy to come back to the Committee to discuss the code, if the Committee would like that.

Q180 **Nigel Mills:** There has been a lot of pressure—certainly from the previous Pensions Minister—to get schemes to invest more in UK infrastructure and other such assets. Will your new funding code encourage that, or is it not something you are keen to encourage schemes to do?

David Fairs: Investment in some of those vehicles, because of the very nature of them being illiquid, often means that they generate higher returns and, because pension schemes are long-term vehicles—notwithstanding what happened in September; in generality they are long-term vehicles—investing in those types of assets, if they generate a high return, is good for the pension scheme.

Clearly, when investing in illiquids, you have to understand the liquidity position of the scheme in order to continue to pay members benefits, but also, if you are operating LDI, any collateral calls that you have. We think it is the right thing for schemes to do, but they do have to have a liquidity plan in place to understand how much they can invest in those sorts of assets.

Q181 **Nigel Mills:** I guess that makes some sense. I am trying to think what most trustees' pension journey will now be. My starting point is, "I am 130% on average funded. Presumably, I don't want to get any more than that, so I guess I can do nothing." Hasn't the position changed quite a lot in the last year?

David Fairs: It will. I think there are more schemes now that are in a position to approach insurance companies to buy out. There probably are more schemes than insurance companies have the capacity to transact immediately. Insurance companies will also be conscious that they want those schemes to make sure that their data is clean, and that the scheme is operated in accordance with the rules, so there is some tidying up work that insurance companies would expect schemes to do.

My guess is that they will start to transact with those schemes that are most prepared, in terms of cleansing their data and being ready to transact, as well as the funding position, because there are probably more transactions they could do than they have the capacity to do.

Q182 **Nigel Mills:** It strikes me that consolidation is now more viable because there are fewer deficits around, or they are smaller, so it is easier to see how that sort of vehicle could work. Would you be worried we might see a wholesale exit of sponsors' responsibilities because schemes can effectively try to do that, or do you actually think that if a scheme is well enough funded, there is no downside to that?

David Fairs: There are three options. Essentially, the trustees could have a fully insured buy-out with an insurance company, in which case the insurance company takes over entirely the assets and liabilities. In terms of superfunds, as Charles said, we would ideally like an authorisation regime to be in place. In terms of master trusts, the employer is still attached to the scheme and is still responsible for funding any deficit, so you get some economies of scale, if you like, by going into a DB master trust, but you don't extinguish the link to the sponsoring employer.

Q183 **Nigel Mills:** Okay, so you can find a way. It would be a tragic error for some actuarial gymnastics to have got us into what looks like a very sweet spot, and then people do foolish things and it all unravels again in six months' time or a year's time, and we end up with a worse position than we wanted. That is presumably the thing we need to be quite careful of in a volatile market, isn't it?

David Fairs: *indicated assent.*

Q184 **Chair:** Can I put a final question to Mr Morley and Mr Guppy? You have been big users of LDI, as you have told us, and you potentially might pick up the tab if some of the problems we have been hearing about turn out to have a particular form for some schemes. What lessons do you think ought to be learned about LDI from the experiences of the end of September and beginning of October?

Oliver Morley: Again, I would say very similar to those described by Charles and David. From our point of view, it is this point about governance—the ability to be able to react in very short-term market disruption. It is really important that trustees are in a position and are able to meet that. As I said earlier, that is why we have built the governance that we have—to be able to react accordingly.

We are supporters of LDI. Obviously, we use it. To Mr Mills's point more widely, LDI is an important part of the overall investment approach that schemes may have, when well managed. The opportunity to obtain better returns from, for example, UK infrastructure, in part allows some schemes—particularly if they have the capacity to do so and the right management of collateral—to invest in things like UK infrastructure and so on. Without that, you would see a lot of very immediate de-risking and moving effectively to some quite strange portfolios, in which you only had illiquid assets and gilts. From our point of view, we believe that LDI has a point, but it just needs to have the right governance, and it realistically also needs to be done at scale. The scale is an important point, and that that capability is there.

I have one final point on this wide comment about schemes being in a good state. We would urge, with the funding code and the regulator, that it is really important for schemes to consider their overall position, make sure these funding gains have been locked in properly—both from the point of view of future claims on ourselves, and the position of the schemes that would come into us—and ensure that we are able to take the opportunity of this environment to move forward generally in terms of a funding position for the long term.

Q185 **Chair:** Are there particular additional data points that you would want to see? Charles has said that further data will be collected. What would you be keen to see collected?

Oliver Morley: The regulator, as part of our arrangement with it, collects the data for us in the scheme return, and we use that to aggregate, both for our own calculation of PPF levy, but also for a publication that we put out regularly but is effectively based on those annual returns: "The Purple Book". Clearly more insight into schemes' position on derivatives and the hedge would be extremely useful, but I reiterate that it is a challenge for schemes to provide data—even on an annual basis in some cases. They need a lot of resource to be able to do so. Providing that very up-to-the-minute information that would allow us to mitigate some specific implications of the crisis would be a real challenge for some smaller schemes. It needs to be proportionate. Better information on derivatives more generally would be helpful.

Chair: That concludes our questions to you. Thank you all very much for being willing to give evidence to us this morning; we are grateful.

Examination of witnesses

Witnesses: Nikhil Rathi and Simon Walls.

Chair: Can I start by asking both of you briefly to tell us who you are?

Nikhil Rathi: I am Nikhil Rathi, the chief executive of the Financial Conduct Authority.

Simon Walls: Good morning. I am Simon Walls. I am director of Sell-Side at the Financial Conduct Authority. From May to September this year I was also the director of Buy-Side, which is most relevant to this discussion.

Q186 **Chair:** Thank you both very much for being here. I asked the Pensions Regulator, in the previous panel, about the big shift in pension fund investments from equities to gilts that we have seen over the last couple of decades. What do you think has caused that shift and what does it mean for the UK economy?

Nikhil Rathi: I am sure the Pensions Regulator is closer to this issue in terms of the defined benefit pension schemes, but clearly we have had a period where defined benefit schemes have been closing. They have been moving into run-off. Employers have been looking to manage down their

risk. There has been a shift in the interest rate environment. There have also been tax changes from the late 1990s, which affected dividend tax credits for pension funds, which affected the relative fiscal attractiveness of equity versus other securities. All those factors will have contributed to the trend you described. From our perspective, where we look at contract-based schemes, you will still see, broadly, 60% of the investments being in equity as opposed to less than 20% for defined benefit schemes. Defined contribution schemes are gathering a greater proportion of overall pension savings in the UK.

As to your question about the impact on the UK economy, I think it is a serious issue for us because we have a challenge in terms of growth and productivity. Equity is long-term capital. The prices move up and down, but over the long term it is important because it enables companies to grow, invest and think beyond a narrow, shorter-term horizon. In contrast to colleagues in other developed jurisdictions—compared with Australia or Canada, where they have a small number of very large pension schemes that are able to support investment in productive assets and infrastructure in their countries and overseas as well—we have not been able to secure the same type of investment environment using this big pool of savings.

Q187 **Chair:** Do you think we need to change things so that there is more going into equities and infrastructure investments?

Nikhil Rathi: There is some work we have been doing that I chaired with the previous Economic Secretary to the Treasury and the Governor of the Bank of England on long-term infrastructure investment, and we have now established the rules of the FCA for a long-term asset fund, which has a specific framework. It does not require daily dealing. We have made various other regulatory changes that we hope will enable pension funds to access long-term assets more easily. The first applications have now started coming in and we will see how that proceeds. That is one intervention that we have taken. There is always going to be a judgment, however, about risk appetite, which is ultimately a matter for trustees to judge, based on their investment principles and investment strategy.

Q188 **Steve McCabe:** When Sarah Breeden said that the root cause of the events was poorly managed leverage, what exactly was she telling us?

Nikhil Rathi: Sarah's speech ran though the chronology of what happened in September, and I think there are two things. First, we saw a scale and speed of movement that was unprecedented—250 basis point moves in long-term index-linked gilts in the space of five days—and never seen in history. That placed an extraordinary stress on this part of the system where there is a concentration of owners of those gilts. That exposed a series of vulnerabilities. That level of stress showed us that there were a number of issues. As a regulatory system, we are part of it and we look closely at the investment managers. I think what she is saying is—but let me not try and put myself in her shoes; I will say what I think the issue is. If you are ending leverage as an end investor, you need to understand what happens in different stress scenarios. You need to ensure you have the governance and decision making that enables you to

respond properly. We saw in this situation, for example, that if you are taking an investment in derivatives or in pooled LDI funds, that requires in certain scenarios margin to be called if prices move against you. Having decision-making procedures that take 10 days in fast markets does not work. That is one question about governance decision making.

There is then a question about whenever you take leverage, you do not want to be 100%. You need some buffers. There will always be a judgment about what level of buffer any investor, manager or fund applies. Simon can talk you through the work that was done over the last year or so and previously. We have now moved into a world where long-term sovereign debt markets are much less liquid than they were 15 years ago for a whole range of reasons. Monetary policy is unwinding. There is asset price volatility. This is happening here and around the world. That means that the level of buffering to secure resilience will need to be higher than it was previously, but there is always a balance to be struck. If you apply larger cash buffers or use more of your collateral, that simply means there is less to invest in other things. Trying to work out what is a severe but plausible stress is a very difficult balancing act. You can predict a 250 basis point move over a certain period, but you couldn’t predict it happening in five days. That has never happened.

Simon Walls: Perhaps I could come in briefly. The power of the speech that you are referencing is that it puts this in the context of the other extreme events in the markets in the last 18 months or so. It situates the role of leverage—often hidden and cross-jurisdictional leverage, although not in this case. It sets out the nickel market, the energy market and refers to Archegos. It talks about the concentration of banks lending to particular counter-parties and markets that are dominated by a small number of counter-parties. That is true in this case. There are relatively few LDI managers operating. One of the details revealed in the LDI market was how concentrated the market for index-linked gilts was. You had the Debt Management Office issuing them and a very small number of participants buying them.

The speech is powerful in reminding all market participants that what was extreme but plausible, which is the language that we use when people are preparing buffers, has changed. If people haven’t redone their stress testing in the last year, they need to change it now because the scale of events that are covered is much broader. It goes back to the changing role of banks in markets. There are not as many participants to warehouse risks, so lots of people who are relying on the liquidity of markets need to stress-test those assumptions, and this was another example of that.

Q189 **Steve McCabe:** I accept what you say about the speed of these events being a major factor, but given that our regulators are responsible for oversight, should they have been better prepared to anticipate what might happen?

Nikhil Rathi: Between January and September, there was a movement in prices of about 247 basis points. The funds and the management were broadly able to absorb those, as that was over a steady period of time.

As I say, it is always going to be challenging to prepare for black swan events—one-in-100-year events. I will give you an analogous example. We are in a recession and we are thinking about the house price situation—what may or may not happen to house prices and over what time period. There are some very extreme predictions out there. If we try to prepare the entire system for the most extreme predictions, and have that happen very quickly, the consequence would be that mortgage supply dries up.

You have to make a judgment about where the stress is and where the buffers are. The regulators overseas—Ireland and Luxembourg—manage these funds, and that is another dimension with this. In co-operation with us and the Bank of England, they have put out guidance.

The other important lesson that we learned in 2008-09 from the banking system is that you have to be more prepared for a situation in which you blow through the stress. We put in place very elaborate resolution regimes for banks so that whatever stress you have done, if something happens that takes you beyond that, you can support failure. It is managed failure or managed resolution of a situation—it is reverse stress testing.

In this situation, there was perhaps inadequate preparation in a number of the pension funds. There probably was not the financial and operational acumen there to really understand what would happen if things went wrong. All the way through the chain there is work to be done. We have said that we think investment consultants should be regulated, and we have made a previous recommendation on that. The custodian banks that were managing the movements of collateral suffered strains and had to move to manual processing in some cases. They were slower than they needed to be. The bank counterparties also have lessons to learn about how they manage risk.

The point that I would take away most powerfully from this is that we need to be planning for failure in an environment in which, as Simon alluded to, we are seeing these one-in-100-year events happening every three or four months at the moment because of the vulnerabilities out there.

Steve McCabe: Thank you.

Q190 **Siobhan Baillie:** I think you have already started to touch on this, but the FCA has a limited role in regulation for LDIs. Do you have a list of lessons learned from the last three months and what the FCA could be doing to make changes? I will ask my second question at the same time, as you touched on it too. Ireland and Luxembourg look after the AIFMs and you have the portfolio managers to regulate here. Do you think that is a fundamental flaw in our ability to make changes in regulations? Are there proposals to make changes in that respect, although that would be quite dramatic?

Nikhil Rathi: In all these areas of non-bank finance, we are dealing with cross-border and cross-jurisdictional situations—we are in a global market. Our system has built up over the decades of being in the European Union,

where funds could be sold from any member state in the European Union into our market. The approach that the UK authority, led by the Government, took at the point of exit from the European Union was to keep an open approach, and we run a global financial centre, where we rely on equivalent jurisdictions and the standards they have in place.

It is clear that in relation to these funds there is more work to be done in terms of how they are overseen going forward. At the moment, real-time data is not necessarily collected by our partner supervisors. It is the overseas regulators that make decisions around leverage limits, evaluations, approval of prospectuses and so on. We are in discussion with them, and the Bank of England Financial Policy Committee made some recommendations as well in the last day or so that point to this.

That is a subset of other global work that we are doing with jurisdictions around the world on how we can strengthen the framework for non-bank finance. Our starting point would be not to make some dramatic change in the chain, but to work in partnership to make sure we have got the information sharing and the common international standard that allows these markets to function as effectively as possible. So that is an important set of standards.

As we are thinking about the transposition of EU law into UK statute, which is going to happen once the Financial Services and Markets Bill is adopted— next year we hope—there are elements of that that we should look at. On AIFMD, for example, in terms of the reporting template, at the moment the way that inherited EU law works is that there is a one-month lag in reporting. As we have seen, one-month lags do not work in these kinds of markets; you need real-time information. We will need to wait for the legal changes to come through before we can tackle that question, so that is another thing on our list as well.

I touched on investment consultants. We did some work in 2018 and referred it to the Competition and Markets Authority, which made a recommendation that they should be brought into the perimeter with the FCA for the purposes of the work they do on investment strategy and advice to pension funds. We reiterated that in our annual perimeter report, which we provide to Parliament every year, and we reiterated that in 2020-21. We think now is the moment where we should really try to grasp the nettle on that. That is obviously a matter for Treasury, and ultimately Parliament, to decide on.

Simon Walls: We are talking about lessons learned in the future, but a number of things have been done already. Resilience has been built up at some pace in this market, learning from what has happened so far. We had the statements from the overseas authorities on 30 November, which we welcomed, which is around keeping the buffers that they currently have in place.

The stress test in 2018 was around a 100-basis point instantaneous move. When we checked, anticipating that there would be a rising rate environment, back in May and June this year, they were up to 150 basis

points. They are now generally at around 400 basis points, so resilience to a very big shock is in place now.

To some extent, the overseas regulators banked it and said, "Don't reduce the buffers that you have built up at this stage." Buffers are quite a blunt tool and there is a trade-off—a cost—to maintaining a buffer, but as we sit here now there is a lot more resilience in the system than there was previously.

We have also observed a number of the operational changes that we will be looking at. We will be returning with a statement of good practice at the end of Q1. We have already observed some of those things occurring. We have spoken to each of the major managers, and they all have their lessons learned in place, but we have highlighted issues around what we call "operational", but that covers quite a lot of ground. It is any way of getting money from the end pension schemes more quickly. The speed, rather than the distance, was the problem here—the speed of getting the money from the end pension schemes that should generally have had the money, albeit, in some circumstances, not sufficiently liquid. It was about getting it more quickly, changing the two-week timelines that Nikhil mentioned to something much more fit for purpose in a crisis, and educating trustees to be ready to do that. There are discussions around having the asset managers co-locating other assets there, so that in emergencies they can access the other assets, rather than having to go to the trustees.

Then there is quite a lot on information flows in this crisis, particularly because the participants were used to dealing with week-long timeframes or two-week-long timeframes. There were real challenges in getting information to trustees, and it gummed the system up in various ways, including on the settlement side, where there were challenges in determining whether a gilt had been repoed or sold. There are a lot of lessons.

While the buffers is a trade-off—and you cannot just say, "More and more and more," because there is a cost—a lot of these operational lessons are much lower cost and would be robust to any state of the world. We are making sure that asset managers, investment banks and custodians learn these lessons now and will be coming out of the end of Q1 with the lessons learned.

Q191 **Siobhan Baillie:** We have heard quite a lot of evidence about the way different schemes handled September. As we heard from the last panel, a third of DB schemes have under 100 members. On what you were just saying, bigger schemes could do that pretty quickly, couldn't they? They are resourced, they are organised and they have the professional trustees who, as we were hearing from the previous panel, are so important. Do you think we need a two-tier approach in terms of what we are asking for the smaller schemes, or even additional support to bring them up, so that they have the agility to react more quickly? That is what we saw as the issue.

Nikhil Rathi: Any scheme that is investing in these types of products needs to have the governance in place to move quickly, and where we have seen some issues is in relation to pooled funds, which were used by the smaller schemes. There were issues in segregated, single-client funds as well, but with respect to pooled funds, the fund manager is relying on assets coming in from multiple different end pensions schemes. Often a number of them would be, as you say, small and were not necessarily set up to move in the time available, nor did they necessarily understand the implications of the funds they had invested in when things went wrong. Before we get to any regulatory intervention, there is definitely some thinking going on—even within the industry, frankly—as to the current structure of that product and the interaction that will be needed in the future with the end investors in that product if it is going to continue to be a sustainable product going forward.

Simon Walls: Pooled funds represent about 10% to 15% of the industry, with the balance being segregated mandates, but it was the pooled funds that we had a particular focus on, for the reasons that you set out. Unfortunately, if you take leverage, someone might ask you for money at very short notice, and you need arrangements to be able to respond to that.

Q192 **Siobhan Baillie:** When we started this investigation, I would have thought of LDIs as quite toxic. Actually, as we have gone through and heard more evidence, we have seen their importance to the industry. It has certainly changed my view, and I think the media are changing as well in terms of their reporting on these things. It is quite fascinating. On the lessons learned, practical things can be put in place to give confidence to the smaller schemes, so it is good to hear your views on that.

My last question is about the FCA's calls to bring investment advice into your regulatory perimeter. Where are you on that? Are you thinking about bringing in consultations earlier? What steps have been taken, and do you think that this is a likely change for the FCA? What do you think are the key issues now in relation to previous concerns that have been raised about the quality of advice? Are we still looking at those issues or are there new problems, particularly given what we have had this year?

Nikhil Rathi: Our perimeter is established under statute, so it is determined by the Government and Parliament. The status of that particular work is that we have made recommendations. The Financial Policy Committee this week has supported those recommendations. It is now for Government to consider that and whether it wishes to bring forward any amendments to statute for Parliament to consider as well. Only once that is done can we proceed with the issues that have taken that forward.

The issues that we have raised before prevail today. We have raised concerns about conflicts of interest, the comparability of performance, the availability of information and the ability to switch between providers. All those points that were raised in 2018 and repeated a couple of years ago

are there today, which is why we think this is one bit of the value chain. I wouldn't want to suggest to the Committee that somehow, if these had been regulated, what happened in September would not have happened. I wouldn't want you to take away that message. But this is all about risk management and making sure we have appropriate levels of resilience all the way through the chain and, where there are conflicts of interest in different parts of the chain, there are processes for managing those conflicts, to give the confidence that you described.

Q193 **Chris Stephens:** The Financial Policy Committee of the Bank of England have recommended that you, in co-ordination with other regulators, take what they deem to be regulatory action to ensure that LDI funds remain resilient. What do you plan to do in response to that recommendation?

Nikhil Rathi: Work has been done already. This is about increasing the buffers, in co-ordination with the other regulators, as Simon described, from what was 100 or 150 basis points to 400 basis points. That is the immediate solution, and letters have been written to all the funds—they are of course overseas and not under our jurisdiction; the managers are delegated to here, but the decisions about the funds are overseas—to say that they should not reduce that level.

There is work we need to do now. That's a sort of temporary approach—400 basis points—given the extreme circumstances we are in. We need to work out what the right framework is for the future, in terms of the appropriate level of buffers and stress scenarios to be running. That is work where there is a balance to be struck on how far you go to maintain cash—which is not then investable elsewhere—as a buffer in the system and where we set that level. That is going to require some quite detailed thinking, which we will be undertaking with all our different partners.

Simon talked about the lessons-learned work that is under way with those parties that we supervise—the particular parties that we supervise—and we will publish a statement about those in quarter 1 next year. We have been working with all of them to make sure that in the interim, even before they have completed their lessons learned, they have improved some of the resilience issues that we saw there.

Then, internationally, we are very active alongside the Bank of England in the international fora on bank finance, because this is one set of issues in a much broader set of issues where we have seen stress on banks. We are trying to understand where else we are potentially going to see a similar pattern of issues emerging. I am talking about concentrated counterparties, liquidity limits, and the margins perhaps being based on scenarios that are not consistent with some of the severe stresses that we may see coming. We are working with our colleagues overseas on leveraged hedge funds and on some of the other risks that we see in markets right around the world, because often those are markets that are based overseas but that have participants here and so it flows back into our market.

Q194 **Chris Stephens:** Will you be reporting back to the Bank of England? If

so, can you share those reports with this Committee?

Nikhil Rathi: Whenever a recommendation is made from the FPC, we respond, and the responses are published and the way in which they are taken forward is public and transparent, yes.

Q195 **Chris Stephens:** And you will share that with the Committee.

Nikhil Rathi: I will happily share that with this Committee.

Q196 **Chris Stephens:** Thank you; that's really helpful. I want now to pick up on what you said about working with partners. I was going to ask about your work with other regulators. You have said you retain a supervisory focus on vulnerabilities and identifying those and making sure they are addressed. To what extent can you do this alone? Does it require co-ordinated action by a group of regulators? If so, who should be in that group?

Nikhil Rathi: The FCA sits at the intersection of so many financial regulatory issues, including other topics that the Committee has looked at before, such as fraud, online scams and so on. We can deal with hardly any public policy issues on our own; we have to work with a whole range of partners. In this area, the Pensions Regulator is firmly in the lead. It regulates defined benefit pension funds and the trustees.

We have responsibility for the investment managers; they are delegated to us. The Bank of England—the PRA—is responsible for banking supervision. Ultimately, if there had not been a financial stability intervention by the Bank of England, the gilts would have fallen in value and they would have been returned to the banks that had provided the repo contracts. They would have had to work out whether they wanted to hold on to them or sell them at potentially very significant losses. The banking supervisors are important. The overseas regulators that I have talked about are important as well, particularly Dublin and Luxembourg being the fund domiciles. Then there is a role for the Government in the context of the overall perimeter, as we mentioned as well.

Simon Walls: I will just add a little detail if it is helpful. The situation is slightly different on the segregated mandate side and the pooled funds side. On the segregated mandate side, trustees will ask an asset manager, which is often UK-regulated, to do something very specific. Our core job is to make sure that they do what they have been asked. On the pooled funds side, they are very explicit in what they are seeking to achieve, including the amount of leverage and risk that they will take. That is the responsibility of the Irish or Luxembourg authorities and managed by an AFM that is in Ireland or Luxembourg, but it is often delegated to a UK manager. We have this constraint of making sure that these vehicles do what they have promised to do. We will regulate to ensure that is the case and that they can do it in an operationally sound way. We need to work with our partners. If we collectively think that what they have been asked to do is not sensible or engenders too much risk, then we need to work closely with the Irish or Luxembourg authorities, or the Pensions Regulator in the former case.

Q197 **Chris Stephens:** Thank you. My final question—and it is my final question, Chair, before I leave the Committee—is that there is a wide range of priorities between different regulators, with a different focus. For example, the Bank of England looks at financial stability. The Pensions Regulator looks at things that are applicable to it. Is there any way for information sharing to be unified into a single reporting exercise, containing all the data returns needed by each interested regulator? For example, is modifying the annual scheme return that goes to the Pensions Regulator possible and something that the FCA could look at?

Nikhil Rathi: It is an honour to be answering your final question. I hope it's not my final answer! We have to make sure that data sharing works as smoothly as it possibly can. There are certain issues with the speed of data collection and data sharing during stressful times. I think we need to fix those, particularly cross-border. That is why the MOUs with our partners overseas, and in the EU in particular since we have the European Union, are so important to make sure there is a robust framework for data sharing. Other than the Bank of England, there is a fairly free ability to share information. The next level of that question is when you have the data, what are you doing with it? We have invested heavily in our cloud capabilities. We are increasing our use of artificial intelligence, data science and analytics. We are getting tens of millions of pieces of data across the market every single day into the FCA. The question is about how we can use data analytics and technology to help us analyse that and work out where the key areas of risk may be. Once they are triaged, we can focus on them more systematically.

Chris Stephens: Thank you, Chair.

Chair: Thank you, Chris, for that question and for your very substantial contribution to the work of this Committee for over five years. We are very grateful for that, and we wish you well for the future.

Q198 **Nigel Mills:** You do get another question to answer, however. Let's see if I can tempt you down a route that might make it your final appearance. You have just talked about some very sophisticated things that your organisation is doing, but most of the schemes that ended up in a bit of shtook a couple of months ago are not within your regulatory ambit. Were you beating your head against the wall that day, thinking, "Oh God, if only we were supervising these schemes we wouldn't be in this mess." Or were you thinking that there was nothing anybody could have done, and it was just the way it was bound to have ended up?

Nikhil Rathi: I wasn't banging my head against the wall. As I say, I think the underlying issue was the extraordinary move in the gilt market. I have worked in or adjacent to these markets for a long time, and I have never seen anything of that scale before. Once confidence was restored, things calmed down relatively quickly. I think you heard from our colleagues at the Pensions Regulator earlier that they are thinking about the data they collect on an ongoing basis, not just annual scheme returns and so on. They are asking if there is more real-time data that they may wish to look at in the future.

There is an issue around the financial acumen of some of the trustees. These are complex products. From our perspective, we are thinking about pensions funds as professional investors. We do not treat them as retail investors; these are investors that have the ability to access advice and to make some decisions. Ultimately, it is the Pensions Regulator that decides on the regulation of pension funds, but the question is do the trustees really understand what they are doing and the risks they are taking? There is a growing use of professional trustees, and, to go back to the Chair's first question—I am stepping a little outside our remit here, so you will have to indulge me—there is a question for us about whether having several thousand of these schemes, rather than a significantly smaller number that are highly professionalised, is delivering the right economic outcome in terms of the long-term investment we want to see in our economy. But that is a very delicate question.

Q199 **Nigel Mills:** Do you think we would get a better outcome on that issue if we had one financial conduct regulator in the area of pensions rather than two? Had you been regulating pension schemes, do you think you could have mitigated some of those problems, or do you think TPR has done roughly what you would have, so we would have still been in the same position?

Nikhil Rathi: I always duck these questions when I am asked them; I often get asked whether there should be changes to the perimeter and whether we should merge. The nature of the work we do at the FCA is very broad. We intersect with just about everybody in the system. Ultimate decisions around structure of regulation are matters for Government, and it is our job to do what you tell us to do.

Whatever structure is put in place, whether it is on pensions policy, economic crime or online safety, requires us to work in partnership with a range of different partners. In pensions, we are working with the Pensions Regulator and the Bank of England. On fraud, we are working with law enforcement, police, and the National Economic Crime Centre. On online safety, Parliament has decided that Ofcom is going to be in the lead, but, when it comes to financial fraud, we will make a big contribution to that work. The key thing is our mindset of partnership, making sure we can share data and having aligned outcomes and goals.

Q200 **Nigel Mills:** What were you sharing with the Pensions Regulator in the run up to September? You say you have this AI that scrutinises millions of transactions a day and you can see what is happening. Were you sending alerts over to say, "This is all going horribly wrong—do something quickly"?

Simon Walls: I think it is helpful to remember the speed of events. "This is all going horribly wrong," was not our view back in March and May. It is unusual that this issue was so clearly in our spotlight, but it was through the work that had been done with the Financial Policy Committee back in 2018, and with the TPR. Conceptually, we all thought that interest rates would rise this year and rate expectations would go up. We had looked ourselves in March and May and had seen the large rise through the

year—which was larger in scale from January to September than in those few weeks in September—had been digested properly. We were talking to our peer regulators, but we were relatively confident that the LDI model would be able to digest the moves that were coming. We saw the vulnerability to speed of moves, but, at that stage, we did not see the moves that were coming as credible.

I think you have heard this before, but the biggest move on a single day on a 50-year bond was previously 29 basis points, which occurred during the covid period. There were holding buffers around 150. Then we had consecutive days of 35, 53, 61, and then half a day of 46 before the Bank intervention. They really were extraordinary periods.

As it happens, by coincidence on the Friday of the mini-Budget we were scheduled to speak to a board of one of the big providers. On the Thursday, pre-mini-Budget, we were looking at our agenda and talking about this issue as a conceptual. On the Friday itself, the mini-Budget had been announced. We were in there and still there was a sense of relative calm—that this was going to be frothy for the industry, but there was relative calm. On that day I did ring the Bank of England—and I know that conversations were had with TPR—but still on the Friday of the mini-Budget it was still digestible. That move was 35, which is the biggest move ever, but still in the context of 150 basis points it was manageable.

Of course, if we look back to what was happening in the world at that time, the shocks kept coming, or rather there was the shock of the mini-Budget, then aggravation kept coming. There was news over the weekend and people's assessment of fiscal policy was really weighing on gilt prices. It really started to move. Beforehand, we were having calm conversations about it as one of the many things we might worry about in the overall landscape, and that is particularly true of us and the Bank. At the moment it occurred, on the Friday, there were conversations between regulators to say, "This is one to keep an eye on. Have you had any conversations yourself? Let's share information."

Then on the Monday when the moves began to accelerate, it became very clear that there was a potential issue. The tenor of our conversations with investment managers changed, and they were deeply concerned. From then, we were on to a crisis footing and we were meeting with the Bank of England multiple times a day and the Pensions Regulator daily, I would say, co-ordinated by the Treasury. It picked up very quickly. Prior to that, it was all conceptual, because it was the speed of the moves that led to the particular challenges we faced.

Q201 **Nigel Mills:** Going the long way around, I think what you are saying is, "No, if we had been regulating all pension schemes we couldn't have prevented this in reality," and that you do not think something obvious was missed.

Nikhil Rathi: It is a hypothetical question. What is important when you are regulating any large financial institution is to ensure you have data on an ongoing basis that enables you to understand not just the individual

risk that those institutions are taking, but how that all adds together. There has clearly been a gap in that domain. I know there are efforts to fix that going forward. It is very hard to hypothetically talk about what we may have done if we had been regulators. What we can assure the Committee about, going forwards, is our contribution. We are working very closely with all the relevant partners.

Q202 **Nigel Mills:** I guess what the Committee is trying to understand is whether this could and should have been prevented, or whether it was one of those things people were doing entirely reasonably, and things just went wrong that could not have been foreseen. That is what we are wrestling with. When you look back with hindsight, a collection of unsophisticated people being encouraged to invest in some quite sexy, complicated instruments that they may or may not have completely understood, and that had risks they may not have fully appreciated, may not have been the cleverest situation to get ourselves into, but that was where we were. Is that a fair assessment?

Nikhil Rathi: There are some that were unsophisticated and did not understand it, but there were some extremely large pension schemes involved as well. To talk about another domain, we are very anxious in the retail world about the fact that perceived high net worth investors can self-certify and access high-risk investments. That self-certification is there in statute. We have seen that as being a major source of consumer harm, and the Committee has looked at some of that. We would like to see that changed. We would like the threshold for what is defined as "high net worth" to be lifted from £250,000, because £250,000, as this Committee knows, will not buy you a very big pension these days. We can make those recommendations and give the evidence, but those are ultimately statutory decisions.

The reason I make that point is that that is in the retail space, before you even get to the professional investor space, where the general view is that these are professional investors. If you look at the documents of the pooled funds, in the risk log it says that you can lose all the money. It is not as though it was hidden away; it says it very clearly. The question was: did the pension trustees and the pension funds really think through what might happen if that risk crystallised? With hindsight, there is a lot that we may have wanted to do differently. The key point from my perspective is what I said before about planning for failure—planning for things going wrong, and understanding what you might do in those situations.

Q203 **Nigel Mills:** One final question. It still strikes me as slightly counterintuitive that I would want to hedge interest rate risk at the bottom of the market. A year ago, I would think that it was more attractive to take a fixed-rate mortgage than a fixed-rate bond, because the potential for movement upwards in interest rates was much greater than the potential for movement downwards, given where they were. Does it worry you a bit that a lot of pension schemes have effectively hedged themselves at the bottom of the market, locked themselves out of a load of benefit, and maybe locked in a load of losses that they took

12 years ago, and that that was not really a sensible investment activity?

Simon Walls: You have to put yourself in the mindset of a trustee and think about the decisions that these trustees made. Nikhil made points at the start about defined benefit pension schemes being relatively unusual in our system; they are largely closed schemes, and they are not open to new members. I can understand the mindset that thinks about them as books of liabilities, rather than of assets, so you are desperately seeking to find assets that match the liabilities you will have to pay. At some point, when everyone is retired, you should have an asset book that looks very much like an annuity; you just want gilts to pay that match what you need to pay. Yes, even though you might not have invested in that way personally, there is a good logic to what they chose to do.

It is worth saying that these pooled funds are limited liability vehicles. It was open to the trustees and pension funds to walk away and say, "Okay, it has gone to zero as advertised, but we do not need to put any more money in," but they chose to; I think upwards of 90% of the recapitalisation demands were met, notwithstanding the stress of the period that we described and how quickly the calls came. It demonstrated a long-standing desire for these hedges. Since that period at the end of September and the start of October, yields have come down substantially and have to some extent validated the value of the LDI.

As always, there is a trade-off. Some of the big pension schemes have come out recently and said, "This was riskier than we anticipated. We want to reduce the amount of leverage we will have in LDI", but the consequence is either slightly more volatile funding gaps, which will fall on the sponsor, or the sponsor needing to put more money in now. There was a risk being taken—clearly, in this period the risk was really brought into the spotlight—but it cannot be eliminated. If you are not going to use LDI and you are not going to take leverage, you need to put more money in now.

Q204 **Chair:** Thank you. Can I put a final couple of points to you? Some witnesses have told us that the approach taken by the Pensions Regulator and DWP to scheme funding risks increasing herding. You talked about the concentration in the LDI market and the small number of market participants in some of these areas; the worry could be that if there is more pressure to go down this road, the herding could create difficulties in the future in the financial markets. Do you have concerns about that?

Nikhil Rathi: I have two points, and then Simon may wish to add something. We see a lot of leaning on investment consultants on strategy and asset allocation. One of the reasons why we have asked for greater regulatory oversight here is a sense that, at times, they were giving standardised advice—templated advice—to a range of different clients, rather than really thinking through in depth and detail what might be the right thing for each pension fund.

Secondly, having talked to my Dutch colleagues about this—their pension funds have a similar historical, defined-benefit-type pension structure to

ours—their pension funds were using LDI, but using it to manage about 50% of their interest-rate risk. It feels as though ours got to about 85% of interest-rate risk being managed, so there is the question of the right balance.

The other thing that is different for the Dutch is that, ultimately, they get a larger bond market, because they are a smaller bit of the overall euro-denominated bond markets. We are one jurisdiction, so the liquidity at the longer end of their bond market, relative to their size, is obviously much larger, whereas 90% of the index-linked sterling bonds are held by defined benefit pensions. That was another factor. Those are two points that I would register.

Q205 **Chair:** Could the potential problem with hedging 85% rather than 50% arise around herding?

Nikhil Rathi: I think what it means is that we have a concentration in that part of the gilt market. Therefore, when stress arises, it affects more people faster and becomes systemic more quickly.

Simon Walls: The particular concentration that was an aggravating factor here was that pension funds tended to buy the same type of gilts—first, long dated, because that was the best hedge for their long-dated liabilities; and, secondly, they favoured the index-linked or inflation-hedged bonds, which makes sense, because they often have an inflation liability as well—but there were not many other natural buyers in that market. That caused us interest. We wondered at what stage there would be buyers coming into the market, because it did seem to become dislocated and there seemed to be good value at one point.

The history of the market, however, is that the DMO issues the gilts and the LDI practitioners buy them, so there were really only those two sides. Therefore, when the buyers became sellers, it took some time for any buyers to come in, which is one of the reasons why we saw such precipitous drops. I would not say that the concentration of that market was unknown—the participants and the DMO would have known it—but a spotlight has now been shone on it. The schemes might want to take diversifying actions and buy other things, and there might be lessons for the DMO to learn.

More generally, I think we are worried about concentration in markets outside this. As we described, generally, the number of liquidity-style crises has increased, volatility has increased and the buffering of warehousing of risk by banks has changed, so market participants should look out for areas where they might constitute a large part of the market or where, if they are looking to sell, it would represent a large part of the selling of that day, and they should probably be more cautious than they have been in the past.

Q206 **Chair:** Has that problem of concentration in the index-linked gilt market eased, or is it as concentrated as it was?

Nikhil Rathi: I do not think that we have the data, but I do not think we have heard anything to suggest that it has eased.

Simon Walls: The proximate pressure on the market has eased, but I do not think the concentration has changed. It is not 100% concentration; it is not only those five players. During the period we were looking at for who the buyers might be and were, there were some principal trading firms, along with asset managers and hedge funds, that operated in the market, but the large volume was through those big five.

Q207 **Chair:** A final point to you: you have made the point about your interest and the Government's interest in securing investment in infrastructure and illiquid investments of that kind, but the Pensions Regulator has made it clear, rightly, that it has been given a remit by Parliament, in essence to protect the Pension Protection Fund and to ensure that calls made on that are not excessive, which means a focus on minimising risk. Is there not a bit of tension between those two things? How do you think that could be resolved?

Nikhil Rathi: There is a balance of objectives here, and there is always going to be a tension, I think, between the level of risk taking and some of the prudential objectives. That judgment about risk appetite is struck, I think, in the statute. For example, there is a Bill going through Parliament now about how our objectives should be balanced. A very vigorous debate is going on in both Houses around that. We take that decision. We take the remit letter that is sent to us by the Government every year about Government economic policy and the priorities that we should take account of, and then act accordingly.

Q208 **Chair:** But doesn't the statute at the moment require the Pensions Regulator to minimise risk—not to balance it, but if possible to go for zero risk? That is the remit that the Pensions Regulator has, isn't it?

Nikhil Rathi: I am not familiar with the precise detail. Simon, would you able to—

Simon Walls: Perhaps the way I would look at this is to say that although defined benefit schemes are large pots of money at the moment, that will be in decline. Perhaps the big prize here is the defined contribution schemes and other pots of money where that tension does not apply. There are pools of capital that are available for long-term investing. Generally, if investors have the advantage of time, they should use it. If they are resilient to shocks, it is generally in their best interests to invest in the long term. That is why we are working with many other partners to try to encourage long-term investment, including with the long-term asset funds.

I suspect that the DB schemes are a particular pocket, and it is challenging. I think the tension there is very clear, because people have been promised a set defined benefit outcome, and you can see in the trustees that it is not really in their interests to exceed that. They have a laser, asymmetric focus on delivering that. It is challenging to see our current DB schemes investing much longer term, but you have this large

and growing pool of money on the DC side, where I think there are possibilities.

Nikhil Rathi: I am grateful to you for raising this theme, because it is something that we need to engage with Parliament on. In our consumer investment work, we have set ourselves a target of reducing the number of people in the United Kingdom who have more than £10,000 of cash that is not invested based on a judgment that that is not going to be in their long-term financial interest. We want to make it easier for them to access stocks and shares, ISAs and other longer-term products. That requires an understanding, though, that sometimes those things go wrong. These things can go down. Over a 25 or 30-year period, they should be fine, but there can often be bumps along the way. When those bumps come, that is when it can get a bit more challenging when you try to take some bold action, as we have tried to in the consumer space, because in your constituency mailbags you will be getting concerns raised with you.

Simon Walls: There is a large operational element as well. The consumer distribution platforms typically have a very strong weighting towards daily dealing funds—funds that allow people to have their money back in a day. There is quite a lot of work in the overall infrastructure to create the culture for long-term investing, for individual consumers to get comfortable that they will not be able to have their money back in the moment that they want it, and in the operational plumbing, but I think that we would think that the prize is worth it.

Chair: Thank you both very much indeed for your evidence. It has been a very helpful and interesting session. That concludes the public part of our meeting.