

Work and Pensions Committee

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

Wednesday 23 November 2022

Ordered by the House of Commons to be published on 23 November 2022.

Watch the meeting

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

Questions 1 - 64

Witnesses

I: John Ralfe, Independent Consultant, John Ralfe Consulting; Dr Con Keating, Head of Research, Brighton Rock Group; Professor Iain Clacher, Leeds University Business School; and Henry Tapper, Executive Chair, AgeWage.

II: Leah Evans, Institute and Faculty of Actuaries; Steven Taylor, Association of Consulting Actuaries; Joe Dabrowski, Pensions and Lifetime Savings Association; and Jonathan Camfield, Lane Clark & Peacock.

Written evidence from witnesses:

[John Ralfe Consulting LDI0020](#)

[AgeWage LDI0007](#)

[Prof Ian Clacher & Dr Con Keating LDI0018](#)

[Association of Consulting Actuaries LDI0026](#)

[Pension and Lifetime Savings Association LDI0035](#)

[Jonathan Camfield, Partner, Lane, Clerk & Peacock LDI0023](#)

[Lane, Clerk & Peacock LDI0049](#)

Examination of witnesses

Witnesses: John Ralfe, Dr Con Keating, Professor Iain Clacher and Henry Tapper.

Q1 **Chair:** Welcome, everybody, to this meeting of the Work and Pensions Select Committee and the first evidence session in our inquiry into what happened with LDI in pension schemes. A warm welcome to the members of our first panel this morning. Can I ask each of you very briefly to introduce yourselves, starting with Professor Clacher?

Professor Clacher: I am a Professor of Pensions and Finance at the University of Leeds.

Dr Keating: I chair the Bond Commission of the European Federation of Financial Analysts Societies and I have worked in bond markets since 1969, until I retired.

Henry Tapper: I am a blogger. I run two fintechs and for most of my career I have sold pensions.

John Ralfe: I am an Independent Pension Consultant. For about 20 years I have been advising companies and trustees on their pension schemes, in particular matching their assets and liabilities.

Q2 **Chair:** Thank you. I will put the first questions to you. I will start with Mr Ralfe. You were at the Boots Pension Fund when it switched fully into bonds in 2001, I guess reflecting a much healthier funding position than many pension funds find themselves in. What is your view of the widespread take-up of LDI in the 20 years since Boots made that switch?

John Ralfe: Thanks for the opportunity to give evidence this morning. LDI is not a defined term. It is used by investment consultants to mean all manner of things. It involves opacity, it involves cost and it involves quite a lot of money being siphoned off by various parties, including the pension consultants. LDI, Liability Driven Investment, at its simplest is exactly what we did at Boots 20 years ago, which is matching our assets and liabilities. We can talk about why that is a good thing as a separate thing.

At some point—and I have to say, I was not entirely aware of this—over the course of the last 20 years, and it was certainly in existence in 2015 because I got a call out of the blue from a company I did not know saying, “Our pension scheme is being encouraged to do leveraged LDI. Can you please tell us what this means?” There is a difference between matching your assets and liabilities, which is hedging, and leveraged LDI, which is pure speculation. The problems that we have seen following the mini-budget have only been in those companies that have gone out and spivved around.



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The handful—and it is only a handful, because I am a one-man band—of schemes that I have been involved with, did any of them have any liquidity problems? No. Why is that? Because they were simply matching their assets and liabilities. They had not gone out and implicitly borrowed.

Q3 **Chair:** It is your view that leveraged LDI is a bad thing?

John Ralfe: Yes, it is. It is a bad thing not in and of itself necessarily, although I would say it is a bad thing. Forget about the pension schemes. You are a company and you want to say to your shareholders, “We are going out and we are borrowing and we are investing” or, “We are buying back shares” or whatever, rather than issuing equity, that is absolutely fine. There are lots of reasons for doing that, particularly the tax break, but the important thing is that that is clearly on the face of the balance sheet. You open the report and accounts of any company and you can see what its position is. The accounting has improved. It has become much more transparent over the course of the last few years, so off-balance sheet things—Enron, going back almost 20 years—could not happen today.

In what we have seen over the course of the last few weeks, the thing that has absolutely shocked me is that what you have is hidden leverage. I mention British Telecom because it is the largest pension scheme in the country and it does a lot of leveraged LDI. I submitted evidence, including an article I wrote for the *Financial Times* recently. Can you see what is going on in the British Telecom pension scheme and, therefore, the company by looking at the British Telecom report and accounts? The answer is no. If you look at the pension scheme report and accounts, you can get part of it.

I think the answer to your question, Mr Chair, is hidden leverage is undoubtedly a bad thing. Leverage, if you are being absolutely clear what you are doing—that it is clear to the shareholders, it is clear to the members, it is clear to the Pensions Regulator and anybody else—it may be a bad thing, it may be a good thing, but hidden leverage is always a bad thing.

Q4 **Chair:** Thank you. Can I come to Professor Clacher and Dr Keating? You told us in your written evidence that the Pensions Regulator did not understand leveraged LDI and did not understand how to regulate DB scheme funding. In your view, what should the Pensions Regulator have been doing over this period when LDI take-up has increased?

Dr Keating: The Pensions Regulator has adopted an approach where scheme funding is everything. The famous quotation is from Alan Rubenstein, who was then the CEO of the Pension Protection Fund, and he expressed it as, “Funding trumps covenant”, whereas the element that is most important here is not funding, it is covenant. The emphasis all the way through has been an interpretation of the discount rate, the valuation methods, which is totally dependent on scheme funding. The result has been two decades of huge demands for additional special



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repair contributions to the order of perhaps £200 billion of corporate assets going into their pension schemes.

That emphasis on a market-based discount rate, gilt-related, has led to artificial volatility in the valuations of pension schemes and, indeed, with the prolonged decline in rates, which resulted in massively excessive demands for funding. The result has been LDI. LDI came about as a response to an accounting standard that introduced market volatility into pension scheme valuations when it was not there otherwise. The very first LDI transaction that most people generally credit was one done by Dawid Konotey-Ahulu for Merrill Lynch and Rob Gardner for Friends Provident. I spoke with both Dawid and Rob at the time, and indeed with the finance director of Friends Provident. They all confirmed that the purpose of buying their interest rate swap was to hedge the volatility of their pension scheme arising from market prices. That was the origin of LDI.

It has come to pass that some people are describing what John did at Boots—which was a brilliant piece of timing, which was to buy bonds and to have an all-bond portfolio for the pension scheme—and that is what I would refer to as traditional asset and liability management, rather than LDI. LDI transformed itself over the first decade. I am not sure when the first leveraged LDIs were done, but LDI, in the simple hedging of volatility, is quite expensive. Most schemes were in deficit, according to the accounting standards.

The next step was to move away from simply hedging the variability to trying to use the assets to make good the deficits. If you are in deficit and you are trying to hedge a set of liabilities, your assets have to be riskier than your liabilities in order to achieve that matching. If you then add to that the requirement or the objective to make good deficit, you are adding yet another layer of risk to your asset portfolios. It is for those reasons that, as currently conceived, I don't believe LDI makes sense. I don't think it has ever been fit for purpose.

Q5 Chair: You are making the point that it is a sort of creature of the way it has been developed to value pension fund liabilities. Is there some other way of valuing those liabilities that wouldn't get into this?

Dr Keating: Yes, there are numerous ways. For example, you can consider cash flows of both assets and liabilities. Iain and I have devised an approach, which is simply to value the promise, as made by the company. In other words, to consider this as if it were a corporate bond, a corporate obligation, which in many regards it is very similar to. We refer to that as the contractual accrual rate and we have written numerous papers on it.

The big problem, the proximate problem of the gilt market was leverage. It was leverage that led to collateral calls when gilt prices came down and short rates started to rise, and that is what triggered everything else. That was all entirely predictable, including its speed.



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Q6 **Nigel Mills:** Did you predict it, Dr Keating?

Dr Keating: We did not predict an economically illiterate budget triggering it. Did we say that it was possible that this might happen? We said rather more than that. We said that this was an endogenous risk spiral and should be expected to have these sort of results. We have known them in other markets. It is not original.

Q7 **Chair:** When did you say that, Dr Keating?

Dr Keating: When did we first say that? Seven years ago.

Professor Clacher: We have talked about it for a long time. The first time we wrote about it this year would have been substantially in March and then much more substantially in June, and you started seeing it being reported in July in places like the *Financial Times* that this was already happening.

Dr Keating: To predict chaos of that order ahead of time would have been an invitation to be described as nutters, which we have been on occasion.

Q8 **Chair:** Thank you. Mr Tapper, can I come to you? There are lots of supporters of LDI and they say it has helped a lot of schemes to improve their funding position substantially. Are they mistaken in that view?

Henry Tapper: The period around 2010 and the back end of 2021, LDI rode the quantitative easing wave. During that period of time, bonds rose in price inexorably and everything in the garden was rosy. What had started out as a short-term fix to get over the problems, which Con has described, was turned into an investment strategy and people starting referring to LDI as a kind of long-term investment strategy, which I don't think it was considered initially.

Certainly, companies profited from the positive aspects of LDI, the smoothing of the liabilities on their balance sheet. They also benefited from the improvements in their funding position from the bots. In answer to your question, Mr Timms, yes, over that period of time LDI worked very well for companies and it worked very well for the trustees too.

Q9 **Chair:** Is your implication that it will not work well in the future?

Henry Tapper: All things work well until they don't. It certainly has not worked well this year.

Q10 **Chair:** John Ralfe referred to the problem being the leverage. That is a question to anybody, but how much leverage of LDI is too much, in your view?

Henry Tapper: I am going to speak here as a non-expert, but I would say any leverage in a pension scheme when it is held on a long-term basis is too much. Because pension schemes should not borrow money and leverage is, in my mind, borrowing. I don't believe that pension schemes should borrow. I don't believe in leverage. Any amount of



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leverage in a pension scheme of the type we have seen in LDI is too much. I do not know if my colleagues would agree with that.

Dr Keating: Could I just add to this question of leverage? Borrowing is explicitly prohibited under the scheme funding investment regs, yet the Pensions Regulator does not consider repo, which is economically borrowing, and there is no doubt that it is economically borrowing. Contrary to what the Pensions Regulator said, repo is not a derivative. There has been a lot of borrowing going on. The ONS tells me that, as of the third quarter of 2021, it was of the order of £195 billion-worth of borrowing of cash using repo, and 88% of the non-pension liabilities of UK DBH schemes was repo. There is a question of legality there with repo.

There is also a further question, which is that derivatives are being used in the form of interest rate swaps. There are a number of problems with interest rate swaps, but we will just deal with the two principal ones. With an interest rate swap, as the pension scheme, you are receiving a fixed rate for a fixed term, 10 years, 20 years, 40 years, 50 years. A 40-year interest rate swap would hedge a 20-year duration pension scheme.

The problem with these is that you receive a fixed rate, but you have to pay the short rate, so you are vulnerable to loss if either the price of long-dated gilts goes down or the cost of short financing goes up. Of course, we have seen both of those things this year. That is why we saw the collateral calls on the scale that we saw. What is the correct level of leverage in a pension fund? I concur with Henry: zero. I believe that is what the law says.

There is a question of interpretation. In fact, not interpretation but mis-transposition of a European directive on the use of derivatives. The European directive limits the use of derivatives for investment purposes, for investment risk management. The UK transposition omitted the word "investment" and added a second line, which appears to permit this. No English court, to our reckoning, would support that transposition. We believe that a court would just put a line through the added sentences and reinsert the word "investment". The use of derivatives to hedge liabilities is also almost certainly illegal.

Q11 **Chair:** I will bring in the next question, but just a final factual question from me. It appears that local government pension funds have not used LDI very much. Any comment why that is?

John Ralfe: The answer is because the local government pensions schemes—I have done a lot of work on them—are not set up to match their assets and liabilities. They have something like 75% or 80% equity as private equity, hedge funds, quoted equities, and the accounting is different for local government pension schemes when the schemes are opened. Unlike most private sector schemes, they are not in the business of trying to match assets and liabilities. For completeness, there are one or two quasi-public sector schemes, university pension schemes, for



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example, which have done it, but for local government pension schemes, in particular, they are just not in that game.

Professor Clacher: There is one other aspect to that, which is local government schemes are not regulated by the Pensions Regulator. Private sector DB is regulated by TPR; local government schemes are not.

Q12 **Nigel Mills:** This is all a bit beyond many of us and we are trying to wrestle with what you are telling us. I think what you are telling us is that pension schemes found gilt rates, which they used to basically discount their assets and liabilities to be too prone to volatility, that made the position on their sponsor balance sheets go flying all over the shop and they decided that they preferred to get rid of that volatility by taking a bet on interest rates, basically.

Dr Keating: A little more than just that. The volatility was what drove things initially. The prolonged decline in rates also massively inflated the value of the liabilities.

Q13 **Nigel Mills:** What I cannot get my head around is: effectively, what these leveraged LDIs did was try to take away the volatility of gilt rates going up and down, so if I entered into one of these pre-2008, there was a chance that rates might go up or down, but why the hell would I enter into one after 2008, when interest rates were low?

Dr Keating: To leverage LDI, there was a huge advantage. Short rates dropped to 0.5% or lower, whereas in 2008-09 the long gilt rate, the 15 and 20-year gilt rate, was between 4% and 4.5%, so you had a 4% arbitrage by borrowing short and buying long-dated bonds. That arbitrage is huge. It is the largest I have seen it in a working lifetime—well, more than a working lifetime. It was the response to the crisis of 2007-09 that led to central banks everywhere dropping rates to close to zero, and in some cases below zero. Bond yields were slower to respond to that. They did come down a little, by about 50 basis points or so, and the yield curve normalised. However, what was motivating people to borrow money and buy long gilts is really very simple. It is 400 basis points of return in my favour. Most hedge funds would dream of such margins and there were hedge funds who were very active in the early days.

John Ralfe: I am not sure whether I agree with your characterisation. What we have not talked about is what is going on in the asset side of the balance sheet. Leveraged LDI matches what is going on on the liabilities, so the value of the liabilities goes down because interest rates go up and the value of the matching asset goes down because interest rates have gone up. If you are sitting there in a position where you have 100 of assets and 100 of liabilities, and a year later it is 110 and 110, you don't care, or a year later it is 90 and 90, you don't care.

What we have not talked about is what goes on in the asset side of the balance sheet. A big incentive for companies to do leveraged LDI is because it allows them to match the liability side of the balance sheet—pretty standard, common—coming back to them, they have matched 95% of their interest rate and inflation exposure. They can still hold lots



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of these fantastic assets, private equity, quoted equities, property, hedge funds, all sorts of things, on the asset side of the balance sheet. The advantage to the company of doing that is that it can produce the deficit contributions. It does not change the underlying economics. It is exactly as if the company—nothing to do with the pension scheme—is going out and borrowing £1 billion and putting that into equities. I think we should think about the asset side of the balance sheet.

One of the questions that was asked earlier was, “Well, it seems to have worked, doesn’t it?” One of the reasons it seems to have worked is because, broadly speaking, asset values have not plummeted. If asset values went down by 20%, equities went down by 20%, which is entirely possible—and I am not picking on British Telecom—British Telecom would be losing £4 billion in the pension scheme and its market capitalisation is £12 billion. However, on the liability side of the balance sheet it is absolutely true to say it is insulated, it is hedged, it is matched, whatever happens to inflation, whatever happens to interest rates. I would like the Committee to think about the asset side of the balance sheet, I guess.

- Q14 **Nigel Mills:** Thank you. From what Dr Keating was just saying, this was not an entirely stupid thing to have done, but you thought it was the wrong thing to have done.

Dr Keating: It is speculation is the problem with it. Trustees have a fiduciary responsibility that precludes them from speculating. It is almost certainly ultra vires.

- Q15 **Nigel Mills:** It just looked to me like they had done a one-way bet against themselves. It looked like interest rates could only go up and, if interest rates went up, you kind of discount your liabilities by more so your pension scheme position improves, but you just take the—

Dr Keating: If interest rates go down, that is what hurts the pension schemes. As interest rates go down, their liabilities go up.

- Q16 **Nigel Mills:** They could not go down any further, could they?

Dr Keating: At zero, there are arguments that you could see -1% or -2% but the bet at 1% or 0% received fixed rates is insane.

Nigel Mills: Yes. As I say, it just looked like you had locked yourself into the bottom of the market.

Dr Keating: The pension world has been doing that for a very long time in the index-linked gilt market. Pension schemes own in excess of 80%, by some counts over 90%, of index-linked gilts. They drove the 10-year index-linked gilt to such an insane price that its yield, its expected return was RPI -3.2%, so they are certain to lose 3% value a year and yet they were all owning index-linked gilts. They control the index-linked gilt market and they are the index-linked gilt market, such as it is.

It is very interesting to look at the relative behaviours of index-linked gilts and conventional gilts immediately before and immediately after the crisis and so on. There are a few lessons to be learned there, but one



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sees very clearly the influence of the UK DB pensions world by doing that comparison. I can send you over a note on it because we have not written it up in anything we sent to you.

Sir Desmond Swayne: We would never understand it. Please send it anyway.

Dr Keating: I am sorry about that. We will try.

Q17 **Nigel Mills:** I am trying to work it out. When you called this crisis entirely predictable and you say you did indeed predict it, are you saying schemes should have tried to exit these gambles they had taken earlier this year or before that, to say, "This is going to be a lose at some point"?

Dr Keating: Some got it very right. The local government pension scheme, the London scheme, which was one of the few local authorities that did play in LDI, exited last summer. I am told it was somewhere around August. The Pension Protection Fund has been an avid user of LDI for its portfolio. I am told that at the beginning of this year, having decided that interest rates were going to rise, it decided to start reducing its liability-driven exposure. It has stated publicly it has had collateral calls of around £2.5 billion—this was back in September—since the beginning of the year on the LDI that remains. Yes, we wait to see the annual report to see how much is there now, but what can I say?

Q18 **Nigel Mills:** From what you say, pension schemes holding these things is widely known and the scale of it was widely known.

John Ralfe: Sorry to interrupt. I don't think it was widely known. If you look at all the information produced by the Pensions Regulator and the Pension Protection Fund, there is something produced every year called the Purple Book. There is nothing in the Purple Book. If you look at individual company accounts, there is nothing there. It was hidden and I have been genuinely shocked about the hiding in plain sight. Again, not picking on Legal & General, but if you look at the Legal & General Fund Centre, it has gilts 2042, it has leveraged gilts 2042. I think to a greater or lesser extent, people did not know. I certainly did not know. If the Pensions Regulator knew, it was keeping pretty quiet about it.

Professor Clacher: What Mr Ralfe has said is correct. There is very little good information on LDI and leveraged LDI in general, but what was known—and this is where I think it is quite important—is the exposure of pension funds to interest rate swap derivatives. The Bank of England, in its 2018 Financial Stability Report, flagged this in the November report. When you look at the figure in the report, the fact that pension funds were so far away from hedge funds in their derivatives exposure from non-bank finance, it was known that pension funds had these huge leverage exposures. The Pensions Regulator also then had a survey in 2019, which again highlighted the exposure of pension funds to derivatives and started to touch on LDI. That research, in and of itself, was skewed because it focused on large schemes but the exposure of pension funds to derivatives was well known.



Q19 Nigel Mills: I think the question I was trying to ask was: should one or other of the regulators have been saying, "You are not in a very healthy position here. We think these things are going to be doing you harm. You should be getting out of them"? Should one of them have said that at some point in the last year or is it—

Professor Clacher: For me, this comes back squarely to the Pensions Regulator because the Bank of England does not have a mandate over pensions. If we look at the way in which the regulator has operated for the past 15 years or so, what we have seen is this push towards ever more funding and matching assets. The regulator looks at schemes on an individual basis, so you will go to the regulator and you will have a conversation about your investment strategy and how you are going to then be getting deficit recovery and so on sorted. The regulator has been a proponent of matching assets, gilts, index-linked gilts, LDI and leveraged LDI. The regulator will have looked at each scheme individually and given it a seal of approval and a tick, "This is acceptable".

What the regulator has never done is stood back and said, "What are all schemes doing? They are all doing the same thing. Does that present a risk, whether at a macro level or a risk to the individual schemes?" That has simply not happened.

Q20 Nigel Mills: I am no expert on this, but I thought the idea of having a prudential regulatory authority as a separate regulator was that it was there to stop systemic risk to the whole economy, then we had individual conduct ones to do kind of individual. Should you be laying that blame at the prudential regulator?

Dr Keating: No. The Pensions Regulator¹ is concerned with the banking and insurance industries. The prudential regulator has no authority with respect to pension schemes or the system of pension schemes. The Bank of England was correct in drawing it to the attention of the Pensions Regulator in the 2018 Financial Stability Report. The survey that the Pensions Regulator subsequently commissioned looking at that is, frankly, not worth the paper it is written on. It has so many methodological flaws that it is not funny. The most important thing about it is there is not a single numerical risk estimate anywhere in that report and it is supposed to be focused on risk and leverage. It is not fit for purpose.

The PRA and Bank of England use it in their financial stability roles and had a responsibility to draw it to the attention of the relevant regulator and that was the Pensions Regulator.

Q21 Sir Desmond Swayne: What do we know about the position of defined benefit schemes at the end of September, what state they were in? Am I right in thinking that most of them ended up better funded, better able to pay the benefits which after all is what they are for? Don't all speak at

¹ "Note by witness after the evidence session: In referring to the Prudential Regulation Authority they misspoke. They said "The Pensions Regulator..."



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once.

Dr Keating: I will come in again. There are a number of problems with this idea. Had LDI worked, then they would have been no better funded at the end of this episode than they were at the beginning. To say that they were better funded at the end is to say that your LDI did not work. Unfortunately, in all too many cases, it did work and schemes lost very substantial amounts of money. BT is a classic example. The total declines in that period were something of the order of £350 billion over the crisis period. There are many schemes that are genuinely better off, but they are characterised by the fact that they were not doing LDI. They are using traditional bond and equity allocations, the sort of thing that John has done in the past and I have myself.

Q22 **Chair:** Dr Keating, can I just interrupt you? The BT example you have given, isn't that a case of a fund whose liabilities have fallen by more than its value has fallen and therefore, as Sir Desmond said, is better off in funding terms?

John Ralfe: I know all about the BT numbers, if I can answer that question. From March 2022 to September 2022, the value of the liabilities fell by about 25%. The value of the assets also fell by about 25%. People look at the assets because you can count the assets, they are there, they are in the bank account, it is very easy, and forget about the liabilities. The truth is British Telecom end to end on the liability side is about where it was six months ago. It has done what it said on the tin. The actuarial valuation is still about £4 billion, the deficit contribution has continued to be there, so that is fantastic. Look on the asset side of the balance sheet, it has £20 billion in private equity, quoted equities, property and hedge funds. As it happens, the value of those has not fallen. If the value of those do fall, it has a problem.

Sir Desmond, you are absolutely right. The worst that happens is you are no worse off because you have matched 100%. Quite a lot of schemes are not matched 100%. They might be matched 90%, 80%, which is significantly better than they were 10 years ago. Yes, they are better off because the value of their liabilities has fallen more than the value of their assets. What do they need to do about that? They should not be patting themselves on the back. They should be locking in that position and they should be switching from equities and private equity, and all that sort of thing, into bonds and be very grateful that they had that opportunity to do that.

End to end, what has happened? We have had the moral hazard of the Bank of England standing behind pension schemes, which from a purely personal point of view I think is absolutely appalling, but end to end, the small number of companies—a handful of companies—that I work with, are they better off; are they worse off? They are no worse off and in some cases they are better off.

Professor Clacher: This is where there is a tension not just between what I am about to say and what Mr Ralfe has just said, but a tension



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more generally with the way in which this is discussed. Everything that Mr Ralfe has said is correct but, from my perspective, there is a difference, which is the schemes have less assets. There are fewer assets today to pay out pensions because what we are not comparing is the liabilities as they evolve through time, which is a different thing to the present value of those liabilities, the discounted value of them. On that discounted present value basis, everything that Mr Ralfe said is correct. However, if you look at just the asset side, based upon the calculations that myself and Con have done, we estimate that roughly £500 billion is probably missing somewhere. This isn't a paper loss, there is a real loss, because pension funds were selling assets to meet their collateral calls. When you sell those assets, you get cash. That cash then goes to the person that you have to pay to meet that call.

What you have then seen is a significant reduction in the overall pot of assets that are available to pension funds to pay pensions in the fullness of time and we do not know how that works out into the future. There are two different things. One is the present value of the liabilities and the value of the assets held today and how those meet or don't meet, versus the amount of assets the pension fund has at its disposal to pay pensions as they fall due over a very long time period. That number is not the same thing.

Dr Keating: There are also some very severe technical criticisms of the funding ratio as a measure of scheme health, particularly in times of distress. The confidence you can have in a funding ratio is typically 100% funded plus or minus 3% to 4% is the degree of accuracy you can expect. In times of crisis, such as we have just seen, 100% funded would be plus or minus 10% or 12%, that order of magnitude. To make claims that there have been substantial increases, you need to have seen improvements in excess of 12%. Just about the only schemes where you will see that having happened are those that were not doing LDI.

Henry Tapper: Can I add something? A lot of the big schemes we have been talking about, like BT and so on, had the capacity to manage their way through this crisis, but there were a very large number of the schemes in the Purple Book that did not have that capacity, for two reasons. First, because they did not have the acumen among the trustees and their advisers to act quickly; secondly, because they did not have the information about their funding position because they were in what were called pooled funds. In other words, they had effectively a protected cell, which was their particular position, but they were only one of many protected cells.

There were so many of them that the people who were managing these pooled funds simply could not get the information out to them in a timely fashion. What we suspect has happened is that a number of these small schemes have—to use the terminology—lost their hedge. That means that when interest rates go down, there is no insurance and they find themselves in deep trouble because they have neither assets nor liability protection.



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That is where the biggest part of this problem was seen to be by the Bank of England, in the pooled funds sector. The pooled funds sector was where huge amounts of assets were having to be sold off at very low rates and that was what the Bank of England was principally buying up in that period up to 14 October. We do not know the carnage that has occurred in smaller schemes, but smaller schemes—let's define them as big schemes with less than £250 million; it might be smaller than that—they are the ones who are really on the floor and they are the ones we are not hearing from at the moment.

Q23 Chair: When are we going to hear from them, do you think?

Henry Tapper: They will all publish their reports and accounts in due course.

Q24 Nigel Mills: From what you are saying there, Mr Tapper, small schemes had the nightmare of being hedged for most of the way up so they were not getting the benefit, then lost their hedge somewhere near the top and then when it came back down again they took a loss. They basically had a double-whammy of not getting the upside and then getting some of the downside because they dropped off at the wrong point.

Henry Tapper: Pretty well. When the tide goes out, they are ones who are found to be naked.

Nigel Mills: They have basically locked themselves into a bet at the bottom of the market and then got themselves out of the bet at the top. That wasn't a particularly clever investment strategy.

Dr Keating: It was not their doing. It was the investment managers managing the pooled funds that did it. I have been told—so this is not necessarily reliable—that letters of intended action had been exchanged from one scheme who had 10 days in which to meet a call to subscribe new shares in a pooled fund and the fund was in fact unwound two days later, not 10 days later. The result was that this particular pension fund has found itself locked out by the fund manager. The rally that we have seen in the gilt market since the Bank of England intervention it has not participated in and it has lost many millions of pounds as a result.

Q25 Chris Stephens: Let's look at the role of the regulator itself. John, I will ask you first. Could the regulator have prevented the crisis at the end of September?

John Ralfe: The short answer is no, unless what the regulator put in place, going back right from day one, was much, much better information. The idea that, "The regulator made me do it" is a bit silly, although some companies and pension scheme trustees have been saying that. There isn't anything the Pensions Regulator could have done because by that stage it was too late. Just to echo what we have already heard, there were people warning that this was a problem about to happen. Leverage is always fantastic on the way up; it is not so good on the way down. What the regulator should be doing—and I think it is the regulator rather than the Bank of England and the PRA—the regulator



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should be getting much more information and should be working more closely with you and with Parliament.

Again, we have talked about leverage. I think once you have had a system of leverage that has so demonstrably failed that you have to have the Bank of England bailing you out because otherwise the whole of the UK financial system is going to melt down, you have had your one chance and you have blown it. Again, you have not asked this question, "Leverage, what leverage?" There should be no leverage. You should be matching your assets with your liabilities and that is the beginning and the end of it. As a separate thing, if a company wants to spiv around, that is brilliant, but do not do it with pension scheme money.

Q26 Chris Stephens: Thank you. Henry, this was an unusual case in that the OBR was not allowed to scrutinise the September mini-budget prior to it being presented. Should it be possible to compel a government to allow that objective scrutiny and advice by the OBR or similar bodies, including, for example, the Pensions Regulator?

Henry Tapper: I am afraid that question is above my pay grade. I am not in a position to agree or disagree with you about what should be done at that level. Certainly, as an individual, it made no sense to me that the mini-budget came without the scrutiny of the OBR. The market clearly picked up on that. That was why gilt yields went up as they did and that is why gilt prices went down as they did. That is why we had the problem.

If you wanted to point the finger of blame at anything it would be easy to do it by looking at the crass behaviour of the Government that produced that mini-budget. I do not think there is going to be too much doubt about that.

Dr Keating: Could I just elaborate? I alluded to this earlier: if you look at how the markets behaved for the few days prior and then through the event itself, the movements are quite modest. The day of the Bank of England increase in rates and the announcement of the sale of £80 billion of the QE portfolio, the 15-year gilt fell by 2.5 percentage points in price. The Lincoln market hardly moved at all; less than a quarter of a point in price. The response to the Bank change was correct; a repricing to reflect higher base rate. No signs of distress coming from the pensions' world.

Then you have the budget the following day. The response—you know my opinion of the budget; I have already stated it—to that was another relatively modest fall that day; 2.5 percentage points in the conventional gilt decline in price. We are at five points in price over two days. On that day we also saw selling of index-linked gilts. It is clear on the day of the budget we saw the first selling by pension schemes. No one else owns them to sell them.

Q27 Chris Stephens: Which body or bodies would be best placed to offer the kind of advice that would have forewarned of the impending crisis?



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Dr Keating: You cannot forewarn of the events that are going to create a trigger. What you probably should be doing work on is how large the trigger might need to be. We saw 5 percentage points over two days. That was clearly more than enough. The fact that we had pension schemes already selling on the day of the budget leads me to think that the number was probably no more than 3% or so. That is remarkably low. Those are the sort of numbers that are not that uncommon in bond markets.

Q28 Chris Stephens: Professor Clacher, in 2018 the Bank of England highlighted the need to monitor risks associated with the use of leverage by LDI funds. Yet the Pensions Regulator does not have a system for collecting data on this, so should it, and what difference could that have made?

Professor Clacher: It most definitely should know what pension funds hold and have much more granular detail. I am not of the opinion that the Pensions Regulator would have been able to do anything with that information because having pushed schemes—we can look at the macro data we have from the Office for National Statistics, and what you can see through time, with the Pensions Regulator coming into existence in 2005-06 through to today, is a wholesale shift out of equities and to fixed income assets, particularly index-linked gilts.

The Pensions Regulator has overseen the move out of lots of other assets into fixed income, and that also includes LDI. By having the information that lots of pension schemes have LDI exposures, it is not clear to me the regulator would have done anything about it because they have been part of pushing that.

Q29 Chris Stephens: Henry, the Pensions Regulator relies on pension scheme trustees to manage the risks of LDI. Given its longstanding concerns about the quality of governance in small schemes, should it have taken a more interventionist approach?

Henry Tapper: It is a very good question. Yes, is the answer. Frankly, the Pensions Regulator knows that small schemes are its Achilles' heel and it also knew that its small schemes had very heavy investment into LDI. The real question is what did the Pensions Regulator stress test? We know that it stress tests up to 1% increase in real yields. What we know is that there was a real increase of 160 basis points. Its stress testing was inadequate. If it had done proper stress testing, it would have seen a lot of these small schemes—if it had known the amount of LDI they had, they would have been able to say these small schemes are running risks that they should not have been running. Then they could have done something about it. That is a whole lot of ifs.

In practice, that is what should have happened in a perfect world. They should have known the risks that small schemes were taking and they should have worked with the small schemes to mitigate those risks much harder than they did.

Q30 Chris Stephens: I am going to ask you the next question, Dr Keating. It



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comes to your evidence and Professor Clacher's. You told this Committee when speaking to many investment consultants you found in several cases your questions were answered just with generalities and often incorrect, and the answers to questions would be glossed over. Could you expand on those observations and what needs to be done to deal with your concerns?

Dr Keating: Let me just add one little point about the levels of stress testing first. The trigger to the gilt market spiral was less than 50 basis points so by rights it should have been well within a 100-basis point stress test.

What should be done about consultants? You are, as a trustee, required to take investment advice. There is a statutory obligation to do so. You can take that advice if you want to from Mystic Meg as long as you can convince yourself they have expertise in the areas. There should be a uniform form of regulation and qualification requirements for investment advisers.

There are varying degrees of regulatory compliance for many investment consultants, some are regulated by the actuaries, some are regulated by the FCA under the FSMA. Let's bring it all together in one coherent unit. I have been loth to say anything about this because we have the ARGa, the Audit, Report and Governance Authority, due to take over from the FRC in April. I do not know enough about what their plans are with respect to the regulation oversight of actuaries. If they have published it I have not seen it, but it does not make the newspapers I read.

I have had investment advisers who have not been the right people to take part in LDI arrangements. I have said to them, "How many times a day can you call for collateral under these swap arrangements?" The guy said, "I don't know." The answer is four times a day but he did not know.

I went around asking about pooled funds and what happens to a pooled fund when it hits negative net asset value and the answer is it goes into liquidation leaving all of the bank counterparties with a lot of red ink. How many people were able to tell me that? I asked eight and one of them got it right.

Q31 **Chris Stephens:** John, the FCA has called for regulation of investment consultants to be brought within its scope. What difference could that have made and how could that improve risk management?

John Ralfe: The investment consultants are the villains of the piece. Their business model relies on complexity. Each of the large firms have certainly dozens, it is probably hundreds, of mouths to feed. They are all about pushing complex expensive products of one sort or another, and the product that they have been pushing for the last few is leveraged LDI.

I do not think that regulation, per se, is going to do very much. I am not a believer that the right answer is to add another layer of regulation. My suggestion would be, and by the way there is a huge amount of money in



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the pensions lobby. There is a huge amount of money. The pensions lobby is very powerful. I think you go to the heart of the matter; you go to the root of the problem. The root of the problem is leverage. I do not necessarily agree with the rest of the panel on lots of other things but I do agree on that. I really do agree on that.

I am not a believer in thinking if you simply have another set of regulations that is the answer to the problem.

- Q32 **Dr Spencer:** My questions are going to be around essentially can LDI be made fit for purpose going forwards. I get the feeling the unanimous view is that it is not fit for purpose. Are there changes that can be brought in to make it fit for purpose, and if not that would be very helpful to know? My second question is given what we have seen over the past few months and the concerns that I think you have had over LDI for some time, are there other areas outside of LDI, which are giving you warning signs in terms of lessons learnt from the LDI stuff that we should be thinking about and looking into going forward?

Henry Tapper: The Bank of England have an LDI programme. It is run by Legal & General; it is in their accounts. They own derivatives. It is very light touch, very low level. By and large, the Bank of England is running its contribution rate at just over 50% of member salaries. There is a form of LDI, if they took away that small amount of derivatives, which you could say is totally attainable, and it is a type of LDI that John has been talking about at Boots. Provided that you are prepared to put 50% of people's salary into the pension scheme, no problem. I think we are all happy with that kind of LDI.

To your second point, are there other concerns? Yes. Because the Bank of England does not have anyone in DC. Most pension schemes have the vast majority of their members in DC plans, and the DC funding rate is often no more than 3% of employers' salaries from the company.

If we are ever going to see DC funding rates at the kind of levels that are needed in order to give people dignity in retirement, we are going to have to stem these massive outflows of corporate profits into pension schemes, which stop ordinary people getting decent pensions and focus and concentrate all the money on a small number of very well-off DB pensioners.

Dr Keating: I basically concur with Henry. I do not think there is anything that we should be doing to try to resurrect LDI. If you adopt the approach historically that John adopted with buying an all-bond portfolio it is staggeringly expensive. The Bank of England contribution rate makes that point in spades. To have 50% of salaries being put into a pension scheme is economically insane. There are so many other uses for that capital that should be being used. Let us enforce the law and stop the leverage that will stop crises. Let us get the accounting right and that removes the motivation for LDI in the first place. Can we rely on the Pensions Regulator to do that? No.



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John Ralfe: All this about putting 50% into the pension scheme to pay for new pension promises is a complete and utter red herring, given that 99.9% of private sector pension schemes have closed. What have they said? They have said it is too expensive and they have closed. That is just a complete and utter red herring.

To answer your question, I think if you stop leverage you get to the heart of the problem. Do I have any other concerns? Not in the context of defined benefit pension schemes. I am surprisingly optimistic, surprisingly chipper about the state of defined benefit pension schemes. More optimistic today than I thought I would have been 10 years ago.

Professor Clacher: One area of concern that I have is the proposed funding regulations coming from TPR because I think the shorthand for it is LDI on steroids. If you look at what the regulator would like to do with the funding regime around DB, it is ever more money from UK PLC and to defined benefit pensions, which is tax advantaged, and they want to do more of it and they want to do it faster. If those funding regulations come through I have huge concerns about the impact it will have on UK PLC and economic growth and so on and so forth, but also, as Henry has alluded to, what it does for DC pensions because if all the money goes in there, there is not a lot left in the pot for everybody else.

Q33 **Siobhan Baillie:** My questions were going to be about what we need to do to be better prepared to manage this future systemic risk of LDI, but I think we have covered that repeatedly. I am interested in how do we get to the point where we are stopping leverage or interpreting the law correctly. To John's point, you are working with companies, day in day out on the ground. I was quite struck by what you said, these things were hiding in plain sight. Is there a list of data and collection and monitoring? Is there a wish list that you could have that could be implemented by the regulators and the regulators working together better that you would like to see now? Or do you think the last few months have dealt with the exposure because we have had to look at them so closely?

John Ralfe: I would like to see the Pensions Regulator today requiring all 5,000 pension schemes to provide quite detailed information about their LDI position as of today.

I had not mentioned this earlier and it is quite important. I am a chairman of a tiny pension scheme and the fact it does not have any more noughts on it is neither here nor there. Each year—I do not fill in the form—somebody fills in the form and I wanted to get that form. Is there a section that asks the questions about LDI? There is not. I am not even sure whether the Pensions Regulator is asking the question. We do need to get better information. When we get that information it may well be that the problem today is bigger than we thought or is smaller than we thought.

It is worth you looking at what they call the Legal & General Fund Centre. It is on the website. It lists all the funds that individuals can buy,



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institutions can buy, and it says leveraged funds. You click in and it will tell you all about it. It does not really tell you all about it. It does not tell you what the target leverage is. I believe the target leverage starts at 3:1, which is pretty high. It goes to 6:1, nothing in particular happens. Beyond 6:1 certain things do happen. At 10:1, all bets are off.

The Pensions Regulator—and I have been both a great defender of the Pensions Regulator and a great attacker of the Pensions Regulator—does have a very, very, very difficult job to do because there are so many conflicting priorities and it does not have the political support that it should have.

Anyway, the Pensions Regulator should get that information off the three regulatory bodies. They are the people who should be lying awake at night worrying about it. The trouble is with any joint venture, and I have worked with joint ventures over the years, everybody thinks somebody else is lying awake at night worrying about it, and they are not. Therefore, you have a bit of Bank of England, you have a bit of PRA, and you have a bit of a Pensions Regulator. However, I think it should be the Pensions Regulator.

Dr Keating: The Pensions Regulator has conflicting objectives here. The Pensions Regulator is charged with protecting the Pension Protection Fund. There are lots of pension protection funds in many other countries, none of them have a regulatory guardian angel. The problem you have with that objective is that gives the incentive to the Pensions Regulator to insist on ever more scheme funding. Scheme funding is the answer to everything given that they want to protect the Pension Protection Fund. That puts a bias into the way the Pensions Regulator writes its policies and it has been a real problem.

John Ralfe: As long as we have a Pension Protection Fund it is perfectly reasonable for the Pension Protection Fund—as for any insurance company—to prescribe what the people it is insuring have to do. I am not allowed to store petrol in my house because that is what my house insurance says. That seems perfectly reasonable to me.

Q34 **Siobhan Baillie:** I am enjoying this, by the way. It is such a complex issue but it is amazing to listen to you. Henry, your point about we do not know the carnage that is happening in the small funds and we are basically waiting for the reporting on a lot of them, which is going to come in different stages, which is potentially quite reactionary. Is there anything that you want to add to what John has set out about what needs to happen now, particularly for the small pot funds? Do you think that they are able and ready to be able to respond to additional reporting or monitoring?

Henry Tapper: There are two types of people who can report on those small pots. One is the owner of the assets, who are the pension trustees, and the other people who can tell you what is going on are the likes of Legal & General, Insight, Schrodgers, Columbia, Threadneedle and BlackRock, who are the people who run these pots.



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The FCA must know what is happening in those funds because they regulate them. The funds themselves are out in Ireland and Luxembourg for reasons that we do not understand, but they are. All of those funds must report what is going on to the insurance companies. I would hope that the Pensions Regulator and the FCA can have good lines of communication so they can better understand what is happening.

Obviously there are issues of confidentiality, which I imagine come into this, but that seems to be the obvious place where you would start finding out what is going on before you find out from the regulatory accounts whenever that occurs.

Siobhan Baillie: That could and should be happening quickly then?

Henry Tapper: I would expect it to be happening right now.

- Q35 **Siobhan Baillie:** Professor, you said that, even if we had quite a lot of information, that perhaps we had a list of other data, it would not have made a difference to September. Is there anything that you want to add to that? Do you have a list of information that you would like to see from an academic point?

Professor Clacher: I think disclosure is good and that is a strong starting point but, to the best of my knowledge, such as it is, there is no macroprudential obligation on the Pensions Regulator. The Pensions Regulator, having the full picture of the system, would then not say we might be running risks across the system, which are going to work against us at some point. The other thing with that is the ability to step back and see what are the common risks that we can see in this system, and that did not happen.

I think some mechanism for being able to ask difficult questions of the status quo within the regulatory world is very important. With the Bank having identified it in 2018 in terms of the derivatives exposures, it is not clear to me what the Bank can do other than point to it. Pointing to it is all well and good, I think the Bank did a small stress test on it up to 100 basis points, but that is it. How do these regulatory bodies interact and work together to make sure that the system as a whole is more resilient? I think that is a hard question to answer but it is one that is worth asking.

- Q36 **Chair:** Thank you very much, that completes our questions to you. Dr Keating, I think you said you were going to send us a note, which we would be eager to receive.

Dr Keating: There are a few things we have not covered.

Chair: We certainly welcome any further thoughts that you have, but thank you for a most interesting session. We are very grateful to all of you.

Dr Keating: Could I just add one other comment? Never in the field of human conflict have John and I agreed on so much.

Chair: We will certainly note that. Thank you very much.

Examination of witnesses

Witnesses: Leah Evans, Steven Taylor, Joe Dabrowski and Jonathan Camfield.

Q37 **Chair:** Welcome. Thank you all very much for joining us. Can I ask each of you, as I asked the previous panel at the start, to tell us very briefly who you are? Starting with Leah Evans.

Leah Evans: Good morning, thank you for having me. I am here today in my capacity as the Chair of the Pensions Board of the Institute and Faculty of Actuaries. In my day job, I am a partner at EY where I work with trustees and corporates on pension risk management.

Jonathan Camfield: Thank you again for having me here. I am a partner at Lane Clark & Peacock, a leading pensions advisory firm. I am an actuary. I advise large companies and pension schemes on all aspects of pension scheme risk. I am a regulatory specialist.

Joe Dabrowski: Morning. I am the Deputy Director of Policy at the Pensions and Lifetime Savings Association representing 1,300 pension funds, managing over £2 trillion of assets with 30 million savers.

Steven Taylor: Good morning. I am Chair of the Association of Consulting Actuaries, whose members advise trustees and companies on defined benefit schemes. In my day job, I am an actuary and also a partner at Lane Clark & Peacock.

Q38 **Chair:** Thank you all very much for joining us. Can I put a couple of questions to the individuals among you first of all? Starting with Joe. Can you tell us how many pension schemes use LDI and what are they using it for?

Joe Dabrowski: The data from the regulator indicates that about 60% of pension funds use LDI as part of their strategy. The majority of those schemes—I think slightly contrary to some of the evidence that was given before—tend towards the mid to larger size schemes, in my experience. That is not the very small schemes that have been talked about a little bit. We might come back to that later.

Funds are mainly using that, as discussed, to make sure that their assets and liabilities are largely matched as part of their portfolio, so you do not see this volatility on balance sheets that gets reported on company balance sheets in return. That has other corporate challenges. We are trying to manage the volatility on the balance sheet. Also, some of them using the leverage, using its slightly closed deficits too as part of the strategy, but it is largely to ensure that stability so that the confidence in how the deficit looks, how much contributions need to go in, in terms of planning, stable future contributions in order to avoid a lot of change. A lot of change can have harms.



- Q39 Chair:** Jonathan, can I put a question to you? You have argued in your evidence to us that the Pensions Regulator should be keeping a closer eye on what is going on here and you have called for “new constraints on pension scheme leverage”. What do you have in mind? What kind of constraints do you think there should be?

Jonathan Camfield: That is one, I am sure we may come on to others. It is one of the things that I think should be considered. First, there should be wide consultation and discussion. I welcome this as part of that, as to quite how this should work because, as Joe has alluded to, there is a very significant risk of unintended consequences here. As we know within a complex economy, not just pensions, you push down risk in one area, risk can pop up in another area if you are not careful. This is a complex area.

What has already happened over the last six weeks is that investment managers working with the FCA and probably the Bank of England, have reduced leverage within pensions schemes so there is now more cash, collateral available within LDI than there has been for many schemes before. That risk has already been reduced.

There is a risk that without further guidance from regulators or potentially rules—I would suggest guidance would do it—that competitive pressures over time just put leverage back to where it was. Leverage is a very efficient and useful thing to use, so we just let the market do stuff, everyone uses competitive pressures to say, “Well, I can give you three times leverage” or, “I can give you three and a half times leverage” and there is a risk that over time systemic risks would again increase.

Some sort of strong guidance from the regulators requiring investment managers to have line of sight to amounts of cash or other collateral that would give protection against further rises in interest rates would be helpful.

- Q40 Chair:** Leah and Steven, do you have anything to add on why LDI has been so widely used?

Steven Taylor: Adding to the initial comments, it is worth reflecting and interesting in the first session is what schemes are trying to achieve with LDI, which should be a straightforward question. Clearly, pension schemes have pensions that they want to ensure they are able to pay as they fall due, and successive rounds of regulations have required schemes to set out what their long-term objectives are. Is it to secure pensions with an insurance provider, for example, and to work out what a sustainable financial plan is to ensure that they can do that, which might rely on company contributions, for example?

Once they have set out those plans, and most schemes do now have those plans, they want to manage the risks along the way and two of the biggest financial risks are around interest rates, so movements in long term gilt yields, and inflation. It is in that context that they are using LDI, because without those mechanisms, as we have discussed in an earlier



session, falling gilt yields would lead to higher deficits in contribution requirements.

Essentially, schemes are trying to avoid taking positions on interest rates by entering into LDI contracts. To use an analogy that many people in this room would see daily, when people choose to fix their mortgage rates it is an attempt to avoid taking a position on interest rates. Once they have worked out a financial plan that is sustainable they know they can afford their payments and they choose to fix their mortgage rates. That is in a sense what pension schemes have been trying to do, and also managing risks around inflation which in the background LDI has also been doing.

Over the past decade we have seen as gilt yields fall schemes that have been using LDI have some success. With the recent period some of that success has been reversed but over that longer period LDI will have been a success for schemes that have been in LDI during the longer term.

As Jon says, going forward, we do need to look at the ways to make sure that those products are able to be stress-tested perhaps more robustly to make sure that they continue to do what they are supposed to be doing along the way.

Leah Evans: A couple of additional points from me. As the other panellists have said, the key reason that pension schemes use LDI is to protect against the very significant risk of interest rates falling. As the previous panel said, that leads to increasing contributions but it is also fundamentally about member security, which I do not think was discussed enough in the previous panel. Dr Keating made the point about the focus being too much on funding rather than covenant, but the fact is that pension schemes are not insurance companies. If there are not sufficient assets in the pension scheme it falls on the sponsor. If the sponsor goes insolvent when there is a deficit in the funding, members lose out. Even if they end up in a PPF they still lose out. That is the fundamental reason why regulators, trustees, try to ensure that there are assets to protect against that and LDI performs a valuable part of that strategy. That is one of the main reasons why trustees use it.

In terms of LDI, I agree with the previous panel that leverage is a key factor in looking at this. It is not the fact that trying to match assets and liabilities is inherently wrong. I disagree with the previous panel that any leverage is bad. To my mind, it is more about the level of leverage that is used, so higher levels of leverage clearly introduce more risks, but also how the LDI portfolio fits into the wider strategy of the pension scheme. Those schemes that struggled were the ones that had fewer liquid assets in the rest of their portfolio, so I would not necessarily recommend knee-jerk reactions on banning levels of leverage. More guidance, I think, around leverage could be helpful, more data collection certainly, but I think the problems are a bit more scheme-specific and not just driven by leverage.

Q41 **Sir Desmond Swayne:** I was going to ask you about leverage, and



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whether it was inherently a problem or just the way it was managed, but we have now had both Leah and Jonathan's opinion on that, so unless you differ, let me ask a more general question.

To what extent is LDI useful at managing the real risks that pension funds face, or is it really a management tool for reporting purposes, an accounting tool?

Leah Evans: Accounting, certainly for a corporate balance sheet. It is very helpful in managing volatility in accounting figures and avoiding a pension scheme distorting overall company performance. In terms of the risk management, I think it depends on what risk you are trying to manage. There is a school of thought that a pension scheme is a very long-term strategy, and what you should really care about is having enough money in 20 or 50 years to pay out benefits at that time, rather than necessarily what the current value of assets and benefits is. However, that again ignores the point of how secure the covenant is, how much visibility do you have on that and can you rely on the company being around in 20 or 50 years, in which case you need to take a more short term, current market view to assess what the impact on members would be if there was a sponsor insolvency.

In terms of protecting that risk, LDI is a very useful strategy and probably the most useful strategy that you can have, unless the scheme is so sufficiently well-funded that it could do that just by using the physical bonds, but even with those there are a limited amount of physical bonds. They do not necessarily match the shape of the liabilities. Some level of derivatives to increase the accuracy of hedging as well as leverage to increase the amount of hedging is often part of the solution.

Steven Taylor: In my day job I mostly advise companies and I would be surprised if many are doing it purely from an accounting perspective. What they are very keen on generally is to manage the cash requirements of their pension scheme, which would typically be the annual deficit contributions that are needed when the schemes do their valuations, which are every three years. In that context, LDI has certainly been extremely helpful, certainly over the past decade, in making sure those cash flows are predictable.

Some of the observations at the end of the previous panel, for example, was what happens if those cash flows are not predictable. It is the current employees who potentially suffer who are largely not going to be the people who are in those pension schemes. Companies have lots of other reasons why they need to manage their cash flows, and this is a particularly useful way of companies doing that.

Q42 **Nigel Mills:** Have you advised pension schemes to enter into these arrangements? Leah, it sounds like you are quite a big defender of these. Has your strategic advice been to do these?

Leah Evans: Yes, I have at a strategic level. The previous session touched on the regulation of investment consultants. At the large consultancy that I worked at, which I understand is the norm at most of



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the large investment consultancies, there was a separate subgroup of people who were sufficiently well qualified to give formal advice on the LDI strategies and I did not do enough of that type of work to really give the detailed advice. I would advise them in principle. I worked closely with an investment consultant on monitoring, but my experience certainly is that the very specialist advice of entering into this is limited to very experienced consultants.

Jonathan Camfield: I echo that is my experience. I very much supported LDI and leveraged LDI strategies, companies and schemes. I have not advised on it, because I am not in that regulated category, which we will come on to later, of advisers but I strategically support it and work with others who advise on it.

Joe Dabrowski: We do not provide guidance or advice in that way. We do provide tools and education to members about how to think about some of the choices that they might make around their investment strategy, but we do not provide that formal advice.

Just for context I will add that in our recent engagement and surveys of members I think 80% of respondents are still very much in favour of LDI as a strategy that works for funds to deliver outcomes for members. It is broadly supported across the industry.

Steven Taylor: I will add to my earlier comments, I advise companies in that context. I do not advise trustees on these arrangements, but I would add that we do expect these things to still be needed in the future, particularly if the next round of pension regulations, which the regulator is looking at now do look as they are currently expected to look, that are driving schemes that are getting increasingly mature into lower risk investment strategies. We do need to find a way to help schemes manage those risks. LDI in a fit for purpose way is a way of doing that, but we need to ensure that we collectively can get there.

Q43 **Siobhan Baillie:** Dr Keating's view was that there was a central question over the interpretation of the law on leverage for pension funds. I appreciate it is an academic consideration. Is there a discussion that you are aware of within the companies and trustees about interpretation of the law?

Jonathan Camfield: The short answer is no. The industry, for at least a decade now based presumably on legal advice in the past and none of us are lawyers so you would have to ask the pension lawyers, has operated on the basis that it is entirely legal. I recognise the quotes that Mr Keating raised about borrowing money, that is regulation 5 and I am going to get a bit technical and quote regulation 4 in those regulations, "Investment in derivatives" which is what in essence we are talking about at the moment, "may be made" and I think this is quite important, "firstly to contribute to a reduction of risks". That is significantly what most trustees would believe that they are doing and we think they are doing in the context of LDI, "or to facilitate efficient portfolio management." Again, it is that combination of those two things envisaged in the



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regulations that precede the reference to not borrowing that is the reason why we think not as a lawyer that LDI has been accepted by the legal community.

In my view, it would be bizarre if leverage was not permitted by pension schemes. Pension schemes are some of the biggest financial organisations in this country. They have recently had £2 trillion of assets, a little bit less now. They are very important organisations to pay millions of pensioners their pensions. Every other financial organisation—banks, insurers and individuals—individuals take out mortgages to buy houses, that is leverage. Why do they do that? It is efficient. If we said to individuals, “No, you cannot take that risk. That is too much risk. You must save up to buy your house” then the economy would not work.

This is a complex economy, yes, but in every area of the economy we permit leverage, but leverage does create systemic risk, for example negative equity risk for houses, for example a run on a bank. That is a systemic risk. In LDI we have seen an outplay of systemic risk and that does need some better management going forward but leverage per se is a very efficient tool used by pretty much all of us. It is a good thing.

Leah Evans: To add, I am not a lawyer so I cannot comment on this, but certainly trustees have legal advisers and whenever they enter into investment and agree fund management documentation that gets reviewed by legal advisers. In particular if there is aggregated LDI funds, I have been involved in schemes where those have been put in place, which come with quite complicated legal agreements that set out how collateral is paid, what is eligible for collateral. These very detailed, complex legal documents get reviewed by the legal advisers and I have never once heard a legal adviser raise concern about the legality of entering into them.

Q44 **Nigel Mills:** Mr Camfield, do you accept that repos are leverage?

Jonathan Camfield: Now you are asking a legal question. I recognise the comments made earlier in the session about exactly what falls under this regulation and what does not. Certainly, there is widespread use of repos. I imagine the legal argument has been that it fits into regulation 4 rather than regulation 5 as lending. I am not a lawyer so I could not comment.

Q45 **Nigel Mills:** It is just that you appear to be advocating in the previous answer that pension schemes should be able to borrow. That would be a radical change in regulation of pensions.

Jonathan Camfield: I am advocating that pension schemes should be able to do two things. It is the technical words we have heard repeatedly over this morning: hedging and leverage. To do both of those things at some level it involves borrowing.

Q46 **Nigel Mills:** There is currently a ban on leverage. A pension scheme cannot go and borrow and then invest that money. They can invest their own assets, but they cannot borrow money they do not have. Are you



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advocating that they should?

Jonathan Camfield: There is a ban on borrowing, but there is an explicit permission and envisaging of them using derivative instruments. Derivatives do involve some borrowing, so someone is borrowing somewhere for a derivative.

Q47 **Nigel Mills:** I was just checking, when you said pension schemes should be able to use leverage you were not advocating wholesale borrowing by trustees. That is not what you are suggesting? Are you saying they can use derivatives but they cannot borrow in layman's terms?

Jonathan Camfield: Yes. I was thinking about borrowing in terms of being leveraged LDI. Leveraged LDI at some level will use some borrowing on a look-through basis. That is how pension schemes have created leverage. I think that is a good thing. The legality of that is not my kitbag.

Q48 **Nigel Mills:** I think at least two of you did strategically advise schemes that these things were a good idea. Did you at any point in the runup to the summer start to change your mind and think possibly these things are not very attractive for pension trustees at the moment and change that advice?

Leah Evans: Obviously advice is always scheme specific. Of course, at the start of this year and as we saw over the year yields have risen. If you are trying to take a market view at the start of the year you might not have invested in LDI. What schemes were trying to do generally was specifically not to take a market view, but to protect themselves against volatility. That means they are protected if yields go down; it means they lose out if yields go up, but that is a trade-off they are willing to accept.

Q49 **Nigel Mills:** When interest rates are at historic lows and would struggle to go a great deal lower, are you not just protecting yourself against a risk you do not have and locking yourself out of a benefit that you might get?

Leah Evans: Again, it depends on what your time horizon is. Like I said before, from a trustee perspective, a member perspective, it is making sure that if yields fall you would expect them to rise again, but if the employer goes insolvent while yields are low there is not enough assets to secure member benefits, so that is a problem.

From a company perspective, again there is a short time horizon that pension schemes need to carry out valuations every three years, so if that happens to coincide with when rates are very low even if everyone is expecting rates to rise that still means that the company has to put in significant additional money which they may or may not be able to do.

Jonathan Camfield: Can I add a comment on that? It comes back to again this word hedging and I absolutely agree with Leah. The reason why one hedges, and I know it is a bit of a technical word, is to take risk out of the system. Draw a parallel with companies, for example, hedging currency risk, a very common and very sensible thing to do. If you are buying goods in one currency and selling them in another you take out



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some sort of long-term currency protection using some sort of derivatives or other. You might say that is a complex, risky, speculative thing to do but, no, it reduces your risk, and we have exactly the same thing going on here. The reason why trustees invest in LDI investments is to reduce risk and it takes risk out of the system.

If at the point yields became very low and they said, "I am not sure. I might make more money if I take this off" that would be speculation. You ride the downs, and you ride the ups and everyone knows that. You go in with your eyes open; that is what you are doing. You are trying to reduce risk here, so you are not making those decisions.

Q50 Nigel Mills: You say, Mr Camfield, "If I had done this pre-2008 it might have looked quite sensible" but I just cannot see how it looks so sensible when interest rates are near the bottom, because they might go up to 6% and that seems to me that if I am a trustee it gives me a big benefit. Surely they cannot go down by another 5% so I am kind of looking at my scheme at the wrong point, am I not?

Jonathan Camfield: I am going to go a little bit more technical now. What matters to trustees—and Leah touched on it—is long term interest rates rather than short term. It is the yields in gilt markets, rather than what the Bank of England sets each month.

When long term real interest rates reached -1% everyone said that is ridiculous, a negative guaranteed return below inflation, they cannot go any lower. Well, they did. They went to -2%. When they reached -2% everyone said that is ridiculous, you should not hedge at that level. Well, they did. They went to -3%. The point of hedging is we did not know a year ago whether it would go to -4% or -5%. Given the upcoming funding regulations from the DWP and potentially more demand for index-linked gilts, maybe they could have done. They have not done, they have come back up, but LDI protects you from those very significant movements and LDI has done its job over the course of this year.

Leah Evans: The way that the trustees and companies make those decisions over risk management strategies is understanding what their risk exposures are and then deciding how much risk they can withstand. They may have thought it is more likely that rates go up rather than down, but they would not have been able to deal with the impact of rates going down further compared to what they were.

Similarly, what we have seen over the last 10 or 15 years is that schemes have changed their strategy depending on where they were in their funding level. When schemes were underfunded, they would take more risk because there was some upside to taking risk and some downside, but they were already underfunded so they had to take some risk. What we have seen now is that many schemes are much better funded and therefore do not want to take that risk. They may be able to withstand it now but now they do not want to take the risk, because it is more important to them to protect their position. The reasons that we now see lots of schemes with a very high level of hedging is that their funding



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level is at such a rate that it is more important to them to protect that than it is to participate in market movements. They are looking for stability rather than returns.

Joe Dabrowski: Just to go on to a couple of things that Leah said, it is probably worth saying that the LDI strategy will be part of the wider strategy so there will be other things that trustees are thinking about. They might say, "I would like some stability here. I am happy to lock that up. I might adjust it from time to time and here I am going to do something else that is going to get me some more growth" so it is not just all in one bucket and that is it.

The other thing that is slightly implicit in your original question, Nigel, is that during the course of the year collateral was being increased by pension funds as the wider economic circumstances changed and people were building more collateral. There had been encouragement from some of the regulators for asset managers and providers to do that too, which they had done. What then happened was the explosion of the mini-budget and the gilt market, which changed that in a much faster way than might ever previously have been imagined, which has led to some of the consequences that have followed, so it is not static, it is not all or nothing in the LDI and people were adjusting things as things went.

Q51 Nigel Mills: Do you not think what happened in the summer or September could have been imagined? Dr Keating said it was very predictable, and that they even predicted it.

Joe Dabrowski: I think he said it was predictable that you could have a liquidity squeeze, which is right. That is very predictable. Some of those risks were managed and some of the risk protection measures that were put in place following the financial crisis in fact worked. That is why we have collateral calls and margin in place and the evidence was that funds and managers generally had quite prudent levels of collateral buffers in place, 200 basis points, so beyond the levels that were in those stress tests from the Bank and the regulator which were, let us face it, one in 1,000 chances of happening. We have gone way beyond all of that in what happened following the mini-budget, and I think it is probably worth reflecting the scale of that change is very significant and enormous.

Even if we had stress tested to the extremities, that would have given us a better idea of where that may have played out, but if you stress test to the full extreme of the full polarity, when you pick the thing that you think is a central assumption you do not start on the right-hand corner. You start somewhere in the middle of the funnel, and I think that would have led us more or less to where we were at that point. Clearly lessons to be learned since, more black swan events seem to be coming more quickly and more extreme scenarios possibly need to be understood, but I think a lot of it was understood. There were a lot of protections. The protections largely worked up to a point and I think we must bear that in mind as well.

Q52 Nigel Mills: Some of the previous panel all seemed to, I think, agree that



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these things were a bad idea and almost wished they had never existed. Your view seems to be that they are a good idea, and we should keep them. Is that fair?

Steven Taylor: I think it might be worth reflecting on what would the pensions world look like had there not been LDI over the last 10 years. We have had a whole bunch of challenges. We have had Brexit, we have had the pandemic, we have had wider quantitative easing and in these situations without hedging strategies schemes would have seen their deficits balloon quite significantly. That would have put a huge amount of strain on funding requirements, and we might have been here at various points having other discussions about why there are enormous deficits building up, corporate failures and pension schemes basically not being able to meet their funding requirements.

LDI has helped us on those schemes over the last decade. For example, I think TPR said in their evidence that on the key measure that the Pension Protection Fund uses that funding levels had gone up over that decade from 80% to well over 100%, which means that for the purpose of protecting the PPF from a regulatory position that looks quite rosy, and those levels remain above 100% even now. Without the historic use of LDI that could have looked quite a lot different.

Q53 **Chris Stephens:** I am going to ask this panel some of the questions I asked the first panel. Steven, could the regulators have prevented the crisis at the end of September?

Steven Taylor: I think it would have been difficult to prevent the events because as we discussed the scale was quite beyond what had previously been envisaged. Thinking about some of the numbers we have discussed, we have had these previous stress tests that talk about the ability to cope with a 1% movement in gilt yields over the course of a Bank of England analysis. In practice, schemes were equipped to cope with 1.5% to 2%. It is as if they had built a sea wall based on the worst storm that they could imagine, added a bit and then it has just been overwhelmed by a tidal wave, effectively. The real question going forward is what should the regulators do next to make sure these are fit for purpose? To a degree, as we have discussed LDI providers have already adapted quite significantly and the ability to respond has increased quite a lot to levels perhaps approaching 4% or more ability to cope with gilt movements.

I would expect a combination of regulators, TPR, FCA and potentially others, to make further statements and guidance as to how schemes can improve how they operate LDI. Could they have done some of this in the past? I suspect, when they reflect, they could have had more access to information during the period. Whether that would have made any difference, I do not know.

Q54 **Chris Stephens:** This goes back to the point that the OBR was not allowed to scrutinise the September mini-budget prior to it being presented to the House. What powers need to be given to regulators, and which regulators, to help prevent a similar crisis in future?



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Joe Dabrowski: Some of the lessons have been learnt already. We see what has happened around the autumn statement in comparison to the mini-budget. It is important that those governance norms that we see around big fiscal statements are maintained and nurtured. Clearly, the elements of surprise that came about from the mini-budget were a precursor to a lot of the fallout that followed. I would like to make sure that those governance elements are in place and that they happen.

We saw a particularly unusual difference between the approach that was being signalled to the market by fiscal and monetary policy during this period. That added to a lot of the tension and also added to the uncertainty during that two-week period when the Bank was stepping in with its three interventions. A lot of the extra interventions were required because the first settlement and the apparent difference of views between the Bank and Treasury had not been fully resolved. Ultimately, that came to a head in one way or another.

It is important that those governance elements are in place. Coming back to the point just before, with perfect information the Bank may have been able to recognise the squeeze on the market coming slightly earlier and may have intervened slightly earlier, but I think in the wider circumstances it would not have been able to head off what had happened without some of those other norms being maintained as they are typically.

Q55 Chris Stephens: Jonathan, you have been talking about leverage. The Bank of England highlighted the need to monitor the risks associated with the use of leverage of LDI funds. The Pensions Regulator appears not to have a system for collecting data on this and relies on trustees to manage the risks. Should there be a data collection system, how could that be done and by whom?

Jonathan Camfield: That is a great question that comes to the heart of this and thank you for it. In talking about data and regulation, it is helpful to distinguish between individual schemes and systemic risk. That word “systemic” risk has, I think, come up a couple of times already.

From an individual scheme point of view, some additional guidance from the Pensions Regulator around governance and some scrutiny of governance on schemes would be very helpful, but for systemic risk someone needs oversight of the whole system. That is the point about systemic risk. If I am an individual scheme, I cannot manage the risks of other schemes. I do not have that data.

Systemic risk falls fairly and squarely with the regulators, in my view, and there are two regulators, the Bank of England and the FCA, who have the statutory objectives to do with market risk. TPR does not have that statutory objective. They identified back in 2018 that they needed more data and there was a little bit more data obtained, but TPR does not have the data. It is clear in its response to the Committee that it does not have the data. It has the means to collect the data—it is called an annual return—and I think it should be collecting data because it has line of sight



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to all schemes and systemic risk is about everyone. With regard to the systemic risks of a bank failing, you cannot just regulate the big banks; it is going to be a small one that goes first. You have to be able to see all the banks. That is what the PRA does. From a pension scheme perspective, you need to have the same thing. You need data across the whole system.

TPR should collect the data, it should share it with FCA and Bank of England, and further analysis should be done about the level of systemic risk and shared appropriately with pension schemes, us and the market, so that individual pension schemes can then adjust their decisions based on the level of systemic risk from time to time. That, to me, was a gap, a regulatory gap, as we came into September.

Q56 Chris Stephens: Leah, there is a contradiction, isn't there, in terms of the regulator's position, in that it relies on the trustees to manage the risks of LDI but at the same time it is saying that it has longstanding concerns about the quality of governance in small pension schemes? Should it be taking a more interventionist approach? What do you think is stopping it taking a more interventionist approach?

Leah Evans: Do you mean specifically in relation to LDI?

Chris Stephens: Yes.

Leah Evans: Governance of pensions schemes varies across the board. There are 5,000 pension schemes and they will have a differing quality of governance. In terms of what we saw in September, governance was a key focus because it required trustees to make decisions very quickly and sign forms for very large amounts of money to be disinvested. That was a challenge for some schemes but many did very well. It is particularly the very small schemes that would probably struggle with that level of governance but as somebody else mentioned, my experience is that the very small schemes are less likely to use leveraged LDI strategies. They typically would use physical bond funds in order to achieve a certain amount of hedging, accepting that they cannot hedge as exactly.

Overall, I would say that the standard of trusteeship and governance for pension schemes has improved enormously over the last 10 to 20 years, there is now a much greater requirement for trustees to understand what they are doing and there is a lot more training, but pension schemes have become more complex and as a result of that we have seen a greater number of professional trustees.

Q57 Chris Stephens: Is that the way ahead, do you need more professional trustees and how do we grow that?

Leah Evans: I would not necessarily mandate it because in my personal experience as a practitioner I have seen excellent lay trustees and excellent member-nominated trustees, but we are already seeing a trend towards more professional trustees, partly because companies often struggle to find staff who have the time and understanding to take on trustee roles. There is already a trend towards that. I do not think it



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needs to be mandated. There is also a requirement for trustees to carry out a risk assessment on their governance. There are already steps in train but it is something that the regulator should continue to monitor, in particular in relation to trustees' assessment of their governance and risks.

Q58 Chris Stephens: Jonathan, last question to you. The investment consultants were described by one of the panellists in the first panel as "the villains of the piece". The FCA has called for the regulation of investment consultants to be brought within its scope. What difference do you think that would make?

Jonathan Camfield: First, it is worth saying that most investment consultants already have some regulatory oversight. I cannot be sure of all because I do not know all of them, but the expectation from the Pensions Act 1995, section 36, to give the quote, is that trustees are sure about the competence, experience and ability of their investment consultants. Where the investment involves an FCA-regulated "product", if you want to use that word—which would include, for example, pooled LDI—they have to be FCA-regulated. The FCA already has some considerable oversight of at least some of the advisers. Other advisers are regulated directly by the Institute of Actuaries. There were some quite detailed rules agreed with the FCA and with Treasury about 20 years ago as part of the FSMA 2001. There is a lot of regulation.

I recognise the FCA's call to have regulatory oversight. I have not seen it define what it means by that. Does it mean that all investment consultants must be fully FCA-regulated rather than just some of them? That is a possible way forward. I do not think that dramatically improves standards for most people because most people are operating under that sort of a basis already. There may be a few investment consultants who get caught out, I would not know about those. Is it saying that the nature of the regulation needs to be more detailed, more stringent? Possibly.

I think I can support the former, that investment consultants should come under some regulation where they are not now—many of them already are—but for more detailed regulation, I do not know. As Leah described, this work is done by specialists, people with experience who know what they are doing, and that will remain the case even more so going forwards.

Q59 Siobhan Baillie: It seems to me that the September period, the mini-budget, has almost toxified LDI. Yet, thinking about what Joe said about the autumn statement and the governance, "We have brought back boring", it seems there is more of a chance that LDI will not hold that status of being the devil's work or the villains', said much better in Chris's beautiful accent. Notwithstanding that we need transparency, information and urgent work done with the regulator, do you think we are in a very different situation, post-autumn statement, with consultants and LDIs now?



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Leah Evans: Schemes, investment managers and investment consultants have already taken quite a lot of action in response to that. One example is what Steven mentioned: the amount of collateral that they now hold for typical schemes is much increased. It was aimed at withstanding immediate increases in yields of 150 to 250 basis points; it is now more like 350 to 450 basis points. That means that if we had a repeat of the spike in yields that we saw, it would have to be far more extreme before we had the same sort of reaction.

Another example is pooled funds. One of the challenges for them was getting additional collateral more quickly because it would have involved going out to lots of investors and getting extra money. Some of the investment managers are looking at requiring investors in pooled LDI funds to have additional assets invested with the same manager, say, corporate bond funds, which they can directly draw collateral from. There is already quite a lot happening in the industry.

Q60 **Siobhan Baillie:** Not necessarily a big push to extract yourself?

Leah Evans: Lots of schemes have reduced the level of leverage that they have had. Partly they have been able to do that because there has been an improvement in funding level and so they have been able to adjust their strategy to reduce leverage. Some schemes have reduced the level of hedging, not necessarily taking off the hedge completely but if they were, say, targeting 100% protection from matching assets to liabilities in terms of yield movements, some have reduced that down to 80% or 90% to ease liquidity and because—to Mr Mills's point earlier—it feels less obvious that rates will necessarily fall that much. Steps have been taken. In terms of monitoring, this greater data collection and understanding of what is going on and what steps have been taken is important so that regulators can then decide whether what the industry is doing is sufficient or whether further action is needed.

Q61 **Chair:** On the regulation of investment consultants, the earlier panel did tell us that funds could take advice from Mystic Meg if they wanted to. They were wrong about that, were they, Mr Camfield?

Jonathan Camfield: Technically, I suppose they are right. I did have this on my phone and I can tell you exactly what the regulations say in the Pensions Act 1995. For certain types of investment advice, if the giving of advice constitutes regulated activity—which of course some LDI work definitely would do—then a person must comply with the Financial Services and Markets Act, which is about FCA regulation or regulation from, for example, the Institute of Actuaries. In any case, the advice of any person that they take advice from must be reasonably believed by the trustees to be qualified by their ability in and the practical experience of financial matters, and to have the appropriate knowledge and experience of the management of the investment of pension schemes. If that is Mystic Meg, fine, but trustees have a statutory duty to pick sensible investment consultants and they do. They are responsible for millions and millions of pounds. They are not going to pick Mystic Meg; they are going to pick someone responsible and experienced.



Q62 Dr Spencer: I assume you are not casting aspersions on Mystic Meg. I do not think any of us know of her financial CV when it comes to giving advice. Just a very brief question, which is: are there any areas outside LDI where you think some of the lessons learned in the last few months apply, any other danger areas or things that should be given more thought?

Steven Taylor: One is linked to LDI because obviously the other thing LDI does is manage risks around inflation. In the background, LDI has been managing that risk. Inflation is currently very high. It is entirely possible that this time next year or the year after, inflation is no longer high but is falling very quickly or may even be zero, depending on geopolitical events. We need to be aware of how things like LDI are operating in that context as well, particularly as schemes are effectively rebuilding their strategies focusing on this interest rate risk.

Jonathan Camfield: I would agree with that. Deflation costs pension schemes money. I will not go into the detail now but a long-term deflationary environment would be very expensive for UK pension schemes.

The other risk that I would mention that is significant for pension schemes is longevity risk. That is how long people are going to live for. That has been reasonably predictable, rising over 20 or 30 years. It has now levelled off, sadly, related to the pandemic, of course. If you are looking for 'black swan' type events, shocks to longevity expectations either one way or the other—headlining *The Times* yesterday was a cure for cancer, for example—would have a very significant financial consequence for pension schemes.

Joe Dabrowski: I would add that, given the economic outlook that has been predicted by the Bank for the next two years, a potential recession, how that might play out systemwide for the sector and for the regulators would be important to consider. I know from my past life that both the Pension Protection Fund and the Pensions Regulator in the past have considered sector-wide shocks such as the airline industry collapse. How does that fall through the whole chain of suppliers that that might impact? We are possibly looking at more squeezes more widely across the economy over the next two years. Understanding how that might play out more widely and the systemic risk would be useful, as well as building this wider information that we have talked about in the last two sessions.

Jonathan Camfield: I agree with that.

Leah Evans: Yes. In terms of pension scheme risks, they are long-term investments, there are lots of assumptions about longevity and so on, and there are plenty of risks. In terms of real crisis systemic risks, interest rates inflation and LDI are the most obvious ones. There is clearly growing awareness of that now and, as we talked about, some lessons learned and action already being taken.



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One thing that is important to note is that the DWP has recently consulted on the new DB funding code and we are expecting consultation from the Pensions Regulator on funding rules. There is certainly a risk of the systemic risk of LDI increasing if there is greater herding of pension schemes towards a very 'one size fits all' approach to funding based on gilt yields. The great strength in our current funding system is that it is scheme-specific and allows schemes to do different things. It is important for DWP and the Pensions Regulator to reflect on that and the recent experience in the way that they then update funding rules.

Q63 Nigel Mills: Can I just follow up on that quickly? I am sure I saw some data that said that overall, pension funds are now much better funded than they were and we have gone from a big deficit to quite a big surplus, but if I was being naive I would have thought that inflation rising pushes up pension scheme liabilities because they now have to find more money to pay people with. If there is real economic turmoil that might depress all my equity investments and all my gilt investments have just dropped in value because interest rates have gone up, I would have thought that pension schemes would be in a worse position than they were a year ago, not a better one, yet we are all celebrating that the balance sheets look a lot better. Does that not suggest that we have some strange actuarial gymnastics going on that does not reflect the real substance of the situation?

Leah Evans: A lot of pension schemes have significantly reduced their allocation to equities and growth assets, in parallel with funding levels improving over the last however many years.

Nigel Mills: They bought gilts, which have just dropped in value.

Leah Evans: So have their liabilities. In terms of funding level, their assets and liabilities are much more—

Q64 Nigel Mills: How have their liabilities gone down? Inflation has gone up.

Leah Evans: Part of LDI, as one of my fellow panellists said, is matching inflation as well. LDI funds would typically seek to protect pension schemes against both the movement of inflation and interest rates. Again, schemes are protected—at least to some level—against rising inflation. It is not exact. Pension schemes are quite complicated. Benefits typically are not fully linked to inflation but might be inflation between a certain range. Overall, schemes have protection against that, but with levels of inflation at the level that we are seeing now, that does put some stress on the pension schemes and related things like member auction factors and so on. Inflation is a big topic for pension schemes but, in terms of just pure funding, much of that is protected through the use of LDI.

Chair: Thank you very much indeed, that concludes our questions. We are most grateful to you. Thank you for giving us such interesting and helpful answers. I make the point to you that I made to the earlier panel: if other thoughts occur to you after this morning that you would like to



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draw to our attention, please do email them through. We would be very interested to see them. Thank you all very much indeed.