



HOUSES OF PARLIAMENT

Work and Pensions Committee and Industry and Regulators Committee

Oral evidence: Defined benefit pensions with liability
driven investment (HC 826)

Wednesday 22 March 2023

9.25 am

Watch the meeting

Members present: Sir Stephen Timms (The Chair); Lord Agnew of Oulton; Siobhan Baillie; Baroness Bowles of Berkhamsted; Lord Burns; David Linden; Nigel Mills; Lord Reay; Selaine Saxby; Sir Desmond Swayne.

Questions 277 - 308

Witnesses

[I](#): Laura Trott MP, Minister for Pensions, Department for Work and Pensions; Tom Josephs, Director, Private Pensions, Department for Work and Pensions; Andrew Griffith MP, Economic Secretary to the Treasury, HM Treasury; Lowri Khan, Director of Financial Stability, HM Treasury.

Examination of Witnesses

Laura Trott MP, Tom Josephs, Andrew Griffith MP and Lowri Khan.

Q277 **The Chair:** Welcome everybody to this meeting of the Work and Pensions Committee in our inquiry on defined benefit pensions with liability driven investments. A very warm welcome to members of the House of Lords Industry and Regulators Committee, who have also joined us for this meeting, and a welcome to both Ministers and your colleagues. Can I ask you to introduce yourselves to us briefly and tell us who your colleagues are?

Laura Trott: I am the MP for Sevenoaks and Swanley and the Minister for Pensions. With me is Tom Josephs, who is the director of private pensions at DWP.

Andrew Griffith: I am the Economic Secretary to the Treasury. With me is Lowri Khan, who is the director for financial stability in His Majesty's Treasury.

The Chair: Welcome, all, and thank you very much for coming. Can I just make a point at the outset? I would like to declare a non-financial interest this morning in that I was the Minister, in Laura's role, who signed off the Occupational Pension Schemes (Investment Regulations) 2005, which may well be referred to in our discussions this morning. Does anyone else want to declare an interest of any kind?

Baroness Bowles of Berkhamsted: Yes. I declare my interest as is in the register, in particular as a director of the London Stock Exchange.

Q278 **The Chair:** Thank you very much. I put the first question to you both. What do you think was the aim of pension funds in adopting LDI? Did that purpose change over time as the LDI became more leveraged over the years?

Laura Trott: We saw that, with the use of LDI, schemes' funding position improved over time. That was the ultimate aim: to allow them to invest in gilts whilst also hedging themselves against movement in interest rates and to invest in illiquids and inequities. So although there have been a number of problems, which the committee has outlined and the Lords' report very clearly goes through, I do think it was successful in that aim of improving scheme funding performance. Do you have anything to add, Andrew?

Andrew Griffith: I have nothing to add, thank you.

Q279 **The Chair:** Do you think advisers should have advised the funds they were advising to move away from LDI when interest rates started to rise?

Laura Trott: That is getting into details of what investment advice should be, which is not my place. Obviously, nobody knows what is going to happen to interest rates. Interest rates may go up; they may go down. Therefore, I do not think it is my position to comment on advice at a specific point in time.

Andrew Griffith: I think the same. It is easy to say that with hindsight. There were collateral buffers that were being held, and I understand that the work of this committee is for lessons learned, and that is something you will probably want to get into.

Nigel Mills: I am not sure it is rocket science, though. I suspect that a year ago I was much more inclined to take a fixed-rate mortgage for five years than a fixed-rate deposit.

Laura Trott: I cannot comment on investment advice, though, because it is not my place to say what schemes should or should not be doing, and it was not the Pensions Regulator's place to say what schemes should or should not be doing at one point. Their role is very much about regulating risk in the market, making sure that they are abiding by the rules, and reducing the call that could be made on the PPF. It is absolutely not my place to say specifically what should have been done and when in investments in certain things.

Q280 **Nigel Mills:** You said that the use of LDI improved investment performance. What did you mean by investment performance?

Laura Trott: I meant scheme performance. I believe the overall funding of DB schemes was 83%. You had evidence from Charles Counsell, the previous TPR, who said that scheme funding was 83% in 2012. At the moment, it is more like 130%—is that right, Tom?—which is a significant performance.

In a time of falling interest rates, which as we all know are difficult for DB schemes, LDI allowed scheme performance to improve. That is not to say we have not learned a huge number of lessons. We had the report from the Lords, which rightly identified a number of issues with LDI, and the governance of LDI, which we absolutely agree with, but it remains the case that LDI has a useful place, I believe, in the overall investment options available to pension schemes.

Q281 **Nigel Mills:** The irony is that schemes are now much better funded because interest rate volatility has helped them quite significantly, so I am not quite sure I understand that.

Can I ask a question on the interest the Chair declared? There was a suggestion to us that the intention of the EU directive that we transposed was that pension schemes should not be allowed to borrow at all, and somehow we slightly mis-transposed it, or people have been misinterpreting what we wrote, and the use of repos and leveraged LDI is basically illegal. What is the Government's feel on that?

Laura Trott: My letter to the committee dated 9 December was clear that we do not agree that using leverage or borrowing in the context of LDI is illegal. The response to the consultation in 2005 specifically said that adjustments to the EU legislation were made to allow schemes to use derivatives and repo arrangements to manage risk. This was the clear intent of the legislation.

Nigel Mills: Andrew, do you agree with that?

Andrew Griffith: Yes. That is the Government's position.

Nigel Mills: Do you think, in hindsight, that is still the right position? Do we want pension schemes using supercharged, leveraged instruments that are really quite complicated and quite risky? Are they the right people to be using them?

Laura Trott: Andrew will also have thoughts on this, but broadly my opinion is they have had their place. However, the events of last year have shown there are a number of deficiencies in the way they were managed and governed, particularly in the collateral that they were asked to hold, in data and in overall resilience of the financial system. That is where we absolutely need to make some changes, but the LDIs have played a useful role over the past couple of decades.

Andrew Griffith: I would echo that. It is about a balance. It is ultimately a policy decision for Parliament, but most operationally for the Pensions Regulator. There is a trade-off between the risk in the financial system and making people's pension assets—or firms' assets, if they are underwriting and sponsoring a scheme—work well to deliver performance, to reduce burdens on the state and to deliver people a prosperous time in their longevity.

This forms part of the overall non-banking system. The Minister for Pensions is absolutely right that it would be foolish to say that there are not lessons to be learned. A lot of those would be about data, disclosure, governance, and making sure, as a fairly uncontentious principle, that trustees and those responsible are fully apprised of the risks they take with whatever instrument they use.

Nigel Mills: It is intriguing, is it not? I have maybe a naive view that pensions are there as long-term secure things to provide for my retirement. We need the public to have trust that their money is safe and they will get their pension when they get there. Probably the last institutional things that you would want to start investing in are highly complicated, highly geared, super-sexy, supercharged repo-type derivatives. You would be saying, "No, you invest in real long-term assets. Don't get caught in strange City dynamics". You seem to be saying that that is what they should be doing. Is that really the right answer?

Andrew Griffith: I do not want to anticipate where the committee might want to go. It is probably not right to over-adjectivise these. There are clearly learnings in terms of the governance and the understanding, but I would not classify these as particularly exotic financial instruments; we are talking effectively about leverage secured on gilts, which is a well-understood feature of many markets. Your pension is underwritten in a number of different ways, but, at its heart, the structure is about matching liabilities and assets. When you depart from that, which is what has driven people into gilts, there are other strategies you could follow. You were pushing long-term, high-performing assets that would be less liquid, but there are trade-offs when you do that as well.

Nigel Mills: The use of leveraged LDI was not to end up with all my portfolio invested in gilts to match my liabilities. It was the idea that I could get the match and have some other assets as well. It was the classic “have your cake and eat it”. That is financial engineering, not investing. That is not the situation you are outlining there.

Laura Trott: The point is that gilts are a good match for DB pension scheme liabilities over the long term. We know that, in 2012, the scheme funding position was, on average, 83%, so they did not have the funds they needed to pay out their liabilities. This allowed them to invest in gilts, but also to hedge and invest in other things that were higher return-seeking, and to do it in a way that had a collateral buffer, which was set out by the Pensions Regulator and was more than consistent with market movements over the past couple of decades.

There is a question now as to the governance over particularly pooled funds, which was a problem if market rates moved quickly. There is a question as to the data that was held on the collateral buffer, which was rightly pointed out by the Lords committee. There is a question over the dynamics when collateral buffers were breached. However, there was clarity about their use and what they were trying to do. As I said, overall scheme funding levels were improved as a result. Tom, is there anything you want to add to that?

Tom Josephs: As the Ministers have said, it is very much the case that gilts are a good match for the liabilities of DB pension schemes, and leveraged LDI allowed schemes to therefore match their liabilities in a low-risk asset such as gilts, but also to be able to invest in growth-seeking assets. We are seeing that the DB sector is maturing, and that most schemes are now closed and are very much focused on the decumulation phase where they are primarily paying out to pensioners. As that happens, they will increasingly want to invest in low-risk assets which assures that they will be able to provide those pension payments to their pensioners, and are likely anyway to be moving away from using leverage to the extent that they may have been doing in the past.

As the Ministers have said, clearly we learned lessons around the collateral buffers that were needed to make this system safe and resilient, and we learned that collateral buffers needed to be higher than had previously been thought in order to withstand greater shocks in the gilt market. It is the case that having those higher collateral buffers will introduce a small cost to leverage and therefore will also lead to lower leverage in the system.

Q282 **Nigel Mills:** I can understand why the Government were quite keen for pension schemes to buy gilts, having issued quite a lot of them.

You took me into the question about accounting standards. Twenty years ago, we would not have wanted to be sat here with nearly all private sector DB schemes closed and looking to have decumulation-only schemes rather than being vibrant. Do you think we have got the accounting standards wrong and have driven pension schemes into a low-

risk investing position by mistake because that made the balance sheet easiest for them and the sponsor? Have we made an awful mistake for the future retirement incomes of most of the country here?

Andrew Griffith: Objectively, the data says that there has been a move over time amongst DB schemes into less risky assets. The conjecture is that there are two reasons for that. One, as the Minister for Pensions has said, is the maturity of those schemes; that is just a natural function of the maturity and the expected time at which they are paid out.

The second is the interplay, which we have to look at very carefully, between accounting standards, which are set internationally—as a finance director, I went through the pain of the alignment of international accounting standards, so I do not think we should be departing from that at all, as in other areas where we seek to reduce friction between the UK and the rest of the world—pensions regulation, and the understandable desire of finance directors and those who are managing these liabilities to try to reduce volatility in their income statement, which is a consequence of the accounting standards.

So it is broadly a thing. I note that the Lords' committee suggests looking at this again, and I think there is value in looking at the interplay between those two things, but in my view it would be wrong to just pick on one piece of that and say, "It's the accounting standards". It is the combination of risk appetites, the detailed rules, custom and practice amongst pension funds and sponsors, and what the capital markets themselves think about those pension deficits or surpluses.

Nigel Mills: I ask you this, because, if we put ourselves back into last autumn, we had huge economic turmoil, the value of all the gilts the schemes had invested in had just gone down, and inflation was running at 10%, so all the pension schemes, liabilities and future cash flows had gone horribly south. You would think pension trustees would be quite worried about the financial situation, and you would think their financial position had just become a whole lot worse, because their assets had gone down in value, the economy was under stress so presumably the reliability of their sponsor was worse, and their liabilities were shooting up. Yet the pension schemes showed the healthiest accounting position for 20 years. It does not suggest that the way we are forcing these schemes to account is reflecting the real-world position of schemes.

Laura Trott: Tom will have further points on this, but ultimately the interest rate does have a real-world impact on the value of the liabilities of pension schemes. It means that, as the interest rate goes up, the value of the liabilities will go down, so it does have a real-world impact.

Nigel Mills: It does not change the future cash flows. I have to pay out these pensions to people in real money that is now going up in theory by 10% rather than 2%.

Laura Trott: Tom, do you want to go through the detail?

Tom Josephs: The future liabilities of a pension scheme, when looked at in today's terms, will be lower when interest rates are lower. The cost of servicing those future liabilities is lower when interest rates are higher. I do not think that is an artificial construct of the accounting standards.

Nigel Mills: You are discounting those back by a rate, but it does not change the fact that if inflation is running at 10% rather than 2%, those cash flows are all going to be much higher in the future than I thought they were going to be. That is a simple fact, is not it?

Tom Josephs: Most DB pension promises are linked to inflation, but there is a cap on that, so when inflation is higher than that cap—

Nigel Mills: Five per cent is still higher than 2%.

Tom Josephs: The Economic Secretary has talked about the company accounting standards that are used to value pensions on company balance sheets, but it is worth taking into account the fact that it is not the company or the employer who will be making decisions directly on pension scheme investment; it is the trustees of the pension scheme. The employer will have input into that, but it is the pension trustees who are making those decisions, and they will be guided by the requirements and the guidance of the regulator on pension-specific valuations of funding positions.

There are a range of different approaches that are used specifically for pension schemes. For example, the statutory valuation which the Pensions Regulator requires to be done every two years to look at DB schemes' funding position is based on market rates, but it also allows some flexibility to reflect the asset mix that schemes have. As they mature, many schemes will be looking to enter into buyout with an insurance company, and that will also be valued on the basis of market rates. It is not just the company accounting standards that are important here.

Nigel Mills: I was not asking you about company accounting standards. I was trying to understand whether you are happy that the way we get pension schemes to value everything makes sense when you hit a situation where all their future cash flows are now higher than they thought they were going to be, and they are stuck invested in gilts at 2% while trying to service cash outflows going up by 10%, maybe capped at 5%, yet all of a sudden their balance sheet does not look a hell of a lot worse, and it looks the best it has looked for 20 years. The contention I was trying to put was that it is quite hard to square how things look incredibly much healthier when a naive, simplistic understanding of the fundamentals suggests they ought to look worse.

Laura Trott: It is a very interesting question that you raise. First, the decision on investments is for scheme trustees. I completely see the drawbacks in the accounting standards and whether the mark to market approach is appropriate or not, which I think is at the heart of your question. I understand that. But we have to accept, as Tom outlined, that

inflation and interest rates have a real-world impact on the liabilities of pension funds, so you have to capture that in some way. If you went to expected value, for example, which is one of the things discussed in the Lords' report, you would then have to estimate what that would be, with all the potential moral hazard that is in that area. I completely see the drawbacks of the current process, but I have not seen a system that works better overall. Does that answer your question?

Nigel Mills: I think it is as clear as we are going to get.

Q283 **Baroness Bowles of Berkhamsted:** I would like to pick up where we got to. It has been said, Mr Griffith, that it is relatively simple to say that a gilt matches pension liabilities and therefore that gilt and repo were not complicated. However, associated with that there were interest rates swaps, and it is these that have actually required collateral. In evidence that was given to committees it was said that, "The extensive use of derivatives such as interest rate swaps—where the scheme receives the long-term fixed rate, the yield on the gilt, and pays the short rate—fundamentally alters the risk-bearing capacity of the scheme", and that, "Through that process, DB schemes have moved from being stable, long-term institutions with the highest risk-bearing capacity of any financial institution into being among those with the shortest horizons and the highest sensitivity to short-term financial market performance". Something similar was in the letter that the Lords' committee sent to you.

It is not really a question of things having been made more low-risk; in fact, low risk has gone to high risk because of the increased sensitivity. That is all in valuations. It is not actually what happens to the gilt. There is a reason why fixed income is called fixed income; it does not actually change. The value of the bond does not change. You get it at maturity, and you get your fixed income as it comes along. The wagging around that happens when you value for it being on a trading book does not apply when you are in a held-to-maturity situation.

The question is: why should you waggle around? I think that was understood, because you said at the ABI conference that, "The combination of overly prudent regulation and mark to market accounting meant far too much UK capital was trapped in short-term—that is because of the interest rates swaps—low-yielding investments, ie in gilt". This is the most important question: how do we get investment into the economy? Is it too late for DB schemes to ever contribute to that? Might not DC scheme accounting, and the expectation of what you get, follow a similar pattern, so that we are still left with no help in the capital markets?

Andrew Griffith: You raise a really important point, and it is one that the Chancellor and I, and the Treasury, are very focused on: how generally in society we allow productive capital to do its job, which is delivering people long-term performance but also allowing the economy to get the necessary level of investment. It is not simple, as you would expect. I think the biggest opportunity for us is in DC assets because of

the long-term nature and the fact that they are able to tie up capital in those productive uses without needing the short-term liquidity either to pay out beneficiaries or because they are facing a reducing maturity tenure curve. A lot of the efforts we will be spending time on in the Treasury over the coming months are focused on the DC piece in particular.

You and your colleague are pushing on a point that the Minister for Pensions and I fully understand. Accounting standards are not laws of gravitational constants. They are trying to reflect as best they can in an objective way. The focus has moved to a much more market-based one. That is objective, in a way. A price on the screen or a particular metric is used to discount assets and liabilities versus the more expected value basis, which historically has also allowed a degree of subjectivity.

There are no risk-free financial systems. We remember in the past when sponsoring employers would make what, with hindsight, were subjective assumptions about expected value of assets. They were not fully marked to market, and then you saw different issues, and the Pension Protection Fund has ended up trying to protect pensioners from some of those schemes.

It is a balance, but to your direct point about how we get more assets taking appropriate risk and adding productive capital to the economy—the wonderful thing that asset management does—I think the bigger opportunity for us now is the DC scheme and the work that the Minister for Pensions and others have done. Things like auto-enrolment mean that we are seeing asset accumulation grow very strongly in that space.

Q284 Baroness Bowles of Berkhamsted: Have you abandoned DB schemes? Are you not hoping that they can help the UK economy at all?

Andrew Griffith: I will let the Minister for Pensions answer, but I certainly would not say that anyone has abandoned anything. There is opportunity wherever there are pools of capital. We have looked at Solvency II and the rules on annuity-based liabilities, at how we can have a rule book that allows capital to be put for the most productive uses, accepting there is always a trade-off. There are no constants in this. There is always a balance between financial stability, prudential risk at macro and micro level, and the performance for the ultimate beneficiary.

Laura Trott: We have two different roles. My job, as I see it, is to be on the side of pension savers. In defined benefit schemes, we are reaching maturity now. It is for trustees to make investment decisions that are in the best interests of their savers. I do not think it is the job of government to steer them too much in that regard, but it is the case that, at the moment, as schemes are nearing maturity, they will often de-risk.

With DC pensions, it is a completely different ball game, as the Economic Secretary outlined. Indeed, it is very important that pension savers get really high returns, because in DC your returns are not guaranteed in the

same way as in DB schemes. One of the things I have tried to do in my time as Pensions Minister so far is shift the emphasis from cost to returns, because it makes such a massive difference to ensuring the adequacy of someone's ultimate retirement income.

On a cross-party basis, a couple of weeks ago we passed some illiquid regulations that waived performance fees to make sure that we are removing barriers towards illiquids investments. There is much more that we can do. We have a value for money scheme coming through, which will mean that we are focusing on the returns that schemes are getting. That will involve greater investment in illiquids, because they tend to be higher return-seeking. We are underinvested in illiquids—7% over here versus 18% or so elsewhere. This is something that we are very focused on, but, as the Economic Secretary says, it is mainly DC, for the reasons that we have outlined.

Baroness Bowles of Berkhamsted: I am interested when you talk about de-risking, because, as I have just elaborated, the schemes have increased risk because of the LDI strategies and the use of interest rate swaps in particular, along with leverage and yet more interest rate swaps. You are not actually talking about de-risking the schemes; you are talking about de-risking the change of the valuations through the accounting standards.

It is quite removed from what is in the pension funds, and what pays, ultimately—we will come on to this later with others—will be the pool of assets. In this recent debacle, we have seen a reduction in the pool of assets, which cannot be good. Going back to talking about how we get the money into the economy, having events happening and strategies that are praised and celebrated as having been a success when it has eroded the capital value seems ironic in the extreme. Perverse, even.

Laura Trott: It is important when we talk about this to look at overall scheme funding levels. Back in 2012, when DB schemes on average had 83% funding, that was a really big problem, because you then do not have the assets to pay out your liabilities. We are in a very different position now, thankfully, which will mean that schemes are much more able to go to buyout. All these metrics matter for buyout. We will also probably see over time a much reduced use of LDI in terms of de-risking. That is what we expect. Tom can say something about that. Gilts are in a good funding position, and they will match their assets, so they can then de-risk and go to buyout or whatever the next stage is for that particular scheme, so it is very important to emphasise a different overall funding position.

Tom Josephs: As the Minister said, we are certainly not abandoning the DB sector. Although much of the DB sector is maturing and will be looking to move to lower-risk assets, there are clearly still a large number of open schemes, which invest more in growth-seeking assets at the moment. As I mentioned, the regulatory structure in the pension system very much allows for that, as long as it is done in a prudent way and the

employer standing behind that is in a strong position. That is very much the intention, and we will continue with that.

Baroness Bowles of Berkhamsted: I find it quite difficult to see my way through this. De-risking is all to do with the accounting standard mark to market valuations when pension funds are held-to-majority for the majority of their assets. One is using an accounting standard by and large that has to be applied in the company accounts, because that is what the accounting standards say, but it does not have to be applied by the Pensions Regulator. They could choose to do something else, and maybe there are some tweaks going on.

Through the advice that is given to trustees and the accounting standards, we actually have the advisory and accounting standards side of the City killing the capital market side of the City. City kills City, because it is these things that have taken investment away from the capital markets. That is what I think you, as City Minister, are quite interested in getting back in, but you can map the decline to the introduction of these kinds of issues. Are we just going to sit there and let that happen?

Andrew Griffith: We are certainly not going to sit there and let that happen, and the Minister for Pensions and I are very focused on this. Risk cannot be extinguished from a productive finance system. There are different elements to risk. There is the risk of lack of performance leading to underfunded schemes, and the money, the assets and the value are not there when it is needed; there is risk to the overall system that you are talking about, where capital is not deployed to its most productive uses; and there is risk to the sponsor, which is encapsulated in how schemes and sponsors account.

You can move risk around, but you cannot abstract that risk. It is our collective role to work well together to get the right balance. The Minister for Pensions talked about the fact that scheme funding levels were a risk in and of themselves. That is one risk whose performance has been managed through the system and through the regulators over time. Others, you included, are rightly drawing attention to the fact that people have observed de-equitisation of equities by big pools of capital. That is why we are looking at things like Solvency II. We are looking at what we can do on DC schemes from a demand side but also from a supply side, with things like the new long-term asset fund, and the lifts, which the Chancellor announced in the Budget and is now out for consultation, as a potential vehicle that helps pool schemes to invest in technology and science. We will keep looking at that and that broader framework to make sure that we get things in the right place. It will always be a balance. I want to be very clear with the committee: we are trying to get appropriate levels of risk in different parts of the system to deliver good overall outcomes for society.

Baroness Bowles of Berkhamsted: Is it not a bit peculiar that the same set of liabilities and assets held in a defined benefit pension scheme, when it is bought out by the insurance companies, has a whole

different way of valuing, when it is exactly the same? For the purposes of capital markets, it would be far healthier if the pension funds were valued in the same way as insurance companies are able to do. I accept that you are being sensitive to some suggestions about insurance, but what is wrong with those valuation standards being applied to defined benefit schemes, which would then generate the same advantage for the economy? We put this question to L&G on the committee, and the reply I received was, "You are pushing in the right direction".

Andrew Griffith: We both accept that you are pushing in the right direction, but ultimately, as the Minister for Pensions has said, it is not for any Minister to be directing investment strategies. We can try to get the frameworks right. We will work collaboratively with the regulators to ensure that the balance of risks in the system is in the right place, but, in my humble opinion, it would be an overreach for us to be prescribing specifically, however desirable a particular outcome is at a moment in time, how those schemes and those trustees choose to invest their assets.

One of the things that we make common cause on is that the better trustees can be advised, the better they understand the risks, the more confident they are in exercising judgments about those—with a degree of consolidation being potentially warranted to help them access that expertise to have scale and build their confidence—the more we might get towards some of the places that you are pushing to.

Q285 **David Linden:** In preparation for this morning's committee, I was struck by some things that Richard Britton said. He asked why no one in authority was paying attention to the growing systemic risk, and certainly cautions that ownership of long-dated index-linked gilts in DB funds was identified at least as far back as 2016. He goes on ask, "Why, in the ultra-low inflationary environment of the last decade, did the Treasury, through the DMO, continue to issue large amounts of index-linked gilts and did not take full advantage of the record low yields on long-term conventionals". He essentially adds that he thinks this added fuel to the fire. He is right, is he not, Minister?

Andrew Griffith: There are quite a few pieces there, so let me try to unpick some of that. The most obvious point is that it is easy to say these things with hindsight. When the Government Debt Management Office look at what, for a long time, has been a very significant amount of issuance to try to ensure that the Government have good access to low-cost finance, it is very much led by the market. It is a market operation as to where they see demand and how they optimise the price and the yield on those for the benefit of the taxpayer.

That is good in all circumstances. It is a very collaborative approach to testing different points of the yield curve and appetite for different instruments. That is something that each Chancellor receives advice on regularly, and that DMO mandate is both updated and well scrutinised by Parliament. The Treasury Committee regularly takes evidence on that, so

it would be open to Parliament to have that conversation about the optimisation of that at any point in time.

I will see if Lowri wants to add anything on the management of financial stability, but it seems really important to understand—I think the committee has done a lot of work on this and taken a lot of evidence already—the exceptional nature of this particular period in time. There were lots of different moving parts, and it was a set of circumstances that nobody saw with foresight. It is very easy to say that now. You had the Fed increasing rates. If you look at that very narrow window of time, the week or 10 days or so, the Fed increased for the third time by 75 basis points, a really exceptional level of monetary tightening. The Fed had raised its own estimate of where long-term rates would settle in the US. We understand that global markets look very much to each other. You had that as one piece of context—a very exceptional situation in the Fed.

The Bank of England then increased its rates by 50 basis points, but it also announced that it was going to proceed with the sale of gilts, which had been trailed. It had talked about that as the Monetary Policy Committee, but it had never come forward with the actual sale. It said that it would begin the sale of government bonds in the asset purchase facility—the place where it had been buying bonds for a long period of time—shortly after their meeting. That was a second big piece of news and change for the market to digest.

Then literally the following day—these days were all compressed into a short period of time because of the funeral of Her Majesty—was the Autumn Statement, or the mini budget. The then Chancellor himself has admitted subsequently that mistakes were made. That is a very important piece of context, because it saw this unprecedented level of movement in the gilt, which was larger than the collateral buffers that people were holding.

Q286 David Linden: You spoke earlier about foresight. Let us talk now about hindsight. Given all of this, was it wise for the Treasury to continue to issue index-linked gilts?

Andrew Griffith: Yes. I think they are a very valuable part of the overall way in which the Treasury manages its need to issue gilts in the market. Conversely, if the point is to say that the Treasury should have eschewed a very substantial pool of demand and therefore paid more for its borrowings at a greater cost to the taxpayer, I think that would be wrong.

David Linden: If Liz Truss is to be believed, LDI was a headache for her. It was the reason why her premiership collapsed in such disgrace with that mini budget. Do you agree with that?

Andrew Griffith: With respect, I think you would have to ask her.

David Linden: I am asking you.

Andrew Griffith: I do not have a view on that. I am here because we are trying to do a lessons learned review. We are trying to learn what we can do differently in the future to deliver better outcomes. You will have to ask her, with respect.

David Linden: As the Economic Secretary to the Treasury, you do not have a view as to whether—

Andrew Griffith: I do not have a view as to what another colleague in Parliament thinks and I would never presume to do so. I have talked through some of the things that objectively were going on in monetary and fiscal policy at the time to put context around what was, I believe, a unique or exceptional period, certainly in the last 30 years, and I hope that that helps this committee, as it looks for lessons learned, to anchor that in that context.

Q287 **David Linden:** Minister Trott, the Pensions Regulator encourages schemes to use LDI. Why do you think it did not recognise the potential risks in pushing so much investment into a market that was already dominated by pension funds?

Laura Trott: It is important to restate what I have said many times in this committee so far, which is that individual investment decisions are a matter for trustees and not the Pensions Regulator. When Charles gave evidence, he was very clear about that.

In terms of the risk of LDIs, you will know that TPR did a piece of work with other regulators in 2018 looking at the potential risk of LDIs. At that time, it looked at the collateral buffer and decided that 100 basis points was reasonable. If we look back over the last 20 years, you can understand that decision. The maximum movement we have seen, I think, was 75 basis points, which was in 2008—Tom, you will correct me if I am wrong—and the movement that we saw last September was 165 basis points over five days. That really is unprecedented. That word has been used a lot in the evidence to this committee over time, but it is true. It is true to say that TPR and other regulators were aware of the risk, but they thought that the collateral buffer was adequate.

Looking at previous data, I can understand why that was the case. However, that has obviously been proved to be incorrect. That was obviously one of the findings of the Lords committee, and I think that we, as the Government, support that and understand that we now need to increase collateral buffers. That said, when we talk about collateral buffers, it is important to understand that that is not without consequence. When you increase collateral buffers, it increases costs to employers and reduces investment in other areas of the economy, but I think it is the right thing to do and we agree with the Lords committee that that is the direction we need to move in.

David Linden: You said TPR was aware of the risk. Was the department?

Laura Trott: The department and TPR work very closely together. I was not there at the time. Tom, do you want to take that one?

Tom Josephs: We have obviously worked very closely with TPR, but TPR is the institution that, on behalf of the department, acts to work with the sector and with schemes to manage risks, so it was absolutely right that they were the ones leading that work.

Just to add to what the Minister was saying on that, there was the stress test exercise in 2018, and they subsequently produced a number of pieces of advice and guidance to trustees on the back of that, advising on how to manage LDIs effectively. Obviously, as the Minister said, with the benefit hindsight those collateral buffers were not sufficient, and we very much support the work that the regulators have now been doing, with the Financial Policy Committee at the Bank of England, to determine the right level of collateral buffers going forward.

David Linden: Just to be clear—we can cut through some of the civil servant stuff there—the department was aware. Did it communicate that to the Treasury?

Tom Josephs: What I was saying is that it was TPR who was leading on the work on the LDI and I was saying that I think that was right and appropriate because they are the ones who are, if you like, on the front line in dealing with the schemes and the risks that schemes face.

David Linden: Should TPR therefore be given a kind of statutory duty to consider the impacts of pension funds' actions in the wider financial system?

Laura Trott: It is a recommendation that was brought forward by the Lords committee. It is a really interesting recommendation. Obviously, the FPC, which Andrew can speak to, has that responsibility. Increasing the powers of TPR in this area absolutely should be looked at.

I also agree with other elements of what the Lords committee put forward, particularly on data. At the moment, we do not have the systemic collection of data that we need. TPR made a point about notifiable events in evidence to this committee, I think, so we should also look at when collateral buffers are breached.

Q288 **David Linden:** Minister, whilst we have you in front of the committee, the *Financial Times* reported last night that plans to raise the UK state pension age to 68 have been delayed amid falling life expectancy. Is that right?

Laura Trott: As you would expect, I cannot comment on that. This review is being undertaken by the Secretary of State and it will report back by May. It is, however, true to say that life expectancy has changed since the Cridland report in 2017, and obviously Covid has had an impact on that, which is considered as part of the review.

David Linden: Why has the review that was produced by Baroness Neville-Rolfe not been published?

Laura Trott: We have gone over this in questions. That will be published in full alongside the Secretary of State's decision, and I look forward to discussing it with the committee at that point.

David Linden: It would be fair to say that the equivalent of that has been published a lot sooner before. Why is there a hold-up this time?

Laura Trott: The decision has been taken to publish that alongside, but it will be published in full.

David Linden: Who took that decision?

Laura Trott: It is a government decision.

David Linden: The Secretary of State? You?

Laura Trott: It is a government decision.

David Linden: Thank you.

Q289 **Selaine Saxby:** You have already touched on some of the points I was going to cover, so this question is really whether you have any new points that you would like to add on the oversight of risks around LDIs. Did the market turbulence of last year raise concerns about the ability of regulators to identify potential systemic and concentration risks, particularly in relation to pensions, and did the FCA and TPR take sufficient action, given the warnings of 2018 from the Financial Policy Committee?

Andrew Griffith: It definitely raises questions, for sure, which is why we are here. We would be foolish not to approach this with open minds and see what lessons we can learn. The Financial Policy Committee has oversight of the systemic risks. It is doing some work looking at this, and it will work closely with the Pensions Regulator, but also the FCA, which has some pensions responsibility. We look forward to seeing what it has to say about that.

Lowri Khan: You heard from the executive director for financial stability at the Bank of England, Sarah Breeden, a while ago. The Financial Policy Committee took measures to increase resilience in the report it published in December last year, with an increase in buffers to 300 to 400 basis points, and in its current round of meetings it is looking at what a steady state level of resilience should be. It will report towards the end of the month, on 29 March. How we best address these risks at the systemic level is very much in the current plans that it will be looking at, and obviously we will be looking with interest at the recommendations that come out of that.

Laura Trott: It is obvious, as the Economic Secretary says, that we need to learn lessons from this. I have outlined some of those so far, particularly on data and the data that the Pensions Regulator has. I think that Charles, when he was here, made that point too. I do not want to

repeat myself, but the broad resilience point and the duty being put on TPR is an interesting one that I think we need to explore.

Selaine Saxby: Is there anyone specifically that you hold responsible for the fact that no system of data is being put in place, and do you think Ministers should have been seeking further assurances?

Laura Trott: There is a system of data at the moment, and it is fair to say that it needs to be improved in light of current events.

Q290 **Selaine Saxby:** Given that there are previous examples, such as portfolio insurance in the US back in 1987, where small changes turned into a systemic crisis as all funds tried to sell at the same time and market liquidity dried out, should regulators have been more alert to LDI, or are we now only looking at this with hindsight to give us a different perspective?

Andrew Griffith: It is very difficult to sort of cleanse our minds with the benefit of hindsight. The collateral buffer is the key thing, but also the speed of response. Had this played out on a longer-time horizon—a really significant move in how the gilt markets hitherto operated—you could have seen a different outcome. It is the combination of the liquidity buffer, exactly as the Minister for Pensions has said, being set on a data basis based on the best data that was available at the time, and then an unprecedented movement not just in its magnitude but in its velocity.

Q291 **Lord Reay:** Before I ask my main question about trustees, can I please go to you, Andrew, and your comments about the timing and the unique and exceptional circumstances around the LDI crisis? Since then, we have seen the collapse of Silicon Valley Bank in the US. The Government did an excellent job with the UK arm in selling it, and the circumstances behind the collapse of that bank were not dissimilar from the issues surrounding LDI in that they were caught out with their bond portfolio and all of a sudden, between one reporting period and another—three months—they had \$15 billion of unrealised losses, which took them into negative equity territory.

Is it not the case that low interest rates and QE over an extended period of time created this sense of security that rates were not going to rise, and then the rising interest rate environment that came about through rates being raised, probably too late, created an environment where weaknesses in the financial system could be exposed?

Andrew Griffith: I would not fundamentally disagree with that. Financial systems have risks in them. We look to our regulators, to the Financial Policy Committee, particularly in the UK, to regulate those, not to eliminate risks. That is really important. If you eliminate risk, you will not get the performance and the reward that we seek.

I would just observe that we have been through a unique period. I should not say unique—unique is a very overstated word—but an exceptional period of low interest rates. That has found a number of situations where the tenure of assets and liabilities have been mismatched. I am not

commenting on the US Silicon Valley situation in particular, because I am not fully sighted on it. I have seen what is in the press, but that is always a risk when people have not fully matched or hedged the date of particular assets and liabilities. It is one of the reasons why there is such a focus on the non-bank sector, and the Treasury has asked the FPC, this year in particular, to look at the non-bank sector. The observations are that a lot of work has been done through things like the ring-fence on bank balance sheets, but there is a lot of balance sheets that obviously sit in what is called the broader non-bank sector, and that has been the focus for the FPC. Is there anything you would add to that?

Lowri Khan: No. Obviously the situation at Silicon Valley Bank is still something that we are looking at very closely. We are familiar with what happened to the UK entity, but the precise causes of its collapse in the US were complex. There were some idiosyncratic factors there, there were some that were more generalised, but I would not comment further on that at this point.

Q292 **Lord Reay:** Can I go on to trustees and ask Laura about the possible vulnerabilities in the system? In 2016, TPR said that many trustees were still not making the grade, particularly in the small to medium-size pension funds. It identified weaknesses, including lack of engagement with the advisers and the key investment activities. Do you agree that these weaknesses contributed to the gilts crisis, and was it reasonable for TPR to rely on trustees to understand and manage the risks of LDI?

Laura Trott: I will take that in two parts. First, it is important to understand where the issues were, particularly during the LDI crisis with trustees. Tom can outline a bit more on this, but our evidence shows that most trustees in segregated funds actually responded pretty well to the collateral cause. It was in pooled funds particularly that there was an issue, and that is something that we have seen from feedback from the period.

More broadly on trustees, to your point about the professionalisation of trustees and TPR support for them, TPR has been leading work on this. Obviously in any industry some people are less good than others. It is very important that we help and support those trustees, and TPR does a huge amount of work on that specifically.

Tom, do you want to say a little more on what happened during in the actual crisis in terms of with pooled funds?

Tom Josephs: On the pooled funds point, which is important, as the Minister said, many schemes and trustees were able to respond quickly. There are two issues with the pooled funds. One is that, by their nature, pooled funds involve a large number of different schemes, so co-ordinating the response across all those different schemes proved difficult in the time that was available. The key issue here was that the response needed to be done very quickly, given the speed of gilt rate movements.

Secondly, the schemes that used pooled funds tended to be the smaller schemes, and in some of those smaller schemes the trustees proved not to have the kind of processes in place to be able to respond quickly. That is a really important lesson. The regulator is now very much focused on action to support trustees in those schemes by having better processes in place to deal with these sort of situations and the ability to develop their expertise to do that.

Q293 Lord Reay: The regulator has said that they would like to see consolidation amongst some of the smaller funds. Will the Government bring forward legislation to enable this?

Laura Trott: We think that consolidation is generally a positive thing for scheme members across DB and DC, for some of the reasons that you have outlined. We are looking at work in this area, but we have nothing to bring forward at this point.

Lord Reay: Assuming that improvements in governance take time to achieve, are you considering making the use of leveraged LDI conditional—for example, on trustees meeting certain standards or reporting requirements?

Laura Trott: As far as I am aware, we are not at the moment, but it is important. We also want to look at the recommendations of your committee, which obviously we have done and we have come back to you, as well as the recommendations of the Work and Pensions Committee, and other work that is going on before we take further steps to make sure that we are following up on all the various changes that need to be made after the LDI incident last year.

Q294 Lord Reay: Thank you. Andrew, on the regulation of advisers, although investment consultants are regulated for certain activities, they are not regulated for pension fund investment strategies, in which LDI obviously paid a key role. Given that, do you accept that investment consultants should be brought within the FCAs regulatory perimeter?

Andrew Griffith: That is the direction of travel. That is our policy. Bringing them within the regulatory perimeter is about things like the senior management conduct regime, about responsibility. It came from a competition remedy, a markets remedy. It was not about the professional standards or the day-to-day conduct of those investment advisers; it was about was that market operating effectively.

Since then, things like mandatory competitive tendering have been put in place, which was more of a primary competition-style remedy. It is certainly something that we remain committed to doing. As we go through this exercise, I would be interested to hear whether it was particular deficiencies in the investment advisers. That is not what I have heard so far. I have heard about issues of governance, transparency, reporting, the speed of response in a situation that was somewhat exceptional. No one has actually brought forward examples of investment advisers, who are all members of institutes of actuaries and regulated at the professional level, not giving diligent and professional advice.¹

So I am open-minded to that, but to answer your question very clearly, we are committed to bringing investment advisers within the regulatory perimeter.

The Chair: When do you envisage that happening?

Andrew Griffith: I do not want to give the committee a specific timeframe. You will be aware that there is a lot of work for the FCA at the moment. I will take that back and look at it. I have heard, and we have seen the report from the Lords. As I say, we want to be evidence-led as well, and I would urge anybody who has evidence of a deficiency in investment advice as part of this to bring that to me and we will consider it.

Q295 **The Chair:** It was announced in May last year that there will be a draft Bill to establish an audit, reporting and governance authority—ARGA—that would oversee the work of auditors. Can you say what is envisaged with ARGA, and when that legislation is likely to come forward?

Andrew Griffith: I certainly cannot, my apologies. That sits, I believe, in the Department for Business and Trade. If you would like, I will ask the responsible Minister to write to the committee, but I am not sighted on the timing of that. My apologies.

The Chair: An issue that I will just flag up, and you may well not be able to comment on this either, is that the Institute and Faculty of Actuaries says that the Government plan to give ARGA powers to regulate its members' non-public interest work. However, there will not be regulation of the identical work carried out by non-members, and obviously they are worried that a lot of actuaries will simply resign their membership of their institution in order to avoid regulation. Do you know whether that is the intention or perhaps something that we ought to look into?

Andrew Griffith: I do not know what the intention is. I was copied in on a letter, probably the same letter that you have had, that alerted me to the issue. I do not know what the proposed resolution is, but it is of course right that we always consider the unintended consequences of regulation when we bring it forward.

The Chair: Okay. If you can shed any more light on that by writing to us subsequently, that would be very helpful. Thank you.

Q296 **Lord Agnew of Oulton:** Good morning. Let us start with Andrew. I am interested in your views of the scheme funding levels that clearly improved for most pensions on the back of interest rate rises over the last 18 months or so, but do we have clear visibility of those funds that are not in good shape, and have you plans to address that?

¹ Note from witness: I meant to say: "No one has actually brought forward examples of investment advisers, many of whom are members of institutes of actuaries and regulated at the professional level, not giving diligent and professional advice."

Andrew Griffith: I will ask the Minister for Pensions to answer that, if I may, because it sits in the remit of—

Lord Agnew of Oulton: I was thinking more about financial stability, but, of course, if it is Laura's pigeon.

Laura Trott: The answer to that question is that we know that some schemes lost out as a result of last year. Obviously, as you rightly point out, on aggregate it was improved. The Pensions Regulator does not currently have sight of exactly who that is, although that type of data is the sort of thing we need in the future.

Lord Agnew of Oulton: You are not just going to wait until their annual reports are published. Are you actively triaging to that route at the moment?

Laura Trott: The Pensions Regulator is actively having conversations at the moment. Obviously, they cannot go beyond their powers as laid out in regulation, but they are actively having those conversations at the moment.

Lord Agnew of Oulton: What sort of powers do they have?

Laura Trott: Tom, why do you not go through the exact regulatory position?

Tom Josephs: We think that a relatively small number of schemes might have lost out during the episode in September and will have experienced losses on the asset side due to having to sell assets quickly. But overall, going to the earlier discussion, we think that their funding positions will be secured because their liabilities have fallen.

Obviously the regulator is in regular close contact with the schemes. As we have discussed, they do not have the power to direct investment, but they work with the schemes to manage risk and can take action in the event that they feel that the trustees are not acting appropriately in managing those risks under certain conditions. Also relevant is the evidence that I think your committee heard from the Pension Protection Fund that it was not notified of any schemes that might be moving to a position where they needed support from the PPF due to the events of last September.

Lord Agnew of Oulton: When do you think we might get some visibility on this? I accept that the regulators cannot direct investment policy, but surely they can ask for financial information so they have a clear understanding. You mentioned a small number of funds. Do you have any sense of what that means?

Tom Josephs: They will be working with schemes, and if there are any issues, as I say, the PPF might be involved, but we do not think that is the case at the moment. This goes to the earlier discussion we had on data. The Pensions Regulator has been very open with the committee that a key lesson from this episode is that they need to develop their

ability to get more timely data on scheme risk exposure and on leverage and more systematic data. As I say, we are very much supporting them in doing that work.

Q297 **Lord Agnew of Oulton:** More widely, do we have a sense of the losses and gains of this episode? We were given evidence in our committee of colossal sums of money moving around over a couple of weeks, yet there has been no real clarity about who the losers were from this whole episode. Can you shed any light on that at all?

Laura Trott: We know that the overall scheme funding position has improved. Obviously there are some losers there, which we have talked about. The thing that is not highlighted enough and where not a lot of the conversation has been about is the DC schemes. Obviously many DC schemes lost an awful lot of money that day, but there has been less focus on that, because generally when people talk about pensions they still talk about DB schemes, but DC schemes were where a lot of the losses took place.

Lord Agnew of Oulton: Do you have any sense of the numbers?

Laura Trott: Not the exact numbers, obviously, because it moves around so much. DC schemes are obviously much more to market. The risk is entirely with the employee rather than the employer. The state does not have the same role in that as they do in DB schemes.

Lord Agnew of Oulton: For me, the evidence that came to us so strongly in our committee was the real naivety of pension fund trustees, particularly the smaller funds, and that they were ill-equipped to understand what they were taking on board when they were sold these leveraged LDI instruments. I do think there is some urgency in, for example—to earlier questions—bringing what I would call snake oil salesmen into the regulatory oversight of the FCA, so that when they are selling the instruments there is some comeback. I just feel that there is urgency here and that there are some quick fixes that you can make. I accept that it is easy for us all to sit here with hindsight, but I think we have had some jolly good lessons and we need to get on with learning from them and implementing them.

Laura Trott: I completely agree with you on the point about greater data from the Pensions Regulator. I think that is at the heart of what you were saying there, investment decisions aside.

What you said about the Pensions Regulator really understanding at a deep level what is going on in the defined benefit market and where those collateral buffers have been breached and able to take action is absolutely correct and something that we need to take forward. But, as reassurance, as Tom rightly outlined, the PPF is in constant conversation, because obviously it needs to stand by if there is any possibility of any troubling instances with individual schemes. That has not been the case, as it evidenced to you. Scheme funding overall has improved.

Q298 **Lord Burns:** You say that hindsight is a wonderful thing and that

exceptional events could not have been anticipated, but of course they did happen. My experience in my years in the Treasury, and indeed in banking, is that unfortunately exceptional events often happen. What changes is the combination of events, but one thing that most crises do have in common is too much leverage and too little in the way of adequate capital buffers. Does the experience not suggest that actually leveraged LDI was not an appropriate instrument for pension funds? Is this not the point that we have to reflect on and say—that it was not the right instrument for them to be using, given their strategy?

Laura Trott: It is really important to reflect on this issue. On your point about extraordinary events, in fairness to the regulators who were looking at this at the time, the 2008 financial crash was an extraordinary event and the movement over five days was 75 basis points. That said, setting a 100 basis points collateral buffer obviously proved to be incorrect, which is why we all support the work that the Bank of England, along with other regulators, is doing at the moment to increase collateral buffers.

Lord Burns: But of course, as Tom has pointed out, the higher the capital buffers, the less attractive these instruments are.

Laura Trott: Yes, it is not without cost.

Lord Burns: It is effectively saying that we have more capital. We are moving towards saying that if we capitalise these things correctly, they do not become terrifically attractive instruments for pension funds. So we are back to my starting point: that they were never the right instrument in the first place. We had a strategy of saying, “All right, gilts are a sensible thing for people to be holding, given their future obligations”, but then we said at the same time that, in order to try to close the gap for funds that still had a funding gap, we would allow them to engage in some of what turned out to be high-risk investment. Is there not something flawed in the whole notion that this was all right; it just happened to be caught out by some exceptional events?

Laura Trott: Andrew will have thoughts on this too. You are absolutely right to point out the trade-offs, which is why the regulator’s decision to make the collateral 100 basis points is even more understandable, because, in terms of historical events, that was more than sufficient and there are trade-offs to making it higher.

Secondly, in terms of whether the schemes will still use them now with the higher collateral buffers, the Bank of England set that level before Christmas and the schemes are still using LDIs with that. Again, this is not something that we direct as Ministers, and the Pensions Regulator does not direct investment, but they are still being used, even with the higher level of collateral that is required at the moment. Obviously the Bank of England will come back in the near future to say more about the level of collateral. We still think that they are a useful tool in the armoury of pension schemes, but we need to make sure that they are regulated effectively, which is what we are talking about here now.

Lord Burns: Are you saying that 300 basis point is now the right buffer?

Laura Trott: That is exactly the work that the Bank of England is doing at the moment, supported by the Pensions Regulator and the FCA.

Andrew Griffith: We should wait and see what they come up with on the steady state. You are right that the financial system often reteaches itself the same rules as the combination of leverage, which makes it imperative that there is very fast decision-making. Really, what leverage does is accelerate the need to make decisions, because you have gearing, and that requires people to act in a much shorter timeframe than if leverage is not present.

I would not disagree with that premise, which is why it is important that the FPC comes forward with guidance in the context of what we have learned about governance and the ability of the sector to respond at pace. Some parts of the sector were able to respond at pace, make collateral calls and access the that they needed to make their margins. That, for me, is one of the big learnings, and I think we should be diligent, when we think about systemic risk, about looking at the role of leverage. That is one reason why the Treasury has directed the FPC. I think I have the right frame.

Lowri Khan: I do not think we direct it.

Andrew Griffith: Sorry, we have asked. This is why Lowri is here—to correct me. We have encouraged it?

Lowri Khan: We have definitely encouraged it.

Andrew Griffith: We have encouraged the FPC—forgive me—to make a focus for this year looking at risk in the non-bank sector, where it is quite possible that leverage exists and we need to be sure that that leverage is tied to a level of governance that allows people to respond at the right pace in fast-moving markets.

Lord Burns: Where I still have a bit of a problem here is the argument that 100 basis points was perfectly reasonable because of the last 20 years of experience or whatever—that these were such unusual events that it could not cope with that but that, somehow or other, 300 seems to be the number that people think is the right level. It seems to me that one is simply moving them out to the point at which they become unattractive.

The other point is that, for many people, there are trigger points about recapitalising within whatever the buffer they have. Do these occasions not also create the potential for some of the negative spirals and forced selling that we have seen? In other words, whatever the buffer is, we could see these kinds of events repeated if we allow people to take this kind of risk.

Laura Trott: The particular dynamic that we saw in this case was because the collateral buffers were being breached. You would not necessarily have that dynamic if you had sufficient collateral buffers.

Lowri Khan: On the point the Economic Secretary just made, and I think you have heard this from other witnesses as well, the speed of decision-taking in the face of very fast moving markets was also a factor here. A lot of the issues that we saw were very much concentrated in the pooled funds rather than the segregated funds, which were better able to respond to a very dynamic situation. There is an interplay there between buffers and the capacity of decision-takers.

Q299 **Lord Burns:** Is there also an interplay with the amount of the collateral that people have to hold, whether it is cash or other assets, and is that being looked at?

Andrew Griffith: It is ultimately for the counterparty to decide what collateral to accept. My colloquial understanding is that the collateral in this case was predominantly gilts. As you know, the gilt market is regarded as one of the most liquid, and, notwithstanding the significant movements, it continued to operate. There was no market failure in the sense that the market had to be suspended. The Bank of England did make an intervention with a view to stabilising, but the market continued to operate throughout.

At the end of the day, someone has to take a view. I am content and willing to advocate that that should be the FPC. Its interim view is that 300 to 400 basis points is the right buffer. Some would advocate that the tolerance for holding leveraged instruments is zero. That is not our view, because, as I think you are hearing from the Minister for Pensions and me, we are seeking to get a balance in the system, and I am obviously particularly keen to see what the FPC advises is the right level of these instruments on a steady-state basis.

Clearly the reciprocal of a higher buffer is that these instruments will be less attractive, but certainly my position is that we are not advocating that the tolerable level of the use of LDIs should be zero. That would seem to me an extreme position for those that have good governance practices and potentially some of the other safety belts that you are suggesting, such as putting in better data and monitoring, and closer working between the prudential authorities and the Pensions Regulator. If we can establish that framework, which I think is at the core of some of your lessons learned, I am happy to say that LDIs should continue to have a role.

Q300 **Lord Burns:** You also talk about the speed with which this all happened. Should anything be done about the information and frequency of data the trustees have access to? Are there lessons to be learned in that area?

Laura Trott: The set-up of trustees in the individual scheme is for the trustees. They need to make sure that they have information in place to enable them to make decisions. To echo what has been said already, we definitely need to look at the governance of pooled funds. That was

clearly one of the key problems at the time of the crisis last year and something that the Pensions Regulator is doing some work on.

Lord Burns: You do not have any thoughts on minimum standards of the sort of data and information that trustees should receive.

Andrew Griffith: Trustees have a duty to discharge their roles and responsibilities in a diligent way, and to make sure that they have the right level of advice but also that they understand that advice. There is a big piece here, because the construct of the system ultimately is that being a trustee of a pension fund is a significant responsibility. It is why the Minister for Pensions, and DWP more generally, has put a lot of emphasis on that governance framework. Clearly anyone who is a trustee should be approaching that with the right degree of diligence and care. It is a big responsibility.

Q301 **Siobhan Baillie:** Minister Trott, on systemic risk, you said earlier to Selaine that, given current events, data needs to be improved. I think every witness who comes before us on anything to do with DWP always asks for completely different data or new data. However, on this specifically, Andrew Bailey said that it is easy to measure leverage with banks but really hard to spot with non-bank sector and LDI funds. We have TPR suggesting that a new notifiable events framework is necessary, but it will only be voluntary. Is that sufficient to address the systemic risk concerns and spotting things, and what else do you want to see with data?

Laura Trott: As I said earlier, the systemic risk responsibility does not sit with TPR at the moment, and we need to examine its role with regard to systemic risk in the pensions industry. I think the suggestion about data and notifiable events point is a good one. It is a problem that, at the moment, TPR does not fully understand where those collateral levels have been breached. It should know that information. We will be looking at all ways in which we can make sure that it does.

Siobhan Baillie: I think the suggestion is that it is only voluntary to start off with, before legislation can be put in place, but what discussions have been had about who will take up this ability to provide more information and take on this new framework? Do we know whether small funds will be able to provide more information and monitoring? From all the information we have had about LDIs, it is the small funds that experience the most difficulties in this.

Laura Trott: Quite right. I was not there during this period last year, but from everything I have heard there was a reasonable amount of data flow and data sharing between schemes and TPR to understand the issue. Indeed, a lot of this issue was highlighted in many cases because schemes contacted TPR directly. So there was good voluntary information flow, and TPR does have very good relations with schemes.

That said, I do think we need an element of mandation. We need to be very mindful, as you point out, of the burdens we are placing on smaller

funds. In the longer term, it is very important that we see some consolidation for exactly these reasons. It is important that firms are able to comply with the duties that are placed on them, but we will look at this issue in more detail. Tom, is there anything to add to that?

Tom Josephs: I do not think there is much to add. Previously, and during September, TPR was essentially relying on kind of backward-looking data, so it is obviously really important that it can get more timely data, including on leverage and the use of LDI. The use of the notifiable events regime could clearly play a part in that as well.

Q302 **Baroness Bowles of Berkhamsted:** Apart from better data and looking at data better, have you thought any further about any other changes to the existing framework to enable systemic risk to be better managed in future?

Andrew Griffith: I would just observe that TPR and the prudential authorities working closely together feels like a good way of managing this. The contrast I would draw to bring that to life is the very tight working between the PRA, the FCA and the Bank of England, so without prejudicing what currently happens or what the Minister for Pensions decides, the more TPR can be part of those frameworks and very closely aligned as we collectively seek to manage the non-bank financial risk, the better. So there is another one for you.

Baroness Bowles of Berkhamsted: There is a difference between working closely and actually being part of it. The Financial Policy Committee can make recommendations to any regulator, but only the PRA and the FCA are in the "comply or explain" position. Also, of course, representatives of them both are on the Financial Policy Committee. Given the systemic effect of the size of pension funds, that is not going to change. They will always be systemic, and things going on in them will always be systemic. The nature of it means that they will tend to have the same kinds of strategies because they are all doing the same thing.

Might it not be better for the Pensions Regulator to formally be part of that inner circle, and both to be present on the Financial Policy Committee and subject to the "comply or explain" provisions? These are cross-cutting issues, but they are all financial. The fact is that TPR is in a different department. Should it not have that same status?

Andrew Griffith: I respect that as a point of advocacy from you. My point was more general and about closer working in collaboration being a better thing. I will ask the Minister for Pensions whether she has a specific view on that.

Laura Trott: The regulators already work incredibly closely together. We definitely saw that during the period last year that we are discussing. I note in the Lords' report a phrase that I thought was quite correct: "There was more overlap than underlap in the regulators". That is because they work extremely closely together, and that is very important to them. They have very good relations.

On systemic risk, I think we have answered those questions. This is something that we need to look at. On the point of detail, we would have to take that away and consider it, as we will any recommendations that come out of these committees.

Baroness Bowles of Berkhamsted: The thing that concerns me is that everyone, from the DMO onwards through the chain, the advisers, the fund managers and the regulators, recognised that there was this concentration in gilt, but they did not then leap to the conclusion that there might be systemic risk. Actually, one follows the other as night follows day. The DMO even said, "This is a wonderful win-win situation. We can keep on churning out the index linked gilts and sell them at a better rate than we would get in a more generalised market", without recognising that it is churning out systemic risk. That is unacceptable, when you see it going all through the chain. One has to ask who has the economic policy responsibility when you get to these cross-cutting issues. Systemic risk is not something that can therefore be isolated in the FPC because, for all that they said in 2018, what followed was pretty de minimis. I just cannot get my head around how bad we have been in this. I will leave it at that.

We have to have substantive change. It is not enough to say that we cannot see leverage in non-bank financial institutions. Everybody knew it was there. Everybody was boasting about taking advantage of the carry trade. That is where this has all come from. What are we going to do to make sure that things are picked up more quickly, because it was not because of an absence of data? More is good, but it is about what you do with it and how often you do it, not looking at it every once in a blue moon, once every quarter, with the FPC.

How are we going to be more aware and responsive overall? It was no surprise that we were having QT. We were told this for ages. Of course we do not know exactly when interest rates will change, but we were told that one in advance, so why was there still no action on something of such huge social importance? Further down the track, because of the way the valuations are done—they are separated entirely—the sponsors will pay for the asset losses because the interest rates and the valuations will change again, so it is all up and down until you get to the end. The fact that there is a sort of gain from freaky accounting standards now unravels later on. How do we make sure that we do not just say, "Done and dusted, a bit more data, no real change"?

Andrew Griffith: There is a lot there. We are all here today because we are open to learning the lessons. That is the right thing to do. We have both approached this with that openness from our positions of responsibility. We have welcomed some of the recommendations that we have seen published already, and we will do so diligently with any of the committee's recommendations.

To push back very gently and respectfully, I do not think there was an absence of monitoring of systemic risk. With the benefit of hindsight, that may have been under-horsepowered, but the mere fact that there were

buffer limits in place suggests that there was an awareness of that. Again, with hindsight, the fact we have moved from 100 basis points to 300 to 400, acknowledges, as I think is common cause, that the calibration was perhaps not set in the right place. So I am not disagreeing. I am just gently saying that there was some monitoring of systemic risk, there is some awareness of this, and we will seek to learn lessons from that.

Laura Trott: I agree with everything the Economic Secretary said.

Q303 **The Chair:** Thank you. I think it is accepted that there is a need for more data arising from what happened. Do you think we need to know how many pension schemes lost out? Tom, I think, made the point that it was a minority, given the overall figures that we have heard, but do you think we need to know how many lost out and what the scale of their losses has been?

Laura Trott: From my perspective, if the pension schemes are in any danger of falling into PPF, that is important to know. We need more data more broadly. I think the exact amount of losses and how trustees account for that is more for them—would you say, Tom?

Tom Josephs: Yes, I agree. As I have said before, it is important for the regulator to have more timely data on this sort of thing.

The Chair: You do think it is important that we know how many schemes lost and the scale of those losses.

Tom Josephs: Yes, that is obviously important information. I would go back to what I said at the start, which is that the regulator's assessment is that the number of schemes that experienced losses is small on the asset side, and that the overall funding position, given the impact on liabilities, is likely to have offset that.

The Chair: This is a technical point. I ought to know the answer to this, but I do not. How is it that the Pensions Regulator knows the overall picture, but we do not know the individual pictures? How does it have the data to get an overall picture without knowing the individual numbers?

Tom Josephs: The Pension Protection Fund does data collection on the overall asset and liability position of the sector as a whole. I do not have the full details of how they undertake that exercise. Maybe we could get back to you on that.

The Chair: Okay, that would be helpful. I do not quite see how you can get an overall picture without knowing the individual pictures, so if you could drop us a line about that.

A point made to us by the independent trustee firm Dalriada is that it is going to be difficult for schemes that did suffer losses to get redress given how all this happened. Is that a worry?

Laura Trott: I come back to the point that individual investment decisions are for trustees to make, and markets do move around. That is the key point in response to that.

Q304 **Siobhan Baillie:** On DB scheme regulations, it feels like the pensions world has been consulted up the wazoo in recent years and we are still waiting for information. When will the new regulations be coming out?

Laura Trott: We want to make sure that we take into account the recommendations from both the Lords committee and your committee, so we will wait for those to come out, then look at the scheme funding regulations and hopefully bring them out shortly after that.

Siobhan Baillie: Do you know when that will be?

Laura Trott: I do not. It will depend slightly on when your committees bring out your reports. I do not know when you are planning to do that.

Siobhan Baillie: Okay. Basically the delay has led to additional concerns and requests for the new regs to be paused to take into account what happened last autumn.

Laura Trott: That is really important.

Siobhan Baillie: The headline act of the concerns—this is from the railways pension trustee company, the Pensions and Lifetime Savings Association—is the belief that the new regulations will lead to DB scheme closures and an increase in systemic risk and will be contrary to the Government's growth agenda. What do you say about those? I will come to the Treasury about the last one.

Laura Trott: Obviously that would not be the intention of the regulations. Indeed, it is the opposite. What we will be trying to do with this is recognise that DB schemes are in a different place. They are reaching maturity, and we need to reflect that in the guidelines. But, like I said, it is very important that we look at this in light of what happened last year, that we make sure that we are talking to you, talking to the Lords committee, understanding your recommendations in this area, and that we incorporate that into the regulations.

Q305 **Siobhan Baillie:** Treasury, the point about the growth agenda is that the new regulations will “make it more difficult for schemes to increase—or even maintain—current levels of investment in long-term productive UK assets and to support the UK's transition to net zero”. Have you taken a view on that yet?

Andrew Griffith: I am not sighted on the draft regulations; I presume I will be before they are brought forward. I suspect that we are at one on trying to seek the right balance, but it is a concern. We have used the word “balance” a lot. There is a difference between lessons learned, understanding, putting frameworks in place—data obviously being a point of commonality, governance being another—allowing the pendulum to overcorrect in the other direction, and us seeking to do something that

we should not do in a financial system, which is to extinguish risk. Our role is to manage and to mitigate risk. In my view, it is often to telegraph risk and to make sure that risk is fully understood. The objective of a system of financial regulation is not to eliminate risk, because if you do that you are not, in my view, getting the balance right.

Q306 **Siobhan Baillie:** As I came in, I think Baroness Bowles was doing an excellent job interrogating attitudes to DB schemes and their importance, so she may want to come in on this, but do you think that TPR and DWP can do better at showing a commitment to open DB schemes?

Laura Trott: What do you mean by commitment to open DB schemes?

Siobhan Baillie: I mean that, notwithstanding that they are maturing, do you think that, in relation to the regulatory regime for open schemes, there should be a difference versus the other schemes around?

Tom Josephs: Just to reassure you on this point, at the moment we are very much consulting with the sector on the regulations and TPR's code, as well as wanting to take into account the recommendations of your committees. We recognise the issue that you have raised here and we are very much aiming to build in sufficient flexibility to recognise the differences between open and closed schemes. As I say, that is very much a focus of the discussions we are having with stakeholders at the moment.

Baroness Bowles of Berkhamsted: The issue I would follow up here is that we heard from trustees—in the committee and outside, and some trustees have also written to the Work and Pensions Committee—that what is written on paper about how schemes that want to invest more adventurously are treated, and what actually happens through informal pressure and the requirement of leverage on the sponsor covenant and the pledges required, are two different things.

On paper you can say, "Well, you have the choice". In actual practicality, unless you are quite a powerful organisation such as a railway pension scheme or something like that, which is well open, as you are aware, you do not stand a chance. You are herded down a track, but the Pensions Regulator can say, "Hand on heart, we never forced it", because it has not done an enforcement action; it has done arm twisting. Until what is on paper and the regulator's response are the same, absent arm twisting, I will not feel that the alternative investment possibilities are live.

Can you do anything about that? I would have thought it is in the hands of the Minister to be able to do something about that mismatch of what is in writing and what happens in practice.

Laura Trott: We have already talked through the approach that we have taken. First and foremost, whatever happens always has to be in the interest of pension savers. That has to be front of my mind in whatever actions I take and whatever I do. With DC pensions, we have outlined clearly before that we are taking steps to encourage investment in liquids

and to increase returns for savers and increase pension adequacy for those savers over time so they can get the retirement that they want.

In DB pension schemes, as Siobhan rightly outlined, there is a difference between closed pension schemes that are maturing and schemes that are open. It is important that they are treated differently from that perspective, but we come back to the fundamental point that the regulator does not make the investment decisions, trustees do. It is a really important distinction and one that we must make sure we maintain.

Lord Burns: Economic Secretary, can I just respond to your comment about how you did not want to eliminate risk, but you wanted to make it clear and to be able to manage it?

Andrew Griffith: Mitigate it.

Lord Burns: And to mitigate it. Does leveraged LDI not fail on both counts? It turns out that in fact it was very difficult to identify where the risk was and extremely difficult to manage it when it emerged. If you compare this instrument to, let us say, the old-fashioned world of portfolio management where you would have some gilts and some proportion in equities or whatever, it fails on the grounds of clarity and the ability to manage it. It is a slightly cheap point, but you raised that issue. I wholly agree that the issue is not only about eliminating risk but about clarity and being able to manage it and mitigate it.

Andrew Griffith: In fairness, it is entirely consistent with that. For the sake of argument, a strategy that said that we will simply have an ab initio prohibition of any of these strategies—that no matter how sophisticated they are, no matter what advice people are able to assail themselves of, no matter the data governance, that this is just a prohibited instrument—would not be consistent with what I have returned to again and again today, which is about getting a balance.

Lack of performance is a risk in itself. You can have a system that has very little risk in it, but you will also have very little performance and investment return that will deliver people the longevity or the protection that they need. My view is not at the extremities, to be clear; it is about appropriate risk and that mitigation may be the sophistication of governance. It may not be a one-size-fits-all framework. Maybe the level of buffer held by a smaller unsophisticated trust pension scheme could approach zero.

Those are not decisions for me in the delegated framework that we have of financial regulation; they are rightly decisions for the FPC. In the case of pensions, they are rightly the decision for the Minister for Pensions. But my view is that you want a proportionate approach. Of course you learn lessons, seek data, calibrate those mitigations as objectively as you can, but just as it would be wrong to say that there are no buffers, there are no parameters. The reciprocal applies, which is that saying that in no circumstances are these legitimate instruments would not acknowledge

that balance either. I am not quite saying that you are saying that, but that is slightly a thrust of your point.

Q307 **The Chair:** Laura has emphasised a number of times to us this morning that it is trustees who make investment decisions, but I do not think there is any dispute that the Pensions Regulator framework has encouraged funds into the direction of LDI. One witness described the new scheme funding regime, which is being consulted on at the moment, as “LDI on steroids”. Is there any concern—this might be more of a Treasury concern—that the new regime could further impede investment in the UK economy and economic growth?

Andrew Griffith: In respect of those guidelines, to be very clear and very respectful, they are responsibility of the Pensions Minister.

The Chair: If the regime is in the interest of pension savers—Laura has emphasised that that is her job—but not in the interest of the UK economy, who does something about that?

Andrew Griffith: It is for us collectively us in government to take advice from the Minister and reach a collective agreed position.

I will pick up the point made by Baroness Bowles about what people say is the sort of lived experience as opposed to the ultimate direction that is perhaps set by Parliament or at very senior levels, because there are analogies in the parts of the financial regulatory sector that I am responsible for. It is in the nature of a human regulatory system that regulators, to a degree, have asymmetric risk. Just as sometimes in markets we see practitioners have asymmetric incentives on the upside, we also see in regulatory systems, which is sometimes driven from the tone of debates that we have in committees such as this, that those who operate regulatory systems are incentivised to perhaps go too far in trying to reduce risk.

We will all debate top-level principles and agree a regulatory structure that has the right balance of growth, economic prosperity and managing and mitigating risk. Perhaps when you are at the receiving end of some of that regulatory conduct, it ends up being a bit too much risk off, and often it is for us collectively to try to reiterate the tone at the top. It is about getting a balance, not about trying to extinguish all risk. I think that was the point that Baroness Bowles was making.

Baroness Bowles of Berkhamsted: A more fundamental point though, that runs throughout the whole of this conversation about LDI is that risk is not monolithic. The whole risk that is being talked about most of the time—I say this from your side—is that the single bond that comes from the accounting standards valuation of liability is not a consistent valuation because does not take into account what happens when you are actually invested to maturity. The fact that the value of the bond keeps changing is of no relevance whatsoever in a held-to-maturity situation, yet it waggles around in the accounting standard. That wagging around is the risk that you are trying to contain and is not directly related to what

happens at the end. You are concentrating on that valuation risk, or however it is expressed, but you are not concentrating on the reduction of investment risk because LDI and other things have increased it massively, so there is no concentration on risk reduction as normally expressed in financial markets. It has actually increased that kind of risk, so we are not in a risk-off situation.

It is very difficult to talk about risk as if it is monolithic, and, overall, there is a lack of understanding. This goes back to Lord Burns' point, but DB pension schemes were probably not designed with the kind of sophisticated instruments that are now being used in what is essentially quite a light touch regulatory environment. I go back to the comment in our Lords report that the more bank-like the operations, the more bank-like the supervision has to be. We are certainly not in the position to do that bank-like supervision, so there will continue to be a mismatch.

The Chair: You have noted those observations but do not want to respond to them. Economic Secretary, you made the point a few minutes ago that different kinds of schemes might require different kinds of regulations or different approaches in regulation. I wonder whether you have taken a view—I guess DWP will have done—on whether the scheme funding regime that is being consulted on at the moment is flexible enough, given the different types of schemes that are being covered by it?

Andrew Griffith: I do not have a view, and in the same breath I also made clear that those determinations are ultimately for the Minister for Pensions.

The Chair: I just make the point that it might be a subject the Treasury would want to look at, given the impact on the economy as a whole.

Q308 **Selaine Saxby:** Thank you both, and your teams, for coming this morning, particularly the Treasury team, because your predecessor has not always been as willing to engage with this.

I am out of scope with this final question, so I am very happy to take it to the Secretary of State from DWP next week, but if you did want to come back and see us, Minister, we would be delighted, because we still have outstanding questions in the committee on the work that the Treasury in particular has done to address the impact of claimants of historic tax credits when they were deducted from universal credit and whether that might be something that we could engage with you further on.

Andrew Griffith: I am not the Minister responsible, so although I am happy to be expansive in my portfolio, and I hope you feel that I have done justice to that as the committee, it would not be appropriate for me to discuss.

Selaine Saxby: Might it be something that the Treasury could respond to in writing?

Andrew Griffith: I think I will take guidance from my DWP colleagues.

Laura Trott: That is outside the scope of my ministerial portfolio, I am afraid.

Selaine Saxby: Okay, we will take it to the Secretary of State next week. Thank you.

The Chair: We will certainly be able to do that. Can I thank you very much indeed? We understand that you replied to the House of Lords' letter overnight, but the committee has not yet had a chance to see it. I do not think the Members of the House of Lords have; certainly the Members of the House of Commons have not. We will certainly look at that with great interest, and no doubt what we say in our report will reflect to a degree what you have said in your reply, so we are keen to read that.

Can I thank you very much indeed for giving us your time so generously? I think we have kept you here for over two hours, and we are grateful to you for all the information and answers you have provided us with. Thank you to our colleagues from the House of Lords for joining us.