HOUSE OF LORDS

Industry and Regulators Committee

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Dear Ministers,

The use of Liability Driven Investment strategies by pension funds

In September 2022, the turbulence in financial markets that followed that month's fiscal statement and the publication of the then-Government's Growth Plan drew attention to the use of liability-driven investment (LDI) strategies by defined benefit (DB) pension funds. The use of LDI strategies played a significant role in bringing about action by the Bank of England to temporarily purchase £19.3 billion of gilts[1], having initially pledged up to £65 billion to do

[1] Bank of England, *Bank of England sets out plans for a demand-led approach to unwind recent financial stability gilt purchases in a timely but orderly way* (10 November 2022): https://www.bankofengland.co.uk/news/2022/november/boe-demand-led-approach-to-unwind-recent-financial-stability-gilt-purchases

so.[2] The Bank has indicated that following the fiscal statement, rising gilt yields had the potential to cause LDI funds to be wound up, which would have driven further sales of gilts held by banks as collateral, driving a "potentially self-reinforcing spiral and threatening severe disruption of core funding markets and consequent widespread financial instability".[3]

In light of these events, the Industry and Regulators Committee, in collaboration with the Economic Affairs Committee, wrote to the Bank of England, the Financial Conduct Authority (FCA), and The Pensions Regulator (TPR). We felt further scrutiny was required, and therefore held a number of public and private sessions to take evidence on the use of LDI by DB pension funds and its implications for regulation. This included public sessions with Legal and General, the FCA, and TPR.

We were disappointed that ministers could not meet us before writing this letter, but we welcome that you have now agreed to appear before the House of Commons Work and Pensions Committee in March, which members of the Industry and Regulators Committee will attend.

In advance of hearing from you in March, we are writing to you to make a number of recommendations for action to improve regulation in this area and reduce the risk of similar disruption in future, on which we expect a response from the Government.

Summary of our findings

1. **The fundamental issue is that leveraged LDI has been created as a solution to an artificial problem created by accounting standards, but in the real world its application creates downside risks.**

The artificial problem is the accounting requirement to measure the current value of scheme assets against a 'present value' of future pension liabilities discounted at a low-risk market interest rate. This fails to recognise the potential upside from investing in a broad portfolio of assets including equities and other real assets that could be expected to have a higher return over the long term, so a scheme may show an accounting deficit now even if the expected returns from the investment strategy should allow commitments to be met. It also means that when market interest rates fall, the discounted value of future liabilities is shown as having grown, with a corresponding increase in the scheme deficit, even when the actual future payment commitments and the long run expected return on assets are unchanged. Since the scheme deficit has to be reported in the accounts of the parent company, such volatility is unwelcome. LDI strategies were designed to avoid this accounting volatility by investing assets in bonds and gilts that had the same sensitivity to market interest rates as the discounted liabilities, so their values move up and down

[2] Bank of England, *Gilt Market Operations – Market Notice 28 September 2022* (28 September 2022): https://www.bankofengland.co.uk/markets/market-notices/2022/september/market-notice-28-september-2022-gilt-market-operations [accessed 12 January 2023]
[3] Treasury Select Committee, *Letter from Sir Jon Cunliffe, Bank of England, to Committee Chair on gilt market intervention* (5 October 2022): https://committees.parliament.uk/publications/30136/documents/174584/default/ [accessed 11 January 2023]

together whether interest rates rise or fall. Because this then reduced the expected long run return on assets relative to equity investments, leveraged LDI strategies retained a proportion of their investments in higher return equity assets and then borrowed money using the smaller gilt part of their portfolio as security to buy swaps and repos that still extended fixed interest rate cover across the whole portfolio.

This strategy meant that over a period of falling interest rates the pension fund assets benefitted from having a high sensitivity to interest rates. Real asset values rose, matching the higher accounting value of discounted liabilities, while the equity returns and ongoing contributions were able to accumulate to close the deficit. For this reason many claimed that leveraged LDI strategies had been successful in helping to reduce or eliminate pension fund deficits. However, this amounted to a one way bet on falling interest rates. In the real world when interest rates started to rise again last year the high sensitivity to interest rates worked the other way. Asset values fell while the future value of pension liabilities (the actual commitment to future pension payments) stayed the same, so LDI strategies meant that, while the accounting deficit was protected, pension funds actually lost real value. Furthermore, since in leveraged LDI strategies they had borrowed using the value of their gilts as security, the increased collateral requirements on swaps and repos as interest rates rose meant they were forced to sell longer dated gilts to meet the collateral cash requirements. Given how significant pension funds had become in the gilts market, that in turn further depressed gilt prices, increased yields and created a further spiral in rising rates until the Bank of England intervened. These forced sales of gilts at low prices were another real loss to the pension funds.

LDI investment strategies may have a benefit for schemes which have significant near-term pension payment commitments by locking in matching cash flow income and avoiding short-term asset volatility. However, for schemes with a longer-term horizon where the higher expected real returns on equities and other real assets would be a better match, the LDI schemes artificially encourage overinvestment in low-return gilts. And, as recent experience shows, while leveraged LDI schemes may deliver higher returns when interest rates fall, they not only further accentuate investment losses when rates rise but also run the risk of market instability and further losses from the collateral requirements.

The better solution would be to adopt accounting standards for parent companies and pension funds which reflect the expected long-run return on the actual asset portfolio, enabling pension funds to invest an appropriate share of their portfolio in equities and other real assets without increased volatility in the reported fund deficit, and avoiding the need for leveraged LDI strategies to boost their returns.

The use of LDI strategies caused the Bank of England intervention. If it were not for the use of leveraged LDI, then it is likely there would only have been some volatility and a market correction. The approaches of accounting standards, the regulator, and the widespread adoption of leveraged LDI has transformed pension schemes from being long-term institutions into ones focused mainly on short-term volatility in prices and interest rates.

The Government and the UK Endorsement Board should review the system of pensions accounting to see whether a less volatile, longer-term asset-led approach would be more appropriate for schemes that still have some time left to run.

2. **Underlying EU legislation, which does not permit the use of borrowing and derivatives for the purposes described above, appears to have been permissively transposed in a way that allows pension schemes to continue using such strategies.**

The Government should review whether the use of leverage and derivatives by pension schemes should be more tightly controlled in the future. If schemes are to continue to use leveraged LDI, there should be far stricter limits and reporting on the amount of leverage allowed in LDI funds and greater liquidity buffers introduced for leveraged exposures.

3. **Trustees and regulation of investment consultants**

We were told that it is possible that some pension scheme trustees were not aware of the potential implications of their LDI strategies and their decision-making struggled to match the pace of markets. This led them to become dependent on advice from investment consultants, whose advice to schemes is currently unregulated and may not be comprehensive over the whole portfolio or cover operational requirements.

The Government should ensure that investment consultants are brought within the regulatory perimeter as a matter of urgency.

4. **Regulators, systemic risks and leverage**

Despite calls for more information and a review of stress tests from the Financial Policy Committee, regulators in the sector appear to have been slow to recognise the systemic risks caused by the concentration of pension schemes' ownership of assets such as index-linked gilts, and the increasing use of more complex, bank-like strategies and instruments by pension funds.

Regulators should ensure they have more information on the leverage present within pension scheme finances and that stress tests are conducted. The more bank-like strategies and instruments that are used by pension schemes, the more bank-like its supervision should be, and the Government should consider giving the Prudential Regulation Authority a role in overseeing pension schemes.

Meanwhile, The Pensions Regulator should be given a statutory duty or ministerial direction to consider the impacts of the pensions sector on the wider financial system. The Financial Policy Committee should continue to take the lead on systemic risks to financial stability and should be given the power to direct action by regulators in the pensions sector if they fail to take sufficient action to address risks.

Accounting standards

Defined benefit (DB) pension schemes promise to pay their pension beneficiary a set amount in the future for life, often a sum that will rise in line with inflation. This is the actual value of pension funds' liabilities. Although it is impossible for pension funds to know exactly what the total cost of this will be, as it will vary based on inflation and how long a beneficiary lives, they are able to make an estimate of the present value of their liabilities. These net present values of estimates of liability are commonly just called liabilities. In order to meet their liabilities, pension funds invest in assets. The funding position of a scheme is how its current market

value of assets compares with the present value of its liabilities. It can be expressed as a ratio of the scheme's assets and liabilities (known as the funding level) or as the difference between the assets and liabilities (referred to as a surplus or deficit).[4]

As the Bank of England noted in its November 2018 *Financial Stability Report*, in recent times most UK DB pension funds have generally had estimated liabilities that exceed their assets, meaning that they were in deficit. The Bank argued that these liabilities are "exposed to interest rate and inflation risk", and that pension funds "could invest only in bonds to hedge this risk", as bond fixed cashflows line up with pension schemes' liabilities. However, the returns on bonds would not provide enough return to close pension schemes' deficits. Pension funds therefore also needed 'growth assets', such as equities. Using LDI strategies that employ leverage, a majority of DB pension funds aimed to hedge against interest rate and inflation risks while retaining their exposure to growth assets by using existing holdings of bonds as collateral to borrow cash, which is then invested in a variety of gilts, swaps and derivatives.[5]

The Committee heard from several stakeholders that the uptake of LDI strategies has been, in the words of Legal & General (L&G) CEO Sir Nigel Wilson, "accounting driven".[6] Changes to accounting standards in the late 1990s meant that pension fund deficits counted as part of the sponsoring company's balance sheets, meaning that corporate managements became more concerned about these deficits and the liabilities of their pension schemes. The value of these liabilities on corporate balance sheets appeared to "bloat and shrink" over time, not due to changes in longevity or other factors that are relevant to liabilities, but through the effect of changes in the interest rate used to estimate the present value of the liabilities. In the following years, it became "conventional wisdom" in the industry that liabilities should be hedged and framed around low risk market interest rates, rather than expected returns on assets, as had previously been the case. As a result balance sheet volatility increased, as a short-term fall in interest rates increased the discounted value of liabilities and increased the reported deficit, even though the actual future value of liabilities and assets might be unchanged. This led to a change in pension fund managers' investment objectives from "open-ended growth to clearly defined liabilities".[7]

We heard that the shift towards focusing on liabilities rather than assets has led DB pension funds to dramatically increase their investment in bonds and reduce their investment in equities, which are regarded as riskier, reducing the amount of capital that pension funds provide to invest in the growth of UK companies. Very little focus, if any, seems to have been given to the riskiness of the substantial use of borrowing, derivatives, or the operational resilience these require.

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[4] The Pensions Regulator, *Understanding the different ways of valuing a defined benefit (DB) scheme* (March 2021): https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/understanding-db- scheme-funding.ashx [accessed 11 January 2023]

[5] Bank of England, *Financial Stability Report, Issue No. 44* (November 2018): https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2018/november-2018.pdf [accessed 11 January 2023]

[6] Q 30

[7] 'A brief history of LDI', *Financial Times* (5 October 2022): available at https://www.ft.com/content/a86f410e-6a5d-467d-a1b2-cd6ab30ded0e [accessed 11 January 2023]

The Pensions Regulator told us that while the accounting rules fall outside its remit, "it is true that many sponsoring employers, in many cases, are happy for a pension scheme to move to more bonds to help protect it against the volatility of that accountancy number".[8] However, TPR Chief Executive Charles Counsell argued that there are many drivers of LDI use, including ensuring that savers get the full benefits promised to them by their employer and managing the expense and risk to the sponsoring employer.[9] The 100 Group Pensions Committee, representing the views of the Finance Directors of FTSE 100 and large UK private companies, argued against any regulation action that would discourage hedging, arguing that this "would lead to more risk and cost for schemes and their sponsoring employers.[10] Yet it is worth noting that only the sponsoring company is required to adhere to the accounting standards, and trustees do not have a responsibility towards the expense and risk of the sponsoring employer.

Critics of the use of LDI claim that it is entirely driven by the need to hedge against interest rate risk and thus volatility in estimates of the present value of liabilities over time. They argue that interest rate risk is only introduced by the accounting standards and the use of market-based discount rates, as interest rate risk does not apply to actual liabilities, which are only affected by the extent of the promised benefits, wage inflation, inflation and member longevity. They suggest that while LDI creates stability in how pension deficits are accounted for on corporate balance sheets and in conversations with the regulator, it involves taking on a large amount of risk through leverage and derivatives in order to address an issue of measurement. They also point out that although using leverage to maintain a high bond coverage while investing in equities reduces exposure to falling interest rates, it creates an increased real loss in asset values when interest rates rise.

However, others suggested that LDI is not just a response to a measurement issue, but a real issue in that companies now guarantee their pension schemes in a way that they did not historically. Consultants suggested that market-based discount rates reflect the nature of pension risks and the guaranteed nature of liabilities and argued that accounting standards have not been the driver of investment strategies, which are more concerned with levels of risk and funding regulations from TPR. As L&G Chair Sir John Kingman told us, "there is a very strong view in the accounting world that the current approach is the right way to value liabilities".[11] It is noted that insurance company liabilities for pension portfolios that they have taken over attract significantly lower liability estimates under insurance accounting standards, which use best estimate rather than 'prudent' methods.

TPR's Neil Bull stressed that a lot of schemes are closed and maturing, moving rapidly towards a situation where they have cashflows to mirror the assets that they hold, meaning that they move towards bonds as a lower risk position to match these cashflows. He argued that it is right for such schemes to look at a bond market rate of discount to measure their risk position, but emphasised that this does not mean that the scheme cannot invest in other ways, suggesting that schemes with a strong employer covenant may want to take more risk. He also argued that investing in riskier assets would put savers at risk if the fund was in a position where it was paying out to members. He stressed that many pension schemes are looking to

[8] Q 10
[9] Q 14
[10] Written evidence from The 100 Group Pensions Committee to the House of Commons Work and Pensions Committee's inquiry into Defined benefit pensions with Liability Driven Investments (LDI0062)
[11] Q 29

secure their liabilities with insurance companies through a buy-out, with buy-out pricing using an approach driven by bond yields and market rates. He clarified that some pension schemes, particularly those with longer term liabilities and stronger covenants, do use an asset-led discount rate, stressing that "that flexibility exists in the system" and will be reflected in TPR's scheme funding code. However, he emphasised that mature schemes use market rates of discount because they are looking at matching cash flows.[12]

Mr Bull said that LDI is also used in the US and the Netherlands, both of which "clearly have different regulatory regimes and different nuances to their liabilities" but are both "exposed to the risks of inflation and interest rates" due to the use of a market rate of discount. He noted his experience working in both regimes, arguing that using LDI was "a useful tool to help with that risk, hedging a degree of the interest rate and inflation exposure". Mr Rathi noted that one distinction with the Netherlands is that typically its pension funds will manage around 50 per cent of their interest rate risk through hedging, whereas the UK's pension funds have "typically been significantly higher than that".[13] Critics observe that in the Netherlands, pension scheme borrowing, including through the use of highly leveraged repos, is prohibited in line with EU legislation.

It is clear that the main driver of the increasing use of LDI, and particularly leveraged LDI, by DB pension schemes has been changes in accounting standards, which have introduced a sense of short-termism to what should be long-term investment strategies through the regular measurement of the present value of liabilities on company balance sheets. This has been exacerbated by the use of market-based discount rates, which have introduced an artificial volatility to liabilities which has led DB schemes to focus very heavily on investing in bonds. The low returns on these bonds have led schemes to introduce leverage to their investments to boost returns. The artificial volatility introduced by the accounting standards has become the dominant risk consideration and the risks in the compensating LDI strategy have been ignored or underestimated.

Pension schemes could have found a balance between growing assets and meeting liabilities by investing more of their funds in equities and other long-term real assets, rather than multiply leveraged borrowing to increase returns. This is not a typical or prudent situation for pension schemes to be in and would likely be a surprise to pension scheme members.

While using a market-based discount rate and investing closely in line with liabilities may make sense for mature schemes that are beginning to make payments, it is not obvious that it is a suitable approach for pension schemes, even DB pension schemes, that may have decades left in them. However, despite the fact that some DB schemes take an asset-driven approach with an asset-based discount rate, current accounting standards mean that this approach would cause volatility in pension schemes' funding ratios and on sponsoring employers' balance sheets. The Government and the UK Endorsement Board should review whether the current system of accounting for pension scheme finances in company accounts is appropriate and whether to introduce a system that does not drive short-termism in pensions investment. More schemes should be allowed to take

[12] QQ 4, 10, 15
[13] QQ 4-5

an asset-based approach if this is appropriate for them. If a change is deemed appropriate, the UK should adopt different accounting standards and promote their adoption internationally.

The impacts of LDI

Debates over the appropriateness and value of regularly measuring liabilities using market rates dominate assessments of the impact of LDI strategies. Proponents of LDI suggest that it has allowed funding ratios and deficits to be stable under current accounting rules, which is good for sponsoring companies and trustees. They suggest that LDI allows the matching of assets with liabilities and the use of leverage has allowed schemes to address the scale of their deficits during a period where returns on assets have been low due to quantitative easing and low interest rates. Mr Bull stressed that bonds are an ideal investment to match cash flows with liabilities.[14]

Mr Counsell told the Committee that the ability to use leverage to invest in growth assets has helped to mitigate the impacts on pension funds of low and falling long-term interest rates over the last 20 years.[15] He said that about 60% of DB schemes have invested in LDIs in one form or another. He said during the period of LDI's existence, funding levels have improved, rising from 83% in 2012 to 108% in 2021 on aggregate. However, he acknowledged that LDI is not the only thing that has contributed to increased funding.[16] Sir Nigel emphasised that LDI has delivered "really good outcomes", arguing that schemes are "probably in the best place they have been" in the last 20 to 25 years, with many finding themselves in surplus "after many years of being in deficit".[17]

The 100 Group Pensions Committee argued that leveraged LDI investment strategies have played an "important role" in "efficiently and appropriately managing key pension scheme risks". They argue that this "has resulted in a steady improvement in the financial position of most key schemes" and that without leveraged LDI in place funding deficits "would have been more volatile, and/or likely to have been significantly larger", placing greater contribution obligations on sponsoring companies.[18]

Critics of LDI argue that funding positions have improved because LDI put pension schemes in a position where as long as gilt yields were falling, the swaps involved would make profits. They suggest that this was speculation on interest rates remaining low, but that the reverse of this spiral was always possible and was triggered by the September 2022 fiscal statement. Others suggested that the leverage involved in LDI allowed pension funds to benefit doubly from the boom but questioned whether remaining in that position was the right thing to do at the end of a long boom market and with interest rates known to be rising. They suggested that while LDI had been successful during a period of low interest rates and resolved

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[14] Q 4

[15] Industry and Regulators Committee and Economic Affairs Committee, *Letter from The Pensions Regulator to the Chairs of the Economic Affairs Committee and Industry and Regulators Committee* (11 October 2022): https://committees.parliament.uk/publications/30302/documents/175300/default/ [accessed 11 January 2023]

[16] Q 1

[17] Q 18

[18] Written evidence from The 100 Group Pensions Committee to the House of Commons Work and Pensions Committee's inquiry into Defined benefit pensions with Liability Driven Investments (LDI0062)

accounting difficulties, it had caused real effects in markets, including driving index-linked gilt prices to very high levels and causing visible systemic concentration risks in gilt markets.

These disagreements extend to the effects of the recent market turbulence on pension fund finances. Proponents of LDI suggest that while pension funds hold less valuable assets after the turbulence, their liabilities are also at a lower level, emphasising that this is important for insurance buy-outs. Mr Counsell told us that there has been an improvement in the funding level of schemes in aggregate, so funding has risen, in effect.[19] Mr Bull argued that the point of UK scheme funding arrangements is to invest in a way that means assets and liabilities move in lockstep, suggesting that whether assets rise and fall is less relevant than whether the funding level of the scheme has changed.[20] Critics of LDI suggested that the volatility in the market-based measurement of liabilities means they are not useful in measuring the funding position of pension schemes, arguing that it cannot be beneficial that pension funds have lost assets.

Bank of England Governor Andrew Bailey has indicated that the Bank has made profits of "around £3.8 billion" on the gilts that it bought during its temporary intervention.[21] Given that LDI funds are likely to have been the owners of a large proportion of the gilts sold, it is probable that DB funds have lost out on much of this figure as a result of the turbulence. Others estimate that losses by pension funds are potentially significant and far exceed this amount, as other assets were sold by pension schemes in order to meet collateral calls.

Pension funds' concentration in the market for gilts, and particularly index-linked gilts, through their following LDI strategies, helped to trigger market instability following the September 2022 fiscal statement. As large numbers of DB pension funds and LDI funds were attempting to sell gilts at the same time, this led to a downward spiral in the prices of those gilts. The Bank of England argues that if it had not intervened, a large number of pooled LDI funds would have been left with negative asset value and faced shortfalls in the collateral posted to banking counterparties, with DB pension fund investments in those funds being worth zero. If the LDI funds defaulted, the large quantity of gilts held as collateral by the banks that had lent to these funds would then potentially be sold on the market. This would amplify the stresses on the financial system and further impair the gilt market, which would in turn have forced other institutions to sell assets to raise liquidity and add to self-reinforcing falls in asset prices. This would have further disrupted the functioning of the core gilt market, which in turn "may have led to an excessive and sudden tightening of financing conditions for the real economy".[22]

The increasing use of LDI, and particularly leveraged LDI, is claimed to have improved the funding levels of DB pension schemes, at least in the way they are usually measured. We have concerns that any such growth has been enabled by a large increase in leverage at a time of falling interest rates, meaning that pension funds have been borrowing to boost investment returns. The risks associated with

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[19] Q 5

[20] Q 4

[21] Oral evidence taken before the Treasury Select Committee, inquiry on Bank of England Financial Stability Reports, 16 January 2023 (Session 2022-23), Q 286 (Andrew Bailey)

[22] Treasury Select Committee, *Letter from Sir Jon Cunliffe, Bank of England, to Committee Chair on gilt market intervention* (5 October 2022): https://committees.parliament.uk/publications/30136/documents/174584/default/ [accessed 11 January 2023]

such operations did not appear to have been given due consideration, nor had gilt concentration risk both within schemes and systemically.

While this leverage may have worked well for pension schemes during a long period of low and falling interest rates, schemes' exposure to leverage put them at risk when interest rates rose, with schemes taking a one-way bet on interest rates remaining low. This effect was exacerbated by the fact that so much of the pensions industry was heavily invested in gilts, particularly index-linked gilts, meaning that when schemes were required to sell these assets to meet margin and collateral calls, their effects on the financial system were amplified and led to loops that endangered both pension funds and the Government's ability to sell its debt.

The use of borrowing and derivatives by pension schemes

The use of leverage and derivatives is key to considerations of the risks posed by LDI. In December 2019, TPR published a survey on DB pension scheme leverage and liquidity prepared by a research company, which found that 45% of all schemes had increased their use of leverage over the last five years, accounting for 58% of scheme assets. The notional principal of schemes' leveraged investments totalled £498.5 billion. The survey sets out that the level of leverage ranged from 1x to 7x..[23]

Critics of LDI suggest that LDI funds, and particularly pooled LDI funds which involve several small and medium-sized pension schemes, tend to be leveraged several times over, making them unstable and requiring only relatively small declines in price or yield to require high degrees of leverage to be unwound. Sir Nigel said that L&G had told its regulators that the gilt market was "a lot more fragile than we had ever seen, and relatively small amounts of volume were causing very large price movements".[24] However, as noted earlier, those more sympathetic to the use of LDI emphasise the benefits of leveraged LDI in helping to close pension scheme deficits, particularly in situations where schemes are heavily invested in bonds.

Critics also question the legality of what is effectively borrowing by pension schemes in their LDI strategies. They argue that the Occupational Pension Schemes (Investment) Regulations 2005 say explicitly that borrowing by pension schemes is illegal except in the short-term for liquidity purposes, and yet pension schemes have been borrowing using repurchase agreements (repo). Repos see organisations sell a security such as a gilt and agree immediately to repurchase it at a later date from the same dealer it was sold to, with the difference between the two prices being the short rate of interest. They argue that TPR has deemed that repo agreements are not borrowing but that most other organisations, including the Bank of England and the FCA, do see it as borrowing.

Similar concerns are held by critics in relation to the use of derivatives by pension schemes. Critics highlight that in the EU legislation which underpins the UK's current regime, derivatives are only permitted to be used by pension funds for investment purposes, which would mean

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[23] The Pensions Regulator/OMB Research, *DB Pension Scheme Leverage and Liquidity Survey* (December 2019): https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/db-pension-scheme-leverage-and-liquidity-survey.ashx [accessed 11 January 2023]

[24] Q 19

that hedging liabilities using derivatives would be illegal.[25] However, the UK regulations transposing the relevant EU legislation do not include this reference to investment, with some suggesting that this may have been done in order to allow the continued use of leveraged LDI.[26]

Mr Bull explained TPR's view that the use of LDI does not equate to borrowing money. He also outlined that the use of derivatives is "explicitly allowed" in the Regulations for efficient portfolio management and to reduce risks.[27] However, FCA Chief Executive Nikhil Rathi said that it is "clear that there was leverage and, effectively, borrowing going on in the system".[28]

Witnesses told the Committee that it was the extent of the September 2022 fiscal statement that was to blame for the market turbulence, rather than the use of LDI.[29] While the fiscal statement was the trigger for changes in gilt markets, we believe that the downward spiral was caused by the presence of leverage in LDI funds and subsequent collateral demands from lenders against a backdrop of rising inflation and interest rates.

We have heard from firms and regulators that the repo arrangements used in leveraged LDI funds are not technically borrowing and so are legal for pension schemes, which are prohibited from borrowing except for short-term liquidity purposes. This appears to be contrary to at least the spirit of UK and EU legislation in this area. The use of borrowing and derivatives by pension schemes, which transforms them from long-term, stable savings institutions into short-term, market-driven vehicles, is of great concern, and the UK's regime appears to be particularly permissive in this area. The Government should review the relevant regulations and consider whether the use of repos and derivatives, instruments more commonly used by investment banks than pension funds, should be more tightly controlled and supervised in future.

Regulatory oversight of systemic risks

The Bank of England, particularly its Financial Policy Committee (FPC), has oversight of overall UK financial stability, including overseeing risks relating to pension funds. This was noted in its November 2018 *Financial Stability Report*, which discussed the liquidity risks in non-banks caused by the use of leverage. The report suggested that fund managers running LDI programmes reported daily monitoring of the level of liquid assets held against potential calls on collateral arising from stress, but it was not clear whether pension funds paid sufficient attention themselves to liquidity risks. The Bank outlined that it would work with other domestic supervisors, including the FCA and TPR, to enhance monitoring of potential liquidity demands and losses generated by non-bank leverage.[30] However, while the Bank was aware

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[25] Directive 2003/41/EC of the European Parliament and of the Council on the activities and supervision of institutions for occupational retirement provision, Article 18(1)d
[26] The Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378)
[27] Q 13
[28] Q 13
[29] Q 18
[30] Bank of England, *Financial Stability Report, Issue No. 44* (November 2018): https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2018/november-2018.pdf [accessed 11 January 2023]

of these issues from a financial stability perspective, it has no power or influence over pension schemes, which are directly supervised by TPR.

TPR Chief Executive Charles Counsell told the Committee that TPR's role is to regulate trust-based DB and defined contribution (DC) pension schemes, focusing on governance, risk and ensuring that trustees comply with the relevant legislation.[31] Mr Rathi told the Committee that the FCA's focus is on DC pensions rather than DB pensions. In relation to LDI, specifically the FCA supervises investment managers who have been delegated investment management responsibility from funds in overseas jurisdictions, particularly Ireland and Luxembourg. The FCA also regulates bank counterparties in relation to their conduct in this area, as they help to provide leverage, while the Prudential Regulation Authority (PRA) looks at the solvency and liquidity of bank counterparties.[32]

The Telegraph reported in October 2022 that the Bank of England had "lashed out" at the FCA and TPR for having "failed to crack down on risky investment strategies that left retirement funds exposed to ructions in the bond market".[33] Mr Rathi pointed out that in the article, "there is a difference between the headline and what was said in the note of the Financial Policy Committee", which he sits on. He argued that the FPC talked about the "need for regulators to work together on increased standards in future".[34] [35]

We have heard criticisms of TPR that it has focused insufficiently on the overall systemic risks caused by pension fund investment strategies. Some evidence we heard suggested that TPR focuses narrowly on the funding positions of each pension scheme and does not seek to understand the consequences of encouraging pension schemes to invest in a very similar way. Others in the industry were not clear on what action had been taken following the FPC's warning in November 2018, arguing that the risk of a downward spiral had not been fully understood and managed. We also heard from industry witnesses that none of the regulators have the mandate, the powers and the information to cover pensions investment systemically, suggesting that a regulatory grip on investment strategy has not existed at any level.

Mr Counsell said that regulators collectively had looked for the degree to which pension schemes and LDI funds would be able to withstand shock increases in bond yields, typically to something like 100 basis points, whereas what happened was a "much greater" increase of about 150 basis points in less than three days. He argued that this was an "extraordinary shock" that was far beyond what was expected to be reasonably plausible. Mr Bull agreed that the speed of the rise in gilt yields was "outside the realms of plausibility" and followed an existing, slower increase. He suggested that if the increases had happened over months then schemes would have been able to deal with them, but the problem was that they occurred in "a matter of days".[36]

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[31] Q 1

[32] Q 1

[33] 'Bank lashes out at City regulators as borrowing costs surge', *The Telegraph* (12 October 2022): available at https://www.telegraph.co.uk/business/2022/10/12/economy-latest-pound-sterling-bailey-bank-england-ftse-100-bond/

[34] Q 1

[35] Bank of England, *Financial Policy Summary and Record – October 2022* (12 October 2022): https://www.bankofengland.co.uk/financial-policy-summary-and-record/2022/october-2022 [accessed 12 January 2023]

[36] Q 1

Mr Counsell emphasised that TPR surveyed pension schemes on the issue of leverage following the November 2018 *Financial Stability Report*, which found that schemes were well diversified and actively monitoring risks in relation to leverage and liquidity. He explained that TPR issued guidance in 2017 asking schemes to carry out stress tests but the regulator does not carry them out itself, suggesting that this could lead to burdens for schemes. Mr Rathi said that the FCA looked at how asset managers could cope with interest rate rises between March and September 2022 and 150 basis points "seemed fine". He argued that the system did not think about what would happen if something "very dramatic" and unprecedented happened, noting that some asset managers were subsequently requiring buffers of 300 or 400 basis points but that there is a judgement about how much cash to hold versus what is available to invest in other assets.[37]

Simon Walls, Director of Wholesale Sell-Side at the FCA, said that following the November 2018 *Financial Stability Report*, the FCA was involved in follow-up work including discussing with LDI managers the buffers they used, which at the time were around 100 basis points. He said that the regulator identified "idiosyncratic" operational issues and as rate expectations rose, it asked LDI funds whether this was being managed, finding that generally it was being managed well. He also stressed that the vulnerabilities during the market turbulence were the size and speed of market movements, explaining that LDI funds were generally "designed for calm times", with trustees having a week or two to provide money. He said that this "would generally be okay, but was proven wanting here".[38]

Mr Rathi said that all regulators have a responsibility to look at systemic risks, and while the FPC has an overview, the other regulators contribute to its discussions. He said that LDI risks were on the radar but did not receive the attention that other issues did, arguing that going forward, where regulators are dealing with fragile markets where 'black swan' events are happening every few months, it will be important to test whether risks that regulators have not thought of could crystallise.[39] Mr Walls said that the FCA expects companies to risk manage to "extreme but plausible events", but stressed that what this means has changed, highlighting that the FCA is continuing to monitor this issue on a regular and at least weekly basis and is looking for the next such event.[40]

Sir John said that L&G sees more overlap between regulators than underlap, suggesting that the issue was not that regulators were failing to work together effectively. Sir Nigel stressed that ultimately the Bank of England is the "ultimate decision-maker", with Sir John agreeing that in the end, "the central bank had to take the lead", because it has the balance sheet to provide support.[41] Sir Nigel agreed with the suggestion that the Prudential Regulation Authority (PRA) might have a bigger role to play in overseeing DB pensions, given its oversight of insurance and the increasing likelihood of pension funds being bought out by insurance.[42]

Sir Nigel said that L&G did not have a dialogue with any of its regulators that the scenario faced was one that the firm should be modelling in its stress testing. He suggested that the event "caught us all by surprise" and that the firm's stress testing had "never taken into

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[37] Q 1
[38] Q 3
[39] Q 2
[40] Q 6
[41] Q 26
[42] Q 27

account the degree of stress that was in the market".[43] Sir John suggested that if the UK had experienced a "large secular rise" in rates, as happened in the rest of the world, there would not have been as dramatic an incident, arguing that the issue was "the particular speed of what happened in the markets" and that none of the relevant stakeholders, including industry and the regulators, "believed that it was a plausible scenario that the Government would do something that would create such extraordinary instability in the market in two trading days".[44] Sir Nigel accepted that following recent unpredictable events, "we should be looking for more black swan events", which will result in a different type of stress testing and a need to think about the capital buffers in place.[45] However, Sir John emphasised that "there is no free lunch here", and that "the more protection there is in the system, the greater the cost will be to pension funds and their sponsors".[46]

Questions have also been raised about the amount of information regulators receive in relation to LDI exposures. We heard from industry that while TPR has an annual return process for all schemes to provide information, this is voluntary and not completed by many schemes, meaning that the regulator does not have information about levels of leverage, buffers and liquidity related to LDI. It was suggested that TPR could collect systemically important information in this way but it asks the wrong questions.

Mr Counsell told the Committee that TPR has not historically collected data on leverage, liquidity and buffers in LDI exposures systematically, and is "certainly considering" whether it needs to do so going forward. He argued that TPR has "pretty good intelligence" about what is going on across schemes through its discussions with supervisors and other means. However, he explained that TPR has been focused on improving the data it holds and collects from companies over the last couple of years and has consulted alongside the Pension Protection Fund (PPF) on being able to collect information on asset breakdowns in much more detail, with changes set to be implemented in 2023.[47]

Mr Walls said that when looking at the leverage of LDI funds, looking at buffers is probably better than looking at leverage, as this provides information on the sensitivity of the portfolio to moves and the number of basis points that can be handled. He said that the FCA has looked at this on a periodic basis, reviewing this with 90% of firms in the market. He said that during the market episode the FCA was reviewing this on a daily basis and by November it was doing so weekly. However, he said that this would not be the steady state level of oversight, as the FCA has thousands of funds and numerous other risks to look at, and their job is not to "second-guess the risk management of companies". Mr Rathi said that the FCA is getting information on leverage on an intense and frequent basis, leading leverage to be managed down "fairly materially" over the weeks following the episode. However, he stressed that there have been issues in the non-bank system more broadly with "not just the traditional visible leverage but synthetic and hidden leverage" which often "comes to light only after the event". He argued that the international community has to get "far better at least at tracking what is going on".[48] Sir Nigel said that L&G provides regulators with key information on systemic risks on a weekly basis.[49]

[43] Q 18
[44] Q 19
[45] Q 24
[46] Q 20
[47] QQ 2, 6
[48] Q 6
[49] Q 24

Mr Rathi argued that in banking, there is a stress test but also a resolution regime, so there is something in place if institutions fail. He argued that this needs to happen in the non-bank system, as that is where leverage has moved from the banking sector following post-financial crisis reforms. He argued that the question of how to cope with failures must be addressed, especially in an environment where government bond markets around the world are "much less liquid, particularly at the long end of the curve", meaning that previous assumptions about the ability to sell collateral "do not necessarily hold in the same way today".[50]

Mr Rathi also stressed that the difficulty of non-bank finance reform is that the sector is so interconnected and the UK is a "small part of the overall global pie". He explained that the FCA and the Bank of England have been working with international counterparts on non-bank finance, as lots of firms are supervised overseas, and they have been trying to secure international agreement for a cross-border strengthening of resilience through the Financial Stability Board (FSB) and the G20. But "that is hard going" and it is taking time to get the necessary agreement and execution.[51] He also explained that there were operational difficulties with some custodians being overwhelmed using manual procedures.[52]

While the Bank of England's Financial Policy Committee noted levels of leverage in pension schemes in its November 2018 Financial Stability Report, it is unclear that sufficient attention has been focused on these risks since that time. While The Pensions Regulator and the Financial Conduct Authority have been surveying firms on this issue in the intervening period, it is a concern that the regulators, and The Pensions Regulator in particular, have not had enough information on pension schemes' LDI exposures and liquidity buffers or their operational capabilities. The Pensions Regulator should require DB pension schemes to provide it with information on the levels of leverage and liquidity buffers present in their LDI funds, while the Financial Conduct Authority should ensure it is collecting sufficient information on systemic risks in the sector from investment managers.

We have heard from regulators and the industry that the recent market turbulence was a result of the speed of movements in financial markets, which could not have been foreseen. It should not be a surprise to financial regulators, firms or pension schemes that financial markets can move quickly and create unforeseen risks, especially where hidden pockets of leverage exist. It appears they have focused too much on static risks such as the funding levels and liquidity buffers of individual schemes and funds, rather than being aware of and ensuring the system is protected as much as possible against dynamic, systemic risks.

These systemic risks are more likely to be found in the pensions sector now that it is using more complex, bank-like strategies and instruments, including leverage and derivatives. The more bank-like a pension scheme's strategy is, the more bank-like its regulation and supervision should be, although it is noted that pension scheme supervision was designed not to be burdensome on small schemes. This suggests that there could be a role for the PRA in overseeing

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[50] Q 1
[51] QQ 3-4
[52] Q 1

pension schemes, particularly given the increasing likelihood of schemes being bought out by insurers, who are also overseen by the PRA. The Government should review whether the PRA should be given joint or direct supervisory responsibility of pension funds using bank-like strategies and instruments.

The shifting of leverage from the banking system to non-banks and the increasing number of unexpected, 'black swan' events means that regulators need to think about applying more elements of banking regulation to other areas, especially where they have the capacity to pose systemic risks to the financial system. Rather than providing guidance that pension funds should carry out stress tests, The Pensions Regulator should closely supervise stress testing by at least a sample of DB pension funds, or carry out its own stress test, to ensure it is on top of systemic risks in the sector. If TPR feels it is unable to do this, it should request that the FCA, the PRA or the Bank of England carry out this stress testing on its behalf. Similarly, the FCA should carry out much more stringent stress testing of leverage within investment managers where this has the potential to cause systemic risks.

The Financial Policy Committee should continue to take the lead on systemic financial stability risks, but it is a concern that little action beyond surveys appears to have been taken following the November 2018 Financial Stability Report. The Pensions Regulator and the Financial Conduct Authority need to follow up on the risks outlined by the FPC more actively in future. The FPC should have the power to direct action by the other regulators if they fail to do so. Substantial improvements in supervision are required throughout the chain of regulators involved in this area, including the FPC.

We recognise that it is difficult to oversee leverage within non-banks due to the international character of many of their operations. We welcome that the regulators are pushing for international agreements on managing leverage in non-banks and hope to see further progress in this area. Nevertheless the sources for the turmoil lay within strategies and regulation that are entirely in the control of the UK and can be independently addressed.

The role of The Pensions Regulator

The Pensions Regulator regulates occupational pensions, including DB pension schemes, in the UK. Its statutory objectives are:

- to protect the benefits of members of occupational pension schemes;
- to protect the benefits of members of personal pension schemes where direct payment arrangements are in place;
- to promote and to improve understanding of the good administration of work-based pension schemes;
- to reduce the risk of situations arising which may lead to compensation being payable from the PPF;

- to maximise employer compliance and employer duties and the employment safeguards introduced by the Pensions Act 2008;
- in relation to DB scheme funding, to minimise any adverse impact on the sustainable growth of an employer.[53]

In the Pension Schemes Act 2021, the powers of TPR were strengthened to improve its ability to protect DB scheme members' savings. The measures in the Act include: strengthening the existing criminal and civil sanctions regime by introducing three new criminal offences and a new power to issue civil penalties of up to £1 million; strengthening the regime for Contribution Notices, which allow TPR to recover losses caused to be DB pension scheme as a result of avoidance behaviours; requiring increased transparency around corporate transactions, including how any detriment to a DB pension scheme is to be mitigated; and extending TPR's information gathering powers, enabling it to enter a wider range of premises and requiring individuals to attend interviews. [54]

The Act also requires DB pension schemes to have a funding and investment strategy, and to submit a statement on this strategy to TPR. The Department for Work and Pensions recently consulted on the draft regulations that will enable this requirement.[55]

Critics of TPR suggest that it has strongly encouraged the use of LDI by pension funds, leading to a monoculture among pension schemes, particularly noting that the one area of the DB pensions landscape that is not regulated by TPR, the Local Government Pension Scheme, is barely involved with LDI. TPR Chief Executive Charles Counsell emphasised the benefits of LDI in his evidence to the Committee, particularly in bringing about an improvement in the funding levels of pension schemes and allowing schemes to hedge interest rates and inflation. He accepted that TPR had "absolutely encouraged the use of hedging strategies, and LDIs are a key part of that". However, he stressed that TPR "does not dictate to pension schemes what their investment strategies be", as these should be scheme-specific, dependent on the risks to scheme funding, and the strength of the underlying employer and the employer covenant.[56] Despite this, we heard that pressure to use LDI has come precisely during scheme-specific negotiations around sponsor strength.

Critics also argue that TPR focuses too much on the estimated present value of liabilities at market rates rather than the actual liabilities in the long term, suggesting that the only justification for this is TPR's statutory obligation to protect the PPF, which is also concerned with present value estimates. They also suggest that TPR should have been aware of the implications of funnelling large numbers of pension schemes in a similar direction, particularly if interest rates rose, and should have made the Bank of England aware of financial stability concerns.

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[53] The Pensions Regulator, *TPR Strategy: Pensions of the future* (10 March 2021): https://www.thepensionsregulator.gov.uk/en/document-library/corporate-information/corporate-plans/tpr-strategy-pensions-of-the-future#d75a38cf7db24a5c9d46f3ce5218dc83 [accessed 11 January 2023]
[54] Pension Schemes Act 2021
[55] Department for Work and Pensions, *Draft Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2023* (26 July 2022): https://www.gov.uk/government/consultations/draft-occupational-pension-schemes-funding-and-investment-strategy-and-amendment-regulations-2023 [accessed 11 January 2023]
[56] QQ 1, 4

Mr Counsell told us that TPR "typically" leaves engagement with the sponsoring company to trustees and only engages directly in particular scenarios, such as companies in difficulty and those experiencing takeovers, despite their important role as the ultimate guarantor of schemes.[57]

However, those more sympathetic to TPR accept that while the regulator encouraged the use of LDI, it did not force schemes to use it. They also argued that it is hard for TPR to look at large, systemic issues, given the thousands of schemes they are regulating, suggesting that it would be easier for the FCA to take a systemic view in overseeing the lower number of large asset managers who dominate provision of LDI funds.

Asked about TPR's statutory objectives, Mr Counsell said that the regulator has a clear understanding of the job given to it by Parliament, noting that the original objectives had been amended to require TPR to take into account the strength of the employer.[58]

It appears that even if The Pensions Regulator did not advise or direct funds to undertake LDI strategies explicitly, its regulatory framework has firmly pushed schemes in that direction, leading to a situation where almost the entire DB pensions system was investing in the same types of assets. The index-linked gilts market then became almost entirely dominated by DB pension funds, meaning that even small actions in the same direction by each pension fund could cause large swings in key markets for government debt, with leverage multiplying these effects. It appears that TPR was so focused on individual scheme finances and protecting sponsoring employers that it underestimated the potential systemic risks its actions were causing for the wider financial system. TPR should be given a statutory duty or ministerial direction that it must consider the impacts of pension funds' actions on the wider financial system and report to the Financial Policy Committee on potential systemic risks. TPR should also understand that trustees' responsibility is the viability of the pension scheme itself, rather than that of the sponsoring company.

Trustees and scheme governance

Trustees play a crucial role in the operation of pension schemes. The law requires that most occupational pension schemes in the UK are set up as trusts. A trust ensures that the pension scheme's assets are kept separate from those of the employer. A trustee is a person or company, acting separately from the employer, who holds assets in the trust for the beneficiaries of the scheme. Trustees are responsible for ensuring that the pension scheme is run properly and that members' benefits are secure, including by collecting contributions, investing assets and paying benefits. The law requires that trustees have knowledge and understanding of (among other things) the law relating to pensions and trusts, as well as the principles relating to the funding of pension schemes and the investment of scheme assets.[59]

[57] Q 1
[58] Q 14
[59] The Pensions Regulator, 'Trustee guidance': https://www.thepensionsregulator.gov.uk/en/document-library/scheme-management-detailed-guidance/governing-body-detailed-guidance/trustee-guidance [accessed 10 January 2023]

The law also obliges trustees to take advice. However, individual advisors do not necessarily cover the whole portfolio.

Concerns have been raised about whether trustees had the requisite expertise to know the potential implications of LDI, as well as the appropriateness of pension scheme governance. Mr Counsell said that there is "a question" around the governance within pension schemes, particularly small schemes. He said that there was an issue with the speed of decision-making during the episode, particularly with pooled funds. He stressed that this is not true across all schemes, but noted that many of his positive conversations were with larger schemes and with professional trustees operating across multiple schemes, questioning the degree to which trustees of small schemes were aware of what they were involved in. He expressed his preference to move to a point where all schemes have a professional trustee on their board but said that this is not currently practical as there are too many schemes and not enough professional trustees.

Mr Rathi said that there were "clearly gaps in competence" with some investors. He outlined the need to look at the structure of some LDI funds, particularly pooled funds, as some small schemes "do not have the financial acumen to know what they are buying", especially where derivatives have been overlaid. He said that schemes need to be able to move quickly when markets shift but some schemes had to wait ten days to move cash. Given the "staggeringly large moves in markets", he emphasised that this was "too slow", noting that there is now some "soul-searching" among asset managers as to whether leveraged LDI will be available in the way that it had previously been.

Mr Counsell said that concerns over the quality of governance of small schemes had led TPR to push for the consolidation of smaller schemes, due to the evidence that they are less likely to be well-run than large schemes. He explained that in the DC market there are master trusts, which are large, well-run schemes that are authorised by TPR. In the DB market, TPR has set up a framework for 'superfunds', which are vehicles into which individual DB schemes can consolidate to take advantages of scale, but he noted that this is currently done on a voluntary basis. He called for superfunds to be put on a statutory basis, noting that while putting such a framework in place is complex, there have been a number of discussions over the last two or three years about how it might work, including with the Government.

It is clear that not all pension scheme trustees had the financial acumen to fully understand the LDI strategies that they were signed up to and their potential ramifications. The governance of small pension schemes may be inadequate in the face of the speed of modern financial markets and the increasing use of bank-like instruments such as leverage and derivatives in the pensions space. We note TPR's work to establish superfunds.

Investment consultants

Under the Pensions Act 1995, pension scheme trustees "must obtain and consider proper advice on the question of whether the investment is satisfactory".[60] We heard that the role of investment consultants in DB pension schemes is poorly understood, meaning that they often sail under the radar of regulation despite the fact that they are often key to decision-

[60] Pensions Act 1995, section 36

making on schemes' investment strategies. Given the small size and limited professional capacity of many schemes, consultants often operate as an outsourced executive to schemes, yet are not regulated in relation to most of their role in the system. We heard from consultants that only a narrow piece of their work is currently regulated, relating to particular products and investment decisions. Critics of LDI suggested that investment consultants had played a key role in persuading pension schemes to adopt LDI strategies, sometimes in quite a forceful way. We also heard that consultants can benefit from the complexity of LDI strategies, which can generate higher fees.

FCA Chief Executive Nikhil Rathi said that the FCA has been clear since 2018 that investment consultants should be brought within its regulatory perimeter, but stressed that this was a matter for Government and Parliament to decide. He explained the FCA's belief that pension funds do not necessarily have the ability to compare the performance of consultants in terms of the quality of disclosures and how to assess fees. He also suggested that there is a "nagging concern" about conflicts of interest in the investment consultancy model, and the extent to which consultants have used their privileged position with schemes to steer them towards other services that consultancies provide. He said that consultants are a "core part of the chain" yet this activity is not subject to regulatory oversight. Asked why the FCA did not take a lead and start regulating consultants, Mr Rathi said that the FCA cannot act outside of its perimeter due to a lack of powers to gather information and questions over the appropriateness of spending money to regulate an activity that the regulator has not been asked to. TPR Chief Executive Charles Counsell noted that trustees are required to take advice from consultants and yet this advice is not regulated, agreeing that there needs to be more regulation of consultants. He said that where trustees do not know the right questions to ask, then there is a risk for them.[61]

However, Sir John said that while L&G's preference would be for consultants to be brought within the scope of regulation, that is "not particularly for reasons connected to this episode". He emphasised the importance of consultants as "important players in the system" with "serious responsibilities" and accepted that there are conflicts within the consultant model, but argued that the debate about regulating consultants has "nothing to do with this issue".[62]

Investment consultants play a key role in determining the investment strategies of pension schemes. Given the predominance of LDI in those strategies, it is clear that consultants helped to drive schemes towards adopting LDI. While some of the work of investment consultants is currently regulated, it is problematic that they are not fully regulated as part of the regulatory perimeter, especially in relation to their advice to schemes on their investment strategies, for which they should not be able to disclaim liability. The Government should ensure that investment consultants are brought within the regulatory perimeter as a matter of urgency. Once this is done, regulators must have heed to the non-professional nature of trustees in their regulation of consultants and ensure consultants are liable for their advice.

Solutions

[61] QQ 4, 9
[62] Q 28

Those more sympathetic to the use of LDI, including regulators and the industry, suggest that the issue is not the continuing use of LDI, instead calling for operational and governance changes to avoid such an episode occurring again. Mr Counsell said that immediately, work needs to focus on the degree to which there is sufficient collateral to respond to shocks, ensuring a stronger buffer against bond yield movements than before the episode. However, he stressed that the more capital that is put aside as collateral, the bigger the cost in terms of the ability of schemes to be fully funded by investing in growth assets, suggesting that there will always be risk and a balance to be found. He argued that TPR is trying to create a system that puts a fair amount of burden on the employer and creates the right level of returns to get to a place where schemes are fully funded. Mr Rathi said that higher leverage caps and higher liquidity buffers are "on the table" in regulatory discussions. He stressed that LDI funds are organised overseas and marketed in the UK, but noted that regulators need to think about whether there should be greater safeguards against leverage.

Mr Walls said that the there are lessons for asset managers around the consequences once the liquidity buffer is exhausted, arguing that there is a need to make the initial buffer big enough to deal with the subsequent consequences, even though this has a cost. He explained that each asset manager will have a range of funds with different buffers and that each of these buffers is likely to be higher now, at about 300 to 400 basis points, emphasising that lots of resilience has been built into the system through this episode, although this has costs and is not a steady state.

Mr Walls also argued that there is a need to make the knock-on consequences less severe when whatever buffer set is exhausted. He argued that there are "more obvious wins" on the operational side, such as reducing the time a manager of a pooled fund needs to call money in from trustees. He said that some managers have dealt with this better than others and some have introduced new arrangements, noting that there are "some fruitful ways" to manage funds' vulnerability to a sharp move.

Mr Counsell also suggested that the speed of decision-making by funds needs to be looked at, which is partly about governance but also the speed of decision-making by trustees and others in the system. Mr Walls said that there may be mechanisms that allow asset managers more discretion to access liquid assets outside of pooled funds. Mr Rathi said that some funds were not able to move quickly enough to provide capital to counterparties, which leads to thinking about whether the structure of these funds is right for the future, due to the inability to move assets that are outside the LDI mandate into the mandate to manage these risks. He also suggested that there needs to be a conversation about increasing insurance buyouts and professionalising the industry.

The *Financial Times* reported on 25 October that lawyers are attempting to redraft LDI contracts in order to be able to use assets other than cash as collateral for LDI exposures, in order to avoid having to sell off gilts to generate cash in a future stress scenario. Many current contracts state that LDI exposure collateral must be in the form of cash, and law firms told the FT that pension fund trustees are exploring the ability to use options other than cash, which in some cases would involve rewriting the underlying agreements.[63]

[63] 'Pension lawyers rewrite contracts to prevent another sell-off of gilts', *Financial Times* (25 October 2022): https://www.ft.com/content/5b99578b-bbc2-4b33-8b8a-b8575be52175 [accessed 11 January 2023]

Critics of LDI suggest that using assets as collateral and limiting leverage would not work and could see similar issues recur in future, noting issues with the use of assets as collateral during the financial crisis. They argue that stopping the use of derivatives is an option and might tackle some of the excesses on the leverage side, which is what prompted calls for cash and the sale of gilts but suggest that other assets could be used by schemes to replicate the effects of derivatives. They instead suggest the need to move to an alternative method of accounting for pension scheme finances that would eliminate the variability of market-based discount rates and would better reflect the true position of the pension scheme and sponsoring companies. They argue that this would recognise the fact that there is an employer covenant supporting pension schemes, suggesting that TPR has been looking at this issue from the wrong perspective, seeing pension scheme as being there to meet the employer's costs rather than the employer being there to support the scheme.

If schemes are to continue to use leveraged LDI, there should be far stricter limits and reporting on the amount of leverage allowed in LDI funds. The argument against this is that it might limit the benefits of LDI for growing pension schemes' assets, but if this is a concern, pension funds should invest more of their own funds in growth assets rather than using leverage and bonds. Changes to this effect should be included in the draft Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2023 and TPR's DB funding code.

Greater liquidity buffers should be introduced for any leveraged exposures to avoid collateral calls leading to cascading loops in markets. However, given the instability caused by even small price movements in the index-linked gilt market, buffers cannot be the only answer and must be accompanied by a reduction in leverage and in the concentration of ownership of certain types of bonds by DB pension funds.

Using assets other than cash as collateral has the potential to be risky due to the difficulties in valuing assets as collateral, particularly in stressed markets. LDI fund managers should not be given access to other assets within a pension scheme to pay collateral, as this would only open pension scheme finances up to even greater risks from leveraged LDI.

We would appreciate a response to our recommendations in writing by 7 March, and look forward to speaking with you on these important subjects further in March.

Yours sincerely,

Lord Hollick
Chair of the Industry and Regulators Committee