House of Commons

Work and Pensions Committee

Defined benefit pensions with Liability Driven Investments: Government Response to Committee's Seventh Report of Session 2022–23

First Special Report of Session 2023–24

Ordered by the House of Commons to be printed 15 November 2023

HC 259
Published on 20 November 2023
by authority of the House of Commons

Work and Pensions Committee

The Work and Pensions Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of the Department for Work and Pensions and its associated public bodies.

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The following were also members during this inquiry, Chris Stephens MP.

Powers

The Committee is one of the departmental select committees, the powers of which are set out in House of Commons Standing Orders, principally in SO No 152. These are available on the internet via www.parliament.uk.

Publication

Committee reports are published on the publications page of the Committee's website and in print by Order of the House.

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The current staff of the Committee are Henry Ayi-Hyde (Committee Operations Officer), Sarah Dixon (Committee Specialist), Oliver Florence (Senior Media and Communications Officer), Ed Hamill (Committee Operations Manager), Alexandra Ming (Committee Specialist), Danielle Nash (Clerk), Paul Owen (Second Clerk) and Djuna Thurley (Senior Committee Specialist).

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Report

The Work and Pensions Committee published its Seventh Report of Session 2022–23, *Defined benefit pensions with Liability Driven Investments* (HC 826) on 23 June 2023. The The Government Response was received, in the form of a letter from the then Minister for Pensions, Laura Trott MBE MP, on 10 November 2023 and is appended below.

Appendix: Government Response

We would like to thank the Committee for conducting such a thorough inquiry into defined benefit (DB) pensions with Liability Driven Investments (LDI), undertaken in response to the economic uncertainty experienced in the UK in September 2022.

As the report recognises, much work has already been done by policymakers in the Department for Work and Pensions (DWP) and His Majesty's Treasury (HMT), in partnership with regulators The Pensions Regulator (TPR) and the Financial Conduct Authority (FCA), to understand causes and take steps to build resilience for the future. This work continues, taking account of the evidence provided to the Committee and the recommendations made in their report.

The Government welcomes the Committee's report. The Government's response indicating the progress to date and proposals for future work to address each recommendation is set out below.

The LDI episode

Recommendation 1

According to TPR the majority of pension schemes emerged from 2022 with improved funding levels. However, external analysis raises questions as to how confident they can be about these improvements. There are concerns that some schemes had their funding levels negatively affected as a result of the events of September 2022. In addition, the aggregate value of scheme assets, according to the PPF, was £400 billion less at the end of 2022 than it was at the beginning. It is important to understand what the impact was and what led to these results so that the system can work better in the future.

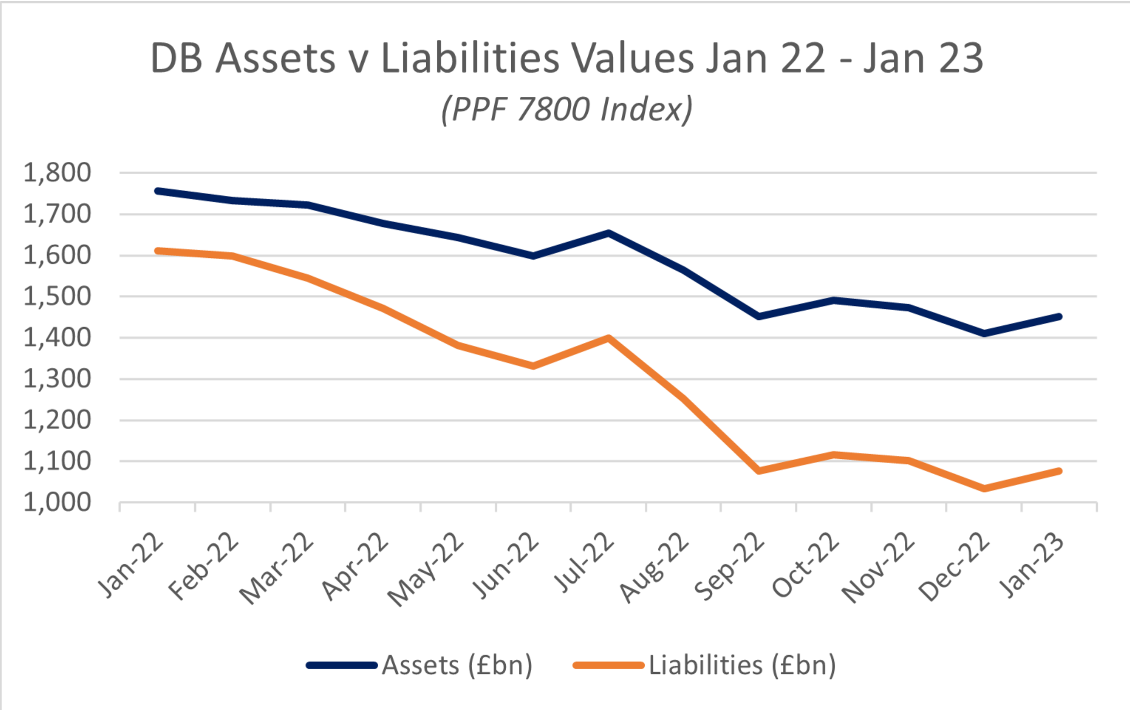
DWP should work with TPR and the PPF to produce, by the end of 2023, a detailed account of the impact on pension schemes of the LDI episode. This should:

i) *look at the impact on funding levels, detailing how the value of their assets and liabilities changed, showing the results disaggregated by whether the fund used LDI and, if so, whether in a pooled, segregated or bespoke arrangement; and*

ii) *include analysis of the factors which contributed to scheme funding improving or deteriorating, including the role played by LDI strategies.* (Paragraph 65)

DWP continues to work with TPR to understand the impact on pension schemes of the LDI episode.

Although DB schemes asset values fell by £400 billion at the end of 2022 relative to the start of the year, the impact cannot be credited solely to the LDI event in the Autumn. Asset values for DB schemes were in decline prior to September's events and declined throughout 2022 as shown below. This is in part due to rising inflation and interest rates causing a sustained fall in asset values including government bond prices. CPI rose by 10.5% in the 12 months to December 2022, which would have contributed to the fall in asset values across 2022.



TPR is conducting further analysis on scheme assets, liabilities and funding changes over 2022. This analysis will consider the key factors which contributed to scheme funding improving or deteriorating, including the role played by LDI strategies.

The Committee will be aware of the limitations of data collected by TPR on LDI prior to the events. During the events of last autumn, the FCA and BoE went to the most direct source of data available, which was the LDI funds themselves. Going forward, as discussed at the session, TPR, the FCA and the BoE will be using an enhanced version of this data set to monitor the resilience of the sector. TPR will be augmenting the existing data, with other sources to create a richer picture for the Committee. TPR are working to produce this report by the end of 2023.

The PPF use the latest annual scheme returns data provided by TPR when producing their Purple Book (annual publication of data and analysis of the UK DB pension landscape). As such PPF would not hold anything further that would usefully expand upon the data TPR currently hold.

Future use of LDI

Recommendation 2

Leverage may have worked relatively well for pension schemes during a long period of low and volatile interest rates. However, it exposed them to additional liquidity risk and requirements, as collateral demands can change over short periods when interest rates change. With the imposition of much higher capital buffers, the cost of LDI has risen. For schemes in deficit who use these strategies, this may mean it takes longer to reach their long-term objective. Trustee boards will continue to have complex decisions to make about whether and how to use LDI. The experience of September 2022 indicates some will face challenges doing so.

TPR should require trustees to report certain data on their use of LDI and should develop a strategy for engaging with schemes based on the results more closely. (Paragraph 81)

TPR will be using a range of sources to monitor adherence to their guidance on Using Leveraged Liability Driven Investment.[1]

Levels of buffer in operation will be monitored by TPR in collaboration with the Bank of England and FCA, as recommended by the Financial Policy Committee (FPC) Summary and Record of their 23 March 2023 meeting.[2] This data will be collected from LDI managers on a regular basis and covers pooled and segregated funds representing approximately 90% of the market.

TPR will be introducing new questions to the scheme return which trustees of DB schemes are required to make to them annually. This will improve TPR's oversight of asset liquidity outside LDI mandates, so TPR can have confidence that buffers can be replenished in a timely fashion in the event of severe market movements.

TPR will also be surveying investment consultants and schemes to check that governance and operational procedures are being implemented in line with TPR's guidance. Market feedback suggests significantly improved processes have been put in place, but such survey information will help TPR detect and follow up poor practice with individual schemes and their advisers.

Governance of LDI risks

Recommendation 3

TPR told us that scheme consolidation would help improve scheme governance, by reducing the number of small schemes. However, consolidation needs to be into a safe vehicle, which requires legislation. DWP consulted on DB consolidation in 2018 but has still not responded to this. Another long-standing question has been whether to require some form of qualification for at least some trustees.

As a first step to improving governance, DWP should respond to its consultation on DB consolidation (superfunds) no later than the end of October 2023. It should then work with

1 Using leveraged liability-driven investment | The Pensions Regulator
2 Record of the Financial Policy Committee meeting - 23 March 2023 (bankofengland.co.uk)

TPR as a priority to improve the regulation of trustees and standards of governance, as it has said it intends to do. Given the time it will take to consult on, legislate for, and implement measures to improve governance, DWP should consider whether the use of LDI could be restricted, for example, based on a test related to a trustee board's ability to understand and manage the risks involved. (Paragraph 99)

DWP published the Government response to the consultation on Consolidation of Defined Benefit Pension Schemes on 11 July 2023,[3] which was shortly followed by updated TPR guidance[4] for Superfunds.

DWP and HMT have undertaken a call for evidence on Pension trustee skills, capability and culture.[5] This call for evidence considered trustee skills and capability as well as the role of advice (including that of investment consultants). The aim was to improve DWP and HMT's understanding of these areas and potentially inform future policy.

TPR expects all schemes to have robust controls in place around the use of LDI, as outlined in their guidance on Using Leveraged Liability-Driven Investment. As set out in response to Recommendation 2, TPR plan to monitor adherence with the guidance using a range of sources. Data from the FCA on buffers alongside feedback from leading investment consultancies and LDI managers strongly indicate that operational governance has improved.

There is no direct means for TPR to restrict LDI use, as TPR does not set schemes investment strategies, including LDI structures. This is ultimately a decision for trustees and scheme sponsors. However, where TPR identifies failures of governance, it may take action, including, but not limited to, appointing an independent trustee, removing a trustee or taking other enforcement action.

Recommendation 4

We heard, including from the FCA itself, that in some cases investment consultants were giving standardised advice, rather than thinking through what was best for the individual pension fund. Given the complexity of the decisions trustees are required to make, this is a concern.

The Government should bring forward plans for investment consultants to be brought within the FCA's regulatory perimeter before the end of this Parliament. (Paragraph 105)

The Government welcomes the Committee's recommendation that investment consultants are brought within the FCA's regulatory perimeter. The DWP and HMT call for evidence on Pension trustee skills, capability and culture considers the role of advice and includes that of investment consultants. The aim is to improve DWP and HMT's understanding of these areas and inform future policy.

The Government will take the Committee's views into account – alongside the perspectives of the Competition and Markets Authority, the FCA, and the FPC – as it assesses its next steps.

3 https://www.gov.uk/government/consultations/defined-benefit-pension-scheme-consolidation/outcome/government-response-consolidation-of-defined-benefit-pension-schemes

4 Supporting innovation in DB superfunds to drive better saver outcomes (thepensionsregulator.gov.uk)

5 Pension trustee skills, capability and culture: a call for evidence - GOV.UK (www.gov.uk)

Recommendation 5

To play their part in monitoring LDI, trustees need timely and accurate information from LDI funds and advisers. We welcome the fact that the FCA issued guidance on this in April.

TPR should work with the FCA to review whether the guidance the FCA issued to LDI funds in April has been implemented effectively and is providing trustees with the simple mechanism for monitoring LDI that the FPC said was needed. (Paragraph 108)

TPR is collaborating closely with the FCA and the National Competent Authorities (NCAs) (the Central Bank of Ireland and the Commission de Surveillance du Secteur Financier of Luxemburg) to review whether that guidance issued to LDI managers (by the FCA) and pooled funds (by the NCAs) has been implemented effectively.

TPR's guidance seeks to align with that put out with by the FCA and NCAs, and sets clear expectation on trustees in terms of monitoring the resilience of their LDI arrangements. TPR and FCA are keeping their guidance under review and will amend it if further clarity is required and in light of best practice.

Managing systemic risk

Recommendation 6

TPR is working to become a more digitally enabled and data-led organisation but has a long way to go to achieve this. We support the Financial Policy Committee's recommendation that TPR should specify minimum levels of resilience for the LDI arrangements in which pension schemes may invest and work with other regulators to ensure these are maintained. TPR does not have the data to check whether its guidance is being followed.

DWP and TPR should report back to us by the end of October 2023 on how they plan to monitor whether LDI resilience is being maintained. They should also set out a timeline for TPR's commitment to become a more digitally enabled and data-led organisation, with plans to resource it. (Paragraph 124)

As set out in the response to recommendation 2 TPR will use a range of sources to monitor whether LDI resilience is being maintained – data on buffers collected by the FCA from LDI managers, data from trustees on liquidity levels, and data from trustees and investment consultants on governance mechanisms.

TPR is committed to becoming data-led and digitally enabled, so it can better spot and assess risk, identify and prevent harm, and provide even greater value for money to savers and pension schemes.

As set out in their Corporate Plan 2023 to 2024,[6] a priority for TPR this year is the development and embedding of their Data, Digital and Technology Directorate (DDaT). TPR is rapidly building their capability in this space, including through the recent recruitment of a new Director of Digital Services and a new Director of Data Services,

6 ttps://www.thepensionsregulator.gov.uk/en/document-library/corporate-information/corporate-plans/corporate-plan-2023–24

who bring with them significant experience from both the public and private sector. In May, TPR's Board approved the business case for the development of a number of new digital services for pension schemes, which will be delivered over the next three years.

TPR will set out their vision in a data and digital strategy by the end of the financial year. Key objectives for this strategy will include ensuring that they have timely and relevant data, and the automation of processes to drive greater efficiency and consistency.

Recommendation 7

In addition to putting in place mechanisms to provide real-time warning of reductions in LDI resilience, the Department for Work and Pensions and The Pensions Regulator should consult on whether introducing disclosure requirements on pension schemes relating the use of LDI through the annual report or investment statement, would help improve standards of governance. They should consult with stakeholders on the data it is appropriate to collect. We suggest that consideration is given to:

i) *The maximum leverage allowed in the LDI funds in which the scheme is invested; the type of LDI they invest in;*

ii) *Compliance with minimum resilience levels; and*

iii) *Data on the pension schemes' asset allocations, by growth and matching assets. If they conclude that requiring pensions schemes to report regularly on their use of LDI would place an undue burden on some schemes, TPR and DWP should explain the basis for allowing such schemes to continue to use leveraged LDI.* (Paragraph 127)

The law (section 35 of the Pensions Act 1995 and the Occupational Pension Schemes (Investment) Regulations 2005) requires trustees of a scheme with more than 100 members to prepare a statement of investment principles setting out their investment strategy, including the investment objectives and policies trustees adopt. This statement is reviewed at least every 3 years and after any significant change in investment policy.

As set out in the response to recommendations 2 and 5 TPR has a programme of work in place to collect data and monitor compliance with resilience standards. DWP will consider, in light of TPR's findings, whether changes to disclosure requirements are appropriate.

Recommendation 8

Given the extent of leverage and the concentration of DB investments, more should have been done to follow up on the risks identified in 2018 by the Bank of England. *Collecting better data on LDI is part of what is needed to improve management of systemic risks in future. It will also be essential that DWP and TPR work with other regulators and the Bank of England to analyse its implications. DWP and TPR should report back by the end of October 2023 on how they intend to ensure this happens.* (Paragraph 137)

As set out above in response to recommendation 2 the data TPR will be collecting data on LDI, including through a collaborative framework with the FCA and BoE to monitor leverage. This framework will be in place by the end of 2023.

DWP with HMT, TPR, BOE and FCA are working together to ensure that they are able to better manage financial systemic risks in pensions both now and in the future. Further details of this are set out in response to recommendation 9 below.

Recommendation 9

When the LDI episode arose, the Bank of England had to intervene to prevent financial instability. The regulatory framework was complex and fragmentary, and not fit for purpose when it came to managing systemic risks. The Financial Policy Committee recommended that TPR should have the remit to take into account financial stability considerations. Given the events of September 2022, we tend to agree, although it depends on what it means. One possible model would be for TPR to be a source of key information, able to proactively identify potential risks in the sector and then work with other regulators to analyse the implications.

DWP should report back to us by the end of January 2024 on how it proposes to take forward the FPC's recommendation that TPR be given a remit to take account of financial stability considerations and how it plans to ensure that TPR has the capacity and capability to deliver on this. (Paragraph 140)

TPR, the FCA and BoE all have a role to play in monitoring risks and feeding into the FPC's assessment of systemic risks to the UK financial system. The Government accepts the FPC's recommendation that TPR should incorporate financial stability considerations in its decision making and balance them with its objectives as a pensions regulator.

As suggested by the Committee, enabling TPR to be a source of key information through data collection is a sensible means of achieving this. Government wants TPR to be more connected within the financial stability ecosystem and bringing the added value of TPR's pensions expertise without duplicating capability held by other regulators. TPR is looking to set up protocols with the BoE to ensure, as a pensions regulator, they are working cohesively with the wider financial regulatory system. Collaborative working is already underway – in addition to monitoring LDI resilience as set out above, TPR and the FCA are also supporting the BoE with their System Wide Exploratory Scenario exercise.

As a direct result of the LDI episode, TPR is in the process of reviewing its approach to the capture, ownership, assessment and management of external risks. This includes expanding its work to consider not only risks to savers and their strategy, but also the risk that the operation of the pension system destabilises the financial system. TPR is currently researching non-LDI trends within pensions (and especially within the gilt and insurance markets) that might lead to concentration risk and have wider financial stability risk implications. TPR are in conjunction with DWP also exploring what additional skills and capabilities they may require to embed the consideration of financial stability in their work.

Recommendation 10

There are two fundamental concerns with the new funding regime. One is that the approach is not sufficient to allow open schemes to thrive. This is an issue to which we will return in our wider inquiry on defined benefit pension schemes. The second is that it will result in greater 'herding' in investment decisions.

In light of the FPC's recommendation for TPR to take account of financial stability, DWP and TPR should halt their existing plans for a new funding regime, at least until it has produced a full impact assessment for the proposals, including the impact on financial stability and on open DB schemes. (Paragraph 149)

DWP plan to lay the draft Occupational Pension Scheme (Funding and Investment Strategy and Amendment) Regulations 2023 before Parliament in due course and it will address this matter. A full impact assessment will accompany the draft Regulations. The Impact Assessment will consider the interactions of the Regulations with the wider macroeconomic environment. These issues will be monitored closely by the Secretary of State for the Department for Work and Pensions and through regular assessment of the data collected by the Office for National Statistics, the PPF and TPR, and DWP will publish a report at least every 5 years.