

Rt Hon Sir Stephen Timms MP
Chair
Work and Pensions Committee
House of Commons
London
SW1A 0A

1 March 2024

Dear Sir Stephen,

Impact on DB schemes after LDI episode

Thank you for your letter of 20 February 2024.

In your letter you have asked the following:

“Tables 5 and 6 provide estimates of liabilities on a buyout basis and on a low dependency funding basis. These tables appear to show that over the period December 2021 to December 2023, the relative cost of buy-out fell by £369 billion (50%); and low dependency by £229 billion (65%). It would be very helpful if you could explain such large shifts in both absolute and relative terms.”

In response, we set out below further explanation of the relative changes over the period 31 December 2021 to 31 December 2023. The results referred to, as set out in different sections of the report, can be summarised as follows:

	31 December 2021	31 December 2023	Change (%)	Change (£BNs)
Technical Provisions (£BNs)	1,734	1,192	-31%	-542
Buyout (£BNs)	2,294	1,383	-40%	-911
Low Dependency (£BNs)	2,036	1,265	-38%	-771
Buyout – TPs (£BNs)	560	191	-66%	-369
Low Dependency – TPs (£BNs)	302	73	-76%	-229
Buyout / TPs ratio	132%	116%	-16%	
Low Dependency / TPs ratio	117%	106%	-11%	

Summary

As you will be aware, pension scheme liabilities are estimates of the assets needed to be held now in order to pay all future benefits promised to members. For a typical pension scheme, it is expected that future benefit payments will be required for anywhere up to 75 to 100 years into the future. As such, rather than hold the nominal amount of all of these future benefit payments in full now, there is time for the current assets held by pension schemes to

grow with investment returns between now and the time when they are required to be paid out to members.

The liability basis can therefore be seen to reflect the expected investment strategy underlying the purpose for which the valuation is required. In particular:

- The buyout basis will typically reflect the assets held by insurance companies plus whatever premium insurance companies might apply for profits.
- The low dependency basis will represent an investment strategy for which the funding position of the scheme is resilient to movements in financial markets.
- The technical provisions basis will reflect the trustees' investment strategy both now and how that may change into the future.

Typically, for all of the above bases, it is assumed that either the current or future asset strategy will be based on investing in a high proportion of government gilts (or other suitable bond-type assets, including swaps), given these assets have very similar characteristics to the benefit payments needed for scheme members (which is why gilts are often labelled as a low risk-asset category when combined with their low default risk). Hence the return is usually based on the gilt yield. For all other asset classes, further adjustments are made to the discount rate to take account of the additional expected return. This is typically done by adding a premium above the gilt yield. Therefore, for all of the above valuation bases the investment returns used to calculate the liabilities are often linked to gilt yields, but with a different premium applying depending on the underlying investment strategy linked to the different valuation basis.

Higher gilt yields provide higher expected investment returns between now and when the benefits are due to be paid. Higher expected investment returns therefore reduce the assets schemes need to hold now i.e., they reduce the liability value. In other words, when gilt yields and the linked discount rates increase, liabilities typically decrease (and vice versa).

Whilst there are a variety of factors that impact on the movement in the calculation of the estimated liability measures over time, the two key factors over the period from 31 December 2021 to 31 December 2023, which have the greatest impact on our estimates are:

- The relative size of the liabilities, which has had the biggest impact on the differences in £ amounts between the three bases over time due to the large increase in gilt yields; and
- Changes in the premia applied to gilt yields for the different valuation bases changing over time. In particular, we made changes to the discount rate premium used for the calculation of technical provisions and to the premium used to estimate the cost of buyout. These changes impacted the relative differences in the value between the three bases.

We have provided further details below regarding these two factors.

Relative size of starting liabilities

All else being equal, given the same movement in interest rates the fall in liabilities in nominal amounts will be larger for the higher starting liabilities compared to the lower starting liabilities. Hence the differential between liabilities in £ amounts will reduce.

As both the buyout and low dependency liabilities had higher starting liabilities than the technical provisions liabilities, this means that the reduction for both buyout liabilities and low

dependency liabilities in £ amounts will be larger than the amount for technical provisions based on the same changes in gilt yields over the period.

This factor impact has the biggest impact on the nominal change in values.

Relative prudence between the different funding bases over time

We have modelled the “relative prudence” (or the differences between the discount rates) between the three different funding bases as changing over time, in line with our understanding of the DB pensions market.

In respect of the calculation of the technical provisions, as we set out in paragraph 72 of the report, we have adjusted the expected returns in excess of gilt yields (on return-seeking assets) between different valuation dates. In particular, we have modelled a lower return in excess of gilts in the discount rate assumption for the calculation of the technical provisions at 31 December 2023, compared to our calculation as at 31 December 2021. All else being equal, this means that the change in technical provisions is less pronounced than that of the other two bases over the period within the report.

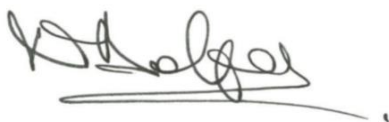
Furthermore, as we have set out in paragraph 75 of the report, our calculation of the buyout liabilities makes allowance for changes in buyout pricing over time. We can confirm that for our modelling, we have made allowance for a reduction in the relative cost of buyout premia over the period from 31 December 2021 to 31 December 2023. We would expect that the reduction in buyout liabilities will be greater than the change in the other bases over this time, due to both the increase in gilt yields but also the relative improvement in buyout prices.

The above factors affect the relative difference between the three bases over time.

The combination of the above changes in relative assumptions means that we expect to see the greatest fall in buyout liabilities, with the smallest fall seen in the technical provisions. This can be seen in the above table which shows that the measured change in the size of the liabilities is greatest for the buyout liabilities and smallest for the technical provisions.

If you require any further clarification in respect of the report and analysis, please do not hesitate to let me know.

Yours sincerely,



Nausicaa Delfas

Chief Executive
The Pensions Regulator



Work and Pensions Committee

20 February 2024

Nausicaa Delfas

Chief Executive
The Pensions Regulator
(By e-mail only)

Impact on DB Schemes following the LDI episode

Dear Nausicaa,

Thank you for sending us your review of the Impact on DB schemes following the LDI episode. I would be grateful for some further information to help us understand some of the estimates. Tables 5 and 6 provide estimates of liabilities on a buyout basis and on a low dependency funding basis. These tables appear to show that over the period December 2021 to December 2023, the relative cost of buy-out fell by £369 billion (50%); and low dependency by £229 billion (65%). It would be very helpful if you could explain such large shifts in both absolute and relative terms.

It would be helpful to have an answer by Friday 1 March.

As is usual practice with the Committee's correspondence, I will be publishing this letter and your response on the Committee's website.

Yours sincerely,

Rt Hon Sir Stephen Timms MP
Chair, Work and Pensions Committee