Written evidence from Eumaeus LDI0002

We write following the Committee's request for evidence on the lessons to be learned from the experience of the recent volatility in gilt yields on DB schemes with LDI strategies and their regulation and governance.

We are Dean Buckner, a former Bank of England valuation specialist, and Kevin Dowd, a professor of finance and economics at Durham University. We run a blog site, The Eumaeus Project, that offers commentary on financial regulatory matters and our is regularly cited in the financial press.

We respond to your questions (in italics) as follows.

- The impact on DB schemes of the rise in gilt yields in late September and early October;
We are concerned that the impact has yet to be assessed. We corresponded with the Pension Protection Fund early in November querying the data provided in the PPF 7800 Index, but received an answer that made little sense. For example, they were unable to say how whether the LDI hedging strategies reduced or increased changes in pension schemes' balance sheets. They said that the data they use to produce the Index is data that "contains some high-level information on how the assets of the scheme are invested. As we collect the data only annually and because it also needs to be audited, it will take some time for us to receive data that incorporates any material changes to asset allocation because of recent changes in gilt yields."

This response is a fat lot of use.

They added, worryingly, that adjusting the data for market movements *will be less accurate when large movements are observed*."

The Committee should make it a priority to ensure that data on the impact of the rise in gilt yields is correctly obtained, modelled and audited.

- The impact on pension savers, whether in DB or defined contribution pension arrangements;

We refer to our answer above. Without adequate data, it is difficult to assess the impact of LDI on DB pension savers (though DC savers should be unaffected). We are concerned by unconfirmed reports that some schemes have very high leverage, and resulting large losses.

- Given its responsibility for regulating workplace pensions, whether the Pensions Regulator has taken the right approach to regulating the use of LDI and had the right monitoring arrangements;

We cannot believe that the Pensions Regulator has taken the right approach to the use of LDI. It should have discouraged any form of leverage, for example. We are also alarmed by reports that the Regulator had even encouraged the use of LDI.

- Whether DB schemes had adequate governance arrangements in place. For example, did trustees sufficiently understand the risks involved?

No comment.

- Whether LDI is still essentially 'fit for purpose' for use by DB schemes. Are changes needed?

We have modelled various forms of LDI and we conclude that all forms of LDI involve a maturity transformation from fixed to floating rate risk, similar to using an interest rate swap. Thus pension schemes were turned into a form of bank, and thereby became part of the 'shadow banking system'. These changes are wholly unacceptable, and must be reversed.

- Does the experience suggest other policy or governance changes needed, for example to DB funding rules?

November 2022