Written evidence from Professor David Blake (LDI0053)

Dear Work and Pensions Committee

I have just listened to the panel session:https://parliamentlive.tv/event/index/ce2d2ff4-204c-4bb2-b34c-f6437f47a95d

I agree with some of the panel members that the only real problem with LDI was the excess leverage used by a sufficiently large number of funds that it created a systemic risk that the industry's two regulators (TPR and FCA) were not aware of - until the PRA and the Bank of England saw the effect of the collateral calls on the gilts market, following the mini-budget.

Apart from that, LDI has a very useful role in asset-liability management. And asset-liability management is as essential for pension funds as it is for banks and insurers – as explained in my book 'Pension Finance'.

I have four other observations:

First, the interest rate hedges that were in place (either in the form of repos or interest rate swaps) were designed to hedge against a **fall** interest rates. Any rise in interest rates will lead to collateral calls which is what happened in September after the mini-budget. But we have known for almost a year that interest rates were going to **rise** (either because of quantitative tightening or because of the increase in inflation resulting from the war in Ukraine). So these hedges were now inappropriate and should have been unwound or even reversed. Had they been reversed, then pension funds would have **received** collateral payments, not **paid** them. There was a very serious error of judgement by those advising pension scheme trustees. This issue was raised by Mr Mills. One of the second panel members in response said that any change of hedge would have been an attempt by the funds to engage in market timing which would have been equivalent to speculative risk taking, since it is possible that interest rates could have gone even lower – and the whole purpose of the hedging is to avoid risk. I have two comments: a) the removal or reversal of the hedge would not have been speculation in this case, since the Bank of England had announced a clear change in policy (quantitative tightening and higher rates due to inflation – the BoE first increased rates last December), and investment advisers should have taken this into account, and b) if the purpose of hedging is to **reduce** risk (as in the case of currency hedging which was mentioned), then leveraged LDI cannot be classified as hedging, since it clearly **increases** risk and should instead be classified as speculation. I pointed this out in a letter to the Financial Times on July 6 2022.

Second, there is much confusion over what pension liabilities are – and this has a lot to do with accounting rules (as was also mentioned). Pension liabilities are not volatile in the way some panel members suggested. They are projected future pension payments – and these did not change at all during the 'crisis' period (although will change over time as inflation and mortality assumptions change). The present value of the liabilities is a different matter – and there is much disagreement over how pension liabilities should be valued. A while back, I co-authored the report *An unreal number: How company pension accounting fosters an illusion of certainty*. It explains how pension accounting has evolved both to reflect changing views of the nature of the pension promise and to help fulfil the accounting objectives of stewardship and decision-usefulness. The report contends that the most useful information that accounts can provide about a defined benefit plan's funded status is the market, or fair, value of its assets and the amounts, timing and uncertainty of its projected pension payments. By reducing this information to a single number, pension accounting standards create an 'illusion of certainty' which supplementary cash flow projections and sensitivity analyses do not dispel. It was this 'single number' that in the case of the LDI crisis quite ironically

caused far too much short-term 'uncertainty'. Until the contents of this report are fully understood by industry and regulators and a better way of reporting liabilities is found, then we can expect similar problems to emerge in future.

The third observation follows from the second panel session which interviewed four actuaries. The observation relates to the complex and multi-disciplinary nature of pension funding. At least four groups of professionals are involved: actuaries, investment advisers, lawyers and accountants. They are experts in their own fields but have only a modest understanding of the other fields. To illustrate, the actuaries understand pension liabilities and know how to estimate them. But they do not have a deep understanding of investment markets or how investments work (as was clear from the responses of the panellists). In particular, they did not have a deep understanding of how repos work or the impact of leverage (certainly at a macro level) and pointed to the investment advisers as being the experts on this. The investment advisers (who recommended the repos and swaps – but were not interviewed by the Committee) would have pointed to the lawyers – who would have said that what the investment advisers were suggesting was fine if it satisfied the legal criteria of being a 'hedge' or was being used for 'efficient portfolio management'. The lawyers would have looked to the accountants for an acknowledgement that all this would pass muster on the financial statements. The accountants would have turned back to the actuaries with the question: 'pensions are your area, is all this okay?'. The actuaries would have replied: 'Well if you are all happy…'. No one would have looked at the systemic implications. And why should they, pension funds have never before in history been a cause of systemic financial risk – and none of these professional groups would ever have thought they could be? I would not describe this as trying to pass the buck – but it is an inevitable consequence of the complex and multi-disciplinary nature of pension funding. As one of the members of the first panel said: no one is losing sleep at night because everyone thinks someone else is staying awake and doing the worrying.

The fourth observation follows from the previous one. Just as there are multiple disciplines involved, so there are multiple regulators – TPR, FCA and now the PRA. And so the same issue of no overall oversight holds. Clearly, better coordination is needed – and that starts with better information. TPR did not collect adequate information on LDI and the amount of leverage – and that needs to change.

I hope you find this helpful.

At the end of the meeting, the Chair Stephen Timms said he would welcome any further contributions, so I would appreciate it if you would forward this email to the members of the Committee.

I would also appreciate it if you acknowledged receipt.

Yours sincerely

Professor David Blake
Director
Pensions Institute
Bayes Business School
106 Bunhill Row
London
EC1Y 8TZ

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