By Email
Sir Stephen Timms MP
Chair, Work and Pensions Select Committee

Date: 6 December 2023

Dear Sir Stephen,

Re: Thank you: 8 November

Thank you for your letter dated 21 November following the evidence we gave to the Committee. Barry, Sara and I were grateful for the opportunity to participate in the Committee's inquiry into defined benefit pension schemes and welcome your request for further information.

Below I have sought to answer each of the six requests for further information:

1. **The estimated annual costs of changes to FAS indexation, broken down by pre- and post-1997 benefits, including the costs for each of the next five years;**

The table below sets out the estimated annual cost of changing the pension increases on FAS assistance for the next five years for pre-97 assistance (capped at CPI 2.5%) and post-97 assistance (capped at CPI 5%). In addition to this, we've also included the estimated total for years 6-10.

Estimated annual costs of changing the pension increases on FAS assistance (£m)

Scenario	Year 1	Year 2	Year 3	Year 4	Year 5	Years 6 - 10
Pre-97 assistance at CPI max 2.5% p.a.	5.0	9.0	12.0	14.0	17.0	122.0
Post-97 assistance at CPI limited to 5% p.a.	0.7	0.8	0.9	1.1	1.3	8.9

2. **You told us in April that a minority of schemes may have seen their funding position deteriorate following the LDI episode of September 2022 and there are several reasons as to why this may have happened which wouldn't be captured in your estimate. We would**

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be grateful for further detail on work since April to understand the position better, the number of schemes that have seen their funding position deteriorate, by how much, and the extent to which different factors have contributed to that;

The data that we use in the annual Purple Book and monthly 7800 Index, which looks at the whole DB universe, is collected by TPR from scheme annual returns. Whilst TPR collect this data annually it is based on schemes' most recent s179[1] valuations and in many cases, as schemes are only required to complete a s179 valuation every three years[2], these will not be current.

For example, the latest data provided by TPR from schemes' annual returns includes valuations that have been updated since September 2022 for only 15 of our 5,051 scheme universe, as shown by the following table which is included in the Purple Book 2023:

S179 valuation dated between	Number of schemes
1 Oct 2022 and 31 March 2023	15
1 Apr 2022 and 30 Sep 2022	230
1 Apr 2021 and 31 Mar 2022	1,466
1 Apr 2020 and 31 Mar 2021	1,630
31 Mar 2005 and 31 Mar 2020	1,710
Total	5,051

It's important to note that, even when we obtain data for the other 5,036 pre-1 October 2022 schemes, it will not be possible to form a meaningful estimate of how much of the funding changes arise from the LDI market disruption. This is because there are many factors that affect the rolled-forward assets and liabilities when moving to a new dataset. Principal among these are:

- changes in asset allocations/investment strategies between old and new datasets, to the degree that different asset classes have performed differently over the periods under consideration;
- any asset outperformance/underperformance between section 179 valuations relative to the market indices that we use for our roll-forwards;
- the performance between valuations of any unfunded hedging arrangements that are not captured in schemes' disclosed asset allocations (for example interest-rate swaps);
- contributions made into schemes by both employers and employees between valuations;
- benefits paid out of schemes between valuations. Since pension retirement terms are not cost-neutral when measured on a section 179 basis, commutation, early or late retirement will cause a surplus/deficit to arise.

[1] The section 179 valuation (s179) valuation is set out in The Pensions Act 2004. It's designed to approximate the value an insurance company would need to be paid to take on a defined benefit (DB) pension scheme and pay its members benefits equivalent to those we provide.
[2] We experience a further lag in receiving this data as schemes have up to 15 months to submit their valuation after the valuation date and the results are only reflected in the following 31 March scheme return.

3. **How much of the £400bn loss in asset value as a result of the LDI episode you would expect to see restored if interest rates rose again, and an explanation of how this would happen?**

As set out above, the data we use when producing analysis of the whole DB universe is collected by TPR from scheme annual returns and is based on schemes' most recent s179 valuations. However, schemes are only required to complete these every three years. In the absence of more up to date data on schemes' asset allocation we aren't able to provide an answer with any meaningful precision.

However, regarding the mechanism by which a rise in rates would impact assets, it would actually be a reduction in interest rates that caused scheme assets to increase. For physical holdings such as fixed interest government bonds, the price is inversely related to the yield, so when the price of a bond rises the redemption yield will fall. For interest rate swaps, also commonly used to hedge interest rate risk, scheme trustees typically receive a fixed rate of return on a notional amount of "principal" and pay a floating rate that is linked to short-term interest rates. So if short-term interest rates fall, the pension scheme continues to receive a fixed rate from its counterparty to the swap, but pays out a lower rate, hence the present value of the arrangement will increase from the perspective of the pension scheme.

4. **In response to a question on why your estimate of the reduction in the value of DB assets over 2022 differs from that of the Office for National Statistics (ONS), you said the data was collected for different purposes—in your case, the potential impact on the PPF meant it was important to have information on funding levels across the PPF universe. We understand that your estimates are based on a roll-forward methodology using data from scheme returns to TPR, whereas those of the ONS are based on a direct survey of a smaller number of schemes. Is the divergence between the two figures in 2022 exceptional, or have there been significant divergences in previous years? In addition, to what extent would it improve your assessment of the potential risks to the PPF if your estimates were based on more recent data?;**

The divergence we've seen between the ONS survey and the 7800 index has been exceptional this year, however, it isn't overly surprising as the ONS sample post-dates the LDI market disruption, whereas our data source pre-dates it. We are clear in our 7800 index publications that we don't hold enough data to capture the structural changes to asset allocations, nor to capture changes to in any leveraged LDI portfolios (these factors have been particularly pronounced since March 2022) and, as a result, the impact on assets will often be less accurate than the ONS survey. As both measures use different methodologies[3] it is not possible to reconcile their outputs, and so, in the absence of more up-to-date scheme return data it is hard to know precisely what impact that would have on our view of wider scheme funding.

With regard to understanding the risk to the PPF balance sheet, where we consider that a scheme sponsor has an elevated risk of insolvency we will proactively engage with scheme trustees, so that we understand those situations on a case-by-case basis.

5. **You said that if schemes invested in assets whose value changed in the same way, then a scheme's ability to meet the payments was unaffected. How are you able to assess the extent to which schemes have effectively matched their assets and liabilities?; and**

[3] The ONS data is collected every three months from a sample of c.900 DB, DC and hybrid schemes,

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We use data on asset allocation provided to us by TPR from schemes' annual returns. However, as we note above, in many cases this data is not current. In addition, this data does not completely capture the impact of leveraged exposure, however, we understand that TPR plan to collect richer data on leveraged exposure in the future.

6. Your assessment of the negative impact on the Wilko scheme assets of the LDI episode.

We note the information provided by TPR, on the Wilko scheme's funding and assets, during the period Q2 2022 and Q2 2023, in their response to you dated 25 October. This showed that despite a c.£37 million fall in the assets held by the scheme over that period, the funding level experienced no significant variation due to a corresponding c.£44 million fall in liabilities.

The estimated funding ratio of the scheme, on both a buy-out basis[4] and a s179 basis, before and after the LDI market disruption, tells a similar story. The scheme's trustee provided the below information:

	Pre-LDI market disruption		**Post-LDI market disruption**	
	Buy-out basis[5] *as at 1 September 2022*	**s179 basis** *as at 5 April 2022*	**Buy-out basis** *as at 12 July 2023*	**s179 basis** *as at 1 May 2023*
Funding ratio	63%	80%	63%	87%
Deficit	£87.7m	£48.4m	£70.2m	£19.8m

The scheme's trustees have also confirmed to us that the scheme's hedging exposure, whereby the scheme's funding ratio was approximately fully hedged with respect to changes in interest rates and inflation using its LDI portfolio, was maintained throughout September 2022. Consequently, the scheme was protected from the 'snap back' in yields following intervention from the Bank of England. However, the scheme did face a substantial volume of collateral calls during this period, which resulted in it selling most of its more liquid growth assets. The scheme was subsequently advised that they were unable to maintain their existing hedge ratios based upon liquidity requirements at that point in time and with the risk of interest rates rising further, and decided to reduce their hedging ratios to 80% in October 2022.

I hope the Committee finds this information helpful and I would be happy to assist if you or colleagues have any further questions.

Yours sincerely,

Oliver Morley
Chief Executive

[4] As defined by Section 75 of the Pensions Act 1995.
[5] Note that this figure is based upon a roll forward from the 5 April 2020 triennial valuation.