NAPF

Securing the future of pensions

Pre-budget report 2009

Bcj Ya VYf &009

Submission by the National Association of Pension Funds

Executive Summary

1. The Government must use the PBR to announce that it will skew gilt issuance towards long-dated and index-linked gilts (ILGs). This single measure would benefit pension funds by helping to reduce deficits, and support corporate scheme sponsors by reducing the scale of pension fund liabilities on their corporate balance sheets. It is for this reason that NAPF pension fund members rank greater long and ILG issuance as the single most effective way Government can assist defined benefit provision.

2. Given low yields at the long-end of the curve, skewing issuance towards longer maturities will help to give the Government access to a cheap source of finance. We therefore believe such a step could help to accelerate the economic recovery.

3. There is a strong and on-going demand from pension schemes and insurance companies for long-dated and index-linked gilts in order that they may match their liabilities. Notwithstanding current poor yields, this will remain so for some time to come.

4. While Quantitative Easing is still in operation the Government has a golden opportunity to raise capital cheaply and, by issuing long and ILGs, to do so in an area where it is not in direct competition with the Bank of England.

5. We believe that skewing issuance towards the long end of the yield curve and ILGs will have little political or economic risk to the Government and have considerable social benefit as it would help to improve the retirement security of the millions of workers who depend on their employer's pension scheme.

About the NAPF

1. The NAPF is the voice of workplace pensions in the UK. Our members include 1,200 pension scheme members with combined assets of £800bn who provide benefits to 15m people. NAPF members also include 400 businesses providing essential services to the pensions sector.

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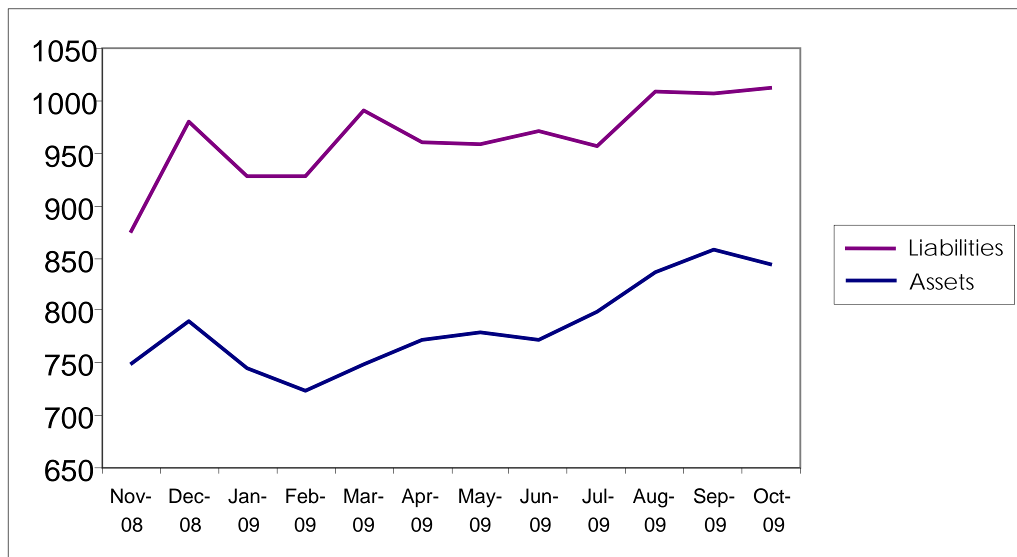
Pension funds and the recession

2. The financial crisis has placed pension funds under considerable strain. Falling markets have increased pension fund deficits. The recent recovery in asset values has done little to reduce scheme deficits as artificially reduced gilt yields arising from Quantitative Easing have lowered returns on their assets and increased scheme liabilities. Over the last 12 months alone, while aggregate pension scheme assets rose, according to PPF data, by 16.8% from their low of £723bn in February this year to £844bn in October, liabilities rose by 9.2% to £1,013bn, with the result that pension scheme deficits only narrowed from £205bn to £169bn. Over the twelve months to October, deficits widened from £124bn to £169bn.

Fig 1: Estimated s179 aggregate assets and liabilities Nov 08 - Oct 09 (£bn)



***Source**: PPF 7800 Data, November 2009*

3. In response to deteriorating economic conditions, increasing liabilities and escalating pension costs, many employers have re-examined their pension arrangements. The 2009 NAPF Annual Survey shows that just 23% of DB schemes in the private sector remain open to new employees, a 5 percentage point fall from the previous year – the sharpest fall since 2006; as many schemes closed last year as in the previous two years. The survey also shows that there is further significant change on the horizon: around a third of private sector DB schemes open to new accruals plan to close to existing members over the next five years.

4. DC schemes have been equally hit hard by the recession. Falling markets have reduced the values of scheme members' accounts whilst falling gilt yields have made annuities more expensive.

5. The NAPF recognises that the key to ensuring healthy and sustainable workplace pension schemes is a strong economy. We accept, therefore, that the recently announced £25bn extension to Quantitative Easing is a necessary step on the road to economic recovery. However, Quantitative Easing is a strong medicine which has seen artificially depressed gilt yields feed through to increased scheme liabilities (as liabilities are valued off gilt prices), placing further pressure on scheme sponsors and their company balance sheets. This has been all the more acutely felt as many schemes are undergoing valuations this year.

6. To help tackle the challenges posed by this difficult operating environment, pension funds need urgent Government action and support.

7. **That is why the NAPF is calling on Government to announce in its Pre-Budget Report that it will skew gilt issuance towards long-dated and ILG. This single measure would benefit pension funds by helping to reduce deficits; support corporate scheme sponsors by reducing the scale of pension fund liabilities on their corporate balance sheets; and give the Government access to a cheap source of finance. Ultimately, it will benefit the millions of working people saving in employer-supported pensions.**

The case for more long-dated and index-linked gilts

8. The NAPF welcomed the announcement in the 2009 Budget that the Government would be issuing more long-dated and index-linked gilts which reflected the record increase in gilt issuance across all maturities. However, overall proportions of long-dated and ILGs remained the same as in previous years, as Table 1 shows. We were disappointed that the 2009-2010 gilt issuance remit did not skew issuance more towards the long end and ILGs. This was a wasted opportunity and one that should not be repeated.

Table 1: Gilt issuance 2008/9 and 2009/10

	2008/9 out turn		2009/10 remit	
	£bn	% total issuance	£bn	% total issuance
Short	62.8	43	74	34
Medium	33.4	23	70	32
Long	30.3	21	46	21
Index-linked	21.0	14	30	14
Total	147.5	100	220	100

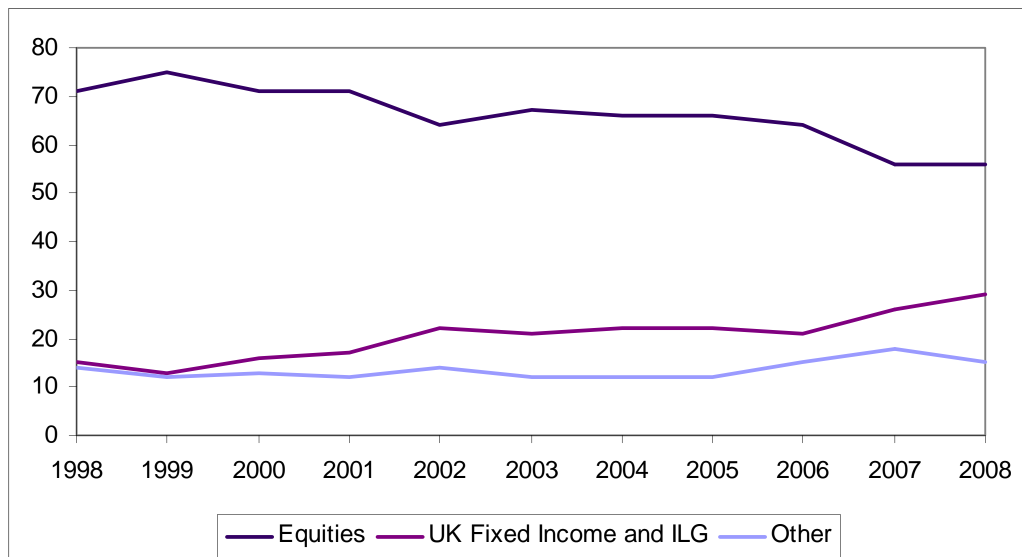
Source: *HM Treasury, Budget 2009 Report*

Benefits for pension funds

9. Pension funds are significant investors in gilts. According to Office for National Statistics figures, self-administered pension schemes' gilt holdings were £113.6bn at end-2007, around 22% of total issuance. In addition, pension schemes accounted for a significant proportion of insurance companies' gilt holdings of £158.7bn through their purchases of insurance company products. Their demand is very much concentrated on long-dated and index-linked gilts, which together account for 80% of their gilt holdings[1].

10. Indeed, over the last ten years, pension funds' have shifted their assets away from equities towards gilts. The average pension scheme's holdings of fixed income and ILGs have almost doubled over that period, rising from 15% in 1998 to 29% in 2008, a rise almost exactly matched by the fall in equity investment[2].

Fig 2: Asset allocation – average UK pension fund



Source: *UBS Pension Fund Indicators 2009*

11. This demand will remain strong for years to come, not least because the regulatory environment requires pension funds to be buyers of gilts:

   - Pension scheme liabilities are, by their very nature, long-term with an average duration of 20-25 years. They need assets of the right duration to match these liabilities and, while the specific mix of assets required is not specified in law, The Pension Regulator expects trustees and sponsors to make a 'prudent' choice of assets to meet their scheme funding obligations required under the 2004 Pensions Act.

[1] Long-dated gilts are gilts with 15 or more years to maturity.
[2] UBS Global Asset Management *Pension Fund Indicators 2009*, page 70, Figure B2.

- As corporate accounting requires companies to use current market values for pension scheme assets and to quantify their liabilities by reference to the return on AA rated corporate bonds, if they do not invest in corporate or government bonds of a similar duration and nature to their pension liabilities, they are faced with unacceptably high levels of volatility in their corporate accounts.

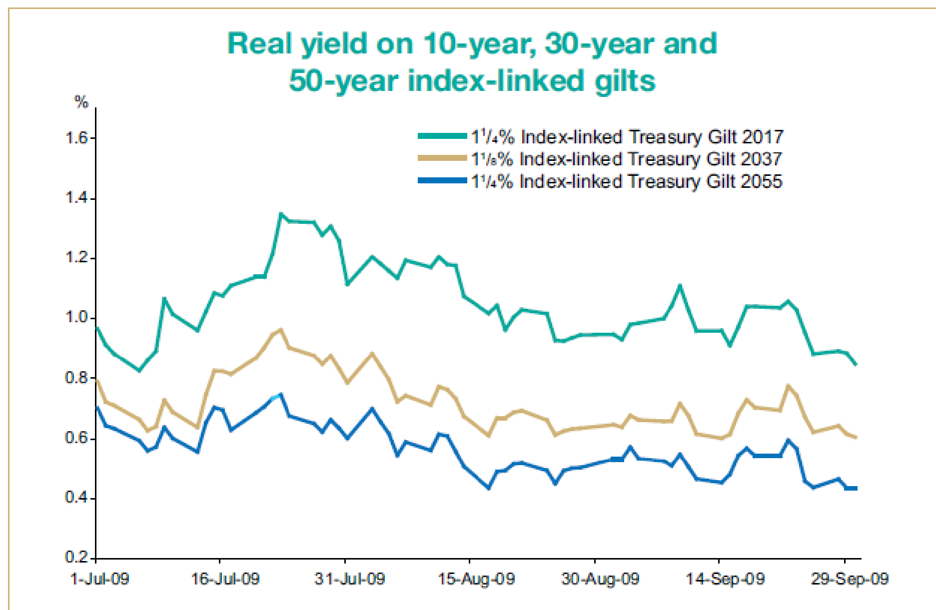
- The closure of DB schemes to new entrants, and increasingly future accruals, has had the effect of hardening their liabilities, further increasing their demand for gilts.

- The demand for gilts is not exclusive to DB schemes. DC schemes (and their providers) also have a strong and increasing demand for long-dated and indexed-linked gilts. This demand arises in two ways: first, from lifestyling investments – the default investment option for the majority of schemes and savers – which switch savers out of more risky assets into safer assets (bonds and cash) as they approach retirement; second, bonds are used to back annuities, for which the market will grow rapidly over the coming years as DC schemes mature. Greater issuance at the long end would reduce annuity prices, so lifting more pensioners out of means testing at retirement as their pension pots would provide a greater income.

12. Pension funds therefore have a strong and on-going demand for long-dated and ILGs and as such are natural and willing buyers of such assets. The Government has itself recognised this. Announcing the 2009 remit the then Economic Secretary to the Treasury Ian Pearson said: *"Our annual consultation held in January 2009 with dealers and investors showed continued high demand for gilts of all maturities and particularly for long maturity and index-linked gilts…"*

13. Further evidence of the strong demand for gilts of this nature and maturity can be seen in the shape of the UK yield curve for long-dated and ILGs. Until mid-2008, the UK was almost unique among developed countries in having had an inverted yield curve over the previous decade and even now, after Quantitative Easing artificially depressed short-term rates, the yield curve remains flat after 15 years. We would not be surprised to see the re-establishment of an inverted yield curve after Quantitative Easing has come to an end. Real yields on index-linked gilts remain inverted, as can be seen from Figure 3, which shows the real yields of three index-linked gilts of different maturities over the past quarter. The longest of the three, the 2055 index-linked, yielded just over 0.3% real on 17 November 2009. Real yields on index-linked gilts are considerably lower in the UK than in other countries, particularly at the long end. We believe this is clear evidence of a shortage of supply at the long end and that more long-term issuance can be easily absorbed.

Fig 3: Real yield on 10-year, 30-year and 50 year index-linked gilts



Source: *DMO Quarterly Review, July-September 2009*

14. The benefits to pension funds of issuing more IL/long gilts are considerable. As explained in paragraph 11 above, it would provide a greater supply of a strategic asset to match their liabilities and to de-risk at an affordable price. At a time when scheme sponsors are re-examining their pension arrangements, this is likely to be an important factor in companies' decisions to retain their schemes for new and/ or existing employees.

15. The financial benefits would be considerable. A greater supply of long and index-linked gilts will, over time, cause yields to rise. Our work with pension funds suggests that a 1 percentage point (100 basis points) rise in yields (which would lead to an increase of around 12% in their allocation to gilts) could reduce pension schemes' reported accounting liabilities by 30% for a young scheme; 25% for a medium scheme; and 15% for a mature scheme. Even higher yields would represent extremely good value for money for government.

16. It is not surprising, therefore, that pension funds see greater issuance of such long and index-linked gilts as being the most effective way Government can assist defined benefit schemes. The 2009 NAPF Annual Survey asked members for their assessment of the effectiveness of a range of government-backed measures aimed at helping pension funds. Topping the list was gilt issuance with more than eight in ten (82%) saying this would be either very or quite helpful.

17. When we discussed gilt issuance with DMO and HM Treasury earlier this year, both accepted our case for skewing issuance to maturities and types that would help pension funds. However, a major concern was the risk that auctions at the long end could remain uncovered, and that this would have damaging economic

effects, in particular for Sterling. That has not, though, proved to be the case in practice. DMO auctions and syndications of ILGs and long-dated gilts have been well covered or over-subscribed, with the four successful syndications of long-term conventional and index-linked gilts in particular showing the strong demand for such gilts. Given the current funding pressures on pension funds and their sponsors, there is no reason to expect this will not continue to be the case.

Benefits to employers

18. It is not just pension funds that will benefit from a greater supply of long and ILGs. Their corporate sponsors will benefit also. The resulting reduction in pension scheme liabilities arising from a greater supply of appropriate gilts will reduce the pension funding strain on pension schemes and, as described elsewhere, reduce the liability and volatility on corporate balance sheets. A greater supply of long and ILGs would also provide greater opportunities for schemes to mitigate their risks at an acceptable cost, for example through buy-outs.

19. Companies would have access to short and medium term debt with less 'crowding out' by government borrowing. Many companies seeking to recapitalise over the next few years will seek to do so by issuing corporate bonds. It is essential that they have the space in the market to operate.

20. Moreover, the resulting reduction in deficit levels would free corporate sponsors to direct their capital and profits into investment rather than pensions, which would itself feed back into economic growth.

Benefits to Government

21. As noted already in this submission, demand for gilts from pension funds and insurers is, and will remain, strong. But notwithstanding early signs of economic recovery and a predicted emergence from recession at the start of 2010, so too will the Government's need to supply gilts to the market in considerable quantities. The Bank of England has indicated that it is likely to draw its Quantitative Easing programme to a close in the near future. We believe that whilst Quantitative Easing is still in operation, the Government has a golden opportunity to raise capital cheaply and, by issuing long and ILGs, to do so in an area where it is not in competition with the Bank of England. As the Bank's foot comes off the Quantitative Easing accelerator, it will be necessary for Government to have buyers to step into the market as the Bank moves out.

22. As companies find themselves under less pressure to put additional funds into their pension schemes, the Government's tax take is likely to be boosted by improved corporate profitability. Every pound that goes from a corporate sponsor into a pension is tax free; alternatively that money is potentially profit for that company which could raise 28p for the government in corporation tax. Reduced scheme

deficits would also reduce pressure on the Pension Protection Fund and enhance confidence in its ability to operate without a crippling rise in levies or government support.