



# Quantitative Easing: the pension scheme perspective

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### Introduction

Over recent months the NAPF has been monitoring the impact of economic developments on UK pension schemes. The announcement by the Monetary Policy Committee on 6<sup>th</sup> October 2011 that it would launch another round of Quantitative Easing (QE) over the coming months has thrown these issues into even more stark relief. This paper broadly summarises the issues and outlines:

- the NAPF's approach to QE;
- the potential impacts of another round of QE on scheme assets, liabilities and deficits; and,
- the specific impacts on (i) defined benefit and (ii) defined contribution pension schemes.

### The NAPF's approach to Quantitative Easing

A strong economy is a prerequisite for strong pension provision. So the NAPF's prime concern in the current debate about QE is to secure the economic recovery and to promote sustainable growth in the long term. We recognise that the current monetary policy prescription of low interest rates and QE is needed if we are to achieve those objectives.

However, policy-makers should recognise that it represents strong medicine for savers and pensions funds. The short-term consequences for pension funds can pose real difficulties for sponsors and trustees when reviewing the funding position of DB schemes and can result in falling income for those for members of DC schemes affected by low or negative investment returns and falling annuity rates.

This paper sets out the NAPF's initial qualitative and quantitative analysis of the potential impact of QE on UK pension schemes.

### The impact of QE on assets and liabilities

From a pension scheme perspective, QE will mainly impact on defined benefit schemes through the changing valuation of assets and liabilities. In broad terms, QE can be expected to have the following consequences for pension schemes:

- it will push up the price of gilts, which increases asset values for those with gilt holdings, but means lower returns on pension funds' new investments in gilts (due to downwards pressure on gilt yields) and on other investments more generally;
- it will increase liabilities (for DB schemes), since QE holds down gilt yields and interest rates and, therefore, the discount rates that are used by actuaries in liabilities calculations; and
- it will increase deficits (again, for DB schemes), because of the disproportionate negative impact on liabilities compared to the positive impact on assets, resulting in more challenging recovery plans and employers having to make increased contributions to their company pension schemes, increasing the risks of scheme closure. Estimates of funding sensitivities are taken from the Purple Book 2010, which suggests a 0.1% reduction in gilt yields raises scheme liabilities by 2% and raises scheme assets by 0.4%, so a five fold greater impact on liabilities than assets.

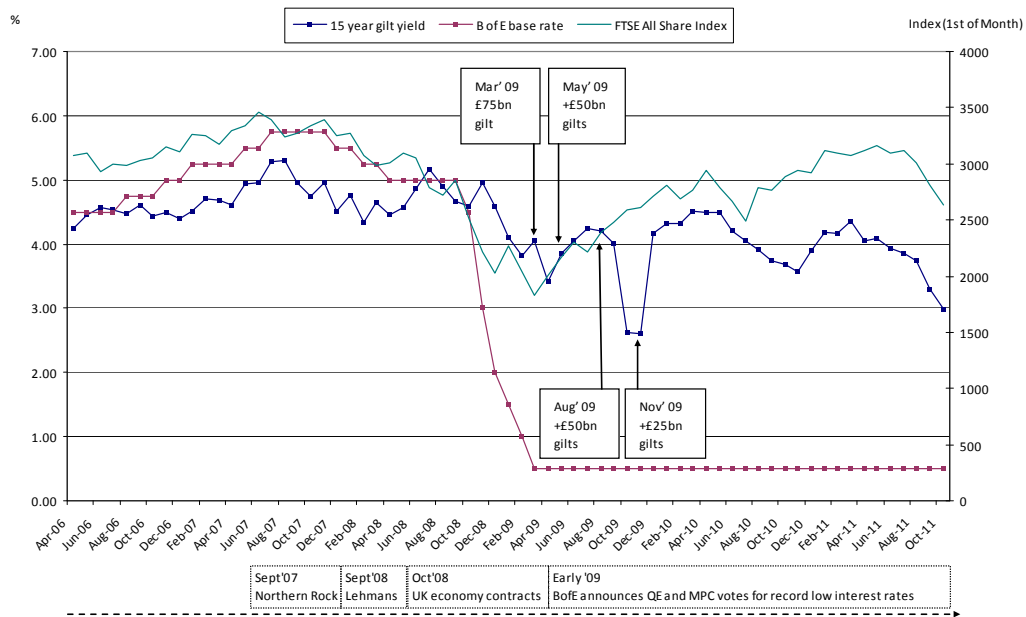
Of course, over the long term, the aim of QE is to boost the economy leading to strengthening financial markets and increases in asset returns over the longer term. However, the impact of QE, and the timing of that impact, is highly uncertain. In the short term, the predominant impact is likely to be on the upward revision of scheme liabilities whilst equity prices and interest rates remain low.

**The first round of QE and current gilt yields**

Chart 1 below highlights the significant impact on the financial markets of the first round of QE in 2009. It shows that current gilt yields are already close to the lowest point reached during the initial round of QE due to prevailing market conditions. A further £75 billion round of QE could be expected to depress yields even further, to unprecedented low levels, with real yields on index-linked gilts of up to 15 years already negative.

Most significant in the chart when considering the impact on pension schemes is the volatility in gilt yields observed in the immediate aftermath of the first rounds of QE (from Mar '09 to Nov '09) and the subsequent rallying of equity markets.

**Chart 1 – Timeline of movements in gilt yields, interest rates, and the FTSE index (2006-2011)**



**The impact of QE on defined benefit (DB) pension schemes**

The Pension Corporation has estimated that the first round of Quantitative Easing (involving £200 billion of gilt purchases) increased pension deficits by £74 billion after netting off equity gains - equivalent to £7.4 billion additional annual payments into pension funds by employers (assuming ten-year recovery programmes and no impact on asset prices).

The impact of a further round of QE on scheme assets, liabilities, and deficits is difficult to predict in advance. In theory, the increase in liabilities (due to lower discount rates) should be accompanied by

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an increase in asset values (due to higher gilt prices for those with holdings of gilts, and due to the knock-on impact on equity prices if QE is effective). However, the impact of QE on asset prices, and equity prices in particular, is not a precise science, and in the short term the impact of falling gilt yields on liabilities is disproportionate so in the short term funding deficits are likely to grow. Currently around 10% of UK pension assets are held in gilts, representing around £100bn of UK gilts, and liabilities are valued using discount rates that are closely linked to gilt yields.

- Applying the ready-reckoners used in the Purple Book and the asset and liabilities figures from the September PPF 7800 index calculations suggests that a 0.25% fall in gilt yields could generate an increase in DB pension scheme deficits of around £45 billion.<sup>1</sup> These figures are sensitive to the assumptions used so should be taken as an indication of the potential impact on pension scheme deficits.
- Other estimates have suggested figures of similar magnitudes, for example Hymans Robertson estimate that a 0.25% fall in gilt yields adds around £25 billion to the liabilities of the FTSE 350 pension funds<sup>2</sup>.

Whilst avoiding buying very long dated gilts and index linked gilts should lessen the impact on pension fund liabilities and deficits it is clear that even a modest reduction in gilt yields, compared to the falls observed after the first round of QE, will have a significant knock on effect on schemes' funding positions.

### ***Consequences of QE for Pension Protection Fund (PPF) levy and pension funds' risk profile***

One of the key features of QE is that the Bank of England will buy gilts from pension funds, thereby incentivising pension funds to shift into asset classes that carry more risk.

Low returns on gilts have traditionally encouraged investors into more risky – and, in particular, speculative – investments, feeding asset bubbles and increasing systemic risk.

Some schemes will be concerned that, by participating in QE (by selling gilts to the Bank of England and investing the proceeds in other asset classes), they will be deemed to have increased their risk exposure and will find their PPF levy rising as a result. In fact, some schemes might well be unwilling to sell gilts to the Bank for this very reason.

The pressure for pension funds to transfer their investments into riskier assets also appears to run counter to much of the Pensions Regulator's work, which consistently encourages schemes to derisk in order to help the Regulator achieve its objective of protecting the PPF. Schemes could be forgiven for pointing out that they are receiving inconsistent messages from the authorities.

On the one hand, lower gilt yields could encourage pension funds to de-risk out of equities more slowly than might otherwise have been the case. But they may also lead to a situation where trustees

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<sup>1</sup> NAPF estimates using figures from the September 2011 PPF7800 index on assets and liabilities and applying Purple Book ready-reckoners.

<sup>2</sup> Hymans Robertson estimates quoted in press coverage.

are driven to further de-risk and match liabilities by investing in safer assets, particularly given the uncertain outlook across other asset classes. Again, the signals from the Bank appear inconsistent with the Regulator's wider objectives.

### **The impact of QE on defined contribution (DC) pension schemes**

For DC pension provision, the impact of QE will be felt most directly by individual savers rather than by employers and trustees.

The vast majority of savers will be in life-style funds - 94% of schemes in the NAPF Annual Survey (2010) are offering a life-styling option and 80% of DC schemes use a lifestyle fund as their default. For those close to retirement individuals pensions will be invested predominately in fixed interest products, including UK gilts. While life-style funds help protect against equity market volatility, individuals close to retirement will not benefit from the increase in gilt prices or from the potential equity gains associated with QE.

In addition, those reaching retirement at a time when asset prices are low may have seen low or negative investment returns in recent months from volatile equity markets and reductions in their pension pots; they may see real losses in their funds depending on how much risk they were exposed to in their asset allocation and when they need to annuitise their pension.

For those looking to switch their fund into safer assets as they approach retirement they may be switching out of equities at a low point in the market whilst the prices of gilts and bonds is high.

Annuity rates are closely linked to the rates of return on corporate and government bonds. And, because of trends in prudential regulation, increasingly the latter. Already low due to low interest rates, these rates risk being driven even lower by QE – a blow for savers looking to turn their pension pot into an annuity in the near future, and a broader reputational risk for pension saving.

### **Conclusion**

The NAPF understands the reasons for the new round of QE and supports the objective of securing the economic recovery. But it is important to recognise the specific impacts of QE on pension funds, particularly in the short term. The NAPF would urge policy-makers to consider the exceptional circumstances now facing pension schemes when issuing guidance in connection to triennial scheme valuations. Hundreds of DB schemes are due to have their valuations in December 2011 and March 2012 whilst the immediate impacts of QE are feeding through the economy. Because pension funds are long-term investors, unrealistic scheme valuations, recovery plans, and elevated PPF levies based on a short-term response to economic conditions will have a damaging impact on their ability to deliver good quality pensions at an acceptable cost.