Securing the future of pensions

NAPF submission to the Treasury Select Committee inquiry: Quantitative Easing

January 2013

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About the NAPF

The National Association of Pension Funds is the leading voice of workplace pension provision in the UK. We represent 1,300 pension schemes from all parts of the economy and 400 businesses providing essential services to the pensions industry. We represent both public and private sector schemes, including 81% of the local authority pension funds. Our members provide pensions for 16m people and collectively hold assets of around £900bn. Our main objective is to ensure there is a secure and sustainable pensions system in the UK.

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Executive Summary

The NAPF welcomes the Treasury Select Committee's inquiry into Quantitative Easing (QE) and the concerns it has voiced about the potential distributional impacts on savers, pensioners and those running pension funds. We have been concerned about the lack of policy coordination on this issue and, over the last 12 months, have been calling for more explicit recognition from the Government and the Pensions Regulator on the unintended consequences for these groups.

A particular concern has been for Defined Benefit (DB) pension funds going through their 'triennial scheme valuations' with valuation dates between December 2011 and March 2012, as the discount rates they use to calculate their funding deficits will be affected by the record low levels of gilt yields observed at the time. Our analysis has found that allowing those with scheme valuation dates between December 2011 and March 2012 to make a temporary adjustment or add a mark-up to their discount rates (where based on gilt yields) would be consistent with the existing scheme funding framework and could be reviewed and switched off as economic conditions and monetary policy responses evolve. We have therefore argued that this is the most proportionate response to the extraordinary economic conditions DB schemes are facing and the impacts of the Bank of England's QE programme. It would ease burdens on sponsoring employers in the short-term, would support business investment and economic growth, and would ensure that further DB schemes were not closed by their sponsoring employers as a response to worsening funding positions.

We welcome the Chancellor's Autumn Statement announcement that greater flexibility will be afforded to those retiring with a Defined Contribution (DC) pension using the income drawdown rules. This will help to offset the impacts that low gilt yields are having on the annuity rates that determine how much income can be drawn. We look forward to the DWP's forthcoming consultation on issues around DB funding and hope that similar assistance can be extended to sponsors with DB schemes who are also adversely affected by low gilt yields.

We also welcome the Treasury Select Committee extending its inquiry to address issues relating to the unwinding of QE and will submit written views to the Committee very shortly.

Introduction

1. The UK economy has faced very challenging economic conditions, with the Bank of England taking the exceptional action of buying £375bn of gilts between February 2009 and October 2012 to stimulate investment in the UK economy and lower borrowing costs. The NAPF has recognised the wider benefits to the UK economy of the Bank of England's QE policy but remains concerned about the damaging and

unintended consequences. These consequences are particularly acute for DB pension schemes where the discount rates typically used for scheme valuations are based on gilt yields that are being deliberately held at artificially low levels through monetary policy intervention. Without coordinated policy action to help offset the unintended consequences of the Bank's Asset Purchase Programme, there is a risk that the ability of DB scheme sponsors to invest in the economy is constrained because of the need to fill deficits inflated by low gilt yields.

2. The Treasury Committee has asked for further written submissions on the distributional impacts of QE, alongside further evidence on:
    - The effectiveness of QE so far undertaken by the Bank of England, and how effective it would be if the programme were to be extended in the future;
    - Whether other unconventional policy measures should have been used by the Bank of England;
    - Whether unconventional policy measures should be used from now on;
    - The policy issues which will need to be addressed by the time of the eventual unwinding of QE; and
    - How the unwinding of QE should be co-ordinated with the management of short-term interest rates and with fiscal policy, and what cost there may be of unwinding QE.

    This submission focusses on the distributional impacts of QE on those running pension funds, and their pension fund members, based on extensive discussions with NAPF members.

3. The NAPF will shortly submit further written evidence to address issues relating to the unwinding of QE and the potential implications for pension funds and pension fund members.

Impacts of QE on DB pension funds

4. The Bank of England's overall assessment of the first round of QE (some £200 billion of asset purchases) was that it may have raised the level of real GDP by 1.5-2% and increased inflation by 0.75-1.5 percentage points and that, whilst highly uncertain, these effects were economically significant. There has been some scepticism about the continued reliance on QE for the later rounds of Asset Purchases (a further £175bn of asset purchases). Analysts at Morgan Stanley have suggested evidence[1] showing that the QE programme may be suffering from significant diminishing returns. They have suggested that alternative methods of stimulating the economy including cutting interest rates, cutting the remuneration rate paid on commercial bank reserves at the Bank of England and shifting the QE programme to non-gilt asset purchases will now have a greater impact.

[1] Morgan Stanley Research Brief, 2012

5. In December 2011 the Pension Corporation[2] recognised the wider benefits of QE but called for any future rounds to be targeted away from the purchase of long-dated gilts and towards purchasing stressed assets from banks' balance sheets. They argued that this could help pension schemes by increasing the investment returns on shorter dated gilts and reducing the downward pressure on long yields. They argued that the fall in gilt yields at the long end (>25 years) has had a particularly large impact on the liabilities of DB pension schemes.

6. The Bank of England's first explicit comments on the effects of QE on DB pension schemes were made by Deputy Governor, Charlie Bean, at the NAPF Local Authority Conference in May 2012[3]. He set out that, for a pension scheme starting in balance, the impact of QE had been broadly neutral, with positive movements in assets broadly matching the movement in liabilities. This assumed that DB pension schemes saw asset returns respond positively to QE over the period in line with the observed movements in UK equities and bonds. However, he also acknowledged that the average DB pension scheme started from a position of deficit in 2007 of 30% of full buy out liabilities. For such schemes, deficits would have risen by a further 10% of liabilities between the start of the Asset Purchase programme in 2009 and early 2012. These estimates were broadly in line with those published by the NAPF in March, where we suggested that the impact of falling gilt yields since the summer of 2011 would have increased DB scheme deficits across all schemes by around £90bn.

7. According to the NAPF Annual Survey for 2011, schemes in deficit (on a scheme specific funding basis, which is less stringent than the full buy out basis) represented 90% of all private sector DB schemes. In 2007, before the beginning of the economic downturn, around 75% of schemes were reporting being in deficit.

8. The Bank of England's most recent analysis[4], published in July 2012, identified that the impact of QE on a DB pension schemes position depends on the extent to which there is a mismatch between the funds' assets and liabilities (whether it is fully hedged against movements in discount rates) and on whether a DB pension scheme begins in a position of deficit or not. They found that QE has two effects: i) pushing up the value of the gilts and equities held by the scheme and ii) increasing the scheme's liabilities by reducing the discount rate the pension scheme applies to its future liabilities, thereby increasing the current value of its liabilities. 'Other factors' are then calculated by the residual and include other movements in gilt and equity prices that are not directly related to QE – including the flight to assets perceived as safe and high quality. The conclusion is that for a model scheme with £100m in assets and liabilities ('Scheme 1') that was fully funded in 2007 but that was not fully matched (i.e. not fully invested in gilts) the deficit would have increased from £0m in 2007 to £33.5m in 2012. For the same scheme that was not fully funded in 2007 and that was also not fully matched ('Scheme 2') the deficit would have increased from £30m in 2007 to £65.5m in 2012.

[2] Pension Corporation Press Release, 2011
[3] Speech by Deputy Governor Charlie Bean to the NAPF Location Authority Conference, 2012.
[4] The Distributional Effects of Asset Purchases, Bank of England, 2012

9. The figures presented by the Bank of England might suggest that, for a typical scheme, around a third of the adverse impact on DB scheme funding since the beginning of the downturn and the Bank's asset purchase programme may be directly attributable to QE. Given that the intention of QE was to have an overall positive impact on the UK economy, there is a strong rationale that the Government and TPR should look for further opportunities to mitigate any of the adverse consequences and bolster the positive impacts.

Regulatory response

10. There is sufficient flexibility within the legislative framework for discount rates to be applied that take into account long term asset returns, long term government and corporate bond yields, or something in between. The extent to which the legislative framework prescribes the discount rate to be used is contained in regulation 5 of the Occupational Pension Schemes (Scheme Funding) Regulations 2005 which provides that:

    The rates of interest used to discount future payments of benefits must be chosen 'prudently' taking into account i) the yield on scheme assets held to fund future benefits and the anticipated future investment returns and/or ii) market redemption yields on government or other high quality bonds[5].

    There is no legislative definition of "prudently". This creates the potential for considerable flexibility in the funding regime and, in particular, the assumptions that can be used when calculating a scheme's technical provisions.

11. There is no legislative reason why the outcome of discussions between trustees and actuarial advisors on these matters may not result in a discount rate being chosen that takes account of yield on assets held to fund future benefits plus anticipated future returns. However in practice there appears to be a perception amongst those running DB schemes that TPR considers the most prudent approach to the calculation of the discount rate to take into account market redemption yields on high quality bonds and that it reinforces this in its guidance and communications.

12. The evidence we have gathered from trustees, actuaries, consultants and sponsors involved in the triennial scheme valuation process suggests that they believe TPR's view to be that a risk free gilts based approach is the most appropriate approach and that this is driven by a desire to eliminate as much risk as possible. As a result we are concerned that the flexibility contained within the legislative framework is not being utilised and the Annual Funding Statement does not go far enough to enable schemes to change their discount rates appropriately to take account of the current economic climate and exceptional policy response.

[5] Calculation of Technical Provisions Regulation 5 (4)(b)

13. Regulation 5 also provides that any movement away from the assumptions used in a scheme's previous valuation must be justified. TPR's Code of Practice on DB funding (page 33, paragraph 93) makes this clear:

> "*At subsequent valuations, trustees may choose a different method or different assumptions to those previously adopted where justified by a change of legal, demographic or economic circumstances.*"

14. We would argue that the unprecedented scale of the Bank of England's Asset Purchase Programme would justify a signal from Government or TPR that different assumption economic may be adopted as part of the current round of triennial valuations. The Bank has taken the exceptional measure of stimulating the economy by buying gilts, and has done so against a backdrop of already strong demand for gilts from investors (against limited supply) due to conditions in the wider sovereign and corporate bond markets.

15. The latest evidence and analysis published by TPR[6] concludes that, based on their current assumptions and modelling, around 25% of schemes currently going through their scheme valuations will not need to extend their recovery plans or increase contributions, whilst the remaining 75% will. Of that 75%, they suggest that:

    - 30% will need to extend their recovery plans by three years and increase contributions by 10%;
    - 20% will need to extend their recovery plans by three years, increase their contributions by 10% and make use of further flexibilities including greater investment outperformance in the recovery plan; and
    - 25% will need to significantly increase their contributions and/or make use of other flexibilities available where there are affordability challenges.

Concerns of sponsors and trustees of DB funds

16. Whilst we welcome TPR's Annual Funding Statement and subsequent assurances around allowing extensions to recovery plans to offset the impact on sponsor contributions, we would argue this is not sufficient. Greater allowance should be given for changes to the discount rates used to calculate the technical provisions because:

- Sponsors tell us that the triennial DB scheme valuations (as well as FRS17 accounting deficits) can, in some circumstances, feed into their corporate activity and the attitude of investors. This can occur, for example, through assessments of credit ratings and in the investment plans of overseas sponsors, both of which can react negatively to the potential for increases in pension deficits should asset values and discount rates continue to decline.
- Sponsors who can afford to make higher contributions still believe they will come under significant pressure from TPR to fill the deficits in their DB plans, which may lead them to hoard cash, meaning that money is being diverted away from investment, expansion, and jobs.
- TPR's approach to extending recovery plans is as yet untested and will take place on an individual scheme-by-scheme basis, creating uncertainty as to what length of recovery plans TPR will consider

[6] DB pensions flexibility and impact analysis, October 2012

acceptable or not and whether the impact of higher deficits resulting from low gilt yields will be fully offset in practice.

17. Trustees of DB schemes have raised concerns about any approach that undermines their position to negotiate with sponsoring employers to get the best possible deal for scheme members, in terms of additional contributions into their schemes. This would be a concern if there was prescription from TPR on exactly what discount rate should be used or if those already far into their negotiations with sponsoring employers were suddenly told by TPR they should be using a higher discount rate. Ideally, trustees and sponsors would be given greater comfort to agree more favourable assumptions *if* the conditions for their scheme are right (for example, where they have previously taken a gilts plus approach but where that gilts plus approach now looks increasingly out of line with their broader investment strategy). This would reflect the valued flexibility contained in the scheme funding framework as it stands and the ability for trustees and sponsors to take measures specific to their scheme's circumstances.

18. Maintaining a scheme specific approach would also avoid appearing to disadvantage those schemes that have already been able to take steps to fully hedge their liabilities for movements in gilt yields and prices where they might otherwise overshoot their asset return assumptions.

19. Whilst some trustees are reluctant of an approach that encourages the use of higher gilt yields, anecdotal reports of their dealings with TPR are mixed. Some trustees report very positive experiences of discussing their valuations with caseworkers and are confident that they will be able to agree extensions to their recovery plans and maintain sponsor contributions broadly at current levels. Others are far more nervous. Because TPR deals with schemes on a scheme-by-scheme basis it is difficult to gain assurances that the flexibilities TPR has talked about in guidance will be there in practice. There is also concern amongst sponsors who are judged as able to afford higher deficit recovery contributions that they will be 'on the hook' for higher contributions because gilt yields are so low.

Policy responses

20. The CBI has argued that a smoothing approach should be introduced in the UK and, in the Chancellor's Autumn Statement, it was announced that:

    "The Government… recognises that volatility in measures of pension scheme deficits can make it hard for companies to manage their investment plans and attract external funding. DWP will also consult on whether to allow companies undergoing valuation in 2013 or later to smooth asset and liability values."

21. We welcome the forthcoming consultation from DWP but have some reservations around a strict smoothing approach, as has been implemented in some other countries, including the US, Netherlands, Denmark and Sweden. Our concerns around a smoothing approach, particularly if not implemented till later in 2013 or 2014 would be that:

i) It reflects a more radical departure from the current legislative and regulatory framework and a 'mark to market' approach;

ii) It can carry with it cliff-edge effects particularly where the smoothing is over a relatively short period where the main impact in practice is to introduce a lag effect;

iii) It requires greater clarification around its application (for example, how it applies to discount rate assumptions other than gilts); and

iv) As a more permanent change is more likely to have unanticipated effects on pension scheme demand for assets with which to hedge their liabilities.

22. From our discussions with members we concluded that the most timely and proportionate action would be for Government and TPR to permit trustees and sponsors to explicitly recognise the impact of the current economic conditions and QE on gilt yields. This would relate directly to the calculation of technical provisions and would allow a mark-up to be applied to gilt yields where gilts are being used as the basis of discount rate assumptions for scheme valuations.

23. This would give trustees a more explicit 'green light' to change the approach taken from their previous valuation, and should give them some comfort, in their negotiations with sponsoring employers, to take a less recklessly prudent approach when agreeing discount rates.

24. Given the political judgement required to trade off the UK corporate growth agenda against the TPR's objectives it is our view that some firm direction from Government, is required for TPR to feel empowered to take further action in this area without compromising its objectives.

25. When considering the appropriate margin to incorporate there are a number of factors[7] to consider, which have already been acknowledged in the Bank of England's own analysis on the impacts of QE on DB pension scheme funding.

26. We have suggested that the appropriate mark-up to a gilts plus basis would be within the range of the Bank of England's estimates of the impact of Quantitative Easing on gilt yields (around the period December-March 2012 for schemes with those effective dates for their triennial valuations) with some downward adjustments to take into account the offsetting impact on the assets side (which will be greater for those schemes already heavily invested in gilts and hedged and who are in less need of relief) and the uncertainty around the extent to which current gilt yields reflect wider economic and financial market conditions. **We have modelled here a very modest uplift of 0.5% as well as a more generous 1.0% to show the range and**

[7] Broader factors, at a macro-economic level, include the wider changes to economic conditions and financial markets which have contributed to the downward movements in gilt yields and movements in other asset values e.g. concerns about corporate debt and European sovereign debt which have contributed to the flight to UK government debt. Isolating the impact of QE, if that is the aim in any policy intervention to mitigate impacts for corporate sponsors, is not a perfect science. And it is not a given that the Government would only wish to factor in the impact of QE, especially given that other countries have already taken action linked purely to their 'safe haven' status and the impact of low bond yields.

the potential impacts on liabilities, scheme funding levels, and implied sponsor contributions. This could see FTSE 350 companies with scheme valuation dates on December 2011-March 2012 being relieved by around £20-£37bn – which reflects the higher deficit recovery contributions they would be expected to make if basing deficit calculations on the prevailing gilt yields at the time of their scheme valuation dates.

27. This would allow policy to be coordinated to offset the adverse impacts of the Bank of England's QE programme without the need to shift to a different regulatory regime or impose prescription around scheme funding.

Impacts of QE on members of Defined Contribution Pension Schemes

28. For those saving in a DC pension the effects of QE can be profound as the impact of QE on gilt yields and annuity rates is locked in when the DC member reaches retirement and needs to buy an annuity. For those members of DC schemes who have no choice but to buy an annuity now the short term impacts of QE and low gilt yields become permanent. Comparing the annuity rates in standard tables from early 2008 to annuity rates in early 2012, a £100k pot would have bought a level, single life annuity at age 65 of around £7,810 a year back in 2008, whilst in early 2012 that same individual could get an annuity of only £6,112 a year. That equates to a fall of over 20% in cash income from the same size pension pot, largely driven by the falls in gilt yields, even before taking account of inflation impacts.

29. Concerns have also been raised about the income drawdown rules which came into effect on 6 April 2011. These explicitly link the maximum about that can be withdrawn annually to 100% of the single life annuity rates published by GAD. The Chancellor's Autumn Statement announced that they would increase the drawdown limit back to 120% (specifically to offset the impact of low gilt yields and annuity rates) but an implementation date has yet to be set.

Unwinding of QE and implications for pensions

30. We welcome the Treasury Select Committee's decision to extend its inquiry to address the impacts of the unwinding of QE as this provides an opportunity for policy makers and regulators to consider the consequences in advance and take coordinated mitigating action. We will provide early written views to the Committee very shortly following discussions members. These views are likely to address both the implications of the broad approach to unwinding taken by the Bank of England and the detail of the process by which that takes place (eg the length of time over which any unwinding occurs and the order in which the assets are unwound).

References

The following documents are attached with this submission:

'QE's impact on pension fund liabilities', Pension Corporation December 2011.

'Exceptional times, exceptional measures: economic developments and the impact on pension schemes and members', NAPF, March 2012.

'DB funding: A call to action', NAPF, October 2012.