Written evidence from the Pension Insurance Corporation (PPF0100)

About PIC

1) PIC is a specialist insurer providing pension insurance buyouts and buy-ins (bulk annuities) to the trustees and sponsors of UK defined benefit (“DB”) pension schemes. At 30 June 2016, PIC had £18.4 billion in assets under management and had insured more than 130,000 pension scheme members.

2) As a specialist pension insurer, our business is focussed on securing the benefits of members of defined benefit pension schemes. We leverage economies of scale and find innovative solutions to achieve this aim. We have intimate knowledge of the DB pensions universe, including the long-term asset and liability strategies of trustees and the funding issues exacerbated by monetary policy. We also have high levels of interaction with the increasing numbers of professional / independent trustees, as well as trustees’ actuarial advisers and asset managers.

3) Our pension fund clients include the London Stock Exchange, Philips, Alliance Boots, Total, EMI, Cadbury, Honda, the Institute &Faculty of Actuaries and the National Association of Pension Funds (now the PLSA), as well as the public sector, including DEFRA. PIC is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and Prudential Regulation Authority (FRN 454345).

4) We are enthusiastic about this consultation and the subsequent inquiry and believe we have a great deal of expertise to offer. It is clear that the DWP Select Committee is seeking to address the systemic problems faced by defined benefit pension schemes and their sponsors and we hope that our views are helpful in this regard.

5) We would be delighted to support the Committee further on what we believe is an area of critical importance to 11 million members of DB schemes, their corporate sponsors and the UK economy.

Summary Recommendations

6) As has been well documented, defined benefit pension schemes and their sponsors face major challenges:
a. A difficult macro-economic environment, including negative real yields and uncertainty about the global economy
b. Shortened timescales, due to the closure of DB schemes, means less time to make good any pension deficit
c. Unfavourable demographics
d. Significant inefficiencies in risk, investment and expense management
e. Complicated, sometimes impenetrable, layers of pension benefit agreements built up over many years
f. Successive layers of regulation, which have added to the expense and complexity of running a DB scheme

7) Given these discrete, but overlapping, challenges, there is no silver bullet. In this submission, we therefore present a package of targeted measures. We believe this is in aggregate the best way to ensure that as many of the 11 million DB pension scheme members as possible get anything close to the benefits they have been promised in either amount or value terms, whilst for those that don’t their losses are minimised. We have also sought to balance these objectives against the needs of corporate sponsors and the wider economy.

8) Our recommendations stem from our view of the best outcomes for each stakeholder group:
   a. **Pension scheme members:**
      i. Increasing significantly the probability they will get the benefits they have been promised (in amount or value terms) and minimising their loss when full benefits cannot be delivered
   
   b. **Corporate sponsors / employers / shareholders:**
      i. Greater certainty over costs and contributions
      ii. Greater flexibility to act when the business is in trouble and reduce the risk of bankruptcy where the pension scheme is a contributing factor (pension contributions are pro-cyclical – they get larger and more constraining on the business the weaker that business is)
      iii. Ability to engage in corporate activity without the DB pension system creating insurmountable hurdles or unnecessary delay

   c. **UK taxpayer:**
i. A more secure DB system overall, with a tolerable level of failure
ii. Monetary policy which helps sponsors of schemes and the UK economy
iii. Protection of the Pension Protection Fund (“PPF”)
iv. A system of pension risk pooling that facilitates efficient investment in the economy, creating jobs and growth

9) Our recommendations in summary:

a. Cut costs through the simplification of pensions administration:
   i. The removal of layers of complexity within pension schemes, particularly around indexation and benefit calculations, i.e. allow trustees to unilaterally simplify the benefits promised on the basis of overall value neutrality
   ii. Increase the Trivial Commutation Lump Sums limit to £50k or scrap it altogether for non-pensioners
   iii. Also raise the Wind Up Lump Sums maximum to £50k and then extend the ability of trustees to offer them to members beyond the current one time offer
   iv. A cap on the maximum benefit entitlement in schemes, such that accrued, very large pension benefits are able to be transferred out
   v. Allow DB schemes to increase the retirement age in line with increases in the State Pension age

b. Transparency
   i. Trustees need to be open and transparent with the members about the likelihood of them receiving their benefits in full
   ii. Fees and expenses paid by trustees to providers (asset managers, administrators) need to be accurately documented and disclosed
   iii. Sponsors need to be more transparent about the level of exposure they have to DB liabilities in their Report & Accounts, for example by having to publish their Section 75 deficit on an annual basis
   iv. Explore ways of encouraging companies to issue debt at very low yields to help close off pension risk
   v. Sponsors should be required to demonstrate in their Report & Accounts how the interests of shareholders and the interests of scheme members have been balanced if there is a deficit
c. **Maximum benefit from economies of scale**
   i. Explore options for some level of pension scheme consolidation to allow them to benefit from improved investment performance and ability to negotiate harder on fees
   ii. Ensure independence: Every pension scheme board should have an independent trustee, who should be required to demonstrate higher standards, perhaps with a professional qualification relevant to the scheme and knowledge of the Board overall
   iii. Explore options for DB schemes to be re-opened, allowing new members to enter and enable schemes to become more active again – to provide inflation proofing via increased investment in equities
      - Re-examine the mixture of secure DB base (guaranteed level of pensions) with DC top-up

10) These recommendations are explored in more detail below.

**Further detail**

**Simplification**

11) The historic changes to pension legislation, which sought to make DB pension benefits more secure, had the unintended consequence of making them unaffordable.

12) We estimate that successive layers of regulation has driven up the cost of delivering DB pension benefits by about 44% since the 1970s. In particular:
   a. Making pension increases guaranteed rather than an intention (3% per annum cost of guarantee) added c.12%
   b. Requiring pre-funding of technical provisions with a prudent margin added c.8%
   c. Removal of ACT for equity dividends (20% on 60% equity) added c.12%
   d. The PPF levy and overall costs of compliance have added c.12%

13) It is therefore not difficult to see why many DB schemes were being closed even before the sustained fall in gilt yields since 2009.
14) For many schemes, the complexities created by successive pieces of legislation governing the benefits provided, such as GMP rules, gender equalisation, indexation requirements have been compounded by the impact of benefit changes arising from scheme mergers, M&A activity and benefit changes. Often the most expedient option was taken in introducing these changes, which resulted in past rights being grandfathered rather than realigned. This expediency has brought complexity: One scheme we were asked to insure had over 100 different categories of promised benefits.

15) Allowing trustees the ability to simplify benefits in a number of ways will go some way to offsetting this huge increase in costs, including the way in which annual inflation increases are calculated.

16) In fact, reviewing the impact that indexation of benefits has on scheme liabilities will be possibly the most significant action this Committee can recommend.

17) There are two realistic options for amending benefit indexation, given the government’s reported reluctance to legislate to allow the Trustees of the British Steel Pension Scheme decision to change indexation from RPI to CPI. These are:

   a. Alter the basis on which RPI is calculated (bringing it in line with RPIJ) so that it is aligned with CPI, avoiding the need to amend individual pension contracts; or
   b. Legislate for trustees to be able to move to fixed increases (e.g. 3% per year), that are equivalent in value, instead of providing inflation-linked benefits

18) In our view the first of these, amending the basis on which RPI is calculated is the option most likely to preserve the integrity of the DB pension system and create the least amount of upheaval.

19) In 2013, following a consultation, the ONS created a new index, RPIJ, in order to address concerns that one of the arithmetic formulae (known as the ‘Carli’ index formula) used to produce the RPI did not (and still does not) meet international standards. RPIJ used a different, but better regarded, formulae, the Jevons Index. Carli has at various times been called “flawed” (Jill Matheson, Britain's former National Statistician), and “outdated” (Sir Mervyn King, former Governor of the Bank of England).
20) The fact that a new Index was created, rather than updating RPI, was done at the time “for the benefit of those who require a consistent series (especially those who struck contracts with the RPI or who own RPI-linked Treasury bonds).”

21) Given the crisis in pensions, we believe the time has now come to review this and to bring RPI into line with international standards. Replacing Carli with Jevons would significantly lower aggregate pension scheme liabilities. A technical move of this nature would remove the need for primary legislation to allow trustees to amend individual member agreements (such as a wholesale move from RPI to CPI). It would also allow many more pension liabilities to be hedged for inflation compared to benefits indexed against CPI.

22) Whatever the inflation flavour used, having benefits that are linked to inflation create significant additional costs and complexities to managing a pension scheme. Indeed there is a significant shortfall between the amount of inflation-linked assets available and the overall needs of the DB pension universe for inflation-linked assets. A fixed benefit increase is also cheaper to insure, reducing the cost to trustees of obtaining certainty for their scheme members. This may be done on a basis that, using the trustees’ actuarial assumptions, is value neutral overall to the scheme’s members.

23) **Recommendation**: Amend the basis on which RPI is calculated to bring it more in line with CPI and allow trustees to implement a fixed increase to replace an inflation linked increase.

24) Other options which would help trustees manage their costs include a cap on the maximum benefit entitlement in schemes. This would be important because we typically see a division in smaller pension schemes whereby the top 10% of scheme members (perhaps pensions built up by the CEO, CFO or other senior management), can represent a very significant percentage of the scheme’s liabilities.

25) This can significantly raise the risk profile of the scheme, particularly around longevity risk. There is some correlation between the highest paid individuals and their life

---

1 Journal of the Royal Statistical Society: Series A (Statistics in Society); Volume 178, Issue 2, Version of Record online: 30 APR 2014
2 “Who Carries the Risk?” Asset-allocation challenges for defined-benefit (DB) pension schemes and their sponsors on the road to buyout. Published by Fathom Consulting and Pension Insurance Corporation, December 2014
expectancy: The higher the life expectancy of an individual, the greater the overall liability.

26) Giving trustees the option of capping the total amount an individual can have (or build up) within a specific pension scheme will allow them to better manage overall risk.

27) This would bring management of very large individual pots into line with their ability to manage small, inefficient pots. However, we believe that their rights under this ability should also be extended.

28) Currently trustees are able to manage out members with small pots under Wind Up Lump Sums (“WULS”) and trivials. Trustees have the ability to pay WULS where the value of the member’s pot is £18,000 or less. However, they have the ability to pay trivials where the size of the individual pension pot is not greater than £30,000.

29) **Recommendation**: Increase the trivials limit to £50k or scrap it altogether for non-pensioners. Based on current annuity rates £50k would be likely to give a pension of less than £200 a month. If the limit was scrapped, it would allow people to cash their pension in with DB providers, rather than having to transfer to a DC fund incurring costs and running a short term investment risk. Similar advice requirement should be retained for DB to DC transfers in excess of the current £18k/£30k limits.

30) **Recommendation**: Bring the WULS maximum into line with the trivials maximum and then extend the ability of trustees to offer WULS to members beyond the current one time offer.

31) **Recommendation**: Trustees should be able to force a transfer of individuals with large, accrued pension benefits as with Trivial Commutation Lump Sums (“TCLS” or “trivials”).

32) As the Government has recognised with the state pension, increasing longevity represents a threat to the sustainability of the pension system. Indeed, it has long been a problem for DB pension schemes, pushing up liabilities year after year. An increase of one year in longevity expectations would increase £1 billion in liabilities by about £40 million, representing about a 1% increase for every three months of extended longevity. Given
that there are now about £3 trillion of liabilities on a buyout basis this represents a considerable risk to overall affordability.

33) **Recommendation**: Sponsors and / or trustees should have the ability to increase the retirement age of their members in line with the State Pension Age.

**Transparency**

34) PIC’s views in this section are based around behavioural incentives, primarily relating to how information is presented about the real level of pension risk to which both the members and the investors in sponsors are exposed. It is our view that this will help lower risk in the system by positively influencing the behaviour of the key actors.

35) For example, it is our view that members of pension schemes are not aware of the full extent of the difficulties many pension funds are in as reporting is not clear. Trustees should have to send an annual report to the members stating the likelihood of the pension scheme not being able to pay the promised benefits, based on a series of metrics (eg current funding level, strength of the corporate covenant etc). They should also include a breakdown of the likely benefits an individual would receive should the scheme fall into the PPF at any point in the future. The benefits of this approach are not that the scheme member will be able to act on the information, but rather that it will concentrate the minds of the trustees.

36) Furthermore, as documented above, expenses within pension schemes can be high. They can also be opaque. There is much evidence to suggest that many trustees are not aware of many of the costs they incur, for example, from their asset managers.

37) **Recommendation**: Trustees should be compelled to send an annual report to members (or put it on online) stating the risks to an individual’s benefits in more detail (eg strength of sponsor and what happens to their benefits if the scheme falls into the PPF) as well as the overall level of expenses within a pension scheme.

38) **Recommendation**: Trustees should be compelled to accurately document all fees and expenses incurred for professional services, including actuaries, lawyers and investment consultants, and publish this to members in the annual report. Where they cannot
accurately assess the level of fees from a particular provider, they should have the right to put that particular service out to tender at no additional cost to the scheme and without any delay.

39) Likewise, we do not believe that companies are being entirely transparent with their investors about the level of pension risk to which they are exposed. A comprehensive study\(^3\) showed that share prices imply that when investors value companies they add around 20% to reported defined benefit pension liabilities. The study reviewed the published data of FTSE 100 constituents over a five year period.

40) This would imply that the market valuations of FTSE 100 companies were depressed by £340 billion\(^4\) at 31 August 2016. This sort of impact has real world implications, not least for the pension funds which are invested in these companies.

41) It would be better therefore if more transparency was brought to the reporting process, not least because this would allow management teams to tackle pension risk in a realistic way.

42) One area that CFOs have expressed interest in previously to help them end their exposure to DB pension risk is to issue debt at the corporate level and use the proceeds to de-risk the pension scheme. The current low level of corporate bond yields makes this idea practical at this point.

43) However, companies have been reluctant to go down this route because it means crystallising the pension deficit. Many management teams have presumably had the hope that deficits would close, or indeed that their successors would have to deal with the problem. However, as we have seen, this hope continues to be frustrated, with the result that in some cases dividends are now threatened and that share prices are weighed down.

44) **Recommendation:** The sponsor should have a requirement to publish section 75 deficit on an annual basis:

   a. Opportunity to move towards a more transparent, standardised model of reporting along the lines of what is in place in the Netherlands. This change could, we

\(^3\) “The influence of DB pensions on the market valuation of the Pension Plan Sponsor” (September 2014), published by Llewellyn Consulting and funded by PIC

\(^4\) FTSE 100 Companies had assets of £613bn and liabilities of £795bn, with an IAS19 deficit in their DB pensions of £182bn as at 31 August 2016, according to figures from JLT Employee Benefits
believe, be effected via FCA rules rather than through negotiations with the international accounting bodies.

45) **Recommendation:** There should be a statutory requirement for companies to be transparent on the management costs of pension schemes – most of which are hidden.

46) **Recommendation:** The committee should explore in more detail why companies do not issue debt at the corporate level to help manage the risk the DB scheme may pose to their balance sheet.

47) **Recommendation:** Finally, there will inevitably be some disruption should these recommendations on transparency be enacted. We would therefore like to see encouragement for sponsors to ‘come clean’ and to negotiate settlements with scheme members, following a precedent set by Philips, ING and others in the Netherlands. This might take the form of the Pensions Regulator (“tPR”) being encouraged to protect the PPF and members’ benefits by working with the PPF and trustees where there is a “zombie” sponsor to compromise above PPF level of benefits.

48) Given the above recommendations, we do not believe that tPR needs more powers at this point. There may well be a case for increasing its funding and manpower to bring it more in line with the PRA. An insurance company is required to deal regularly with a responsive PRA. For example, we have to inform our regulator about every significant pension insurance transaction (and corporate action) that we are seeking to undertake. The PRA is able to review these transactions in a very short space of time – certainly without holding up the transaction process. There is no reason why tPR should not be able to take a similar proactive stance within the DB pension universe, notwithstanding the very large number of DB pension funds.

**Economies of Scale**

49) Despite the issues outlined above, the proximate cause of the current crisis in the DB pension universe is the fall in gilt yields since the 2007 Financial Crisis and the introduction, and extension, of Quantitative Easing (“QE”), which is explicitly designed to reduce yields.
50) The legislative requirement that pension scheme liability assumptions are prudent means that pension funds predominantly base the discount rate for their liabilities on the yield available on gilts, as a risk free asset, with an allowance for additional returns based on investment in other assets. Pension schemes are therefore highly susceptible to movements in the gilt yield impacting the value they place on their liabilities (future pension payments). As yields go down, the level of investment return on their assets that they can allow for also goes down, which means that the level of assets they need to meet future payments goes up.

51) However, the fact that there are so many sub-scale pension schemes (for example schemes with less than £1 billion of assets), means that trustees are not able to effectively invest their way out of a deficit and are at a disadvantage in fee negotiations with asset managers and other suppliers.

52) With deficits continuing to widen, and the burden growing on sponsors, as we have seen with Carclo recently, it will be increasingly important for trustees to invest in assets that have an efficient risk / return profile, and manage costs. However, these desirable outcomes are not realistic for trustees of sub-scale pension schemes.

53) In reality, sourcing good quality higher yielding assets requires the employment of their own in-house investment expertise. For smaller pension schemes this is simply unattainable.

54) This disadvantage, compounded by sometimes less than ideal governance structures, can manifest itself in a number of ways. The most obvious is the amount of time it can take to invest in a new investment opportunity to take advantage of favourable pricing. The investment cycle - from identification of opportunity to deployment of capital - can take many months for some pension schemes, including discussion and review of the matter at quarterly trustee meetings, with recommendations and reviews by investment consultants and asset managers adding further time to the process. More typically, an investment decision of this nature may take up to six months. In either situation, the opportunity will have usually passed, meaning that the trustees have no possibility of outperforming their liabilities.

55) By contrast, a pension scheme with significant scale, for example the Ontario Teachers Pension Plan in Canada, or Calpers in the US, or indeed a life insurance company in the
UK, will do things very differently. An in-house investment team may, for example, notice that a move out of UK corporate debt, which some commentators are starting to believe look expensive compared to historic multiples, and reinvesting in US corporate debt, would be prudent option. However, as noted above, this opportunity is one which is time limited. In six months it may well have disappeared, so to take advantage there has to be in-house expertise with the processes, procedures and authority to move quickly.

56) As we put in our response to the recent consultation by the National Infrastructure Commission, but which we feel is relevant to this response as well, institutional investors still allocate only a small proportion of their assets directly to infrastructure. Pension funds and insurers seeking to match long-term liabilities should be perfectly placed to take on the illiquidity of these assets as the cash flows generated from them match liabilities and provide a measure of outperformance compared to risk free, helping to close deficits. Yet because of a lack of scale, they are not able to take advantage of this potential in any meaningful way.

57) There is now an opportunity to create a virtuous circle, in which the real interest of pension funds and other institutional investors in this sector is encouraged through confidence building measures, enabling the development of in-house teams and expertise. This will lead to successful investments, creating confidence, allowing the further development of teams and expertise, ensuring further successful investments in this area. The net effect of this virtuous circle would transform the overall infrastructure of the UK, improving productivity and boosting economic growth.

58) A second area where being sub-scale heavily impacts pension schemes, is in the ability to negotiate fees with asset managers and advisors. There are very few pension schemes in the UK which we believe have the scale and experience to really get the best deal. Compared to international best practice, UK DB schemes are poor performers.

59) For example, on p.34 of ATP’s (the Danish pension scheme) 2015 Report & Accounts, there is a chart which shows that it has reduced costs every year since 2011. They say that, “The total reduction over the past three years is 16 per cent.” and it now pays costs equivalent to 23 basis points (“bps”) (0.23% of aggregate savings) each year, compared to 50bps in a typical UK scheme. How many UK pension schemes would be able to match that track record of cost reduction year-on-year? Indeed, how many DB pension schemes are actually able to accurately document what they pay in fees and expenses?
60) A recent report by the Pensions Regulator showed that per member expenses for DB schemes with fewer than 100 members was c.£1,000 and that these costs were approximately £500 for schemes with up to 1000 members.5

61) If smaller schemes were able to halve their annual running costs, this could amount to considerable savings per scheme over the typical duration of a scheme’s liabilities (20 years). Multiplied across the more than 2000 smaller DB pension schemes6 this could have a significant impact on the prospects of an individual scheme or their corporate sponsor, even before the benefit of improved investment performance is taken into account.

62) Moreover, not only do sub-scale schemes struggle to get competitive costs on administration, the core services they are offered as part of the costs are often less than bigger schemes. This increases costs and reduces transparency as work is then treated as non-core or project-work at high charge out rates.

63) **Recommendation:** PIC therefore recommends that the Committee explores options for consolidation of DB pension schemes, either directly or via pooled asset management arrangements, such as we have seen with the Local Government Pension Scheme.

64) Over recent years we have seen an increase in the number of trustee Boards which have a professional or an independent trustee. This is primarily a reflection of the increased complexity of the law and regulations surrounding a pension scheme, meaning that trustees need to have greater levels of knowledge and expertise.

65) In our experience, some of the most efficient and professional trustee Boards are run by independent trustees.

66) This can be of benefit to a trustee Board in many ways, not least the ability to see when unsuitable investment ideas are being pitched to the Board by advisors.

67) **Recommendation:** All trustee Boards should have an independent trustee with experience in investment, governance, accounting or another relevant discipline relevant

---

5 “Defined benefit scheme running cost research”, tPR, April 2014
6 Purple Book 2015
to the Scheme and knowledge of the Board overall. They should be required to demonstrate higher standards, perhaps with a professional qualification. Where cost is a factor, this resource might be shared with other, similar schemes as part of a level of consolidation.

68) As noted above, part of the problem which DB pension schemes face is that c.90% are closed, either to new entrants, or to new entrants and future accrual. Either of these events shortens the duration of the scheme, with closure to future accrual dramatically doing so.

69) This means that pension schemes have a much shorter period of time to invest their way out of any deficit and leads them to invest increasingly in low risk / risk free assets as a means of matching cash flows. Trustees are right to be wary of being at risk of becoming a forced seller of an asset to meet a need to pay pensions.

70) Whilst we believe that trustees should continue to invest in low risk / risk free assets to match specific cash flows, there is a case for them to invest in risk assets, such as equities, but only if the duration of the pension scheme could be extended to allow for normal market cycles.

71) We also believe that the DB model of risk pooling is by far the best way of managing pension outcomes for individuals, many of whom will now have been auto-enrolled into DC pensions, where they bear all the risk, including: Longevity, interest rate and investment. It is unlikely that many people will get the level of pension benefits they might expect under this system.

72) Recommendation: The Select Committee should explore options for DB schemes to be re-opened in such a way that accrued benefits are not changed, that costs are lowered and that there is flexibility in the structures that are used, perhaps by combining some element of DC onto the DB scheme.

Monetary Policy

73) As has been well documented, QE has had a significant impact on pension schemes. What has been less well documented however, is the secondary effects this impact has had on the economy. Whilst this is not a primary focus of this consultation, we believe that it is a subject which merits inclusion within the inquiry.
74) When QE was introduced in early 2009, credit supply was effectively non-existent as the banks seized up in the wake of the Lehman Brothers collapse, deflation worries were high, 15 year gilt yields (a good match for many pension schemes’ liabilities) stood at 4.4% and the UK hadn’t yet achieved its status as a safe haven for investors.

75) QE’s first order aims signalled that policymakers were prepared to take extraordinary measures, in extraordinary times, to help heal banks’ balance sheets to allow them to grow lending and, by increasing credit, keep the economy moving. QE’s aims:
   a. Lower gilt yields to encourage borrowing
   b. Encourage investor to sell gilts and reallocate to higher yielding assets
   c. Increase the money supply
   d. Weaken sterling
   e. Increase inflation

76) Given the context in 2009, our view is that the first round of QE was the right thing to do. However, things are very different today.

77) 15 year gilt yields stood at just 1.21% as at 13 September 2016. The near 320 basis point drop in gilt yields over this seven year period has directly led to a combined deficit of c.£1.5 trillion on an insurance basis, according to data from PwC’s Skyval index, across the DB pension fund universe. This is despite more than £300 billion of Deficit Reduction Contributions (all pre-tax) being paid by UK corporate pension plan sponsors to help fill the hole since 2009, according to the PPF.

78) The typical duration of a pension fund’s liabilities are about 20 years (i.e. the average time they have to invest money to meet future pension payments is 20 years), but the duration of gilts held in a typical pension fund is 15 years. This means that the liabilities are more sensitive to movements in gilt yields than the gilts held by the typical pension fund, because of the duration mismatch.

79) As most pension schemes were underfunded at the time QE was started (and remain so) and the duration of their gilt assets is lower than their liabilities, deficits increased disproportionately.

---

7 PPF Purple Books 2010 onwards
80) There has been criticism of the Bank of England (“BOE”) and its QE policy since the impact on DB liabilities (and on savers) became apparent.

81) In response to this criticism, in 2012, the BOE published an analysis of QE’s effects on pensioners - The Distributional Effects of Asset Purchases. The report claimed that QE pushed equity prices and other risk asset prices higher and that therefore the impact on pension schemes had been limited. However, in reality the situation was more complex and the impact on the effects of the policy on scheme sponsors was not analysed in any depth.

82) In the intervening years, the BOE has stuck to its guns. In the minutes of the MPC of August 2016, it noted: “Long-term interest rates had fallen over recent years, reflecting a range of factors including the outlook for long-term supply and the balance between global saving and planned global investment. Lower yields posed potential risks to some aspects of the functioning of the financial system, for example by increasing the deficits of many pension funds and through their effects on the business models of insurers. At present, however, those effects appeared to be relatively limited. Many companies that saw increased pension deficits were able to extend the period over which they brought them back to balance, maintaining the existing level of contributions. Indeed, the overall size of contributions to defined benefit schemes had been broadly stable over the past decade despite fluctuations in the size of the deficit.”

83) In reality, the downside of lower yields is the proportional increase in pension fund liabilities, pushing out deficits. This effectively draws money out of sponsoring companies as they are required to increase contributions to close these expanded deficits, impacting on their ability to invest in jobs and growth.

84) What the BOE also does not acknowledge is that as far as pension funds are concerned, all gilts are not created equal. In fact, over 25 year liabilities are much more sensitive to changes in gilt yields.

85) Analysis by PIC shows that over 25 year liabilities represent about 30% of DB liabilities, but have about 58% of the overall rate sensitivity of these liabilities\(^8\). So long dated liabilities move far more that shorter dated liabilities for a similar rate shift

---

\(^8\) QE’s Impact on Pension Fund Liabilities, December 2011, Pension Insurance Corporation
a. DB pension schemes have in excess of £1 trillion of liabilities with a 20 year duration
b. The movement in these long liabilities represented c.£110 billion of the approximate £200 billion rise in pension fund liabilities under QE1 due to the 1% fall in gilt yields

86) Initially, QE1 did not target over 25 year gilts – so why did monetary policy, as early as QE2, move to this area?

87) At the long end, the UK Government is the main beneficiary of lower yields and DB pension funds and their sponsors are the main losers.

88) Lowering the yield on very long gilts does not stimulate borrowing as lenders will not fund corporate borrower 30 years out due to the increasing uncertainty and credit risk. Very little corporate borrowing is done out there, and any that is for the very highest quality issuers who have no trouble borrowing in any event. The only beneficiary is the government and therefore they should be issuing paper out there, rather than buying it.

89) All the lower long gilt rate does is push up pension liabilities which are filled by transfers from corporate borrowers reducing their capacity to invest. In our view, QE at the very long end of the curve is extremely detrimental to the economy, as the Bank of Japan has recently acknowledged. What is now being called the Pension Emergency as a result of lower long rates deters investment by corporates as they see a bigger deficit to fill, and it creates even more uncertainty for savers. We are watching a very slow train crash in a critical part of the economy.

90) Whilst it is understandable that government needs to support whole system, it’s clear that we’ve arrived at the point where QE is moving beyond targeting companies sponsoring pension funds to pushing the cost of supporting the system onto pension scheme members, as the possibility of benefit cuts (e.g. via entry into the PPF, such as with BHS) rises.

91) **Recommendation:** The BOE immediately stops buying gilts with a duration of greater than 25 years.

*September 2016*