Quantitative Easing - pension impacts and the endgame

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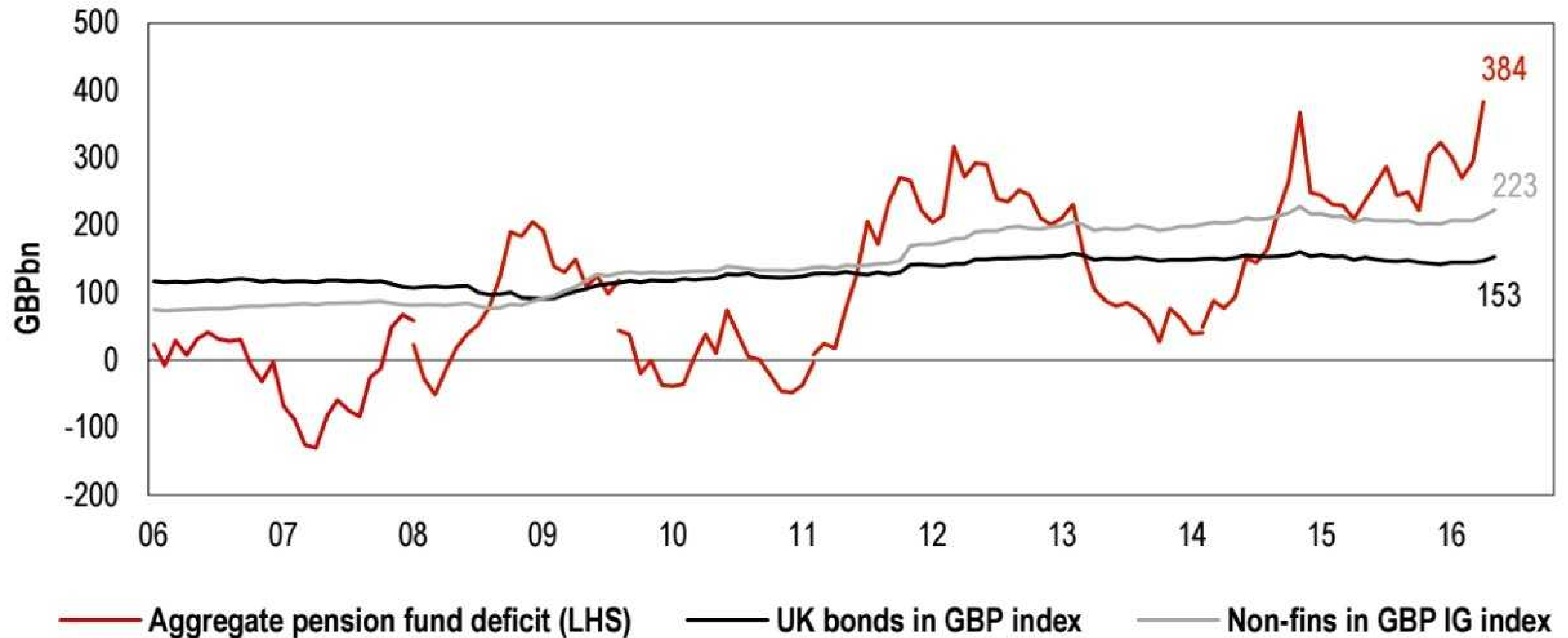
QE – massive monetary experiment

- 2009 – short-rates near zero, wanted more stimulus
- Unconventional monetary policy lowered long rates too
- Central banks created new money to buy Govt debt
- BofE bought £435bn gilts - Fed, BoJ and ECB also use QE
- For past 10 years, long yields exceptionally low
- Maturing gilts reinvested (but not >70% of a gilt issue!)
- Side effects include significant impact on pensions

Pension deficits post-QE



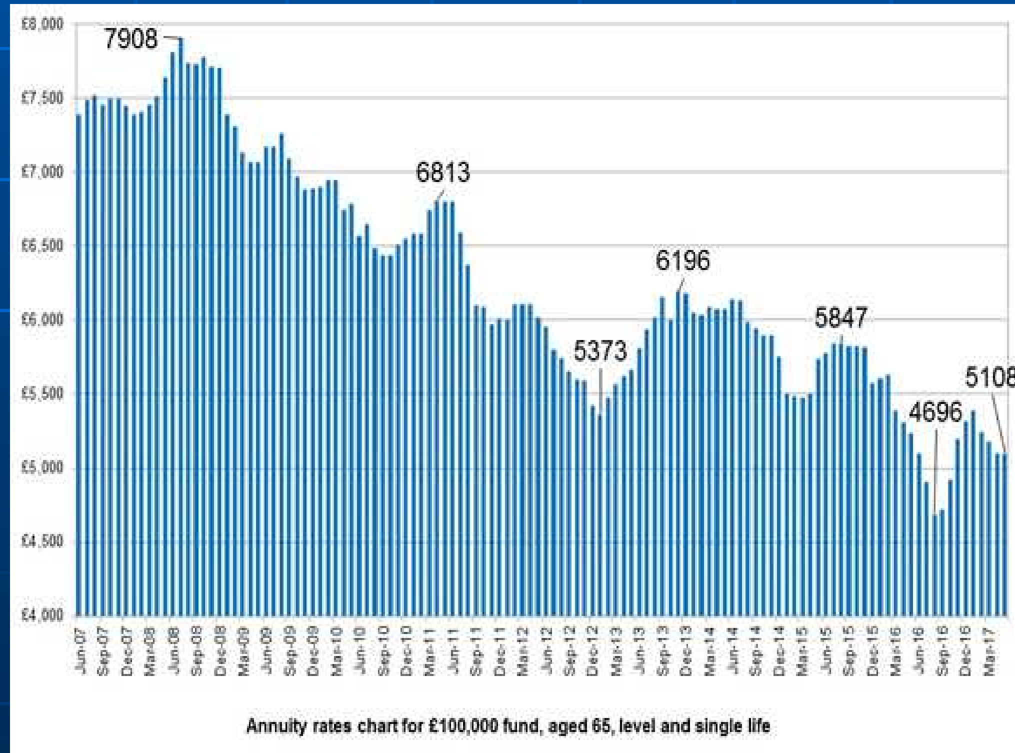
- Source HSBC

DB scheme deficits increase employer burdens

- Present Value of liabilities marked to market at long rates
- Pension liabilities – and deficits - inflated by QE
- Typical DB pension fund sensitivity to lower yields:
  - 1% point fall in long rates => 20% liability rise
  - 1% point fall in long rates => 6-10% asset rise
- Sponsors must increase payments into scheme
- Can’t walk away unless in/almost insolvency

Annuity costs increase too

- Annuities cost more as long-rates fall – Sec75 strain
- DB scheme buy-in/buyout more expensive
- DC pensions more expensive



Capital Asset Pricing Models distorted?

- CAPM assumes sovereign debt is risk-free asset base
- But central banks have artificially inflated prices
- Risk models distorted by QE as gilts not in ‘free market’
- Bonds, equities, housing, alternative asset prices inflated
- Impact of excessive liquidity and concentrated asset purchases on investment risk not yet understood

Changes in pension fund asset allocation

- QE led to more focus on liabilities than assets
- As deficits worsened, trustees advised to ‘de-risk’
- Try to invest more in assets that ‘match’ liabilities
- Traditional approach was maximising long-term returns
- But switch from equities to bonds tries minimising risk
- Is buying gilts/bonds actually ‘de-risking’?

DB pension fund asset allocation trends

Year	Equities	Bonds	Other
2007	**60%**	**30%**	**11%**
2009	**46%**	**37%**	**17%**
2011	**41%**	**40%**	**19%**
2013	**35%**	**45%**	**20%**
2015	**33%**	**38%**	**19%**
2016	**30%**	**51%**	**18%**
2018	**32%**	**43%**	**25%**
Source: PPF	Purple Book		

Impact on employers

- Higher contributions increase employer strain
- Employers want to remove risk, but can’t afford to
- Turning employers into annuity providers with Sec75?
- Scheme closures accelerate (86% now closed) – USS?
- More failures, RAAs, pre-packs – BSPS, BHS

	2007	2018
Open	55%	**14%**
Closed to new members	41%	**54%**
Closed to new accruals	3%	**32%**
Source: PPF Purple Book		

LDI - pension liabilities are not bonds

- Bonds don't match liabilities' inflation, duration, longevity
- Index-linked yields negative so mis-match (lpi, cpi)
- De-risking may also drive gilt yields lower – vicious spiral
- 'matching' liabilities won't solve worsening deficit
- Must <u>outperform</u> liabilities to fix shortfall
- Need to take investment risk and/or higher contributions

Difference between open and closed schemes

- Once closed, scheme is in run-off
- Mature schemes must consider cash flow requirements
- Open schemes should be able to take longer view
- Higher bond allocation reduces expected returns and may not match liabilities - risk impact uncertain
- Will diversification/downside protection better manage risk
  - Look for more alpha and beta

Other issues for liabilities

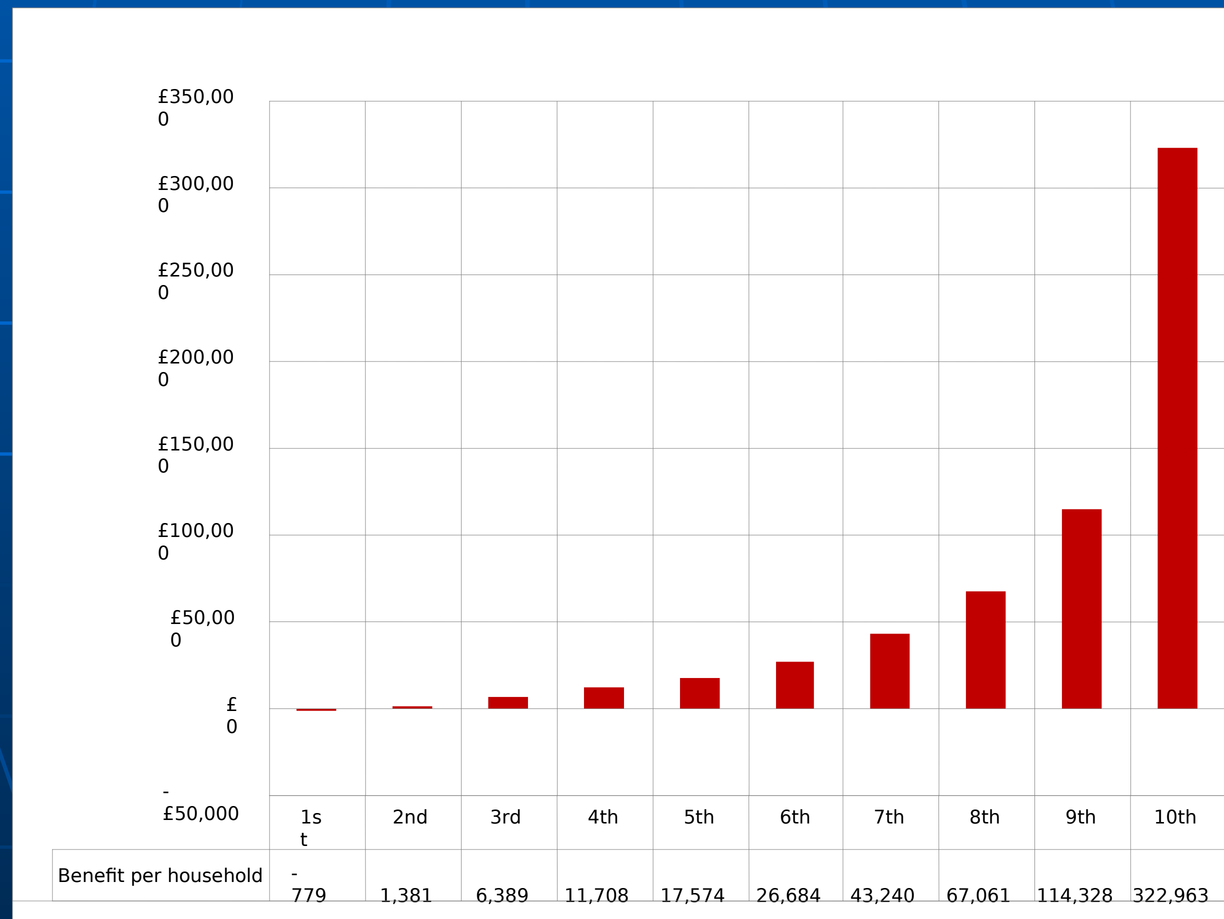
- Trustees conduct more sponsor corporate finance checks
- Liability management exercises:
- Data, PIE, ETV, deferreds, longevity assumptions
- GMP reconciliation and equalisation
- Trustees hoping end of QE may help

QE has other damaging side-effects

- May undermine confidence in capitalism, boost populism
- Increase inter-generational inequality
- 80% of financial assets held by people aged 45+
- Increase wealth inequality, redistribute wealth by stealth
  - Top 5% of UK households hold 40% of all assets
  - Bottom half of US citizens own just 2% of equities, bonds, mutual funds

Transfer of wealth to the wealthiest

Bank of England analysis 2012



	1st	2nd	3rd	4th	5th	6th	7th	8th	9th	10th
Benefit per household	-779	1,381	6,389	11,708	17,574	26,684	43,240	67,061	114,328	322,963

Alternatives to QE?

- If there's recession, central banks may try one more QE
- Taper tantrums show market pressure
- But running out of road
- Encourage pension investors to boost growth directly
- Infrastructure, social housing, build to rent
- May also try 'People's QE' – helicopter money

Why has QE continued so long?

Power of winners

- Governments
- Financial institutions
- Wealthiest groups
- Asset owners
- Owner occupiers

Less power of losers

- Savers
- Less well-off
- DB pension sponsors
- Younger generations
- Those who rent

So what's the end-game for QE?

- 'Quantitative Tightening' would see gilts sold to market
- QT is huge liquidity withdrawal, who will buy the bonds?
- Higher yields worsen fiscal deficit, political problem
- Governments may press central banks to just allow all bonds to run off, without repayment
- Rebase global rates and markets - huge debt forgiveness
- Governments, banks, wealthiest groups all benefit

Impacts on pension funds?

- Need to be prepared for rates to stay lower for longer
- Maybe regulators too complacent about employer strains
- Next downturn will require policy for winding-down, not just winding-up
- Help trustees/employers manage liabilities at lower cost
- Consolidators, scheme mergers, economies of scale
- Deliver more than PPF and allow businesses to exit

Thanks for listening

Any questions?...

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