DEAN BUCKNER AND KEVIN DOWD – WRITTEN EVIDENCE (QEI0018)

QUANTITATIVE EASING INQUIRY

Unwelcome Effects of Low Long Term Government Bond Yields

1. Long term government bond yields are at historic lows. The lowest 10 year yield before 2010 was 2.3% in 1896. The current yield is just over 1%. It is generally agreed that these low rates are the result of QE, i.e. the Treasury limiting, via the Bank of England, the supply of gilts.

2. This low yield environment has had a number of unwelcome effects.

3. First, a lower interest rate makes annuities more expensive, because prices move inversely with yields. The higher annuity value encourages existing annuitants to cash in their pension at the higher value, even though the income from the pension remains unchanged. This lowers the future income available to them, and may encourage them to spend the surrender value when they should not have done. And by the same token, annuities become more expensive for buyers, who as a result may choose either not to save, or to invest their earnings in risky equities instead.

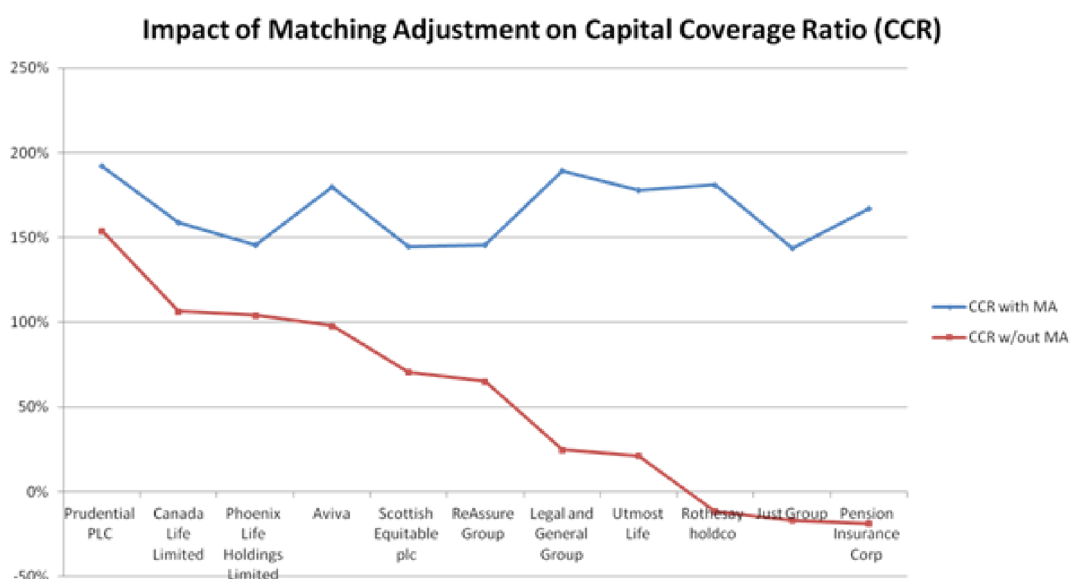
4. Second, the low interest environment has had a dangerous impact on the solvency of providers, who are now using an accounting trick called the 'Matching Adjustment' to artificially boost their reported solvency.

5. The accounting trick, which is of dubious legality, is to increase the annuity discount rate above the gilt rate to counter the effect of falling interest rates. Some firms use the trick to increase their reported capital coverage ratios, whilst others use it to artificially boost profits by substituting low quality assets for high quality ones.

6. Perhaps as many as 10m pensioners are being forced to see their pensions transferred to companies they had not contracted with. The default of any of these firms would cause major hardship to

pensioners and it is unclear whether the Financial Services Compensation Scheme would be able to deal with a large default, and in any case much of the burden would fall upon the taxpayer. Hence these firms are a potential threat to the long-term soundness and safety of the UK pension system.

7. The chart below shows the effect of Matching Adjustment on firms' capital coverage ratios.



8. The Prudential Regulation Authority seems to be aware of abuse of Matching Adjustment, as the following extract from a recent speech by Deputy Governor Woods suggests:

> Coming back to the matching adjustment, this makes a contribution of around £70 billion to insurers' capital base at the last count. The principle of the MA – that long-term investors that match assets closely to their long-term liabilities are exposed to fewer risks – is sound. But it does represent the bringing forward – and potentially paying away in dividends – of unrealised returns. And its calibration is subject to uncertainty which, combined with its size and the quantity and importance of the services that it underpins – retirement income and long-term investments – mean that we have to maintain a very high confidence that its calibration is suitably prudent. (Sam Woods, Deputy Governor for Prudential Regulation of the Bank of England:

"Brave new world", speech at the Association of British Insurers, 16 March 2021. https://www.bis.org/review/r210316b.pdf

9. We would argue, on the contrary, that the MA is unsound on principle, and that the £70 billion in capital Mr Woods refers to is illusory. At the same time, it is to be regretted that the PRA seems unwilling to force firms to issue more actual capital.

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