PENSIONS AND LIFETIME SAVINGS ASSOCIATION – WRITTEN EVIDENCE (QEI0020)

QUANTITATIVE EASING INQUIRY

ABOUT THE PLSA

Our mission is to help everyone achieve a better income in retirement. We work to get more people and money into retirement savings, to get more value out of those savings and to build the confidence and understanding of savers.

We represent the defined benefit, defined contribution, master trust and local authority pension schemes that together provide a retirement income to 20 million savers in the UK and invest £1 trillion in the UK and abroad. Our members also include asset managers, consultants, law firms, fintechs and others who play an influential role in the governance, investment, administration and management of people's financial futures.

INTRODUCTION

1. The PLSA welcomes this call for evidence on the effects of Quantitative Easing and has already given oral evidence in respect of pensions.
2. This written submission complements the oral evidence already given by the Chair of the PLSA, Richard Butcher.
3. The paper answers the three specific pension related questions that were fielded in relation to the effects of QE on different types of pension schemes, the level of risk taken by schemes in their investments as a result of QE and the risks attached to unwinding of QE for pension schemes.

EFFECTS OF QE ON PENSIONS

In what ways has QE affected the viability of different types of pension plans?

Before engaging directly with the questions raised, we think it is important to note that, on balance, we believe that QE has been a positive development for pensions, especially the first rounds of QE, due to the role it played it supporting the overall UK economy and the businesses that sponsor and make contributions to pension schemes.

As the Committee will be aware Pension schemes come in different shapes, sizes and types. The impact of QE has therefore impacted different types of scheme and the holders/savers in different ways. Some directly, some indirectly.

DB Schemes

For DB schemes it resulted in significant increases in deficits. Deficits that have had to be filled by either higher employer contributions, longer recovery plans or

greater investment returns. In most schemes it will have also led to higher employee contributions.

For DB schemes perhaps the most substantial impact has been on scheme liabilities. Because of the way these are calculated it resulted in significant increases in deficits. Deficits that have had to be filled by either higher employer contributions, longer recovery plans or greater investment returns. In most schemes it will have also led to higher employee contributions.

Quantitative Easing pushed up the price of Gilts in a manufactured way. This in turn increased asset values for DB schemes holding Gilts but also reduced the expected yield. With low yields and interest rates, discount rates, used by scheme actuaries, were also lowered, this resulted in liabilities being increased.

The 2010 Purple Book estimated that a 0.1% reduction in yields had the effect of increasing DB scheme liabilities by 2% and only increasing scheme assets by 0.4%.

In effect sponsoring employers of schemes saw their Deficit Recovery Contributions increased as a result of QE.

The PLSA survey our membership (in our previous guise of the NAPF) 75% of DB schemes reported to be in deficit prior to QE (2007) and 87% after QE (2011). Those in surplus fell from 25% to 13% in the same time frame.

Bank of England analysis (July 2012) showed that for a model scheme with £100m in assets and liabilities 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 the deficit would have increased from £30m in 2007 to £65.5m in 2012.

TPR research in 2012 showed that 75% of schemes had to extend their deficit recovery plans with 50% extending by as much as 3 years and increasing contributions by at least 10%. 45% were looking at other flexibilities they could adopt to make the plan work on top of extensions and contribution increases.

The Pension Corporation estimated in 2012 that schemes would be paying in an extra £7.4 Billion per annum until 2020 to overcome the effects of QE.

Concerns raised by DB Schemes at the time:

- Firstly, huge jumps in the deficit can 'spook' sponsors and trustees, prompting them to question whether they can continue to support the scheme;
- Secondly, where details of the valuation are in the public domain, this can then damage corporate credit-ratings, with all the consequences that brings; and
- Finally, the size of the scheme deficit does have a real bite, to the extent that any recovery plan subsequently agreed to fill the deficit leads to higher sponsor contributions into the scheme than would otherwise have been the case.

QE affected future funding service rates and although difficult to accurately quantify, this impact will have also led to an acceleration in closure of DB schemes during the period – as they've appeared unaffordable to employers and

also a dampening effect on the ability of employers to increase contributions in their DC schemes

On the whole this will have led to younger cohorts of members and those joining sponsoring employers later receiving less generous pension benefits.

There are two main exit strategies for closed DB schemes, one is paying out members until the last one has come to the end of their natural lie and the other is a Buy Out strategy. QE and Solvency II have combined to make Buy Out strategies more expensive and this is a real cost compared to the paper cost of a scheme deficit.

DC Schemes

For DC scheme members the largest effect was on those purchasing annuities.

The individual savers closer to retirement were most affected by QE. Many were in lifestyle funds gradually moving out of equities to 75% Gilts/bonds 25% cash positions. They may have been selling when equities were low and buying Gilts when prices were high. In 2010, pre-pension freedoms, 94% of our DC schemes offered Lifestyle funds and 80% had it as their default.

At decumulation, choices were more limited and most people were choosing or defaulting into annuities. QE lowered the annuity rates on offer and those people needing to or deciding to buy an annuity at that time would have been locked into those lower rates.

Income Drawdown schemes were linked to the GAD rate at the time and increasing the rate that people could withdraw from 100% to 120% of the GAD rate was a good mitigating measure to avoid income shocks for those retirees in drawdown.

The Pension Freedoms, introduced in 2015, have changed the nature of decumulation and mean that future DC retirees may be affected by QE in different ways to those retiring during the financial crisis.

Flexible Access Drawdown is now a more popular choice than purchasing an annuity and with the ability to take tax free cash first and then decide on purchasing an annuity later, timing risks associated with AE can also be mitigated for annuity purchase. Flexible Access Drawdown is also decoupled from the GAD rate and there are no maximum drawdown considerations. Some retirees are still members of Income Drawdown policies that are attached to the GAD rate but many can convert easily to the more flexible drawdown policies.

There is also a trend away from life-styling as schemes adjust to savers retiring at different ages and taking different options. 75% gilts and 25% cash was to have some equivalence to the retirement benefits being offered by purchasing an annuity in retirement. With investment pathways there are now 4 different defaults with different objectives.

The lower annuity rates caused by QE may have been a factor in government introducing the pension freedoms. They were certainly a push factor into more people choosing drawdown over annuities, which in turn leaves the individual savers with management of investment risk and decisions about when to convert into an annuity or not.

Have persistently low interest rates and the expanded use of QE forced pension funds to move into riskier assets?

The approach has been different across different types of schemes and at different levels of scheme maturity.

Overall, for DB schemes, QE has not resulted in a move to riskier assets.

Many closed DB schemes had been on de-risking journey due to the maturity of schemes in advance of the financial crisis. There are still some schemes that are open to accruals and their approach has been different.

It is also worth noting that schemes are under a legal obligation to invest prudently so will not seek to invest in high risk investments.

What the low yield environment, has however done is forced schemes to work harder to find returns, that may include carrying some investments which have a little more risk.

This has led to more diversification, and in particular larger schemes looking more at illiquids and alternatives (Purple Book) and there was a bit of boom into Private Equity in the years immediately after the crisis, which has since settled down.

For some however the result has been dealing with bigger deficits for longer and requiring greater contributions from employers.

For DC schemes there has been little impact on the majority of savers who are in accumulation and far from retirement. They have remained invested in equities.

However, there have been some effects on those close to retirement. Following the introduction of the Pension Freedoms in 2015, people have tended to opt for an investment drawdown product rather than an annuity. As a result, people in retirement face exposure to investment risk in a way that they did not when annuities were the norm. However, we are not aware of evidence to suggest that investment drawdown products are themselves invested in riskier assets than before QE.

What risks does any unwinding of QE present that are specific to the banking sector and to pension funds?

In principle, we believe that for the most part the unwinding of QE would be reasonably positive for pension funds if undertaken in an orderly way as we expect liabilities will fall more than asset values.

If there is an un-orderly QE unwind, those schemes which have managed their interest rate exposure by using some sort of leverage with swaps or gilt repurchase agreements, might be affected. A sudden and large increase in gilt yields could create liquidity issues for such schemes and other market participants (through margin calls, cash settlement, and potentially refinancing issues on the repo market).

It is important however to recognise the symbiotic relationship between employers and DB schemes – as the lifting of support may have more direct impacts on companies and test their strength – for example it may mean that weaker companies collapse more quickly.

As investors pension funds will clearly want certainty and clarity about timely exits. Therefore, it is essential that the unwinding of QE is done in an orderly manner and clearly communicated in advance.

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