Compound Interest.

Monetary Policy Edition

July 2025

Introduction.

PIC secures the benefits of hundreds of thousands of members and former members of UK defined benefit pension schemes.

Jeremy Apfel
Managing Director - Corporate Affairs, Pension Insurance Corporation plc

In order to help us have the secure, long-term cashflows we need to pay these pensions over coming decades, we have invested more than £14 billion so far into the UK economy, including in social and affordable housing, urban regeneration, and the UK's education sector, supporting jobs, growth and creating significant social value.

Our sector expects to invest up to £200 billion into UK housing and infrastructure over the next decade. However, as is increasingly well documented, there are not enough projects being brought forward to satisfy investor – or societal – demand. The reasons for this include the planning system, regulatory risk aversion, capacity constraints within the construction sector and other issues.

However, there is another, little noticed, drag on development and hence economic growth – the Bank of England's ("BoE") Quantitative Tightening ("QT") programme. QT is a monetary policy tool where central banks reduce the money supply by selling assets from their balance sheet.

QT helps keep project supply lower than it otherwise would have been – meaning fewer social houses built and fewer infrastructure projects completed – by further increasing the cost of borrowing for developers and increasing the risk of lending to investors. By helping push up gilt yields, QT also helps to artificially inflate the funding levels within defined benefit schemes, inadvertently driving potentially poor policy decisions.

Other central banks, such as the European Central Bank (ECB) and the US Federal Reserve, have adopted different approaches to QT and the management of the assets they accumulated from QE. The BoE could consider ending its policy of selling bonds before they mature (active QT) and stopping paying bank rate on the deposits commercial banks are required to hold with the BoE.

So, in this edition of Compound Interest we explore how QT, and the impact of the BoE's distinctive approach to it, is influencing both the investment environment and the pensions sector.

I hope you enjoy this edition. Please do get in touch with the team if you have any views you would like to share, or suggestions for the next edition of Compound Interest.

In this issue:

Who we are and what we do.

PIC's purpose is to pay the pensions of its current and future policyholders. Our investment strategy is carefully constructed to provide the cashflows to match all future pension payments over the coming decades.

The best way to do this is by investing in very secure assets like UK government and high-grade corporate bonds, and the infrastructure the UK needs.

Our appetite for risk is low and our timeframe for success is measured over decades, not the next four quarters.

We have already invested more than £14 billion in UK productive finance assets such as social housing, renewable energy, urban regeneration projects, and the UK's universities. We have more than £29 billion invested in the UK and have a total portfolio in excess of £50 billion. So far, we have paid more than £16 billion in pensions to our policyholders, with a 99% customer satisfaction level.

Executive summary.

The Bank of England ("BoE") has an objective to support the UK Government's economic policy objectives.[1] Alongside changes to short term interest rates, known as Bank Rate, monetary policy has become a significant tool in the BoE's arsenal.

Initially this was done through Quantitative Easing ("QE"), under which the BoE bought UK Government debt and corporate bonds in large quantities with newly created money, in the wake of the Global Financial Crisis and then Covid.

Since 2022, this policy has been reversed with the implementation of Quantitative Tightening ("QT"), under which the BoE is now selling the assets it built up during QE.

QE was explicitly designed to inject liquidity into the economy by reducing borrowing costs for companies and the Government. Under QT, the converse is true – it raises the interest rate that the Government pays on its existing stock of debt by introducing additional supply into the market.[2]

The BoE has so far sold down £275 billion of the gilts and much smaller quantities of corporate bonds it bought during QE.[3] It now holds around £620 billion of gilts on its balance sheet[4], of which £80-100 billion could yet be sold down annually.[5]

In the year to September 2025 the Government intends to issue £300 billion of fresh debt. The BoE intends to sell down an additional £100 billion of gilts during the same period. This creates dangers. As the International Monetary Fund ("IMF") has noted, "Vulnerabilities have...risen [in the gilts market], given increased supply and the reduction in demand by more patient investors, with hedge funds and non-residents playing a greater role, and the BoE reducing its holdings as part of QT.[6]"

Aside from the more general market risk posed by bond vigilantes highlighted here, it is important to understand how much yields have been raised by QT because higher gilt yields – and the expectation that they will remain elevated – affect Government thinking in a host of different ways. This includes pension policy, as well as government's ability to achieve important goals, such as the delivery of 1.5 million homes over the course of this parliament.

The BoE has stated that the impact of QT on gilt yields is low, estimating that the policy increases gilt yields by around 10-20 basis points ("bps"). Others estimate that QT increases gilt yields by around 50bps or more – a significantly larger impact than the BoE's own estimates.

Whatever the actual level, by pushing gilt yields higher than they otherwise might be, QT is a key factor that is causing those borrowing in the listed and private capital markets – including housing associations (HAs), a major provider of affordable housing – to reduce their borrowing, the cost of which is referenced to those yields.

The net effect is to slow economic growth, and from a PIC perspective reduce the supply of the kind of assets with long-term cashflows we need to back our pension commitments over coming decades.

Whilst there is general agreement internationally among central bankers that passive QT (allowing the bonds to mature and not reinvesting the proceeds) should take place, critics of the BoE's approach to QT note that it includes the active sale of part of the BoE's gilt portfolio at a loss and without appropriate regard for market conditions. They say this imposes large bills on the UK taxpayer, via the Treasury, which has indemnified the BoE against such losses.

The problem with indemnifying the BoE on bond losses is that there is no government body pushing for a cost benefit analysis of the benefits of QT compared to other forms of fiscal stimulus. This needs undertaking.

The BoE believes that it is right to undertake QT, and to do so on a broadly fixed schedule to remove distortions in the gilt market, so that it has more capacity to respond to future economic crises, specifically through a return to QE.

So, the purpose and pace of the BoE's active deleveraging is keenly debated.

Bodies across the political spectrum are campaigning for a change, with the left of centre New Economics Foundation highlighting the costs, and the right of centre Conservative Way Forward think tank and the cross-party Treasury Select Committee urging the bank and HM Treasury to consider value for money criteria in deciding on the ongoing pace and timing of QT.[7]

According to the Financial Times, the BoE itself might reconsider the policy: "If bond prices deteriorate further, analysts reckon the Bank of England could pull back on sales of debt that it accumulated after the Covid crisis.[8] Policies they might want to consider include ending the policy of active QT (selling bond holdings prior to their maturity and often at a loss) and adopting a tiered reserve policy so the BoE stop paying interest on the BoE deposits commercial banks are required to hold.

So, as we enter the fourth year of QT, it is right to add to that debate from the perspective of a significant investor in the UK economy.

[1] Bank of England, **The Bank of England's statutory monetary policy objectives: a historical and legal account, Staff Working Paper No. 1,110**, January 2025
[2] NatWest Business, Economics, **The fiscal free lunch is over: how inflation and monetary tightening will affect the economic landscape**, July 2022
[3] HM Treasury, Correspondence, **Letter from the Chancellor of the Exchequer to the Governor of the Bank of England**, 13 May 2025
[4] HM Treasury, Correspondence, **Letter from the Chancellor of the Exchequer to the Governor of the Bank of England**, 13 May 2025
[5] Bank of England, **Asset Purchase Facility Quarterly Report – 2025 Q1**, May 2025
[6] International Monetary Fund, **United Kingdom: Staff Concluding Statement of the 2025 Article IV Mission**, May 2025
[7] House of Commons, Treasury Select Committee, **Quantitative Tightening**, January 2024
[8] Financial Times, **The bond vigilantes are on the prowl**, May 2025

Section One

Is Quantitative Tightening helping depress productivity and lower economic growth?

Rob Groves
Chief Investment Officer at PIC

In March 2009, in the depths of the Global Financial Crisis, the Bank of England ("BoE") was concerned about the possibility of deflation, due to collapsing aggregate demand.

They believed that encouraging demand in the UK economy by increasing liquidity would help them maintain their inflation target. They also wanted to reduce the potential for further market disruption because there was a real fear that institutions would begin to horde money and the financial system would seize up.

Their main, and preferred, monetary policy tool to stimulate economic demand – reducing Bank Rate – had been exhausted following a series of rapid rate cuts from the 5.75% which Bank Rate stood at in November 2007, to just 0.5% by April 2009.[1] The BoE then rejected reducing it below zero. The solution was Quantitative Easing ("QE") – buying UK Government and corporate bonds in large quantities with newly created money to reduce gilt yields. This would inject liquidity into the economy by reducing borrowing costs for companies and the Government.

In May 2022, the BoE published an analysis of the functioning and effectiveness of its QE programme. This showed that QE's effectiveness at lowering gilt yields was highest in the first round of QE, with an overall reduction of 100 basis points ("bps"). This reduced in subsequent announcements, as shown below in figure one. The BoE's analysis also found that insurance companies played a key role in QE's transmission mechanism by selling gilts to the BoE and shifting to corporate bonds.[3]

The BoE hold the gilts and bonds purchased under QE in the Asset Purchase Facility (APF) a Bank-owned subsidiary, indemnified by the Treasury, separate to the Bank's core balance sheet.

Under QE, the BoE's balance sheet expanded rapidly (see Figure Two). It peaked at £895 billion in January 2022.[4]

Technically there is no limit to the size of the BoE's balance sheet, but there are clearly questions about the sustainability of the quantum of Government debt. We are at a historically unique moment in the history of monetary policy in the UK.

Figure One: Change in 10-year gilt yields after QE announcement and gilt purchase surprise[2]:

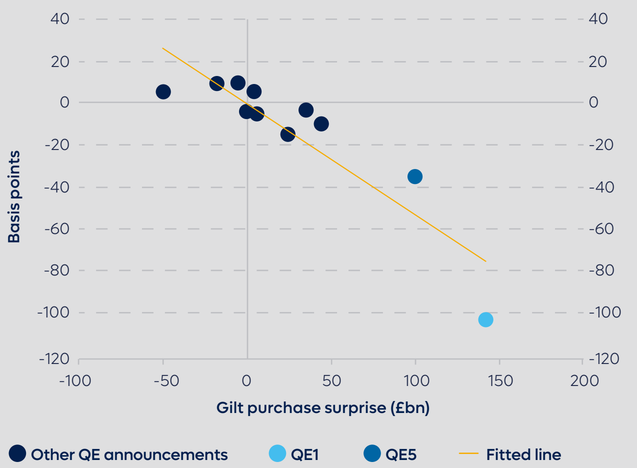
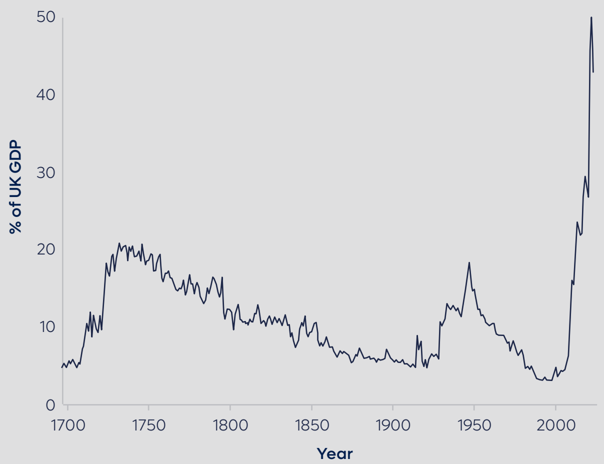


Figure Two: Bank of England Balance Sheet as a percentage of nominal UK GDP, 1697-2023:[5]



1 Bank of England Database, **Official Bank Rate history**
2 Bank of England, **QE at the Bank of England: a perspective on its functioning and effectiveness**, Quarterly Bulletin 2022 Q1
3 Bank of England, **Quarterly Bulletin 2022 Q1, QE at the Bank of England: a perspective on its functioning and effectiveness**, May 2022
4 HM Treasury, **Correspondence, Letter from the Chancellor of the Exchequer to the Governor of the Bank of England,** 13 May 2025
5 Bank of England, **Optimal quantitative easing and tightening, Staff Working Paper No. 1,063**, March 2024

Is Quantitative Tightening helping depress productivity and lower economic growth? Cont.

How is the Bank of England undertaking QT?

In February 2022, the BoE started its QT programme by reducing the size of the APF though passive QT, that is ceasing the reinvestment of maturing gilts and corporate bonds. However, in November 2022, the Bank began the active sale of corporate and government bonds.

The BoE make clear that "the aim of QT is not to affect interest rates or inflation. Instead, the aim is to ensure that it is possible to undertake QE again in future, should that be needed to achieve the inflation target."[6] With the disruption we have seen in markets in recent years, including Covid, the LDI crisis, and the Trump tariff disruptions, the BoE's desire to have the capacity to act decisively again sounds wise.

However, there are consequences in the short term. The size of the BoE's balance sheet can distort the markets by influencing the availability of reserves, which impacts market liquidity and can affect short-term interest rates. The larger it is, the more it distorts markets.

While the BoE recognise that QT is part of the macro environment that informs yields, they believe the impact is limited, and in any case significantly smaller than the reduction in gilt yields under the first round QE. In their view this is because QT has been signalled in advance. However, they do acknowledge there is, "uncertainty about the impact of reducing the stock of purchased assets on monetary conditions."[7]

Writing for the Institute of Economic Affairs on the cost of QT, the right of centre the Rt Hon Sir John Redwood states that an outcome of QE was to drive bond prices higher and yields lower, so we should expect QT to lower bond prices and drive yields higher.[8]

Yet QE and QT may not have precisely matching inverse impacts, because QT is being undertaken well signalled in advance according to a timetable, rather than in high pressure circumstances with dramatic interventions. QT also follows QE, so the economic situation is different, as the UK now has a substantial stock of debt it did not have in 2009 and so the risks of maintaining high debt levels should also be considered.

While the BoE state they are not altering the overall size or pace of their QT programme[9], they have in practice adjusted QT by delaying the sale of long-term bonds in response to the turmoil in long-term bonds in 2022, and the Trump tariffs of 2025.

How is the BoE acting differently to other central banks?

Many central banks are conducting passive QT, but unlike the BoE most have taken action to reduce their losses on QT by not doing active QT or not charging current losses back to the taxpayer.

The European Central Bank is holding its bonds to maturity and since September 2023 is not paying interest on minimum reserves.[10] The US Federal Reserve has created a matching asset on its balance sheet to cover these losses out of future profits.

The indemnity provided by HM Treasury to the BoE for losses in the APF has empowered it to act differently. Initially, it made a profit on QE but current losses on these assets look set to far exceed those initial profits. Overall the taxpayer will begin to make a net loss on the programme (profits minus losses) beginning early 2026. The Office for Budget Responsibility is now forecasting a cumulative net lifetime loss of £133.7 billion on the APF assets, although this figure is heavily sensitive to future interest rates.[11] The taxpayer is losing money on QT in two direct ways: As interest rates have risen, the income on the gilts the BoE holds no longer cover the interest it pays to private banks on their deposits; and through active QT the BoE is selling bonds before maturity at a loss to reduce its balance sheet quicker.

The taxpayer is also impacted indirectly because the higher yield on government debt means higher interest payments, which come out of tax receipts.

[6] Bank of England, **Quantitative Easing**
[7] Bank of England, Monetary Policy Committee, **Monetary Policy Report August 2021**
[8] Institute of Economic Affairs, **The Cost of Quantitative Tightening**, Recommendations for Government and the Bank of England, Rt Hon Sir John Redwood, March 2025
[9] Financial Times, **Bank of England drops sale of long-dated bonds amid market turmoil**, April 2025
[10] European Central Bank, **ECB adjusts remuneration of minimum reserves**, July 2023
[11] Office for Budget Responsibility, **Economic and fiscal outlook – March 2025**

Is Quantitative Tightening helping depress productivity and lower economic growth? Cont.

What are the alternatives to the BoE's approach?

The scale of the losses is controversial because it is linked with the BoE's decision to engage in active QT. This is compounded by the BoE's decision to pay Bank Rate interest on all reserves held with it, when it could pay no interest on bank reserves, or only pay interest on reserves held above the minimum level – operating a tiered reserve policy – as other central banks do.

The BoE could decide to allow the APF assets to run off without active sales, a process called passive QT and not reinvest the proceeds. This would negate the need for a timetable. Monetary policy could also be more balanced without the swings between long distinct periods of QE and QT.

The BoE could also adopt a tiered reserve policy. Tiered reserves, where banks would be expected to hold a portion of their reserves unremunerated, are in practice not much different to the negative interest rate previously considered as part of the BoE toolkit. Commercial banks' profits might take a hit and/or they could reduce their lending, but they may prefer this to an explicit windfall tax which could otherwise occur.

For example, the Trades Union Congress (TUC) has said one policy option would be to introduce a windfall tax surcharge of 35% on bank profits bringing the corporate tax plus surcharge rate to 60%[12]. The TUC reference analysis by Positive Money, a campaign group, which estimated that a surcharge of 35% would have raised £20 billion in 2023 alone[13].

Were the BoE to end active QT, there would be a substantial saving for the taxpayer. The left-wing think tank The New Economics Foundation (NEF) estimates that HM Treasury could save £13.5 billion per annum in this scenario.[14]

NEF also estimate that up to £11.5 billion in addition could be saved per annum by adopting a tiered reserve policy.[15] This is a lot of money for a fiscally constrained government to leave on the table.

How QT helps lower productivity

Whatever the actual level, by helping to push gilt yields higher than they otherwise might be, QT is causing those borrowing in the listed and private capital markets – including housing associations ("HAs") – to reduce their borrowing, the cost of which is referenced to those yields. This depresses productivity and slows economic development.

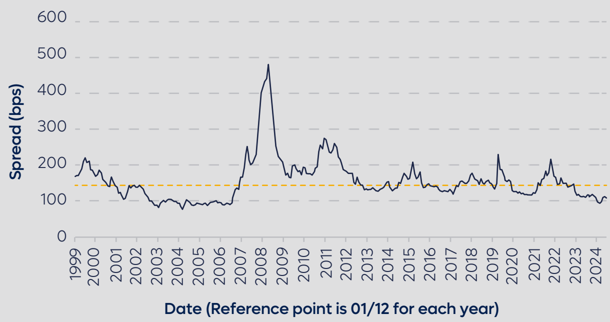
PIC has lent more than £3 billion to HAs to date. However, over the past year, the supply of HAs looking to borrow has dried up, because of the overall rise in the cost of borrowing including the impact of QT.

HAs set long-term strategy to match expected borrowing costs over periods of up to 30 years, and do not want to lock into high borrowing costs for long periods. So, even where they are currently borrowing, they are doing so for shorter terms, hoping to refinance when rates drop (see Section Three: Focus on Social Housing).

Institutional investors like pension funds and insurance companies, seek to lend over the very long-term in order to secure the cashflows to match pension liabilities which stretch out decades into the future. As prudent investors who expect to hold these investments over multiple economic cycles, institutional investors are wary of investing when markets are overvalued – which in practice means when credit spreads are low. The credit spread represents the additional compensation investors demand for taking on the credit risk of a non-government borrower, compared to the "risk-free" government bond. They are used by investors as a reference point to price risk in credit markets and, as figure three shows, credit spreads are historically low today due to the sheer weight of money chasing investment opportunities.

Figure Three: Long Dated UK Credit Spreads:

Long-dated UK credit spreads are now trading in the 17th percentile



So, we have a situation where, in the current environment, the HA thinks it is expensive to borrow – a situation compounded by QT – but institutional investors think it's expensive to lend. So overall investment in social and affordable housing goes down.

In turn, this impacts the outcomes of the UK Government's stated missions to grow the economy and deliver 1.5 million houses.[16]

Money spent covering BoE losses on bond sales also represents an economic opportunity cost. It could be spent on extra hospital places; government guarantees to boost private investment in infrastructure; or a range of other projects that could boost economic growth.

The problem with indemnifying the BoE on bond losses is that there is no government body pushing for a cost benefit analysis of the benefits of QT compared to other forms of fiscal stimulus. This is an important piece of work that should ideally be completed. If the BoE is incorrect and is underestimating the real impact of QT on yields, it could cause an economic downturn by tightening too much.

[12] Trades Union Congress, **Bank taxation**, November 2023
[13] Positive Money, **Campaigners Trick or Treat the Banks**, October 2023
[14] New Economics Foundation, **Treasury to hand Bank of England £130bn in next five years in stealth subsidy to bankers**, February 2025
[15] New Economics Foundation, **Government could save £55bn over next five years by limiting Bank of England's interest payments to commercial banks**, November 2023
[16] HM Government, **Plan for Change, Milestones for mission-led government**, December 2024

Is Quantitative Tightening helping depress productivity and lower economic growth? Cont.

How can we estimate QT's impact on gilt yields and the bank rate?

Currently, the BoE assess QT's impact on gilt yields by estimating its impact on term premia, the additional compensation investors demand to hold a longer-term bond relative to a series of shorter-term bonds. They believe QT's impact on 10-year gilt yields is low, at between 10-20 bps of the 40 bps term premia impact since QT began. At the other end of the spectrum, the National Bureau of Economic Research (NBER) suggests that the cumulative impact of all QT announcements on government bond yields is between 44-70 bps.[17]

Handelsbanken estimate that QT's impact on the bank rate specifically could be equivalent to the BoE raising interest rates by around 50 bps by mid-2025.[18] Taking up to 50bps off the cost of borrowing would clearly affect lots of marginal investment decisions, but the impact of QT may be greater in future.

Most assessments of QT's impact focus on market movements in the days following future sale announcements. However, the assessments should be made in an analysis of the overall increase in gilt yields, which includes the tightening because of interest rate decisions. QT has reinforced the impact of base rate increases. Since QT was announced, bond yields have surged (see figure four below) and it is in this context that QT is adding to the cost of borrowing.

Figure Four: 30 Year HM Treasury Gilt Yields[19]

We should consider whether it is wise to use the same metric to assess the impact of QE, which was first announced as a surprise, for QT, which has been heavily signalled in advance. For QE, the claim that the market moves represented the impact for QE are justifiable because the announcements were a response to crisis. QT was not a surprise, so the moves in gilt yields on market days following the announcements reflect the extra speed of QT, rather than the quantum of QT. It is therefore likely that they underestimate its impact.

Will QT's impact on UK borrowing costs increase?

The BoE is cancelling the bank reserves it created to purchase the stock of gilts they hold in the APF as they mature or are sold. This reduces liquidity and tightens the money supply.

The market is also being asked to absorb £100 billion of secondary gilts in the year to September 2025, with more sales likely to follow in future years. This is in direct competition with the UK Government's plan to borrow over £300 billion in 2025/26.[20] This means that government primary borrowing could in practice be higher. The OBR has confirmed that for 2024/25 the government has overshot expectations by £15 billion.[21] This can create dangers.

[17] NBER WORKING PAPER SERIES, **Quantitative Tightening Around the Globe: What have we learned?** April 2024
[18] House of Commons, Treasury Select Committee, **Written evidence submitted by Handelsbanken plc**
[19] Trading Economics, **United Kingdom 30-Year Treasury Gilt Auction**
[20] HM Treasury, **Policy paper, Debt Management Report 2025-26 (Accessible)**, April 2025
[21] Office for National Statistics, **Public sector finances**, UK: March 2025

Who'll buy all these gilts?

The question then is who will buy all these gilts? Under QE, private sector defined benefit pension schemes were the primary domestic buyers of gilts – purchasing hundreds of billions of pounds of supply. It is generally accepted that they have no more capacity. Foreign official sector buyers bought £132 billion of gilts at the same time as the Bank sold £131 billion between Q4 2021 and Q4 2023, which means the impact of QT on the UK private market has been limited so far.[22]

However, as QT progresses, observers are starting to become concerned. As the International Monetary Fund ("IMF") has noted, "Vulnerabilities have...risen [in the gilts market], given increased supply and the reduction in demand by more patient investors, with hedge funds and non-residents playing a greater role, and the BoE reducing its holdings as part of QT." [23]

Could the BoE change its policy?

The BoE has been flexible in implementing QT but remains committed to an overall plan to deleverage. Governor Bailey has suggested that bank reserves could fall to the preferred minimum level of reserves by the end of 2025.[24] Policymakers often defer to the BoE because they are reluctant to question the BoE's independence. They are also wary about signalling any change on QT that could spook markets. Given this relative balance, it is possible that the Chancellor says we will just accept these losses.

However, the BoE has an objective to support the UK Government's economic policy objectives and responsible fiscal policy[25]. Bodies across the spectrum are campaigning for a change, with the left of centre NEF highlighting the costs, and the right of centre Conservative Way Forward think tank and the cross-party Treasury Select Committee urging the bank and HM Treasury to consider value for money criteria in deciding on the ongoing pace and timing of QT.[26]

Current economic conditions are weak. This was acknowledged by the BoE when they cut Bank Rate by 25 bps in May 2025. Governor Bailey has stated that while he would not make predictions on interest rates his view was "that the path, gradually and carefully, is downwards".[27] These cuts are designed to support demand and meet the 2% inflation target over the medium term. Usually, the BoE wants both monetary policy tools to support each other e.g. lower interest rates and QE both aim to reduce the real interest rate. If they continue with active QT but reduce the base rate, then their two tools of monetary policy will be working against each other – tightening (QT) and loosening (Bank Rate cuts) at the same time.

One possible catalyst for HM Treasury to drop the indemnity it provides to the BoE would be if the economic situation deteriorates further. The Government could face a scenario where it will break its fiscal rules which they are very wary about changing. There is a lot of political risk for the Government if they are seen to be playing fast and loose with these rules.

Thoughts on the way forward:

As we have seen while QE had some benefits as a response to the initial financial crisis, it was arguably used too much and has caused significant problems including the distortions caused by the large BoE balance sheet. Now QT is being undertaken to enable more QE, and it is causing problems in the form of higher borrowing costs. A more moderate approach without huge swings from QE to QT to QE is needed.

By adopting a more cautious approach to future use of QE we would not need the same pace of QT. It could be slowed through ending active QT, and the losses on keeping the gilts in the APF for longer reduced by ending the payment of bank rate on minimum reserves held with the BoE. QE should return to being viewed as an extraordinary tool for use in a genuine crisis and not to manage routine economic corrections.

In times of genuine crisis recent experience shows that higher balance sheets are tolerated by markets, so the current pace of QT looks too aggressive. How to manage the APF in runoff is a subject which we may explore in more detail in a future edition of Compound Interest.

[22] Financial Times, **Did the Bank of England misunderestimate QT? It's all about the gilt tilt**, August 2024
[23] International Monetary Fund, **United Kingdom: Staff Concluding Statement of the 2025 Article IV Mission**, May 2025
[24] Bank of England, **The importance of central bank reserves – lecture by Andrew Bailey** Lecture in honour of Charles Goodhart, London School of Economics, May 2024
[25] Fiscal policy, **The Bank of England's statutory monetary policy objectives: a historical and legal account**
[26] House of Commons, Treasury Select Committee, **Quantitative Tightening**, January 2024
[27] BBC News, **Bank lowers interest rates to 4.25% and hints at more to come – BBC News**, May 2025

Section Two

How does QT feed into the DB pension scheme funding levels debate?

Mitul Magudia
Chief Origination Officer

Over the past three years, following 15 years of heavy deficits, defined benefit (DB) pension schemes have moved into surplus as government bond yields have increased. The durability of current pension scheme funding levels should not be taken for granted as they are highly linked to monetary policy.

QT has undoubtedly had the effect of boosting DB pension scheme funding levels beyond where they might otherwise have been. This is important because of the current policy proposals to release 'surplus'. However, the ephemeral nature of DB pension scheme funding levels, compounded by the Bank of England's stated objective of starting quantitative easing again should economic circumstances require it, should be considered. Remember, one of the impacts of QE was to push gilt yields to ultra-low levels, creating record deficits in many schemes.

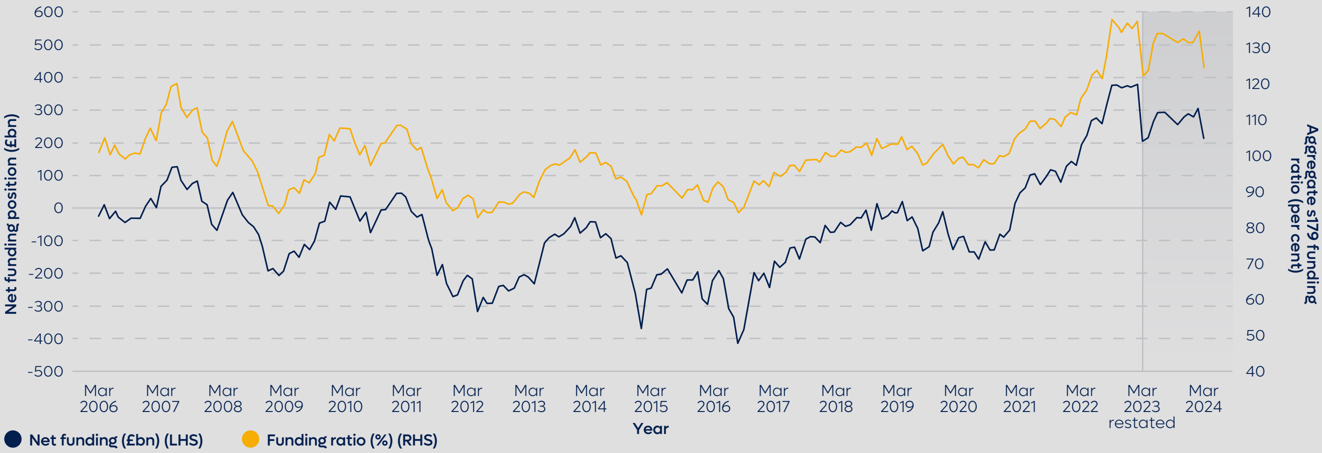
Under QE most DB pension schemes were in deficit (see figure five). In fact, sponsors paid in £200 billion in extra contributions into pension funds to cover deficits.[1] We should ask how long current positive DB pension scheme funding levels will last and whether it is safe to reduce DB pension scheme funding levels based on a short-term snapshot, especially where the stated path of future monetary policy could potentially create deficits once again.

Working on the basis that QT has increased rates at least around 50 bps[2], we estimate that liabilities are around 7 per cent lower than would otherwise be the case. If interest rates were to come down either through halting QT, or a restarting of QE, we would see liabilities increase. The current positive DB pension scheme funding levels could rapidly disappear.

Now that the Government has confirmed that they expect surplus extraction from defined benefit pension schemes to begin in 2028, this situation should come more sharply into focus. By 2028, after three more years of QT, the 50-bps temporary uplift to scheme funding levels QT has given will have unwound.

Trustees will know that the current positive DB pension scheme funding levels are likely to be temporary and many of them have sought to hedge or otherwise lock in their position. The question then is what they are hedging for, whether that is seeking to protect funding positions from the adverse effects of inflation, interest rate movements, or something else. No scheme is perfectly hedged, and without a dynamic strategy a fall in yields prompted by the end of QT, a stated aim of the BoE, or a worsening economic environment, could put many schemes right back at square one.

Figure Five: Historical s179 aggregate funding ratio and net funding position of pension schemes in The Purple Book datasets[3]



Source: PPF

[1] Professional Pensions, UK businesses pumped £200bn in pension contributions to avoid funding level drop, May 2021
[2] NBER estimates between 44bps and 70 bps.
[3] Pension Protection Fund, The Purple Book 2024

How does QT feed into the DB pension scheme funding levels debate? Cont.

Any return to deficit will need to be funded by the sponsoring companies, which in effect means management today borrowing from management in the future, with the risk put on the members themselves. Even today many companies with DB pensions are in financial distress – one in four companies with a DB scheme issued a profit warning in 2024.[4] Until there is complete security for members' pensions, members are inextricably linked to the fate of their former firm.

The only purpose of a DB scheme is to pay their members' pensions so, we polled 1,000 of them to find out their views. Perhaps unsurprisingly we found that security is extremely important to pension scheme members. 96% say certainty about the level of their pension over future years is "very important", or "important."

A sudden reversal of gilt yields, caused perhaps by an end to QT, or a reversion to QE, could put the pension security of millions of people in jeopardy.

The best way to protect against this is buyout where a pension scheme purchases an annuity policy that covers all of its liabilities. The insurer takes on responsibility for paying pensions and the scheme can be wound up, after which the members become policyholders of the insurance company.[5]

With the current pension scheme funding levels this is an ideal time to explore buyout. It guarantees pensioner payments and removes pensions from company balance sheets. It also allows pension insurance companies such as PIC to invest at scale in infrastructure and housing delivering significant social value.

[4] EY, **Profit warnings from UK-listed companies with DB pension scheme reach four-year high**, 11 February 2025

[5] Pension Insurance Corporation (PIC), **The Benefits of Buyout, What do defined benefit pension scheme members think about the risks to their pensions? Pension Risk Transfer Explained**, June 2025

Section Three

Focus on social housing.

Max Cawthorn
Head of PIC Capital Strategy

Many of the announcements in the recent Spending Review such as establishing a National Housing Bank, providing £39 billion in affordable housing support and agreeing a 10 year social rent settlement were widely welcomed in the housing sector for bringing greater clarity and stability for investors. However, to accelerate the delivery of affordable homes Housing Associations (HAs) will need to raise an additional estimated £100 billion[1] in private funding. This is difficult in the current environment when borrowing costs are high, there are multiple demands on HA funds and many HAs are reaching the limits of their borrowing capacity.

HAs plan and invest for the long term. This means they are more sensitive to fluctuating gilt yields than many borrowers. When rates were low, they borrowed significantly. Higher-for-longer yields means that fewer HAs are coming to the capital markets for borrowing and those that do, are borrowing for shorter terms.

This is perhaps a more urgent issue than has been acknowledged. There are about 1.3 million households on the waiting list for social housing today, and we need to increase the annual number of affordable homes by about 100,000 a year to meet demand.

PIC has invested more than £3 billion in social housing over more than a decade and we have seen periods of significant demand, but never so few investable opportunities within the sector. The secure, long-term cashflows that these types of investments produce allow us to match our future pension payments over coming decades.

The sector faces other serious issues which prevents them from building new homes: namely retrofitting existing properties for both fire safety and energy efficiency. However, the Bank of England's ("BoE's") Quantitative Tightening ("QT") programme is perhaps rather surprisingly playing a role in further suppressing the amount of social and affordable homes being built in the UK.

The impact of QE

After the BoE started its Quantitative Easing ("QE") programme in 2009, borrowing costs plummeted. With gilt yields and therefore borrowing costs at historic lows, the amount of investment by institutional investors shot up, over and above the funding by banks. This took a lot of pressure off the public purse.

As shown in figures six and seven, since 2019 there has generally been consistent investment flows into the social housing sector – where bank funding has been more limited, for example in the first three quarters of 2020/21 – a period when banks were focussed on other forms of lending to support the economy during COVID – insurers picked up the slack, and maintained investment flows into the sector.

The Housing Finance Corporation Limited is a non-profit organisation that issues long-term bonds in the Sterling capital markets and on-lends the proceeds to HAs to boost affordable housing supply. They state that "there has been a marked shift towards capital markets funding through facilities such as bonds and private placements, particularly after the banks pulled back from long-term lending to the sector following the 2008/9 financial crisis."[2]

PIC research found that as of December 2018 HAs had agreed total borrowing facilities of £95.4 billion, of which £59.8 billion (63%) were bank loans, so institutional investors, such as life insurers, were funding the £35 billion gap.[3] S&P project that total agreed social housing debt in the UK will increase to £120 billion by 2026.[4] Banks would not be able to fund this by themselves, and as figure seven shows, funding has indeed decreased as lending by institutional investors has tailed off.

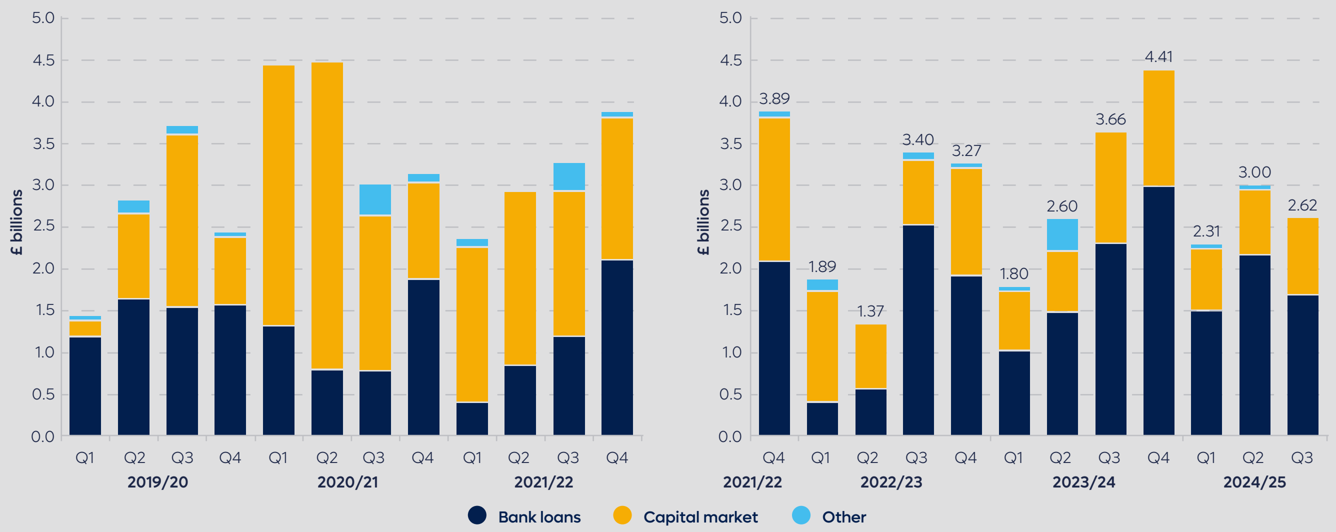
[1] £100 billion in private funding, **New AHP could deliver 500,000 affordable homes over next decade with additional £100bn in private finance**

[2] The Housing Finance Corporation (THFC), **Private finance in the social housing sector: how we got here**, September 2022

[3] Regulator of Social Housing, **Quarterly survey for Q3 October to December 2018** and Pension Insurance Corporation, **Filling the £35bn funding gap. How insurance capital helps fund social housing in the UK**, January 2020

[4] Inside Housing, **Sector's debt pile to hit £120bn by 2026, says S&P**, March 2024

Figures Six and Seven: New Facilities agreed – 2019 – 2024/25



Why has funding decreased?

Since QT was announced at the end of 2021, and gilt yields subsequently began to rise (see figure four, 30-year gilt yields), the demand for funding by institutional investors – and their risk-adjusted appetite for investing in the sector – has dropped substantially.

The National Bureau of Economic Research ("NBER") assess the impact of QT on Gilt yields at between 44-70 bps, taking the lower estimate, it is reasonable to suggest the impact of QT on borrowing costs at around 50 bps.

The additional 50bps on borrowing costs cannot be passed on to customers as social rents are regulated. When coupled with the requirement to spend cash on existing stock, this means fewer social homes are being built.[5] The Regulator of Social Housing Sector Risk Profile report revealed that "providers forecast building 300,000 homes over the next five years, 12% lower than forecast a year ago [2023 forecasts]."[6]

HAs borrow at a small margin above gilt yields. With long term interest rates significantly higher than they have been in recent years, and the expectation that rates will remain high for a long time, borrowing from institutional investors at durations of up to 30 years is now an unattractive option for social housing providers. This means they are borrowing less and borrowing for much shorter periods, typically between 5 and 10 years.

HAs set their plans over the long term and therefore higher yields means lower HA borrowing either to build new houses, or to refinance their existing borrowing. In October 2024, the Regulator of Social Housing released its Sector Risk Profile Report which warned that the sectors weakening financial position "continues to intensify."[7]

It found that in 2023/24 the sectors' debt servicing cost exceeded its earnings for the first time since 2009.[8]

Weakening outlook for the sector could mean that even if rates do decline – for example through the ending of QT – the sector remains unattractive due to its higher risk profile.

This is important because institutional investors like PIC, which ideally lend for very long durations as they seek to match future pension payments over the next 30-50 years, are consequently sensitive to sector risk, especially when markets are expensive, as they are today.

The yield available to investors above the risk-free rate, known as the credit spread, is historically tight. For bonds with a duration more than 10 years it is the lowest we have seen since 2007. This means that in our view, most assets are overpriced, and this is certainly the case when you are seeking to hold the bond for 30 years or more, across multiple economic cycles.

So, whilst HAs believe it is expensive to borrow now, institutional investors believe it's expensive (and risky) to lend.

This situation is compounded by the impact of QT, which has not been well documented so far, but it is clearly a contributing factor to the slowdown in the number of social homes that are being built. Taking up to 50bps off the cost of borrowing would have a real impact on the ability, and desire, of housing associations to bring more projects to market, and in the ability of the Government to achieve its target of building 1.5 million homes over the course of this parliament.

5 Building Cost Information Service, **Latest UK housing starts and completions figures**, April 2025
6 Regulator of Social Housing, **Sector Risk Profile**, October 2024
7 Housing Today, **Regulator warns of 'little margin for error' as housing associations' debt servicing costs exceed net earnings**, October 2024
8 Housing Today, **Regulator warns of 'little margin for error' as housing associations' debt servicing costs exceed net earnings**, October 2024

Glyn Gaskarth
Senior Manager, Corporate Affairs

gaskarth@pensioncorporation.com

+44 7561 400 918

PENSION INSURANCE CORPORATION PLC
22 Ropemaker Street, London EC2Y 9AR

pensioncorporation.com