The Effects of QE on Pension Funds

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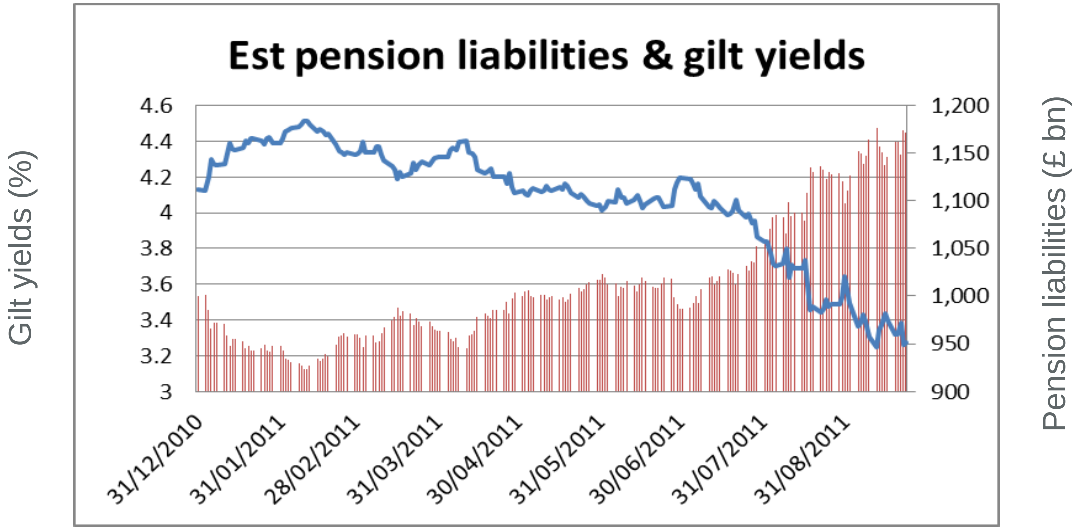
PENSION INSURANCE
CORPORATION

QE was bad for pension funds: Will QE2 be the same?

- Policymakers did not consider the impacts of QE on pension funds and insurers
  - No mention of asset allocation impacts in Bank of England paper on QE
  - Liabilities are only partly hedged so are very sensitive to falling rates as shown below



- We estimate that QE increased pension fund deficits by around £74 billion
- Typical pension is: 70% funded

  60% in equities, 25% in gilts and credit, 15% in index linked gilts
- Duration of liabilities 20 years but duration of gilts held in pension fund is 15 years

Estimated impact of QE on pension funds

- Bank of England paper suggests gilt yields fell by 100 basis points
- Equities estimated to have risen by 20%
- We also assume there was no change in inflation – no change (though long term inflation prospects should theoretically rise)
- Liabilities rise by duration (20yrs) x yield change (100bp) x £1 trillion = £200 billion.
- Assets of £700 billion
- Equities 60% x 20% = 12%
  - bonds 40% x 15yr x (100bp) = 6%

18% x £700 billion = £126 billion

Pension deficits go up £200 billion - £126 billion = £74 billion

Pension funds’ reaction to higher deficits

- tPR encourages a 10 year plan to fund deficits, so roughly £7.4 billion more money moves from sponsors to pension funds each year
- Generally increases the trend to de-risk pension fund position and buy more gilts
  - Money no longer available to invest in the business
  - New pension fund money likely to go into gilts (to help de-risk)
  - Drives yields lower and exacerbating de-risking
  - Sponsor company more financially stretched so banks are less willing to lend to it
- Pension funds with deficits are often SMEs
- These companies are too small to issue corporate bonds on capital markets, so no benefit from lower yields – they need the banks for credit
- So they get a ‘double whammy’ as credit has been withdraw by banks and their pension deficits grow
- Worse case scheme falls into the PPF

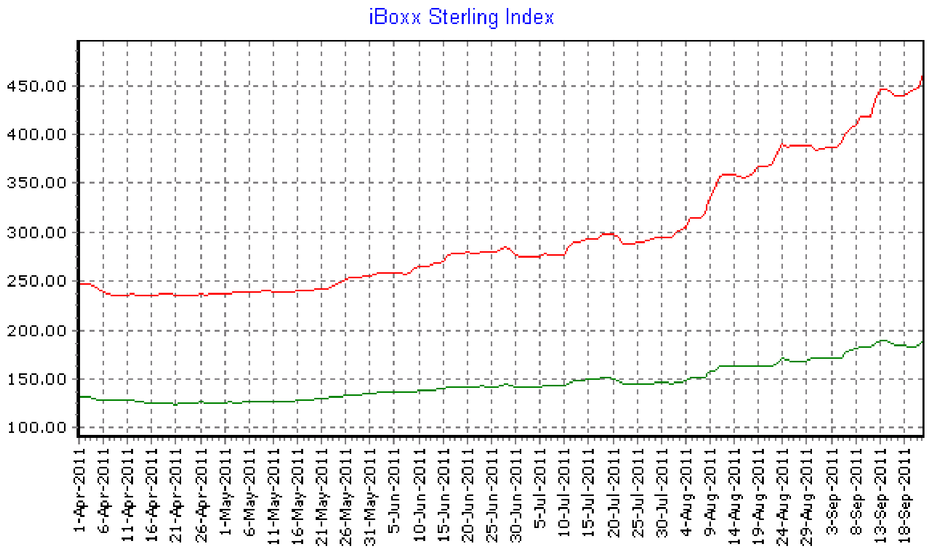
What would ‘good’ QE be for pension funds

- **Do not buy any more gilts – this just increases deficits**
- Pension fund have not fully hedged their liabilities so deficits would rise further with falling gilt yields
- Long dated gilts are already stretched by the quantity of demand from pension funds, and recent “safe haven” buying
- Address the stressed area of economy – the financial system
  - Buy stressed assets off banks balance sheets
  - This allows banks to be more certain of their assets values and makes it easier to lend
  - A steeper short dated yield curve helps banks rebuild balance sheets

What would ‘good’ QE be for pension funds

- Do not buy non-financial corporate bonds as before
  - ►Big corporates (who issue corporate bonds) are awash with capital as they have had access to capital markets
- Consider buying bank bonds
  - ►While banks borrow at higher rates than they can lend, they will not be profitable, so will not lend
  - ►Confidence is low in banks and purchases would help ability to fund themselves, especially in senior unsecured

Iboxx financial spreads and non-financial spreads



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Mark has over 20 years experience in bond markets and has managed a wide range of bonds funds both for pension and retail clients. Prior to joining Pension Corporation he spent 8 years at Morley and 7 years at Gartmore, where he was Head of Credit and was responsible for developing Gartmore's credit process for funds investing in sterling corporate bonds and high yield. Mark previously worked in corporate bond sales and corporate finance at BZW. He has an MBA from Cranfield School of Management. Mark is a Co-optee on the NAPF Investment Council.

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