

Quantitative easing and its impact on pension schemes



Quantitative easing - what is it?

On 5 March, the UK government announced that it will supply £75 billion to the economy in the next three months through "quantitative easing", with the possibility of a further £75 billion later in the year. Quantitative easing is the term for a government policy of increasing the money supply, for example by buying back government gilts, purchasing corporate bonds, and/or lending new money to banks and other deposit taking institutions.

In this case, the UK government has decided to buy around £75 billion of gilts initially, with a mixture of gilts and other assets earmarked for the later purchases.

The existing size of the gilts market is around £500 billion, so in the short term the Bank of England is preparing to purchase the equivalent of around 15% of the government's outstanding debt in the market, whilst the government continues to issue new gilts.

The government intends to purchase only conventional, not index-linked, gilts, and only those with maturities between five and 25 years.

The first purchases were made on 11 March.

Why do it?

The aim of the exercise is to ease the credit crunch, stimulate the economy and manage the risk of deflation, now that the traditional approach of reducing interest rates has been taken virtually to its limit. If more money is made available to the economy, then in theory this should stimulate growth, provided there is sufficient confidence for businesses to make use of the new liquidity. At a macro-economic level this should prove beneficial for employers, since they will be able to take advantage of new financial opportunities.

Immediate impact on markets

Whilst the introduction of quantitative easing had been anticipated by the markets, the extent and immediacy of the policy was unforeseen, as was the inclusion of long duration gilts.

The announcement of this policy has had a major impact on markets and pension schemes as demand for government bonds has increased sharply. By 12 March, the 10-year UK gilt yield index had reached a low of 2.95%. The Bank of England has said that it will concentrate its acquisitions in the five to 25-year band of maturities, avoiding longer-dated gilts, but the policy has lowered yields across the yield curve.

MERCER



MARSH MERCER KROLL
GUY CARPENTER OLIVER WYMAN

There has been a corresponding reaction in corporate bonds, with over 15 year AA-rated bond yields falling by around 50 basis points by the end of the week of the announcement.

Immediate impact on pension schemes

The falls in gilt/bond yields will have resulted in an immediate deterioration in the funding levels of the majority of UK defined benefit schemes. Schemes which have taken action to reduce or remove interest rate risk will be relatively unaffected. If bond yields remain low over March, we would expect the pension deficits reported in the accounts of companies with 31 March year ends to be higher than those reporting at 31 December 2008. Forthcoming scheme funding valuations due at 31 March 2009 or 5 April 2009 are also likely to show increased deficits.

For pension fund trustees and sponsors about to consider appropriate financial assumptions for scheme funding valuations, the announcement on quantitative easing and the markets' reaction have added yet another challenge to the already difficult considerations around the current economic climate. Whilst it is difficult to advise in advance on possible 31 March or 5 April 2009 valuation assumptions, it is important that trustees and sponsors are aware of these dramatic developments and start to consider possible responses.

Falling gilt yields will also result in higher annuity prices which will reduce the pensions for members retiring from defined contribution schemes.

Forthcoming key dates

The Debt Management Office will update its 2009/10 gilt issuance plans in its provisional financing remit on 18 March 2009, with a further update due alongside the Budget scheduled for 22 April 2009.

Longer term impact

Over the longer term, the position is far from clear. If quantitative easing proves successful, it will benefit pension schemes by improving sponsor covenant and funding levels. However this is relatively uncharted territory.

One key risk associated with a policy of quantitative easing is that of inflation. Inflation in itself is not necessarily problematic but if it grows faster than the economy then this can result in stagflation and any economic growth is effectively illusory.

The uncertainty over the medium to long-term impact of quantitative easing highlights the importance of regular monitoring of funding positions, covenant and investment strategy as the situation unfolds.

It also emphasises the value of understanding and managing the different elements of financial risk inherent in defined benefit pension schemes.

