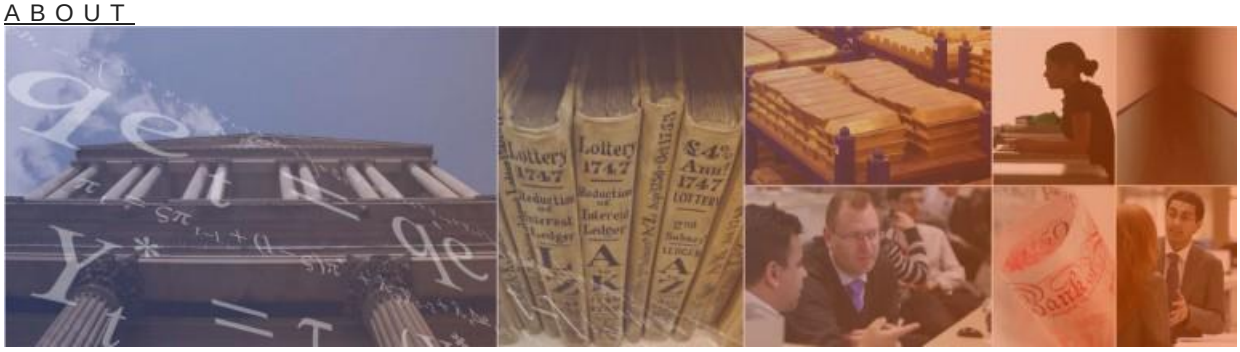

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Low for long: what does this mean for defined-benefit pensions in the UK?

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Despite the fact that the financial crisis erupted nearly a decade ago, its legacy is still being felt today. Disappointingly weak growth and low interest rates are arguably part of that legacy (though other developments also matter), and policy makers are increasingly worried that these are no longer temporary phenomena but instead have become permanent features. This blog assesses what a prolonged period of weak growth **and** low interest rates (sometimes also referred to by "secular stagnation" or "low for long") might mean for the viability of defined-benefit (DB) occupational pension schemes in the UK and what financial stability risks might arise as a result of a changing business environment.

Before answering this question, it is perhaps useful to remind ourselves what DB schemes do and what role they play in the UK. Put simply, DB pensions pay a guaranteed, defined amount of benefit to scheme members when they retire based on length of service and salary. They have played an important role in the provision of pensioner income in the UK in the past, but nowadays only 1.6 million employees are still accruing entitlements in such schemes in the private sector.

"Low for long" could push up DB pension scheme liabilities, which could lead to bigger funding shortfalls

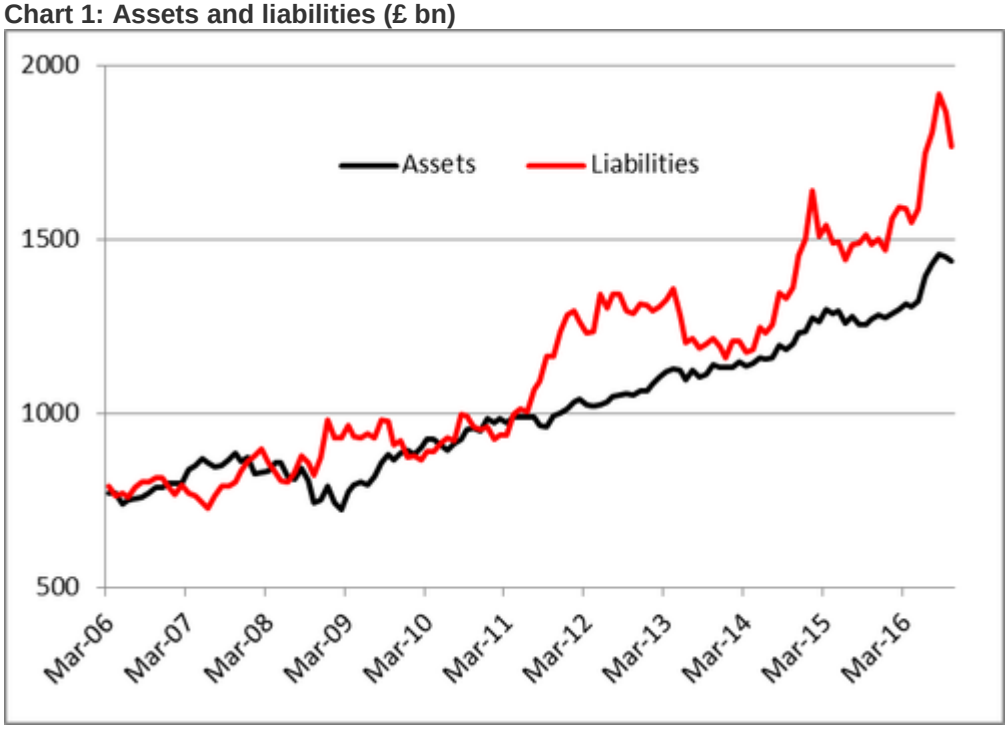
Many of the financial challenges facing DB schemes today are the result of pension promises made by the employer (the so-called "corporate sponsor") when life expectancy at retirement was much lower than it is today. Male life expectancy at age 65 years, for example, has increased by six years since the 1970s. Given that, it is not surprising that dealing with longevity risk has generally been considered to be a key challenge for DB pension schemes. Weak growth and low interest rates make this challenge much bigger and poses a potential threat to the solvency of pension funds in the private sector. This is because the long-term solvency of a DB pension fund depends on its funding position, defined as the ratio of assets (such as equity and bonds) over liabilities (such as today's value of all future promised pension payments that have been accrued to date). Asset values are typically supported by low interest rates, but in contrast are depressed by low growth prospects – so a low interest rate low growth environment pulls asset values in opposite directions, making the net impact ambiguous. However, lower interest rates reduce the rate with which the future flow of payments has to be discounted and thus unambiguously raises pension fund liabilities. All else equal, the combination of weak growth and low rates are generally likely to push up more on liabilities than assets, and so raise the funding gap.

The Pension Protection Fund's (PPF) monthly index, which is one of several indicators used to measure pension fund deficits in the UK, shows the position of the country's main (around 6000) private sector DB pension schemes that are part of the PPF's universe. At the end of October 2016,

for example, the aggregate absolute deficit (assets minus liabilities) stood at £330bn, representing a PPF benefit coverage level (assets divided by value of PPF benefit liabilities) of 81.4%: this is at the lower end of where this measure has been over the last ten years. This shortfall mainly reflects the sharp increase in liabilities since early 2014, partly as a result of the sharp drop in gilt yields that has been associated with the low interest rates and low growth environment (**Chart 1)**.

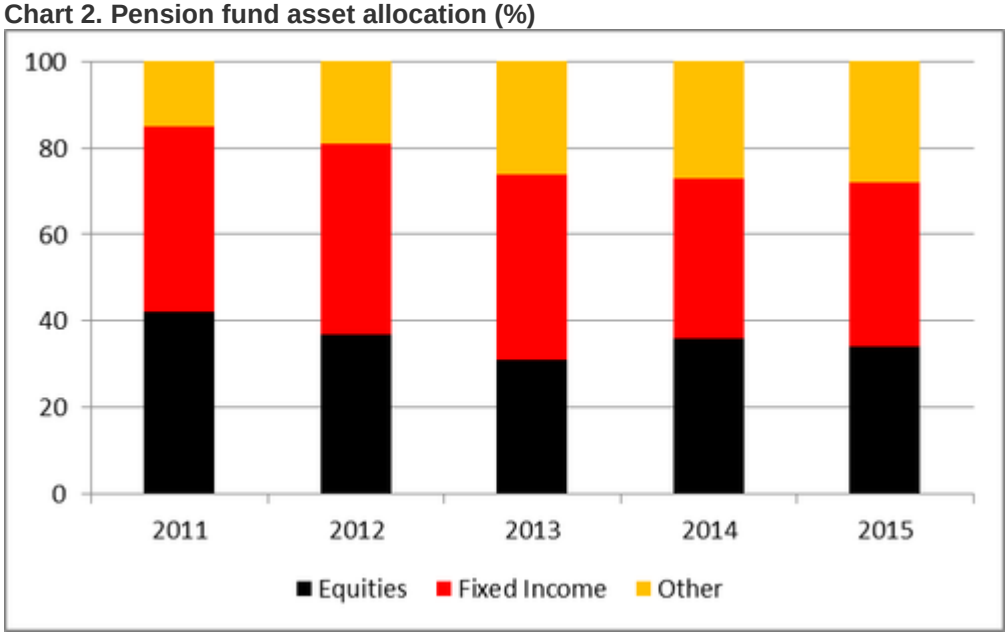
The UK Pensions Regulator and PPF have developed a rule of thumb to estimate the impact of changes in equity prices and gilt yields on pension fund assets and liabilities. Based on that rule (which itself was estimated based on the composition of assets and liabilities as of March 2015), a 0.3pp decrease in gilt yields would increase assets by 1.6%, but liabilities rise by much more at 5.9%.

Chart 1: Assets and liabilities (£ bn)



Source: Pension Protection Fund PPF7800 Index October 2016.

Chart 2. Pension fund asset allocation (%)



Source: 2015 Annual Survey, PLSA.

Pension fund managers can be expected to "search for yield"

What risks could that then create for financial stability? One risk could be that pension fund managers will increasingly "search for yield" and explore investing in non-traditional asset classes to close the funding gap. **Chart 2** provides some evidence of this behaviour, where the share of traditional equities and fixed income investments on pension fund balance sheets has fallen while

investment in “other” assets such as hedge funds, property or infrastructure has nearly doubled over the past 5 years. While the OECD believes that this “search for yield” poses insolvency risks, it is difficult to see how this *on its own* could present major financial stability risks. The normal course of events would be for a UK corporate sponsor to agree with the Pensions Regulator on how to close a funding gap over time. Closing this gap might affect dividend payments or wage settlements but should in practice pose few financial stability risks. The situation is different if the corporate sponsor itself goes into administration: in that case the pension scheme would default into the PPF, which would then pay out reduced pensions to scheme members. Unless the corporate sponsor is itself a financial company whose demise might pose financial stability risks or we are in the midst of a wider economic and financial crisis (but this is not what “low for long” is about), it is again unlikely that such an event could affect financial stability.

A global “search for yield” by all market participants could create financial stability risks

But there might be *indirect* impacts on financial stability. For example, pension funds’ intensified search for yield could bid up the prices for key asset classes such as infrastructure or commercial real estate. And this risk would be greater if such behaviour were common across other financial firms (e.g. banks and insurers) and were replicated abroad.

Over the longer term other issues could emerge. Under current UK legislation, the funding gap can only be closed via the asset side of the balance sheet, i.e. through higher employer/employee contributions and/or one-off financial injections. Such injections may “crowd-out” funds available for corporate investment or more generous pay settlements. Of course this does not mean that the money would no longer be available for investment. What it does mean though is that the pension scheme rather than the corporate sponsor would invest the available funds, potentially pursuing a different asset mix (the Bank’s February 2017 Inflation Report looked in more detail at the macroeconomic risks of DB pension fund deficit).

The decline of DB schemes is shifting the burden of preparing for retirement to individuals

There is another long-term risk. And that has to do with the fact that the decline in DB pension schemes has shifted the burden of preparing for retirement to individuals. While defined contribution (DC) schemes have filled some of the pension provision gap (there are now more than twice as many active members in DC than DB private sector schemes), much is left to the individual. Faced with much less generous DC pensions (reflecting generally much lower contribution rates), individuals may react to these changes by engaging in search for yield themselves (e.g. by buying property), which could push up on asset prices.

So to summarise, this blog has argued that an environment of weak growth and low interest rates potentially poses threats to the solvency of defined benefit pension funds. But while this may accelerate the demise of DB pension schemes, we do not believe that this in itself poses a threat to UK financial stability at present. That said, looking forward, financial stability risks could emerge as the result of an increased search for yield appetite among DB pension schemes and changes in the way in which individuals save for retirement in the absence of the financial certainty offered by a DB scheme.

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If you want to get in touch, please email us at bankunderground@bankofengland.co.uk or leave a comment below.

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06/03/2017: Post updated to clarify that the 1.6 million figure refers to workers in the private sector.