

PREMIER PENSIONS MANAGEMENT

TECHNICAL UPDATE: 07/09

Quantitative Easing

The Government has announced that it is attempting to ease the credit crunch through quantitative easing. There is some anecdotal evidence to suggest that this is starting to work. This update is however concerned with the impact it may have on Pension Plan Funding.

What is Quantitative Easing?

Quantitative easing is the Government's policy to increase short term money supply by:

- Buying back government gilts (conventional gilts with 5-25 year terms)
and/or
- Purchasing corporate bonds
and/or
- Lending new money to banks and other deposit-taking institutions.

Why is the Government pursuing this policy?

In the current financial climate, the Government wishes to make more money available to the economy, as they hope that this will stimulate growth which will be beneficial for employers. Quantitative easing is one way to achieve this stated policy. This, however, has an indirect effect on Pension Plan Funding

What is the impact of this policy on pension scheme funding?

The impact of quantitative easing has had a negative impact on scheme funding. This process of buying up gilts from banks and other institutions has resulted in significant falls in gilt yields and particularly for 15-20 year stock which are typically used for the benchmark for funding pension schemes. For example, the yield on 15 year benchmark stock has fallen from just under 5% in October 2008 to below 3.5% in March 2009.

Typically this yield forms the starting point for deciding the expected return on assets or, in other words, the level of discount which should be applied to future liabilities. For many pension plans the average future term could easily be in excess of 20 years and a 1.5% per annum reduction to this discount rate could easily increase the liabilities by upwards of 30%.

Therefore, not only have the equity assets fallen by 20-30% but the liabilities may have also increased by about the same amount over the last 12 months. So for example, a valuation undertaken at March 2009 which showed a deficit of 10% and was fully invested in equities could now be looking at a funding position of more like 60-70%. This could lead to a significant increase in the Recovery Plan contributions.

If this valuation is used to reset the employer contributions under the recovery plan then these could increase by say a factor of 4 in this example. For many employers, this will simply be unaffordable. The Trustees will need to look at significantly longer recovery plans to help the employer to survive the current financial recession. The Regulator has indicated that he will be sympathetic to those who find that a longer Recovery Period is required to protect the future of the employer as a going concern.

What is the longer term impact?

One would hope that the current depressed asset values and historically low gilt yields are only a temporary feature. The objective of the cash injection from the Treasury is to put more money into the economy and the long term impact should be to drive economic activity. It is likely that this will create some inflationary pressure in the longer term and this would be more likely to lead to significantly higher gilt yields in the medium term. However inflation will have its own detrimental effect on funding by increasing benefits. Overall this will mean that the current deficits may only be temporary and, looking further into the future, changes to the economic background will help to improve current positions in the long term.

How will quantitative easing affect the Company accounting results?

The impact on company accounting is likely to be less intrusive as the yields on AA rated bonds remain historically high and, in many cases, the value placed on the liabilities for accounting purposes is now significantly lower than the value used for funding purposes. Hence, if accounting is the primary concern rather than cash flow, the impact of quantitative easing will be less significant. Indeed in many cases accounting figures are currently looking beneficial which hides the true costs of benefits.



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However, quantitative easing may eventually result in a lowering of corporate bond yields as well as gilt returns. If this is the case, the accounting results will also worsen leading to higher reported deficits and an increase in the service costs reported in the Profit & Loss accounts.

Conclusion

The above show the often hidden changes in liabilities, which can for many Pension Plans be more important than asset valuations.

Trustees have historically spent considerable time reviewing and monitoring their investments but have spent little time on their liabilities.

Premier Pensions Management recommends to all its clients, be it Company or Trustees, that they receive quarterly updates that cover both assets and liabilities so the overall position can be assessed.

This is achieved by using actuarial simple models, which whilst not 100% accurate give an indication of the funding position.

If you do not already use these and are interested in seeing how they operate please contact your consultant or Paul Couchman on paul.couchman@premierpensions.co.uk

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*This update includes general information and cannot be relied upon for individual schemes issues.
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