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News release

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Pension funds and quantitative easing – speech by Charlie Bean

Speaking at the National Association of Pension Funds' Local Authority Conference in Gloucestershire, Charlie Bean – Deputy Governor for Monetary Policy and member of both the Monetary Policy Committee and Financial Policy Committee – discusses how pension funds may have been affected by a range of different factors, including quantitative easing (QE), over the past few years.

Charlie Bean begins by reiterating how QE works and what it seeks to achieve, noting that one consequence of the Bank's gilt purchases is to drive down gilt yields and put upward pressure on the prices of a whole range of assets. He notes that earlier Bank research found that the first round of QE reduced gilt yields by around one percentage point and boosted equity prices by around 20 per cent.

He then asks how the deficit of a pension fund holding a mix of bonds and equities that was in balance at the beginning of 2007 would have evolved in the light of the movements in gilt yields and asset prices during the financial crisis and subsequent recession, including any effects from QE. He notes that such a pension fund would have seen a large deficit emerge during the worst of the crisis as equities plunged and then fall back as equity prices rallied during 2009, before re-emerging in late 2011 and early 2012. Using the estimates of the impact of QE on asset prices found in the Bank's research, he then estimates the path the deficit would have followed if the MPC had not undertaken any QE, noting that gilt yields would have been higher and equity prices lower. His estimates suggest that the evolution of the deficits with and without QE would have been broadly similar, with the overall movement in assets roughly matching that of the liabilities.

But many funds were already in deficit at the beginning of 2007; in that year, the average pension fund deficit was about 30% of total liabilities. Repeating his analysis for a pension fund with such a deficit, Charlie Bean notes that in such circumstances, "…QE widens the deficit from the start of our purchases in early 2009 onwards, and by the end of the period has raised it by about 10% of initial liabilities."

He draws two conclusions from these exercises. "The first is that while the change in the deficit is certainly not trivial for a substantially underfunded scheme, the impact of QE is nevertheless small compared to the movement in the deficit associated with other factors, such as the collapse in equity prices as a result of the financial crisis and the recession. In particular, it would be an error to attribute the deterioration in pension deficits since the start of the crisis solely to the impact of QE." "The second observation is that QE does not inherently raise pension deficits. It all depends on the initial position of the fund...if a fund starts off relatively "asset poor", the sponsors will now find it more costly to acquire the assets necessary to match its future obligations."

Charlie Bean then asks how pension fund sponsors and trustees should respond to wider deficits, noting that "It makes little sense to rush to close a deficit that is likely to prove temporary. But if a deficit is likely to persist, then corrective action is required, initially to prevent it continuing to expand and ultimately to close it, though that adjustment could, quite reasonably, be spread out over time." However, "…the biggest issue here is not the principles involved, but rather the likely future evolution of yields and asset prices."

He then goes on to observe that there was a pronounced downward trend in long-term safe interest rates evident well before the crisis. He attributes that in part to global developments, such as high savings rates in China, a shortage of high-quality safe assets and, more recently, the sharp fall-off in investment associated with the downturn. Some of these factors could reverse in time, but it is by no means clear how soon. As regards the impact of QE on yields, he notes that this "…should ultimately reverse when the economic environment improves and we start to sell the gilts back to the market in order to withdraw the present exceptional monetary stimulus. Unfortunately, with the present heightened uncertainty associated with the problems in the euro area, the likely future date for us to commence selling gilts has receded somewhat." He finishes by noting that: "It may be tempting to conclude that the current abnormally low yields are primarily a consequence of QE, and that the right approach is just to look through the associated rise in deficits", but "Pension funds and their sponsors may...have to contend with low yields for some considerable time yet."

Key Resources

Pension funds and quantitative easing – speech by Charlie Bean (366KB)
http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech573.pdf
Full speech by Charlie Bean