Insights
Liability-Driven Investing

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UK DB Funding Ratios: The Impact of the COVID-19 Pandemic

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The UK has made great progress to overcome the COVID-19 pandemic, but the fight is far from over. Effective vaccines have given hope just as mutant strains present new challenges. The first UK lockdown in response to the pandemic began in March 2020. How have UK Defined Benefit (DB) pension schemes fared since then?

To answer that question, we examine the evolution of Section 179 (s179) funding levels from the Pension Protection Fund (PPF). This looks at the universe of UK private DB schemes eligible for entry into the PPF and is based upon compensation paid by the PPF, which may be lower than full scheme benefits. To set the scene, at the end of 2019, the aggregate scheme funding ratio (the ratio of a scheme's total assets to liabilities) was 99.4%.

The Evolution of Funding Levels During the Pandemic

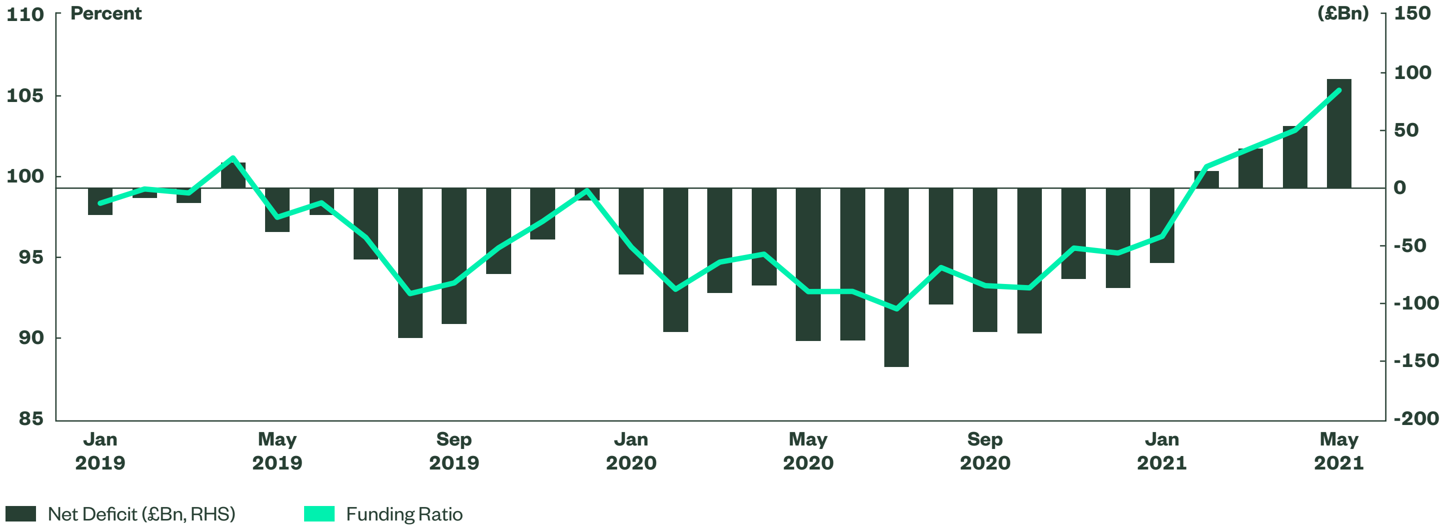
Financial markets began to reflect concerns about the prospect of the global spread of Covid-19 as early as the second half of January 2020. This intensified in February and March as cases surged globally and economies started to lock down.

In the UK, expectations grew that the Bank of England's Monetary Policy Committee (MPC) would need to cut policy rates to mitigate the impact of the inevitable and catastrophic economic downturn that would follow a pandemic-induced lockdown, which was ultimately announced on 23rd March. By the end of March 2020, the MPC had cut base rates twice, from 0.75% to 0.25% and then to 0.1%, where it currently stands. The MPC also expanded asset purchases of UK gilts and sterling non-financial investment-grade corporate bonds by £200 billion.

The result was that yields collapsed, along with equity markets. As shown in Figure 1, together, these two developments were disastrous for UK DB pensions. With the present value of liabilities rising and asset values falling, aggregate DB schemes' deficits widened dramatically to lows of 92% by July 2020.

Figure 1

Evolution of PPF 7800 s179 Funding Ratio and Net Deficit



Source: PPF as of 31 May 2021.

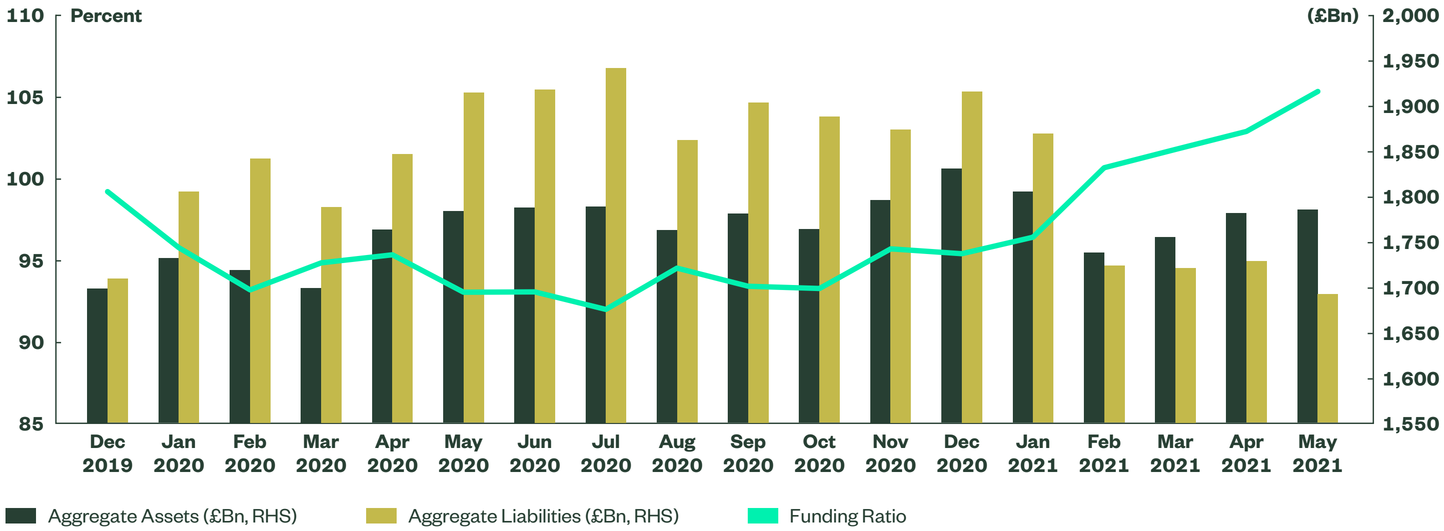
Since then, funding levels have steadily risen, accelerating through the first quarter of 2021 as vaccine optimism has taken hold. The latest reading from the PPF 7800 index shows funding levels back at 106% as at the end of May 2021, levels last seen in May 2008, just before the onset of the 2007–8 global financial crisis.

Delving Deeper: The Evolution of Assets vs. Liabilities

So, what has driven the renewed health of UK DB pension schemes? As we can see in Figure 2, once the funding ratio dropped into the depths of the pandemic around end of February 2020, driven by ballooning liabilities, it then hovered around the 95% level for the rest of the year, as asset prices bounced back but liabilities also kept rising. The lift-off of the funding ratio from the end of 2020 to date has been driven by a precipitous fall (c. -12%) in liabilities, while assets have only fallen 2.5%.

Figure 2

Evolution of PPF 7800 s179 Funding Ratio vs. Aggregate Assets and Liabilities

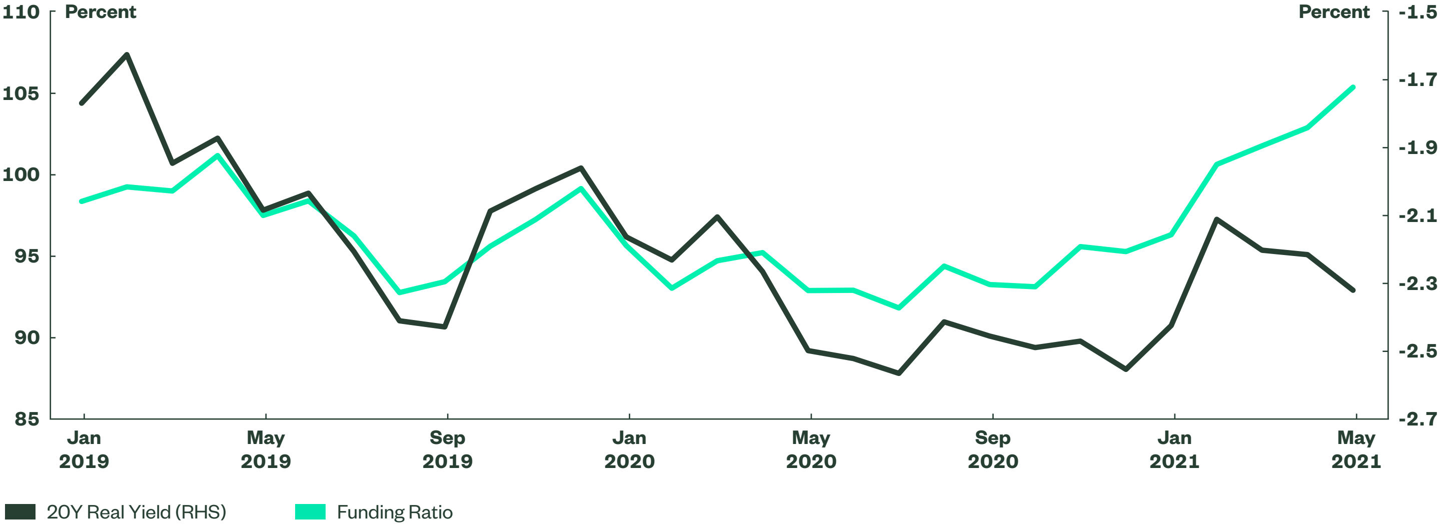


Source: PPF as of 31 May 2021.

Figure 3 plots the recent evolution of funding ratios vs. the UK 20-year real yield. We see co-movement from the start of 2019 throughout the pandemic. However, over 2021 to May, we have seen scheme assets outperform liabilities by around 10%, providing a strong motivation for schemes to de-risk from their growth assets into their matching portfolios.[1]

Despite this, it is clear that some of the interest rate and inflation risk from aggregate liabilities remains unhedged for UK DB schemes. Given the improvement in funding ratio, there is room for further de-risking in order to lock in the better funding levels and increase in yields from the pandemic lows.

Figure 3
Evolution of PPF 7800 s179 Funding Ratio and 20-year Real Gilt Yield



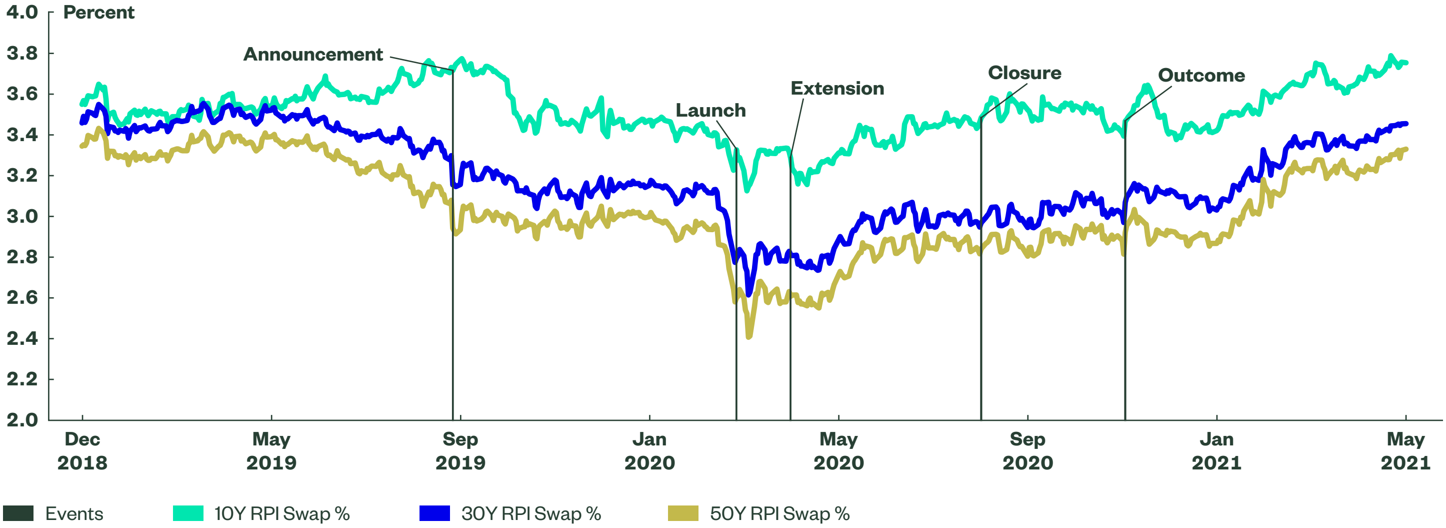
Source: PPF as of 31 May 2021.

Liabilities: RPI and Negative Rates Focus the Market's Attention

One endogenous event in the last year which had the potential to affect pension scheme liabilities was the outcome of the UK Retail Price Index (RPI) consultation, which sought to implement changes in the RPI[2] methodology. Changes to the RPI methodology can directly impact DB schemes on two fronts: changing the value of liabilities linked to RPI, as well as adversely impacting assets linked to RPI - such as index-linked gilts used to hedge those liabilities. The result of the consultation, announced on 25th November 2020 had two main elements:[3]

- The RPI methodology will change starting from 2030.
- The growth of RPI will be aligned with that of CPIH (Consumer Prices Index including owner occupiers' housing costs) with no adjustment spread, or compensation to be offered to the holders of index-linked gilts.

Figure 4
Timeline of the Consultation on the Reform to RPI, Overlaid on RPI Swap Level



Source: Bloomberg, State Street Global Advisors Calculations based on *A Response to the Consultation on the Reform to Retail Prices Index (RPI) Methodology.* Data as of as of 31 May 2021.

Figure 4 shows market movements together with key events around the consultation period.

More recently, inflation expectations have continued to move up as markets price in a post-lockdown bounce, materially increasing at the long end, and looking very rich considering the proposed RPI reform.

The consultation outcome resulted in the removal of uncertainty, which we believe released pent-up demand for inflation hedging, leaving the long end of the inflation curve more expensive than previously. This pent-up demand has also been met with a lack of significant supply given the UK Treasury's reluctance to increase its sensitivity to inflation, in contrast to the temptation for the Debt Management Office (DMO) to issue inflation-linked gilts at relatively attractive levels.

One positive side effect of the ramp-up in UK inflation expectations has been the market's dismissal of the possibility of negative policy rates in the UK. As the pandemic hit in 2020, investors began pricing in the expectation of negative rates in the near term, which enabled the DMO in May 2020 to issue its first ever negative-yielding nominal gilt, the July 2023 at -0.003%.

The market's suspicion was justified shortly afterwards as the Governor of the Bank of England acknowledged that the Bank was reviewing the option of negative policy rates. However, as vaccine optimism has surged, the market's focus has shifted to possible future policy tightening, rather than loosening. At the same time, negative policy rates are set to become a feasible tool in the monetary policy toolkit in August 2021 or later. Whether they will be deployed as a policy tool will depend on the outlook for the UK economy and the merit of negative rates versus other tools available to the MPC at that point in time. For more information, please read our *article*.

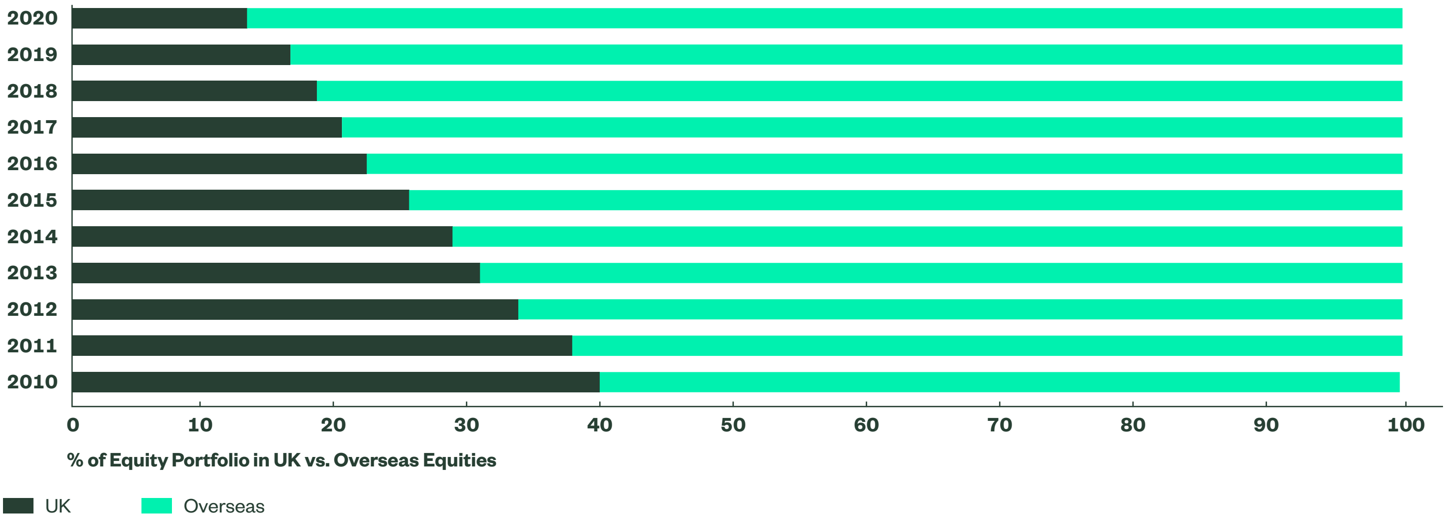
Assets: Home Bias Remains

The 2007–8 global financial crisis and its aftermath saw the US dollar (USD) gain a firm ascendancy in the global currency pantheon, as well as an increasing weight for USD assets in global equity and fixed income benchmarks. Together, these trends provided a windfall for UK investors with overseas asset allocations, as an increasing part of their portfolios' returns were flattered when measured in a weakening domestic currency.

Whilst a domestic bias in the fixed income portfolio can be rationalised to hedge liabilities linked to domestic rates and inflation, it makes less sense in an equity portfolio. Nevertheless, the PPF data shows a persistent, albeit reducing, home bias[4] in UK DB pension schemes' equity holdings.

As Figure 5 shows, the current average allocation of 13.3% within the total equity portion of investment portfolios still constitutes a large overweight to domestic equities given that the UK's weight in global equity indices currently ranges from 3.5–4.5% (4.3% of MSCI World and 3.8% of MSCI ACWI as of 31st May 2021; Source: Bloomberg).

Figure 5
Evolution of Home Bias in Reporting PPF Pension Schemes



Source: PPF as of 31st March 2021.
Methodology note: Total equity includes "quoted UK", "quoted overseas", and "unquoted private". To arrive at a conservative home bias estimate, we count "unquoted private" as being non-UK.

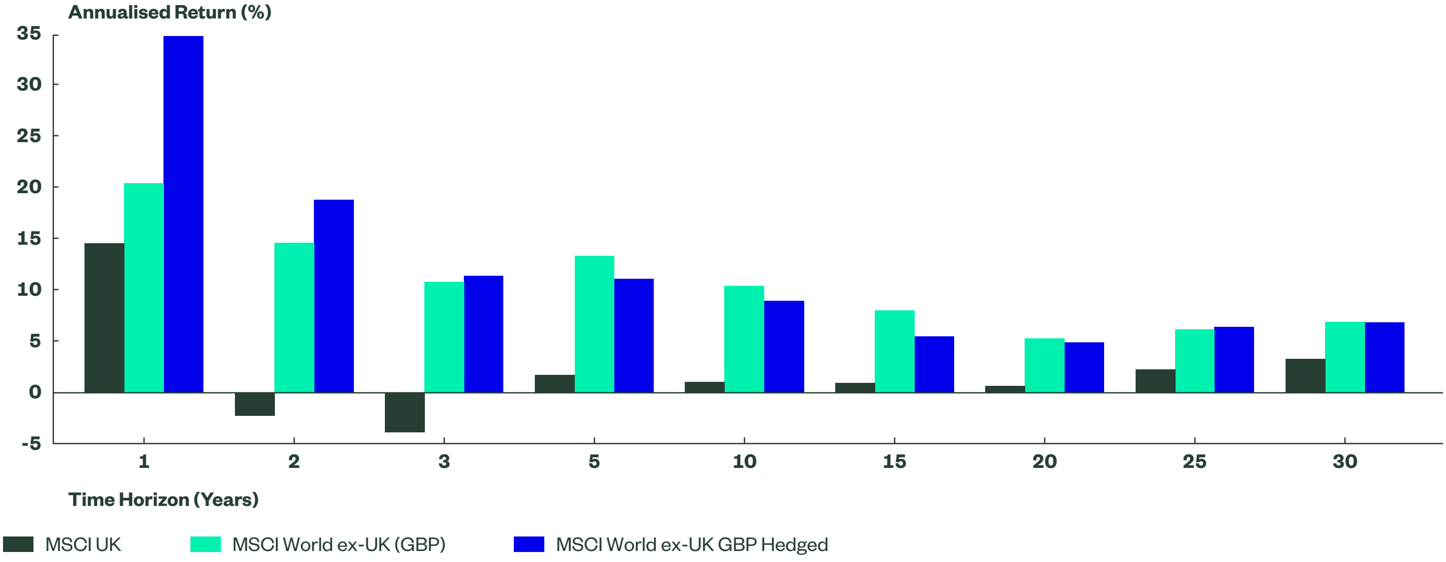
One often-cited reason for retaining an equity home bias is to reduce the effects of foreign currency fluctuations, but this bias has come at the expense of risk-adjusted returns. Figure 6 below shows this by first plotting the returns for a GBP investor over increasing time horizons for investments in:

1 UK equities

2 World ex-UK equities

3 World ex-UK equities hedged back to GBP

Figure 6
Returns Over Increasing Time Horizons to UK and World ex-UK Equities



Source: Bloomberg, State Street Global Advisors calculations as of 31 May 2021.

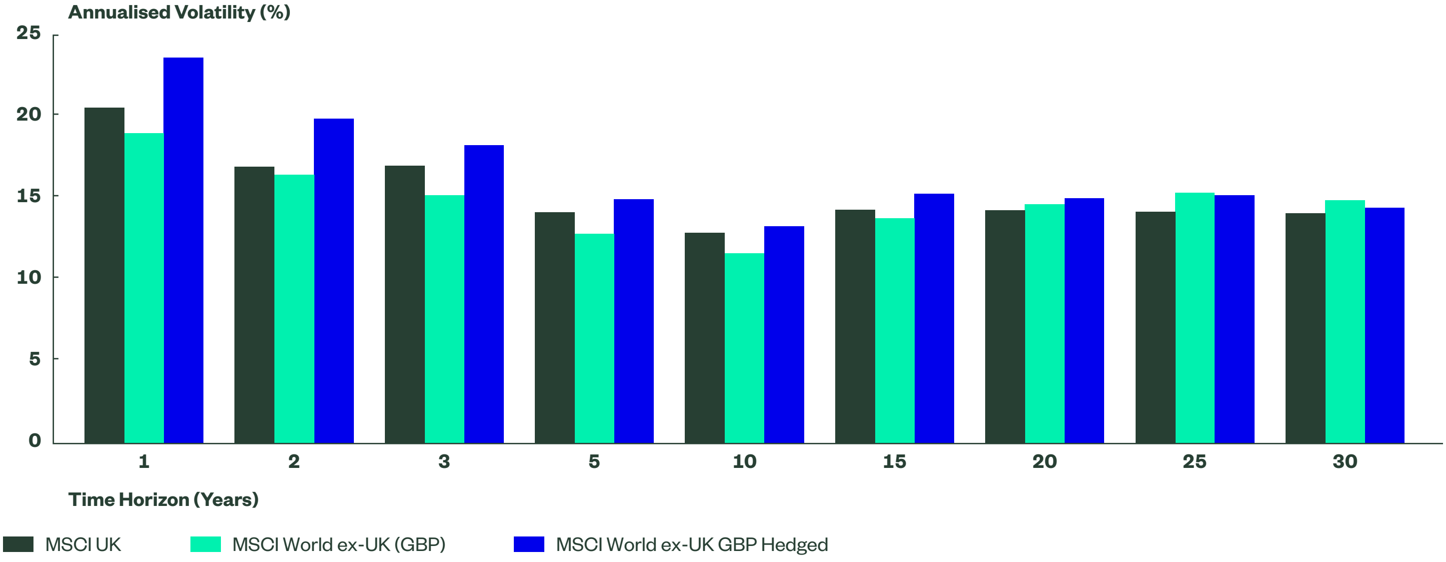
Over each time horizon, UK equities have underperformed against overseas equities, to varying extents, but at all horizons by greater than 3.5% *annualised*, even over the last 30 years. Past performance is not an indication of future performance, and our own long-term asset class forecasts actually predict outperformance for UK equities over the medium term.

However, historical results are clear on the long-term underperformance of UK equities, and also that currency hedging has had little effect on returns, discrediting the persistent equity home bias in UK DB pensions.

What is also apparent is that recent GBP strength — reflecting renewed optimism in the UK economic recovery and the passing of Brexit — has seen hedged returns strongly outperform. State Street's currency strategists continue to see ample upside in GBP, which leads us to recommend UK investors to continue hedging their overseas investments.

At the same time, the volatility analysis in Figure 7 shows that while hedged indices have proved more volatile over the near term, the volatilities of the three investments are very comparable over longer horizons. In short, there is no return or risk justification for home bias, and the availability of currency-hedged overseas equity investments makes the transition to a hedged portfolio easy.

Figure 7
Volatility Over Increasing Time Horizons to UK and World ex-UK Equities



Source: Bloomberg, State Street Global Advisors calculations as of 31 May 2021.

Conclusion

Since the UK's first lockdown in March 2020, private sector UK DB funding levels have experienced great volatility, with most of the movement driven by changes in aggregate liabilities. Our observations of the evolution of funding ratios based on PPF data is suggestive of de-risking activity, and this corroborates what we have observed during our client engagements.

However, we can infer from the breakdown of changes in aggregate assets vs. liabilities that there remain outstanding unhedged liabilities, and with funding ratios having improved recently, there is further room for schemes to de-risk from their growth assets into their matching portfolio in order to lock in the better funding levels and increase in yields. We stand ready to assist schemes in these endeavours.

On the liabilities side, events that have focused the market's attention have been the UK RPI consultation and the ability to use negative policy rates by the Bank of England. The outcome of the UK RPI consultation removed uncertainty, released pent-up demand for inflation hedging, and, given the lack of supply, left the long end of the inflation curve more expensive than before.

Whilst the possibility of negative policy rates dragged expectations of rates lower during 2020, the market's narrative has now squarely flipped to one of recovery and reflation. On the plus side, the resulting moves higher in yields have had a favourable impact on the valuation of scheme liabilities, but matching portfolio allocations have generally fallen in value, apart from inflation-linked gilts.

In the growth portfolio, equities have rebounded strongly since the depths of the pandemic, but home bias remains a long-term drag on returns and a lack of currency hedging has been a near-term headwind. UK schemes should continue to reduce their home bias, while at the same time hedging the currency risk in their portfolios.

Sources

Download the Purple Book 2020 (ppf.co.uk).

Flows & Liquidity: Pension Funds' High Incentive to De-risk. Tue Apr 20, 2021 (jpmorgan.com).

Bank of England Paves Way for Negative Interest Rates | Interest Rates | The Guardian.

State Street Global Advisors' LDI Monthly Report.

Endnotes

1 Note that the PPF updated its valuation assumptions guidance for s179 valuations when calculating the PPF 7800 liabilities. The impact of the change in the actuarial assumptions as at 31 May 2021 was an improvement of the funding ratio by 2.8 percentage points and an increase of £46.5 billion in the aggregate funding position. See PPF 7800 Index for more details.

2 The Retail Prices Index (RPI) is defined as an average measure of change in the prices of goods and services bought for the purpose of consumption by the vast majority of households in the UK. Source: RPI Data (dmo.gov.uk).

3 For more information, please read our paper 'UK Responds on RPI Reform'.

4 Home bias refers to the phenomenon of investors disproportionately allocating their investment portfolios to domestic assets.

About State Street Global Advisors

Our clients are the world's governments, institutions and financial advisors. To help them achieve their financial goals we live our guiding principles each and every day:

- Start with rigor
- Build from breadth
- Invest as stewards
- Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 31 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's third-largest asset manager with US $3.59 trillion* under our care.

* This figure is presented as of March 31, 2021 and includes approximately $60.33 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.