Interest rate rise – a trigger event

Introduction

It is easy to overreact or take for granted the macro-economic waves that buffet pension schemes. If you had said to someone in the 1980s that interest rates rising to 1% would be a call to action they would think you've lost your mind. However, the latest rise (the fourth in a row) has brought interest rates to their highest level since 2009.

This note will summarise the impact of the interest rate rise and what trustees and sponsors should be considering in response to it.

What's happening and why has Bank of England increased the interest rate

Inflation, inflation and inflation. This is the reason behind the interest rate increase. Just a few weeks ago the Office for Budget Responsibility predicted that inflation would peak at 8.4% in quarter 4 of 2022. The Bank of England has been on its own journey with predictions of inflation:

May 2021	Rising to 2%
August 2021	Rising to 4%
November 2021	Rising to 5%
February 2022	Rising to 7%
May 2022	Rising to 10%

This highlights that the expected transitory inflation will be around for the remainder of this year and into next. The target of 2% inflation is not expected to be hit for 2 years.

Central Bankers' key tool for reducing inflation is increasing interest rates. Raising rates is expected to reduce the demand for goods as people are encouraged to save more and spend less. However, rate rises cannot be too high and too fast as this will further impact the general public who are already experiencing a great deal of pain due to the cost of living crisis. The Bank of England are also predicting negative growth in 2023 and what looks like a recession. Raising interest rates in a recession is not considered a wise move. This does mean we should expect future rises to interest rates but perhaps small increases spread out over a number of months.

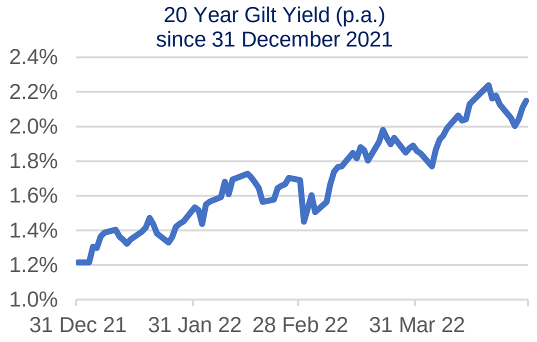
What is Stagflation?

Stagflation is a combination word of Stagnation and Inflation. Therefore, describes an economic situation where an economy experiences low growth together with high inflation. This appears to be exactly what the Bank of England are predicting for the UK over the next 18 to 24 months. Stagflation can be considered worse than a recession as costs rise and unemployment rises at the same time. Solving it will be very difficult. People need to be encouraged to spend less while at the same time creating an environment where businesses can invest and take on staff.

What is the impact on pension schemes?

It is a complicated picture and while we can make some general observations here it is possible that the combination of interest rate rises, inflation rising, low growth and rising unemployment will have impacts on the present value of liabilities and the outlook for growth assets.

Rising bank interest rates – in so far as these have translated to higher gilt yields this will reduce the value of the liabilities where the discount rate is linked to gilt yields, and so many schemes will be seeing their liabilities reduce. The actual impact will depend on the level of interest rate hedging that is in place in the portfolio. Schemes not 100% hedged will see an improvement in funding position, all else equal.



However, the extent of any improvement will depend on how a scheme's other assets have performed, as there has been a wide dispersion in returns both across and within growth asset markets. For example, based on major indices

UK equities have outperformed US equities by close to 15% (+1.6% vs -13.0%), since the beginning of 2022.

Whilst the significant rise in gilt yields is generally good news, schemes experiencing the upside of this position should be sure they are getting that benefit because of a conscious strategic decision and not due to inaction. Having an unhedged liability position should be an active decision.

Schemes that have seen their funding position improve should be considering whether this presents an opportunity to de-risk, or whether it could accelerate their journey to low dependency and even buy-out.

Actions for Trustees

- Speak to your Scheme Actuary to understand the impact on liabilities
- Speak to your Investment Consultant to understand the impact on hedged positions.
- Also speak to your Investment Consultant to ensure the strategy you have in place is appropriate to face an uncertain period ahead.

Rising inflation – we have all seen rising inflation and many boards will have been discussing it. However, if you have not had the discussion you should do so with your Scheme Actuary to ensure you are clear in terms of the impact on:

- Member benefits – what are the caps and collars you have.
- Discretionary increases – many boards will be discussing whether they have the power to give higher increases to assist pensioners with the cost of living rises.
- Early retirement factors – schemes should also review their early retirement factors and method to ensure deferred members do not lose out on the high inflation.

How can Broadstone help

There are also other issues affecting funding conversations beyond the interest rate rise and inflation, including corporation tax increases, the ongoing DB Funding Code consultation and unwinding of pandemic corporate easements which are making scheme funding and investment discussions more complex and scheme specific than ever.

You should be aware of our new funding and investment software Sirius. Using this software will enable you to consider the implications of different strategies to set and then reach the long-term funding targets that schemes now need to have.

Using Sirius we would be able to immediately discuss, for example:

- The updated funding position of the scheme, how this has progressed against plan and any opportunities that have arisen to reduce risk;
- Potential adjustments to the hedging, particularly in response to the inflation movements;
- The impact of any further changes.

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