
Pensions focus

Deflation and pensions

An expectation of increasing prices (inflation) is woven into the fabric of UK pensions. This is intended to help protect pensioners' purchasing power over time. But what happens when prices fall?

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The basic rule is that a pension in payment cannot reduce but, as is so often the case with pensions, the devil is in the detail and there are potential consequences for:

- **Benefit design and payment:** Members under- or over-paid pensions payments including failing statutory requirements
- **Member communications:** For example, benefit statements becoming misleading
- **Scheme funding:** Liabilities increasing, potentially by £millions
- **Assets and risk management:** Strategies underperforming or becoming unsuitable
- **Risk transactions:** Deflation risk adding to the cost of a buy-in or buy-out

Even where deflation is a short term 'blip', there are important mitigating actions for trustees and scheme sponsors to consider. If there is a sustained period of deflation, a more radical rethink is required.

What is causing deflation and will it be sustained?

Inflation has fallen sharply over recent months but overall prices have not yet fallen (this is known as 'disinflation'). Inflation at 0%, as currently, means overall prices are stable, which some call 'noflation'. For 'deflation', prices have to fall. The UK has only had short periods of deflation in the past 70 years, linked to specific events.

Most commentators expect only a blip of deflation in 2015. The main causes (e.g. falling oil prices last year) will drop out of the calculation, and government and central bank responses will have some effect. Also, longer term inflation indicators have not fallen so much.

However, most accept that there is deflationary risk for some time to come. Low inflation or modest deflation can become institutionalised, as individuals and companies come to expect it and behave accordingly. Other factors such as the slowdown in China, reducing pressure on raw material prices, and competition created by online retailing support this.

It is worth remembering that Japan experienced deflation or noflation in every year but one from 1999 to 2013, with prices falling on average 0.5% a year for a decade.

RPI or CPI?

It is widely accepted that the Retail Prices Index is no longer fit for purpose and its status as a National Statistic has been removed.

In a deflation context, RPI will tend to overestimate the size of price falls. This is another reason, if one were needed, to rethink its use in pension schemes and consider adopting a Consumer Price Index based measure. Recent court cases have demonstrated this is much more widely possible in company schemes than was originally thought.

Benefit design and payments

Pensions in payment are typically increased for inflation year by year, with a minimum of zero each year. What is less clear is what happens when prices rise again after a year of deflation. Is the next increase applied to the pension 'as is', or what it would have been if there was no minimum?

Example: If prices fall 1% this year then rise 2% next year, a £100 pension should initially fall to £99 then rise to £101. However, if it can't fall it stays £100 for this year. Does it rise to £101 or £102 next year? It may seem a small point but it means a 1% difference in total pensioner liabilities: a £10m cost for a £1bn scheme, each time it happens.

Individual scheme rules determine whether the answer is £101, £102, something else or whether there is a choice, so each scheme needs checking. Different answers may apply to different parts of each pension, such as guaranteed minimums. And the different parts can interact with each other, for example due to the statutory anti-franking provisions. Once you know the answers, you need to check administration systems do the right thing in practice; this is a complex and rarely tested area.

Deferred pensions are even more complex. Legislation broadly adjusts for inflation over the whole period from leaving employment to drawing the pension (in effect the £101 approach). However, some scheme rules only use legislation as an underpin and have the £102 approach hard-coded. And there are other complications such as step ups at state pension age. Again, checking scheme rules and ensuring administration works as intended is the key.

Current employees can be impacted too, e.g. career average benefit revaluation rates or pensionable pay caps that are linked to inflation.

Member communications

Benefit statements and retirement quotations often make some allowance for inflation, in either the numbers or supporting text. These can become misleading for the reasons discussed above.

Example: A quotation for someone retiring next year shows a benefit of £100 today and notes that it will increase with inflation until paid. If prices fall 1% and the statutory approach is used, the actual pension next year is only £99 but scheme-specific rules could make it £100. Some administration systems use an assumed figure and could quote £103. Clearly, this could lead to an unhappy retiring employee or the Ombudsman upholding a higher pension quoted.

Other communications (newsletters, booklets, etc.) also tend to be written with inflation protection in mind and can be misleading in a deflationary world.

Scheme funding

As noted above, deflation can add significant unintended liabilities each time it happens if the design or administration doesn't allow for it.

More generally, you might assume low inflation improves funding, as benefit increases are low or zero. In practice, it is the relativity of discount rates, inflation and pension increases that impacts funding. Deflation, especially if sustained, can impact funding further.

Example: Actuarial assumptions for pensions in payment may assume a return on assets 1% above inflation and pension increases 0.5% below inflation (for limited price inflation); this gives a net discount rate (the gap between discount rate and pension increase) of 1.5% a year. With 1% deflation but pensions not reducing, pensions are actually running at 1% above inflation. The net discount rate is thus reduced from 1.5% pa to 0.5% pa, adding 10% or more to pensioner liability values.

This is another example of traditional approaches diverging ever more from the underlying reality, as they have with low gilt yields for example. More up-to-date funding techniques are available to address these issues.

Asset strategy and risk management

Most pension schemes have some protection against inflation, either through assets such as index-linked gilts or via derivatives such as inflation swaps. Typically these pay the scheme when inflation is high but the scheme loses out when inflation is low. Any loss is expected to be offset by reducing liabilities but in deflation this breaks down. It is therefore important to review inflation hedging strategies as deflation approaches.

It is possible to buy deflation protection but this usually looks expensive, especially if deflation seems likely. However, there are other things to consider, including:

- For those hedging inflation with indexed linked gilts or swaps, regular checks of the hedging level are needed. As deflation approaches, the liabilities become more fixed (at 0%) than inflation linked. The amount of inflation hedging should therefore be reduced.
- Conversely, if you have deflation protection in place and think deflation will be a temporary blip, you could sell it back to the market at a very attractive price.
- Hedging inflation with assets that themselves have in built deflation protection. For example, long term property leases typically have upward only rent reviews.

In a sustained deflationary world, a fundamental rethink is needed. Just as traditional actuarial methods can break down, traditional asset-liability modelling can go awry. For example, it may point to reducing equity holdings in favour of fixed interest bonds whilst in reality the equities may be a more suitable asset. A real world perspective is needed.

Buy-ins and buy-outs

When scheme benefits are secured with an insurer, they also have to think about the risk of deflation. Insurers are effectively obliged to buy protection or hold extra capital to cover the risk. The cost of this is, of course, passed on to the scheme or sponsor.

Particularly for a buy-in, securing benefits without deflation protection and keeping the risk in the scheme is typically more cost effective, potentially reducing the insurance cost by 5%. Variations of this can also work for buy-outs.

If you already have a buy-in, you should check that it is paying you what you expect (and paid for), reflecting the points on scheme design and administration above.

Action points

Mitigate the impact of short-term deflation by checking:

- You understand how all your benefits link to inflation
- Your admin systems, member communications and any existing buy-ins get it right
- Your inflation hedging still works properly

If you think deflation could become a more regular occurrence or even sustained:

- Review benefit design
- Rethink asset and risk management strategies to bring a real world approach
- Adopt more realistic approaches to funding than traditional actuarial methods – likely to be appropriate anyway given wider market conditions

In any case:

- Ensure you understand the impact of deflation on your corporate financial reporting
- Review the use of the broken RPI measure of inflation wherever possible
- If you have or are considering a buy-in or buy-out, make sure you address the deflation risk

Contacts

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