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Revisiting 2022 UK Pension Funds Crisis: Lessons Learned

- In 2022, UK pension funds industry was under severe pressure as most of the funds, which employed defined benefits plan, put their asset under management in sovereign bonds and fixed income derivatives. The pressure was initially induced by miscoordination of fiscal and monetary policies that drove the government bonds (UK Gilt) yields significantly higher under a short amount of time, while also caused pressure on the Great Britain Poundsterling (GBP).
- While the crisis happened a year ago and proved to be short-lived, the UK pension funds crisis episode can be a valuable lesson for Indonesia, as Bank Indonesia (BI) may need to keep its policy rate relatively elevated to maintain exchange rate stability while Indonesia's Ministry of Finance (MOF) may opt to carry-out expansionary fiscal stance to boost consumer spending power.

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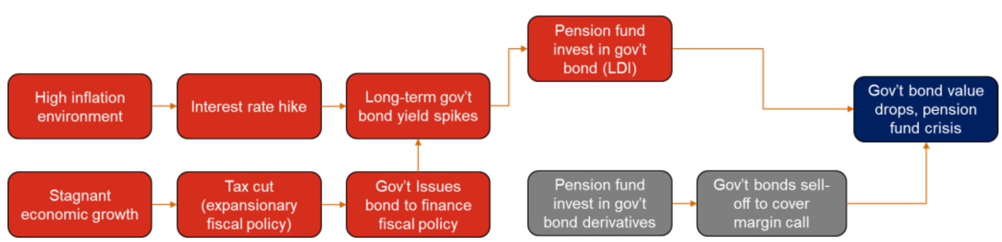
Overall Chronology of 2022 UK Pension Funds Crisis

In early 2022, the UK pension industry held assets between £2.5 trillion (market value of pension funds) and £3.1 trillion (gross assets including derivative contracts with positive asset values). However, between June 30 and September 30, 2022, the market value of private sector defined benefit and hybrid (DBH) pension schemes decreased by 12%, from £1.45 trillion to £1.28 trillion. This decline occurred due to a rise in the yield of long-term UK government bonds (gilts). The rates rose to their highest on September 27, which for the 30-year nominal gilts was a 200 basis points increase from the end of August, inversely impacting bond prices, thus reducing the valuation of pension funds' investment asset (Exhibit 1).

The crisis's genesis lies in a macroeconomic perspective, where the UK's economic growth remained weak in 2022. UK GDP growth in the first quarter of 2022 was at 0.7%, decreasing to 0.2% in the second quarter, then dropping to -0.2% in the third quarter, and stagnating in the fourth quarter of 2022. Additionally, UK inflation was notably high at 10.1% in October 2022, the highest in 40 years. From a microeconomic perspective, excessive risk-taking in UK pension funds, especially those with high exposure to interest rate derivatives, contributed to the crisis in the pension fund industry.

The UK pension fund crisis was also caused by macroeconomic policy disharmony when UK Prime Minister implemented urgent expansive fiscal policies, characterized by tax cuts, while the Bank of England adopted contractive monetary policies, raising interest rates from 1.75% to 2.25%. These contradictory policies created policy disharmony (Exhibit 2).

Exhibit 1. UK Pension Fund Crisis Causes



Source: IFGP Research Analysis

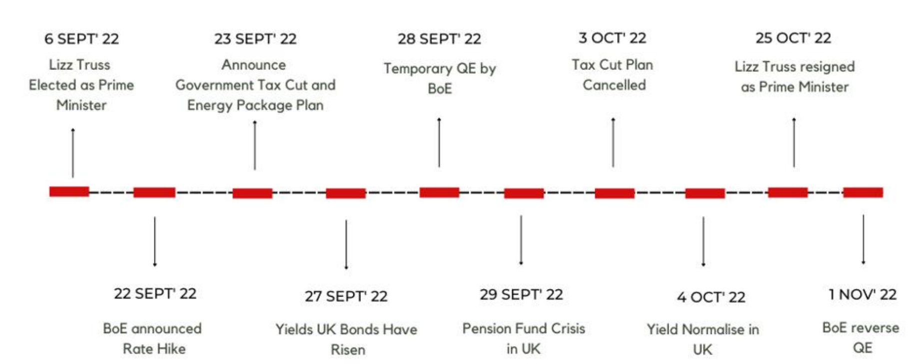
This research aims to provide lessons for the pension fund industry, including in Indonesia, learning from the UK's policy disharmony in addressing weak economic growth. The study addresses three research questions:

a. How do macroeconomic policies trigger destabilization in UK pension funds?

b. How is asset allocation crucial in understanding the impact of macroeconomic policies?

c. What are the lessons for the Indonesia pension fund industry?

Exhibit 2. Timeline of UK Pension Fund Crisis



Sumber: CNBC, Bloomberg, Tax Research, The Guardian, Commons Library Parliament UK, BIS, IFGP Research

Macroeconomic Perspective: Inflation and Monetary Policy

In the UK, inflation began climbing in the latter half of 2021, persistently rising thereafter. Both core and headline inflation trends were initially aligned, showing no significant divergence. However, by the second half of 2022, a considerable gap emerged between them, largely due to the impact of the Russia-Ukraine conflict. This war significantly escalated UK inflation to its highest in 40 years, driven by surging food and fuel prices. The conflict further intensified pressures on prices, particularly in energy and food sectors, compounded by the post-pandemic recovery challenges, labor shortages, and Brexit effects (Exhibit 3).

European wholesale gas and electricity prices skyrocketed by 115% and 237%, respectively. The war's escalation broadened the tension from spot markets to the entire future energy pricing structures, indicating sustained higher energy costs. Europe's heavy reliance on Russian energy imports, accounting for approximately 29% of crude oil and 43% of natural gas imports to the EU in 2020, explained the significant local energy price responses to the conflict. The UK's headline inflation, which includes all basket goods, drastically rose, while core inflation, excluding volatile food and fuel prices, remained relatively stable.

Exhibit 3. UK *Core* dan *Headline* Inflation

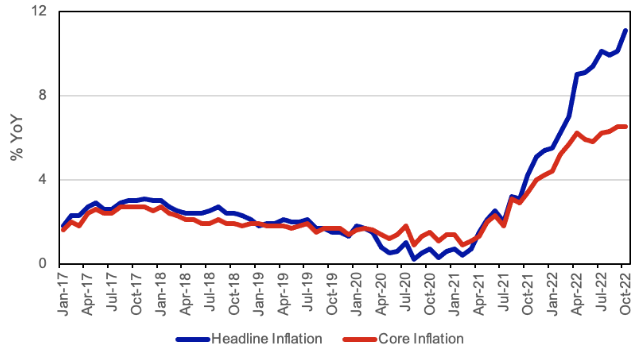
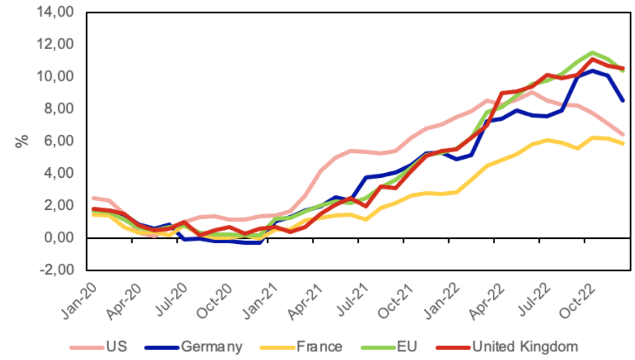


Exhibit 4. CPI Inflation in Selected Developed Countries



Sumber: Bloomberg, UK Government Statistics, CEIC, IFGP Research

By early 2022, the UK's inflation rate was among the highest in developed countries, slightly below the EU average in the latter half of 2022. Consequently, the Bank of England aggressively raised its base interest rate starting in January 2022. This increase in the base rate typically reduces demand for existing bonds, lowering their prices and increasing yields (Exhibit 4).

Macroeconomic Perspective: Economic Growth and Fiscal Policy

Regarding economic growth, the UK's post-COVID-19 real Gross Domestic Product (GDP) has not fully recovered to pre-pandemic levels. By Q3 2022, the UK's real GDP was approximately 5% below that of Q4 2019 (Exhibit 5). In comparison, France, despite also not reaching pre-COVID levels, showed a relatively better recovery. Consumer confidence indices initially showed optimism (CCI > 100) in early 2021 but fell into pessimism (CCI <100) by early 2022 due to COVID-19 uncertainties and the Russia-Ukraine geopolitical tensions, coupled with rising prices. These factors negatively impacted the business climate, as evidenced by a contraction in the Purchasing Managers' Index (PMI < 50) in the latter half of 2022 (Exhibit 6).

Exhibit 5. Economic Growth Compared to Pre-Pandemic Level (Q4-2019), UK and Developed Economies Peers

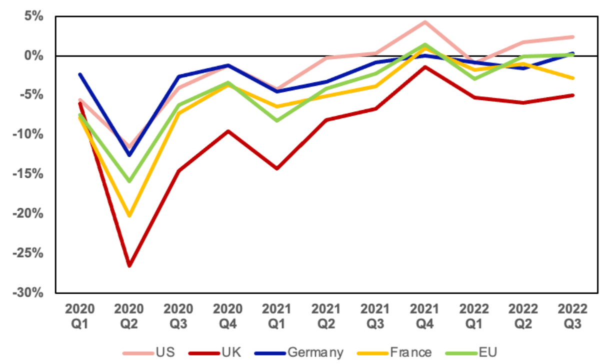
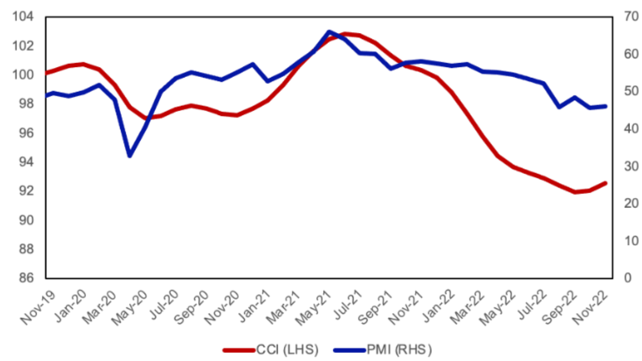


Exhibit 6. UK Consumer Confidence Index (Demand-sentiment) and Purchasing Managers' Index (Supply-sentiment)



Sumber: Bloomberg, Data OECD

Confronted with suboptimal economic recovery, the UK government sought to stimulate growth through expansive fiscal policy maneuvers. Two principal avenues were considered: augmenting government expenditure and reducing prevailing tax rates to enhance consumer and corporate spending. However, government expenditure did not witness significant elevation post-2021, indicating constrained fiscal capacity (Exhibit 7). The 2022 Growth Plan, therefore, emphasized tax cuts as a means of fiscal expansion, in light of the substantial fiscal deficit faced by the UK, second only to the United States among major economies in terms of fiscal deficit to GDP ratio. The limited scope for augmenting government expenditure necessitated exploring alternative fiscal strategies that can be summarized in Exhibit 8.

Exhibit 7. UK Government Expenditure

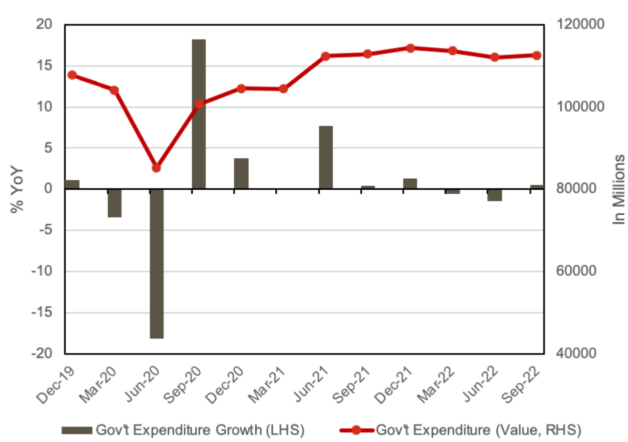


Exhibit 8. Several Tax Cut Measures in UK 2022 Growth Plan

Types of Tax	Pre-Growth Plan 2022	Post-Growth Plan 2022
Income Tax[1]	20%	19%
	45% of Additional Rate of Income Tax	Remove additional rates of income tax
Dividend Tax[2]	Ordinary rate: 7.5% Upper rate: 32.5% Additional rate: 38.1%	Ordinary rate: 8.75% Upper rate: 33.75% Additional rate: 39.35%
Stamp Duty Land Tax[3]	Nil rate band: £125k	Nil rate band: £150k
	FTBR nil-rate threshold: £300k	FTBR nil-rate threshold: £425k
	FTBR property eligibility for purchase: £500k	FTBR property eligibility for purchase: £625k
Corporation Tax[4]	19%	19%
Bank CT Surcharge[5]	8%	8%
	£25m allowance	£100m allowance
Annual Investment Allowance[6]	£1m	£1m
Employee Share Schemes: Company Share Option Plan (CSOP)[7]	Grant at £30k	Grant at £60k
Venture Capital Schemes: Seed Enterprise Investment Scheme[8]	Limit: £150k	Limit: £250k

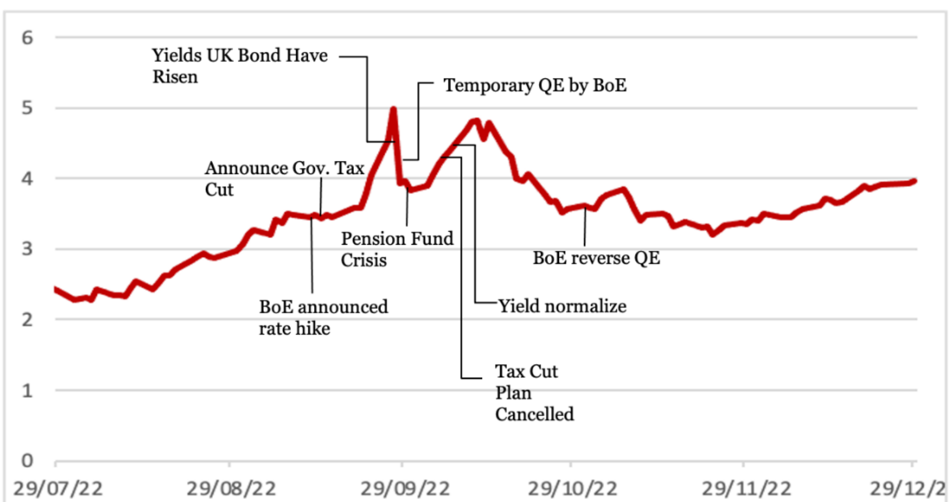
Sumber: Bloomberg, CNBC, UK Government, IFGP Research

Impact of Monetary and Fiscal Policy Disharmony

The UK faced policy disharmony, with monetary and fiscal policies working at cross purposes during a period of inflation. The monetary policy, aiming to contract the economy, raised interest rates to avoid higher rate of inflation. In contrast, the fiscal policy, led by Prime Minister Liz Truss at the time, was expansive, by planning to implement tax cuts to support growth. These tax cuts, along with the government's energy price guarantees, were predicted to further fuel inflation and place additional pressure on the Bank of England to increase interest rates. Higher interest rates led to a fall in bond prices, although the coupon rates remained constant, resulting in increased yields (Exhibit 9).

The UK experienced a crowding-out effect due to higher interest rates, impacting government borrowing and reducing investment impacts. The mini-budget by Chancellor Kwarteng, announcing £45 billion in unfunded tax cuts, necessitated an increase in government bond sales along with a planned sale of around £40 billion in bonds by the Bank of England to reverse its quantitative easing program. The disharmony between fiscal and monetary policies had significant economic and political implications, culminating in Liz Truss's resignation as Prime Minister on October 25, 2022.

Exhibit 9. UK 30-year Gilts Yield, July- November 2022



Sumber: CNBC, Tax Research, The Guardian, Bloomberg, BIS, Common Library Parliament UK, IFGP Research

Microeconomic Perspective: Pension Funds Asset Allocation and Interest Rate Exposure

This section examines the microeconomic perspective of asset allocation in the UK pension fund industry. Excluding derivative instruments, the dominant asset allocations in private UK pension in the third quarter of 2022 are long-term government bonds (including UK Gilts) consisting of ~46.5% of total asset under management/AUM, corporate bonds (~14% of total AUM), and cash equivalents (~11% of total AUM) (Exhibit 10). The valuation of these fixed-income instruments is sensitive to yield movements in financial markets. A sharp increase in yields reduces the valuation of these bonds, due to the inverse relationship between bond yields and prices.

However, the impact of yield movements on public defined benefit pension funds is relatively less compared to private pension funds. This is attributed to the asset allocation in public pension funds up to Q3 2022, which are dominated by equities (~40% of total AUM) and investments in private equity and alternative assets (~31.5% of total AUM). Government and long-term bonds rank second and fourth in investment allocation in public pension funds in the UK. This implies that public pension funds in the UK are relatively more resilient to bond market yield fluctuations (Exhibit 11).

Exhibit 10. Investment Allocation in UK Private Pension Funds (excluding derivatives)

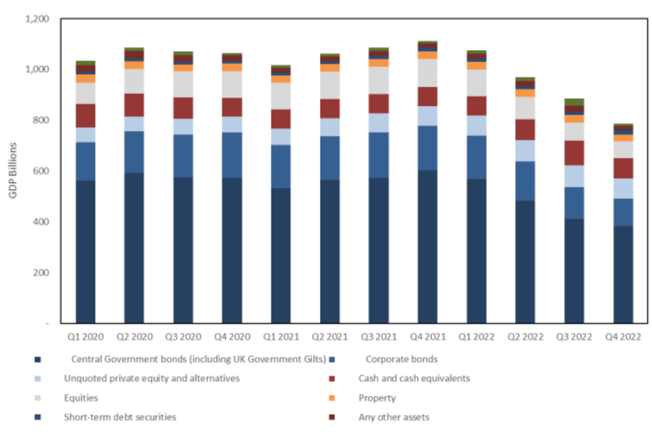
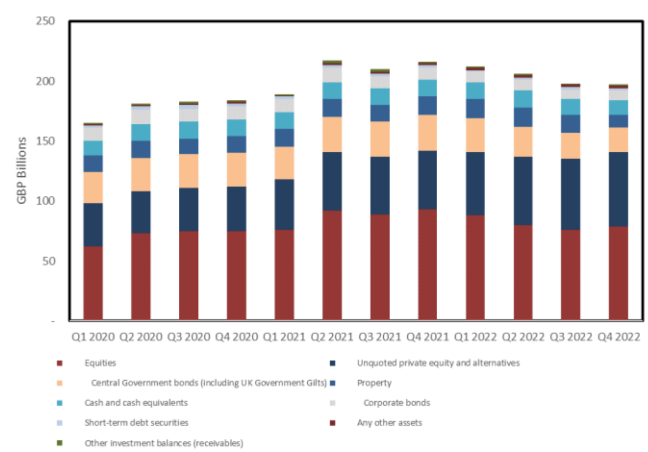


Exhibit 11. Investment Allocation in UK Public Pension Funds (excluding derivatives)

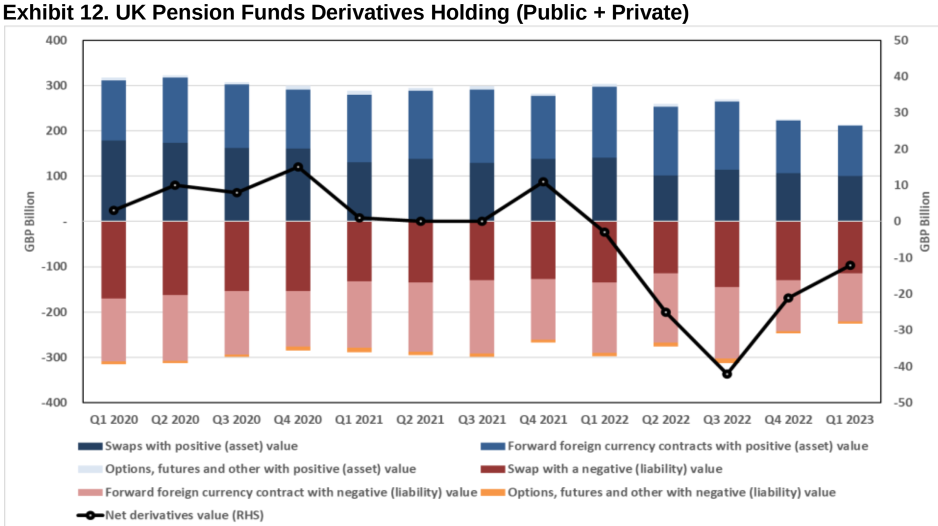


Sumber: Office for National Statistics Government UK

In addition to conventional market instruments, UK pension funds also allocate a portion of their assets to derivatives. Due to the absence of comprehensive data on total derivative asset ownership in UK pension funds, this paper discusses the derivative assets owned by all UK pension funds without differentiation. Derivative instruments exhibit higher volatility compared to conventional instruments, and their value is considered an asset if positive, or a liability if negative. For bond derivatives, their value decreases with rising bond yields and increases with falling yields. From 2020 to the end of 2021, the value of derivatives in pension fund investment allocations in the UK remained positive, although approaching negative territory in early to mid-2021.

However, due to increasing yield movements in early 2022, the value of derivatives turned negative, adding to the burden of pension fund managers in the UK (Exhibit 12).

Exhibit 12. UK Pension Funds Derivatives Holding (Public + Private)



Sumber: Office for National Statistics Government UK, IFGP Research

The shift to negative derivative values is crucial for pension fund managers. If the value of derivatives falls below the minimum capital requirement, pension funds with derivative assets must inject additional funds to cover the shortfall. Due to liquidity constraints, many pension funds resorted to selling bonds to cover these shortfalls. This selling led to a downward spiral effect on bond prices, further deteriorating the valuation of pension fund investments.

Moreover, rising interest rates and yields also affect the liability side of the pension industry in the UK. An increase in government bond yields, used as a benchmark for risk-free rates, reduces the present value of liabilities. The decrease in the present value of liabilities due to rising risk-free rates is comparatively larger than the decrease in asset valuation due to falling bond prices in UK pension funds (Exhibit 13). Thus, on paper, the number of pension funds that are categorised in deficit is seemingly lower when the UK long-term gilt yield spiked. While the large change in yields would provide an accounting benefit to the funds by decreasing the net present value of their liabilities, the benefit would not be realized until the end of the applicable accounting year (i.e., fiscal year-end in many cases). On the other hand, the associated losses on the assets (and associated cash outflows) were incurred immediately. Thus, funds would not eventually realize the benefit on liabilities when yields increase. However, because the asset sale occurred for a loss, there was an impact on pension fund balance sheets, leaving the funds worse off, with lower funding ratios (Exhibit 14).

Exhibit 13. Asset and Liability Movements in UK Pension Funds Index (PPF 7800)

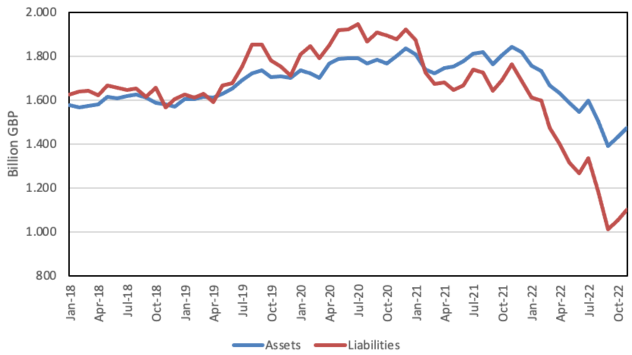
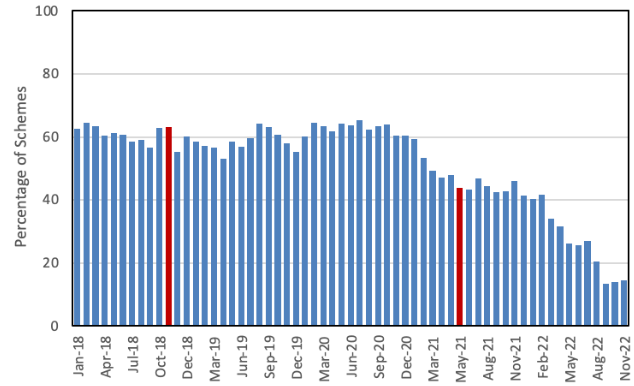


Exhibit 14. Number of UK Pension Funds in Deficit



Sumber: UK PPF, IFGP Research

Lessons Learned for Indonesia

From a macroeconomic perspective, Indonesia can learn to avoid uncoordinated macroeconomic policies. With Indonesia's inflation rate increasing and central bank interest rates relatively higher, careful coordination between monetary and fiscal policies is crucial to prevent the kind of disharmony seen in the UK.

From a microeconomic viewpoint, the UK crisis highlights the risks of excessive investment in volatile instruments like interest rate derivatives. Although such derivatives are not widely traded in Indonesia's capital markets, regulations by the Financial Services Authority (OJK) require pension funds to allocate at least 50% of managed assets into bonds. Therefore, rising bond yields, leading to decreased bond valuations, can significantly impact investment performance, particularly in the pension fund industry.

Indonesia should learn from the UK's experience of fiscal-monetary policy disharmony and recognize the importance of liability management strategies and asset allocation in pension fund management.

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