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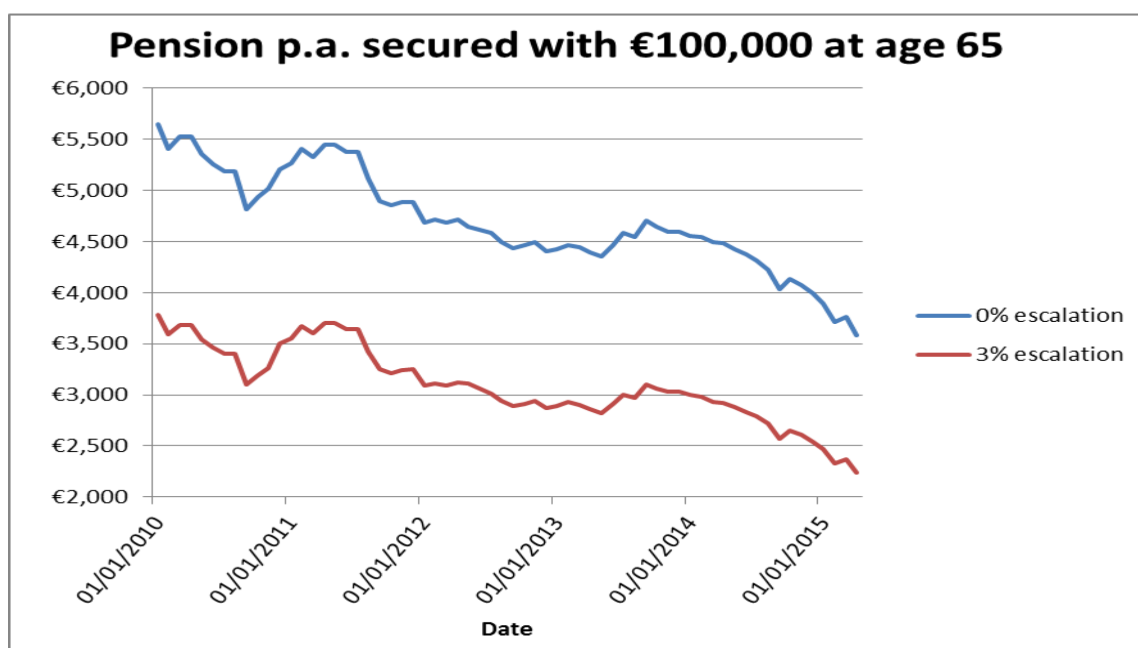
Annuity rates continue to fall – implications for individuals and pension schemes

The cost of a pension is directly related to interest rates or bond yields. A pension is a series of payments payable for the remainder of a person's life. To arrive at the value of a pension, these payments are discounted by a rate of interest which in turn is based on the bond yield available. The lower the rate of interest or annuity rate, the higher the value or the cost of pension.

The impact of lower annuity rates is that they considerably increase how much money needs to be set aside to secure a pension in retirement. The graph below shows the fall since 2010 in the level of income that can be secured with €100,000 at age 65 for a male with a 50% spouse's death in retirement pension and 5 year guarantee period.



Whilst the increased cost of annuities directly impacts on the level of income defined contribution scheme members can secure in retirement, there are also implications for defined benefit schemes.

Many defined benefit schemes currently have funding proposals in place designed to restore the scheme's funding position to 100% funded on a statutory minimum funding standard basis within an agreed timeframe. Despite very strong investment performance, some funding proposals may struggle to remain "on track" due to the continued increase in annuity buy out costs and fall in bond yields. This is because pensioner liabilities under the statutory minimum funding standard are measured based on the buy out cost of annuities and expected asset returns are typically linked to bond yields.

A fall in the value of a scheme's growth assets would also put pressure on a scheme's funding proposal.

In order to protect against this risk, many schemes are de-risking their investment strategies. However, in the current low interest rate environment such a move presents significant challenges. As a result, many schemes are considering alternative investments in addition to the traditional asset classes of equities, bonds, cash and property.

If you would like to discuss any of these issues in confidence with an independent viewpoint, please call the experts in Invesco on 01 2947600.

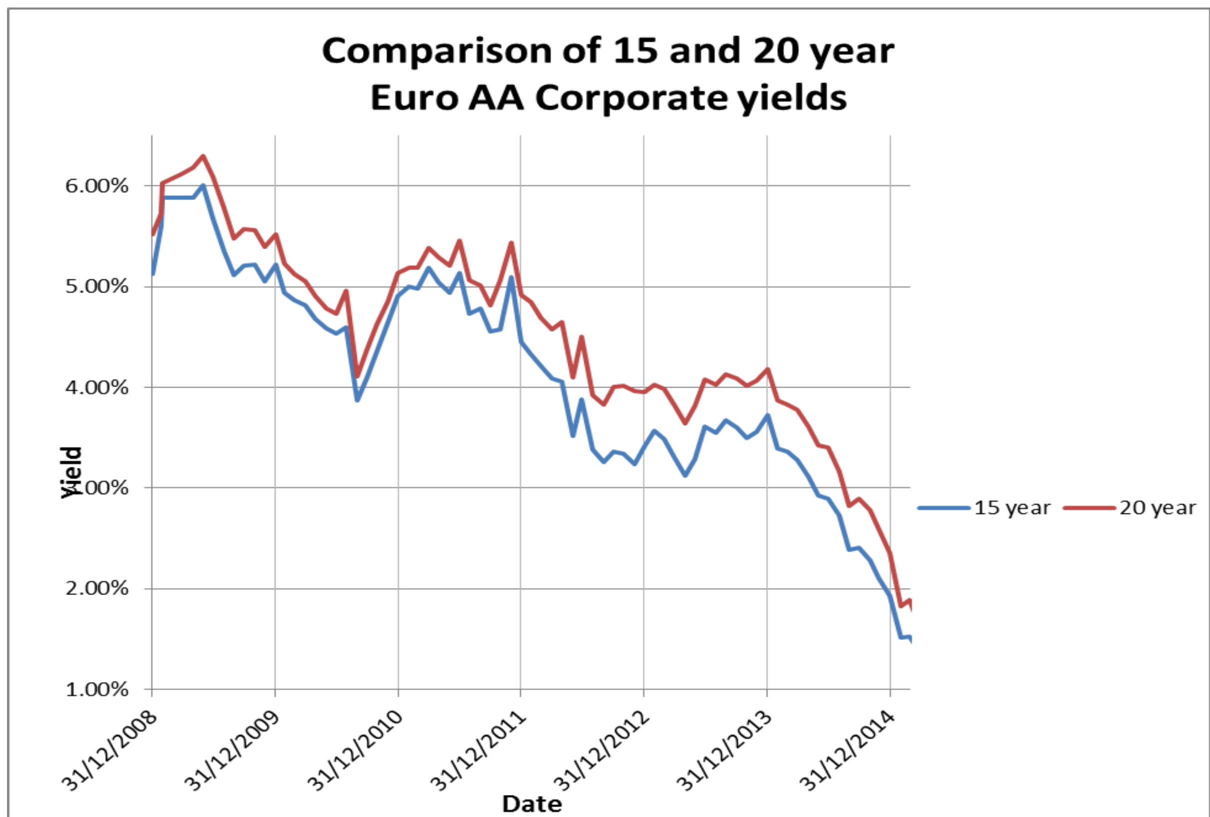
Corporate Bond yields at historic lows – Implications for Company Accounts

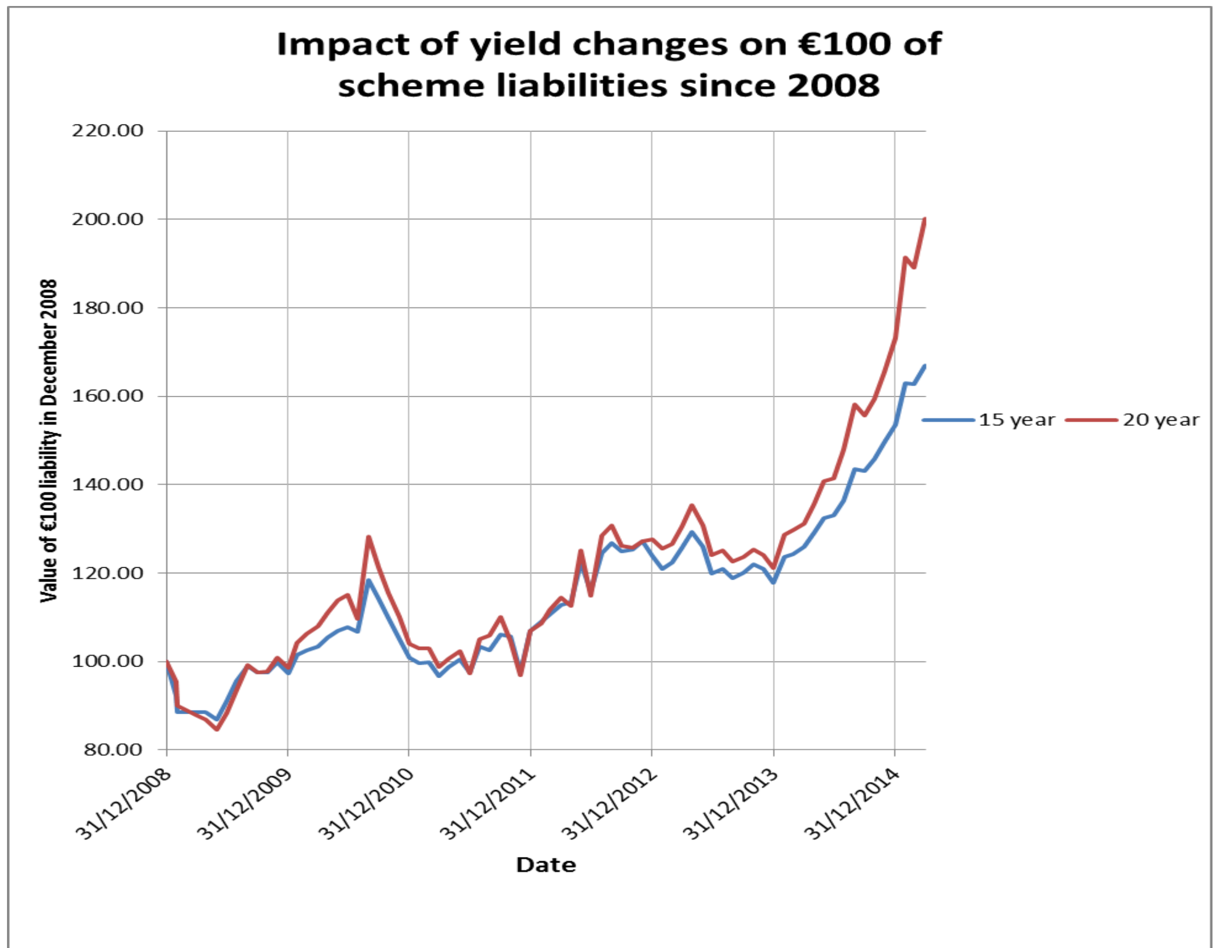
For the purposes of pension accounting standards (FRS 102, IAS 19 and ASC 715), defined benefit pension obligations are calculated using the discount rate on high quality (typically AA) corporate bonds of a duration appropriate to the liabilities of the pension scheme.

The yields on these bonds reached unprecedented low levels in 2014 and have continued to fall during 2015. Since January 2014, yields have typically fallen by over 2.2%, continuing to increase pressure on company balance sheets and budgets. In the first four months of 2015, yields have typically reduced by 0.5%. While this will have been partially offset by the positive return on investments and lower inflation expectations, pension scheme deficits are likely to increase if yields remain at current levels, all else being equal.

Ultimately the impact on balance sheets will depend on the level of bonds yields at the company's year end, the duration of liabilities, the investment return earned on scheme assets and the scheme's funding level.

The following graphs show the changes in bond yields and the impact on liabilities based on the Invesco Euro AA Corporate Bond Yield Curve for durations of 15 and 20 years.





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