January 2024

USS briefing: Effects on the scheme of short-term high inflation

Introduction

This note discusses the effects on the scheme's financial position of short-term realised inflation being considerably higher than our longer-term expectations. In the year to September 2023 inflation, as measured by CPI, amounted to 6.7%, and it is this rate that will likely be the basis upon which accrued benefits and pensions will be adjusted at 1 April 2024. This rate is much higher than the 3% a year average which the Trustee adopted for the valuation at 31 March 2023.

The Bank of England are charged with targeting inflation around the level of 2% per annum. As such action is being taken by the Bank to bring higher inflation rates back in line with this target. Over the past year we have seen the Bank raise interest rates in an attempt to do this.

The higher level of realised inflation impacts the benefits that will be paid by the scheme as well as the assets we hold and the expected return that we will get from them. We discuss the effect of short-term higher realised inflation on the benefits and the expected returns below as well as the overall effect on the scheme's funding position and contribution requirements.

Benefits payable from the scheme

Most of the benefits provided by the scheme enjoy full inflation protection up to 5% a year, as measured by CPI on an annual basis ending in September each year and published as the Official Pension Increases by DWP. The increases are applied from 1 April the following year.

Benefits accrued before 1 October 2011 are fully protected from inflation. Benefits accrued since 1 October 2011 are effectively capped at 10%: full inflation increases up to 5%; half of any increase between 5% and 15%; nothing further if CPI is above 15%.

As such, when realised inflation is above 5% the real value of benefits payable relative to CPI will fall, where there is accrual after 1 October 2011.

Assets held by the scheme

Broadly speaking, the assets held by the scheme can be classified as nominal, inflation linked and growth assets.

For nominal assets, including nominal gilts and corporate bonds, a higher-than-expected rise in inflation ~~will~~ reduces the real value of the income we receive from these holdings as that income is fixed in monetary terms. Further, higher-than-expected realised inflation signals that inflation may remain higher in the future and that interest rates will have to rise more than previously expected in order to bring inflation back to target. If inflation and/or interest rates are likely to be higher in the future, investors will require compensation in terms of higher nominal yields, which leads to a fall in the price of nominal bonds. The greater the inflation surprise and uncertainty on how longer it would last, the greater the fall in nominal bond prices is expected to be.

For index-linked assets, which include index-linked gilts and some of our private market investments where returns are linked to inflation, a higher-than-expected rate of inflation does not materially affect the real value of the income we receive from these holdings but increases its value in monetary terms. However, market pricing of such assets as a result of higher-than-expected inflation is more complex. Real yields on index-linked assets may be affected by unexpected inflation depending on the anticipated persistence of the inflation shock and strength of monetary policy response. In general, real yields on index-linked assets tend to rise during periods of higher-than-expected inflation. That is, they experience a price fall with investors demanding a higher real return. One can interpret this as signalling a requirement for Central Banks to keep interest rates higher in real terms to re-establish their credibility. However, 'breakeven' inflation (i.e., the difference between nominal and real yields) may also widen if investors expect inflation to remain higher for longer. In other words, real yields may rise less than corresponding nominal yields.

Index-linked gilts have returns which are linked to RPI rather than CPI. However, in the recent past the excess of RPI over CPI has been greater than the longer-term expectation and this has resulted in their value to the scheme increasing relative to CPI.

The effect of higher-than-expected short-term inflation on growth assets, such as equities, is more difficult to generalise and is largely dependent on the general economic climate and the ability of those businesses to pass on the unexpected inflation or to absorb it through efficiencies. However, given higher-than-expected inflation is likely to be accompanied by greater economic uncertainty and investors demanding higher returns elsewhere (e.g., nominal bonds), there are arguments which would support higher returns being demanded on growth assets, which potentially results in asset values falling.

It should also be noted that the scheme's current investment strategy does hedge a proportion of the scheme's interest and inflation risks. As such, this will dampen the effect of any short-term increase in inflation on the funding position.

The funding position of the scheme and future service contribution requirements

Determining the funding position of the scheme allowing for higher short-term inflation requires a view to be taken on longer-term outlook for inflation as well as expected returns available from the assets already held and those the scheme intends to hold in the future We can and do allow for *known* inflation when calculating the liabilities. But, given the term of the scheme's liabilities, ensuring there is consistency between the long-term outlook for inflation being assumed in the projection of the benefits and that being used to generate the future expected returns of the assets is more important than the short-term inflation rate itself.

The effect of higher short-term inflation is difficult to predict given the complex interaction between benefits, assets, and discount rates, but in general terms:

- Higher-than-expected inflation (while remaining below 5%) is likely to result in a deterioration of the funding position.
- Higher than expected inflation above 5% could result in the funding position improving.
- Future service contribution rates will not materially change unless the higher-than-expected inflation is expected to persist for a longer period and there is no improvement in the nominal expected returns on the assets the scheme will hold. If expected real returns remain the same, then there will be no change in the future contribution requirement.

As a general point, higher short-term inflation reflects economic uncertainty which is not helpful to the stability and planning of the scheme's finances.