The SPP member research series:

Impact of Covid-19 on pensions

Although the consequences of Covid-19 are still fresh for most of us, it is now over two months since equity markets started to fall, and over a month since the UK lockdown started. After a few uncertain weeks, the Covid-19 crisis has become "business as usual" for many UK pension schemes.

In our latest SPP survey we asked our membership what they were seeing around the UK pensions industry, and we asked members from a range of backgrounds for their observations of some of the issues being faced.

Contribution deferrals

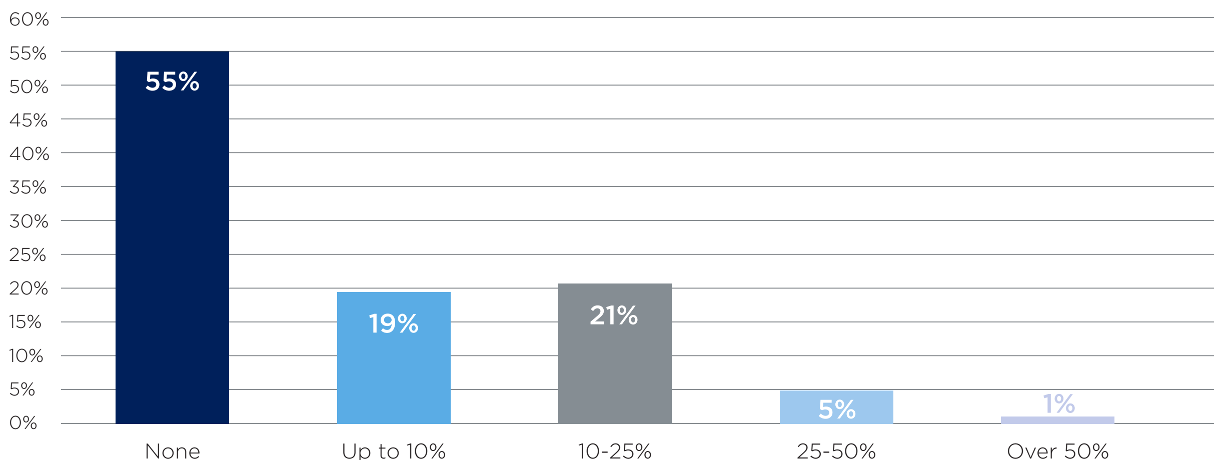
While Covid-19 has had many implications for pension schemes, perhaps the most talked about topic is that of contributions, and whether sponsors should be allowed to defer or cancel deficit contributions.

The rationale for suspension of contributions is clear, with covenants badly affected in many schemes. The Pensions Regulator reacted quickly and helpfully to the situation, with clear guidance on what to consider. We asked our members what they were seeing in practice. Their responses indicate that deferral of contributions is definitely happening, but not in large numbers (Fig. 1).

Although over half of those (55%) responding didn't expect any of their clients to suspend or reduce deficit contributions, 45% of those responding did expect to see activity in this area. Drawing conclusion from a small sample such as this is unreliable, but based on this and other information in the market, we estimate that only around 5-10% of scheme sponsors may be planning to take advantage of this flexibility at the present time.

While that means the majority of sponsors do not need to suspend or reduce their contributions, for those that do it is a valuable lifeline which could be the difference between the business surviving or not. And while numbers are low at the moment, this could increase over time as the impact of the lockdown is felt more severely by businesses.

Fig. 1 What proportion of DB schemes do you expect to suspend or reduce deficit contributions?



Suspension of Transfer Values

Another topical area which The Pensions Regulator has commented on is transfer values from DB schemes. As yields continued to fall over Q1, transfer values were generally increasing, while assets were falling (See Fig. 2 opposite).

Concerns for schemes include the impact on funding levels the volatility of markets, and possible administration capacity. For members there are also concerns about volatility, as well as constraints on access to financial advice and increased risk of scams. Again, TPR's guidance was prompt and helpful

We asked our members what their experience was, the results show again that a minority of schemes have opted to suspend transfer values (Fig. 3).

Fig. 2 The fall in 20 year gilt yield since the start of 2020

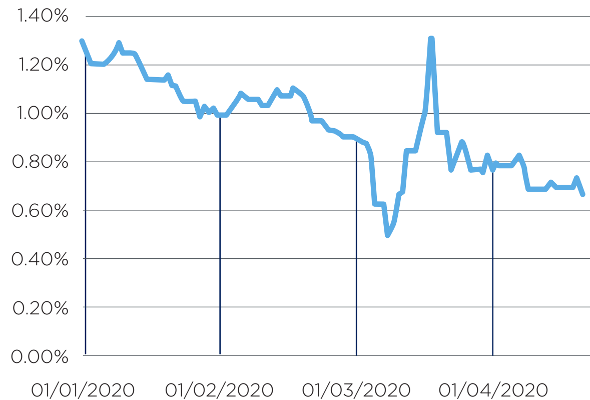
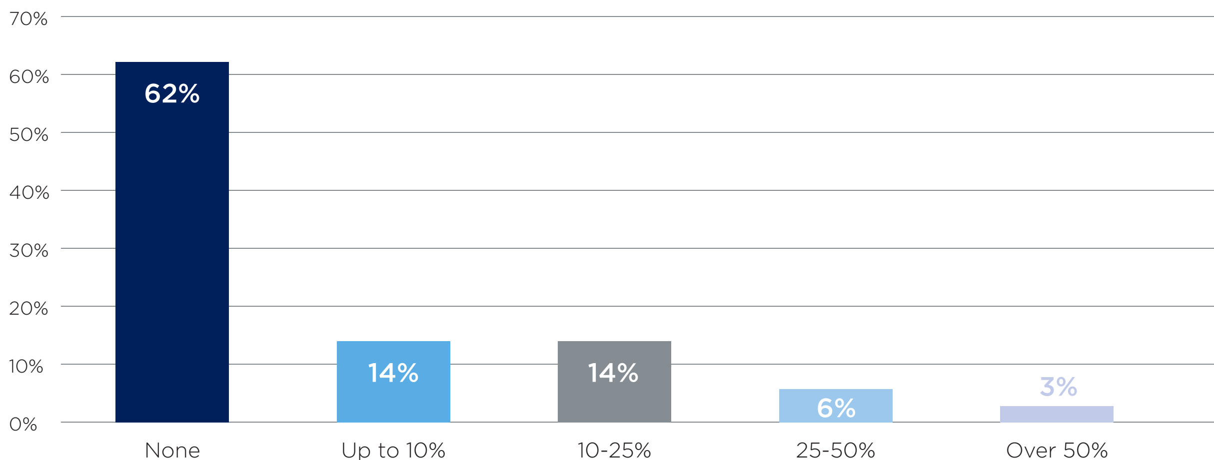


Fig. 3 What proportion of DB schemes have suspended transfer activity (either quotes or payments)?



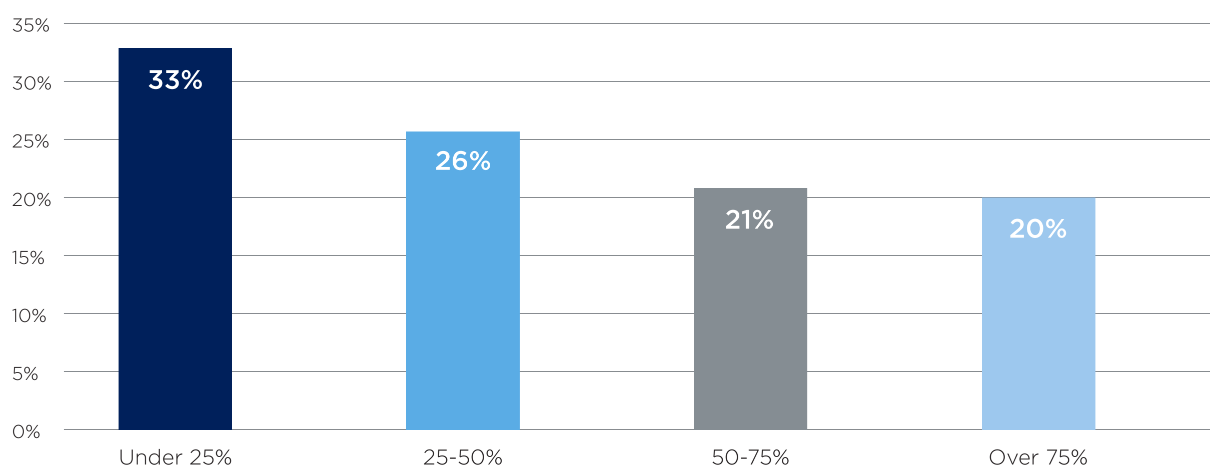
Although gilt yields were very volatile during March, it has been helpful that month-end yields (which many schemes use as a reference point for calculating transfer values) have shown a steadier pattern. And for many schemes, even if transfer values are higher while assets are lower, the amounts being paid out are still lower than the prudent funding reserve that they hold.

Adapting governance

One of the most immediate challenges for pension schemes has been changing the way that they operate. The nature of trustee meetings is such that they tend do to be infrequent (most commonly quarterly) and face-to-face. In a rapidly changing and virtual environment, Trustees have had to adapt their behaviours quickly.

We asked our membership whether their clients had convened emergency meetings to discuss the Covid-19 situation (See Fig. 4 on next page).

Fig. 4 What proportion of schemes have convened special trustee meetings to discuss the Covid situation?

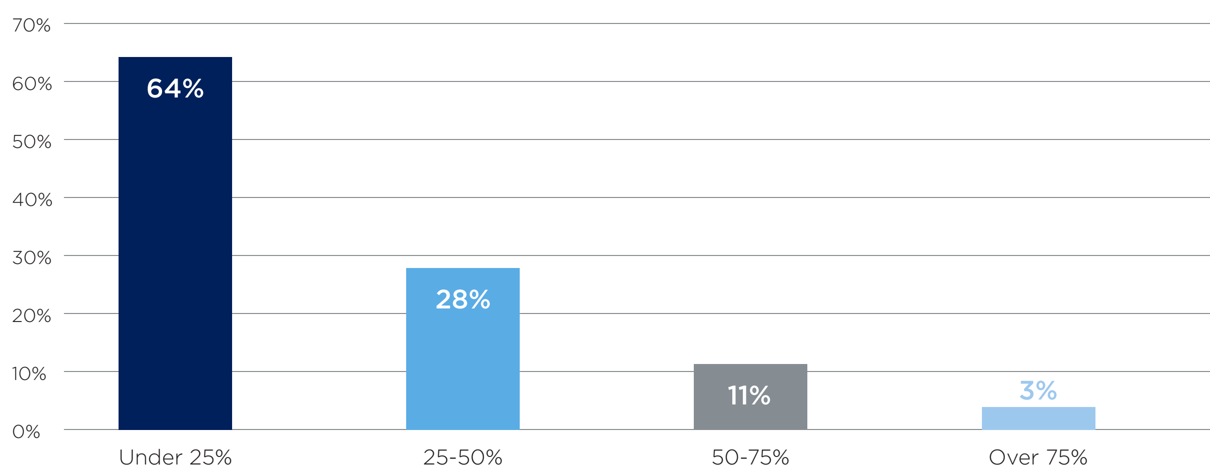


On the face of it, it is perhaps surprising that, on average, only about 50% of schemes have called special meetings. However, in a typical month around a third of pension schemes will have a meeting scheduled in any case, and for larger schemes there will also be sub-committees meeting more frequently. Anecdotally, our conclusion is that many schemes have managed the current crisis within their existing governance framework.

Limiting activity

Across the UK discretionary spend by corporates has plummeted as businesses look to retain their cash and limit unnecessary spending. The final question we asked our membership about was whether schemes were also putting substantial amounts of work on hold (Fig. 5).

Fig. 5 What proportion of schemes have put substantial amounts of work on hold?



The results here are reassuring, as although discretionary spend can be managed, the day to day activity of pension schemes does need to continue.

At one extreme we have heard of some trustee chairs being asked to suspend all pension scheme activity on the basis that it is non-essential to the business. But for most schemes there is a recognition that most activity needs to continue, albeit many special projects have been put on hold, at least in the first months of the crisis.

The challenge will be returning to normal, as suspending projects in Q1 and Q2 of 2020 will inevitably mean more pressure down the line. A classic example is that of GMP equalisation, where the amount of work required will not reduce if work is stalled. Other examples of suspended work include addressing cyber risk (ironic as cyber threats have increased over this period) and member options exercises (as schemes struggle with administration, financial advice and stability of market conditions).

What else are our members worried about?

As well as asking a number of specific questions, we asked six of our members with different areas of expertise for their thoughts on the current situation and the challenges schemes are facing. Their perspectives are below.

Bob Alsop, Covenant Adviser, Crowe

From an Employer Covenant perspective, I find it helpful to split the issue into two timeframes. Firstly, what trustees should be doing right now (i.e. next three to six months). And secondly what to do later when we have more visibility over what the post-Covid-19 world might look like. The focus right now is clearly on the first of these.

Assessing and scoring employer covenant as part of a normal IRM process is extremely difficult (if not impossible) right now, due to the current levels of uncertainty and hence covenant visibility. Unlike other economic downturns (e.g. 2008/2009) and other uncertain events (e.g. Brexit), where it was possible to come up with some reasonable forecast scenarios, we really don't know how long the Covid-19 issue will run, and hence what level of permanent damage (or for some improvement) may have been done to any particular employer's covenant. We may start to get a view on this in the next three to six months, and what an exit 'might' look like – and hence sensible potential scenarios can begin to be forecast, along with the potential long-term impact on sponsor balance sheets.

Right now, the most important thing is to understand and manage the immediate cash flows of both the scheme and the employer, so as to help ensure the health and sustainability of both as far as is possible. Part of that is managing potential requests for deferral of contributions, but there will no doubt be other factors to consider.

Looking forwards, we may begin to see other (and new) issues arising with pension schemes and their sponsors that need to be considered by trustees. These could include structural change to certain sectors, changes in respect of external funding providers (e.g. new business interruption loans and existing bank loans, and related banking covenants in respect of these), freezing of certain corporate investment assets, such that their divestment is restricted, and the impact the crisis may have on the value of contingent security and negative pledges. All of these areas will affect different schemes in very different ways.

Paul McGlone, Actuary, Aon

From a funding perspective we've seen a range of impacts from Covid-19, depending on the underlying asset and edging strategy. Typically funding levels have fallen by 5-10%, although there are clearly outliers beyond that range.

Deficit contributions and Transfer Values have been touched on already in this document, and experience is definitely mixed. Some sponsors with limited financial difficulties have tried to reduce deficit contributions with no good reason, while others who are under serious stress have prioritised deficit contributions and continue to pay them. A common discussion point is around expenses, and whether trustees can limit expenses, or limit how they get re-charged to sponsors.

A natural, if somewhat morbid, question is whether Covid-19 will impact on mortality rates and life expectancy. At this stage it is too early to tell what 2020 will look like, although it is already clear that we will see substantially higher mortality rates than a normal year. Looking forward, impact on future life expectancy is unknown, but it is certainly too early to be changing assumptions in valuations or other calculations.

A helpful impact of the crisis is that bulk annuity pricing has improved, as a result of credit spreads widening. The increase in spreads doesn't flow straight through to pricing, as defaults need to be considered, but with insurer pricing around 5% better than it was a few months ago, 2020 will be a year where schemes that are ready to transact could find some bargains.

Bob Campion, Investment Manager, Charles Stanley

What surprised many people from an investment perspective wasn't the well-publicised sell-off in equities – that's what happens in a crisis, even though it was more extreme than we've seen before – it was the short-lived but dramatic sell-off on Government bonds. After an initial rise in prices (flight to safe assets), in mid-March gilt prices fell around 10% in 10 days, while index-linked gilts fell about 20%, before both broadly recovered by month end.

The impact on corporate bonds was more prolonged, with spreads increasing noticeably over March, to levels which implied substantial defaults. In the meantime, equity markets have reacted very differently, with Indian equities, for example, down 40% year to date at their worst, while Nasdaq (US Technology) was only down 15% at the worst.

Taken together the heightened volatility in risk assets and the government bond market posed challenges for pension schemes with strict risk budgets. Depending on the system used, expected risk in growth assets looked extremely elevated at March month end. And with bond prices causing liabilities to fluctuate wildly, it became difficult to keep liability hedges on track.

With volatility levels so high across all assets during March, trading spreads were the widest we've ever seen, even on low risk assets, as market makers struggled to price assets with any degree of confidence. Corporate bonds became completely illiquid in some areas. That presented challenges for schemes looking to take any action, even basic rebalancing.

Claire Carey, Lawyer, Sackers

While much attention is rightly focused on the financial implications of Covid-19, legal considerations underpin many of the questions to be addressed.

On facing a request to suspend or reduce deficit contributions, Trustees need to not only consider the Regulator's guidance, but wider issues. They have obligations as a matter of trust law to consider, there may be potential traps in scheme rules which need to be considered before they can agree to such changes, and schemes need to be sure that any suspension of contributions doesn't inadvertently get classed as a loan to the sponsor.

The Government's Job Retention Scheme (Furloughing) is also a challenge, with various pension implications. Any employer which does not have a DC qualifying scheme using statutory default contributions needs to think through the contribution impact, which may mean formal scheme rule amendments, a consultation (recognising TPR's limited regulatory concession), or to agree contractual changes.

From a practical perspective, executing documents has proven to be a challenge. Lockdown has exposed just how difficult it can be to execute deeds and other documents when the so-called "wet ink" route is unavailable and no online facility in play. Getting deeds witnessed can be particularly tricky (they must be signed in the individual's physical presence), as is the lingering confusion around whether companies need to execute the same document / counterpart (so that whoever signs in effect witnesses the other's signature).

An encouraging thought is that the lockdown might trigger a change in the law in this respect, with The Law Commission having undertaken a recent review and the Law Society also now taking an active interest.

Finally, while we are in lockdown don't forget GDPR. We have more information moving around electronically, often through home emails and/or hardware. It's important that Trustees (and their advisers) remember to keep their data safe and to keep it legal!

Barry Mack,
Muse Advisory

The immediate administration concern for many schemes has been to ensure that monthly pensioner payroll continues to be paid, as well as activities associated with that such as ensuring there is enough cash in the trustee bank account. Beyond that trustees have begun to think about near term issues such as key person risk (should the administration team fall ill), member communications (particularly for DC) and documenting decisions. Trustees having dealt with the urgent, now need to ensure that the urgent doesn't get in the way of the important' added somewhere.

Receipt of original documents for administration purposes is a challenge. Some TPAs may still have skeleton staff or an outsource post handling firm, so things may be as before. Some have accelerated the introduction of online systems so that, for example, original death certs do not need to be sent.

Where contact centres are in use, if calls are normally being recorded then what is the position if calls are redirected to home? Some firms have managed to put in place remote working where call recording is still being done, but others have not been able to do that.

As demands on administrators change, time-critical projects such as data cleansing for a buy-out/in could come under pressure if administrators are not able to devote the resources with as much priority or certainty as before.

In-house administration presents a different challenge. Some have modern systems that allow remote working, but for those who are still working on a local server, with no remote access, working in the office may remain a requirement. Urgent upgrades may be required if the current situation continues for months, rather than weeks.

And challenges are not just limited to software. While many administrators had systems capable of dealing with remote working, they hadn't been anticipated to be used on the scale now needed. Never mind the run on loo rolls; for many firms, the issue was the run on laptops!

Edward Levy,
Professional Trustee, Law Debenture

In the immediate turmoil of the Covid-19 crisis the focus of many trustees has changed to the near term. In stark contrast to the normal long term perspective of paying benefits over the next 50 years or so, the immediate focus has been on paying the monthly payroll with trustees getting into details that they often take for granted.

Governance arrangements have adapted quickly to be more flexible, with weekly calls looking at covenant, funding, investments and administration often by video conference, instead of the more measured quarterly trustee meeting cycle. We have already seen trustee boards thinking about how they may operate post lockdown, with some considering holding alternate meetings by video. Other governance considerations include delegation to sub-committees, decisions being made more quickly (and documented appropriately) and how to respond to non-availability of trustees.

Paying pensions requires increased focus on short-term cash flows and which assets might need to be sold, as well as an understanding of investment managers' signing requirements. Fortunately, most now accept an electronic approach rather than relying on wet signatures.

Overall, there is a need for more frequent communication with the whole trustee board, advisers and the sponsor, and importantly pension scheme members. DB pensioners will appreciate reassurance that benefits will continue to be paid. DC members can be reminded of the long-term nature of their pension arrangements. It is also important to convey crucial messages about not making knee-jerk responses to current events and also watching out for scammers.

Even more than usual, trustees need to keep a regular and close eye on developments across all areas, including TPR pronouncements which can act as a useful checklist, not to mention the views of the different advisers. The challenge is then to focus on the immediate priorities of individual schemes, without losing sight of the long-term objectives.

The Society of Pension Professionals

Quantum House
22-24 Red Lion Court
London
EC4A 3EB

t: 020 7353 1688
f: 020 7353 9296
e: info@the-spp.co.uk

www.the-spp.co.uk

@TheSPP1

Society of Pension Professionals

THE SOCIETY OF PENSION PROFESSIONALS

leading pension thinking