Red alert

Summary
• The economic impact of the coronavirus pandemic has contributed to DB scheme deficits rising.
• Employer covenants may be weakened as a result, so TPR has encouraged trustees to allow sponsors to pause or reduce deficit recovery contributions.
• Schemes may face cashflow problems as a result, and may look to alter their investment strategies to counter this.
• Long-term ramifications may include extended recovery plans and greater pressure on the Pension Protection Fund (PPF).

Laura Blows looks at how the economic downturn caused by the efforts to stifle the coronavirus pandemic is affecting DB scheme funding levels

It started so well. On 1 January 2020, the aggregate deficit of UK defined benefit (DB) schemes, as defined by the PPF 7800 Index, sat at £10.9 billion – a tiny amount in relative terms.

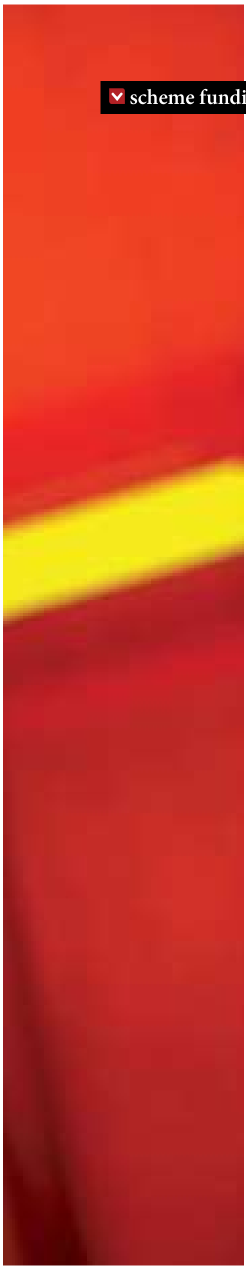
Fast forward a few months and it's a very different situation. By the end of March, the PPF 7800 aggregate deficit had reached a colossal £135.9 billion.

Volatility

Volatility in scheme funding levels is not unusual, but these *are* unusual times. The economic impact of the coronavirus pandemic is having a significant effect on pension schemes' finances.

"We've seen some short-term downward movement across DB deficit levels over the course of the past few months, driven by Covid-19's impact on markets and some of the regulatory responses – including slashing interest rates to record lows," PLSA head of DB, LGPS and Standards, Joe Dabrowski, says.

How a scheme's funding levels have responded to current market changes does depend upon circumstance and investment strategy, Mercer chief actuary



and partner, Charles Cowling, states.

"Most schemes are seeing an increase in the deficit compared to the position at the start of the year," he explains. "Those schemes with little hedging and significant equity exposure may be seeing a much larger increase in deficit."

However, for many the fall in funding level has not been as severe as the headlines about the stock markets might imply, Aon partner, Lynda Whitney, says.

PPF chief finance officer and chief actuary, Lisa McCrory, agrees, noting that "if you take a long-term review of our monthly PPF 7800 Index, you will see that the current aggregate deficit of £135.9 billion is very similar to the average deficit figure of around £135 billion over the past 10 years".

Also, the deficit increased to more than £400 billion in 2016, "and this deficit has of course improved since then", she adds.

"A typical FTSE 100 scheme has seen funding on its accounting basis fall back to where it was around 2.5 years ago," Whitney continues. "They have typically lost the gains they would have expected to have made from the deficit contributions and investment return, but not in a way that isn't manageable if the sponsor survives to pay contributions in the future."

It is that 'if the sponsor survives' that is the question. Certain sectors, such as retail, leisure and transport are suffering more than others. The scheme's maturity can also determine how vulnerable it is to sponsor concerns.

"The current climate leads trustees to be more concerned about protecting their interests, should anything untoward happen to the sponsor," TPT Retirement Solutions head of IRM, Tom Neale, says. "It is critical that trustees understand the impact of current events on the short- and long-term sponsor covenant as this may drive different decisions."

DRCs

To help with those sponsors currently struggling, at the end of March The Pensions Regulator (TPR) confirmed easements for employers to suspend deficit repair contributions (DRCs), as part of its updated guidance on Covid-19.

While it also clarified that TPR has no power to waive statutory duties, it did announce that the regulator would make allowances in terms of its enforcement activity to provide easements for schemes amid the Covid-19 pandemic, and told trustees to be 'open' to requests to reduce or suspend DRCs.

It stated: "Where sufficient information is not available to make a fully informed decision, trustees should, where appropriate, agree to requests to suspend or reduce DRCs for as limited a period as possible while appropriate information is being provided."

If allowing this, Cowling recommends that trustees have a regularly updated understanding of employer business plans and cashflows, and maintain good communication with the sponsor to ensure the pension scheme is treated equally with other shareholders.

According to TPR, the suspension should be no longer than three months, with a condition of the agreement being a "full and ongoing provision of information" to allow trustees to closely monitor the employer covenant.

Despite this, PwC covenant director, Dickon Best, states that its company's research shows 10 per cent of deferment requests are for up to 12 months or more.

TPR's own findings are that 5-10 per cent of sponsoring employers have been requesting to suspend DRCs, it announced at a recent webinar, while LCP analysis is that more than 500 employers are expected to defer on DRCs, totalling around £0.5 billion.

Some of the major companies to have already sought a delay to deficit reduction contributions include Reach PLC, the publishing house for the *Daily Mirror, Daily Express* and *Daily Star,* Arcadia and Debenhams.

However, 47 per cent of pension scheme trustees and professionals surveyed by Hymans Robertson cite a lack of clear information on the strength of sponsor covenant as a 'major barrier' in agreeing DRC deferrals.

Additionally, 21 per cent say scheme funding is a major barrier in accepting deferral requests.

"The current situation may be causing cashflow issues for some sponsors, and where this is particularly acute, they may seek to deviate from the agreed schedule of contributions," DLA Piper partner, Matthew Swynnerton, states.

"Any proposal to alter an agreed schedule of contributions would, as a minimum, require the agreement of the scheme trustees, and the rules of the scheme should also be checked, as these could add additional conditions and provisos above the statutory requirements."

Trustees will need to consider what is in the best interests of the pension scheme, which will usually include making an allowance for the maintenance of an ongoing sponsor who can continue to support the scheme, he adds.

Investments

If employer contributions are suspended, trustees may increase focus on another staple to help plug a funding deficit – its investment strategy.

Dalriada Trustees senior trustee representative, Charles Ward, states that market volatility can actually present

opportunities, as seen with corporate debt during the financial crisis in 2008. "Pension scheme investment horizons are typically longer than for other investors and so they should take advantage of this where they can," he explains.

The fall in the UK's inflation rate could also ease the pressure for some DB schemes with sizable deficits, according to Barnett Waddingham principal and senior investment consultant, Ian Mills.

"Employers of these schemes could then see the value of their liabilities drop, offering a window of opportunity for struggling schemes to address their deficits and edge closer to their endgame," he says.

However, while taking risk out of the investment strategy to prevent further losses would seem like an obvious solution, Ward warns, "this will put strain on the employer due to the resulting increase in funding that could be required and trading in volatile conditions also introduces risk".

With investment markets also going through volatile times in response to Covid-19, trustees may need to look to protect their position through other means such as security or alternative financial structures like asset-backed contributions, Neale suggests.

Those schemes that have a robust integrated risk management (IRM) framework are also expected to be better prepared to handle rising deficits.

So with these weapons in their arsenal, just how concerned should trustees be about their scheme's current funding situation?

For Neale, if there is confidence in the long-term viability of their sponsor, the trustees may be able to accept some volatility in funding and investment plans.

"However, some trustees will be worried, particularly where current events are expected to cause a long-term weakening of the sponsor's covenant, meaning that they may have a reduced ability to take risks, eg in pursuit of investment returns," he explains.

Long-term impact

Ward adds that for the majority of schemes, funding their liabilities remains a long-term project and this gives schemes time to implement appropriate plans to recover their losses.

However, "it is too early to tell how Covid-19 might impact on scheme deficits or recovery plans in the long term," Dabrowski says, but for example, buyouts may have to be pushed back because of short-term funding pressures.

"The longer-term ramifications for schemes will be highly dependent on the wider economic situation, in particular whether markets recover and how sponsors and business bounces back. Emerging analysis from the OBR and IMF indicates that even in the best-case scenarios we can expect a bumpy ride."

This could lead to longer recovery plans, he states, despite TPR's stating that it 'ideally' wants recovery plans to remain the same.

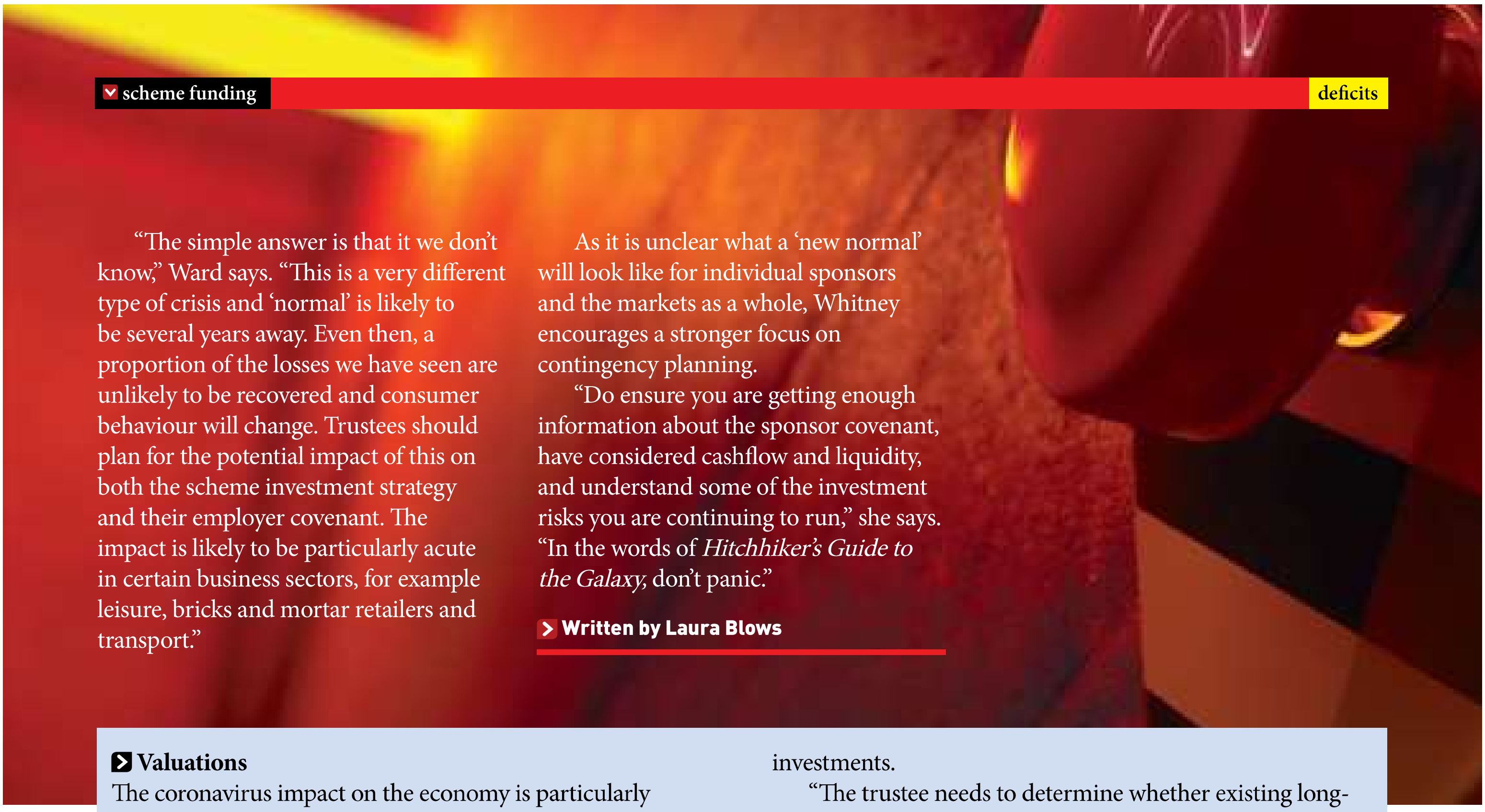
"It also feels like the time has come for both the government and the regulator to set out the interim regime for superfunds, which could play an important role in providing new solutions for schemes and employers", Dabrowski adds.

Even with the additional de-risking option of superfunds, there are concerns that PPF levies will rise as a result of the Covid-19 crisis.

LCP recently stated that, while the coronavirus fallout is likely to see an overall increase in the rise of the levy across all firms, some may face much bigger increases, particularly where their scheme deficit has increased or their solvency position weakened.

However, in response, the PPF has published an update on its website to reassure its levy payers that Covid-19 will have a minimal impact on the amount of levy it expects to charge this autumn.

But even once the coronavirus panic passes, whether things will then return to 'normal' in the longer term is subject to debate.



"The simple answer is that it we don't know," Ward says. "This is a very different type of crisis and 'normal' is likely to be several years away. Even then, a proportion of the losses we have seen are unlikely to be recovered and consumer behaviour will change. Trustees should plan for the potential impact of this on both the scheme investment strategy and their employer covenant. The impact is likely to be particularly acute in certain business sectors, for example leisure, bricks and mortar retailers and transport."

As it is unclear what a 'new normal' will look like for individual sponsors and the markets as a whole, Whitney encourages a stronger focus on contingency planning.

"Do ensure you are getting enough information about the sponsor covenant, have considered cashflow and liquidity, and understand some of the investment risks you are continuing to run," she says. "In the words of *Hitchhiker's Guide to the Galaxy,* don't panic."

Written by Laura Blows

Valuations

The coronavirus impact on the economy is particularly painful for DB schemes having to undertake 2020 funding valuations.

According to Aon, 15 per cent of schemes have an upcoming valuation date of 31 March 2020, or 6 April 2020.

Aon head of UK retirement policy, Matthew Arends, says: "Actuarial valuations with effective dates on 31 March or 6 April 2020 will be anything but repeats of 2017 valuations, given the impact that Covid-19 has had on pension scheme funding and sponsor covenants. And this is despite, in many cases, significant deficit contributions having been made over the past three years."

Following examination of the funding levels of 190 schemes, Aon predicts that a quarter of schemes' funding levels were estimated to have fallen by more than 6 per cent over the past three years due to market conditions.

For a typical pension scheme with a liability value of £250 million, a 6 per cent worsening of funding level would correspond to a £15 million increase in deficit, it states.

The company forecasts that half of schemes would have seen anything from little or no change to a 6 per cent worsening in funding level, while the remaining quarter of schemes were seen as likely to have experienced an improvement in funding levels over the period.

In its newly-released *Annual Funding Statement,* The Pensions Regulator (TPR) emphasises that it expects trustees to approach valuations and scheme funding 'in conjunction' with their employers, with its guidance particularly relevant to those conducting valuations between 22 September 2019 and 21 September 2020.

It also acknowledges that March and April 2020 valuations would be particularly 'challenging', with many trustees not having access to sufficient information to form a reliable view on long-term future returns from scheme investments.

"The trustee needs to determine whether existing long-term strategic scheme funding and investment plans remain appropriate, given what may be a short-term issue for some sponsors," TPT Retirement Solutions head of IRM, Tom Neale, says. "There is a balance of not putting undue pressure on the sponsor during this difficult time, whilst ensuring that suitable long-term funding plans are put in place and member interests are protected."

DLA Piper partner, Matthew Swynnerton, says that current market turmoil could lead both trustees and employers to conclude that it is an inappropriate time to set the effective date of or conclude an actuarial valuation, which is effectively a snapshot of the funding position of a scheme on a given date.

"However, where there is scope within the time limits of the three-yearly valuation cycle and the 15 months in which a valuation must be submitted to TPR, the trustees and the scheme sponsor may think it would be preferable to use a date that falls outside of the acute circumstances currently being experienced when seeking to set longer-term funding objectives," he suggests.

"If that's the case, they should seek the scheme actuary's views in relation to the impact of the current situation and what may be possible in terms of using an alternative date.

"Alternatively, trustees and employers will be aware that, in determining any additional funding required by a scheme arising from the actuarial valuation, it is within the actuary's scope to take account of post-valuation date experience. It may also be useful to discuss with the scheme actuary the possibility of adopting this course of action."

Neale also advocates options such as stepped or extended recovery plans, depending on the circumstances, which may be supported by the provision of contingent charges or assets from the sponsor.