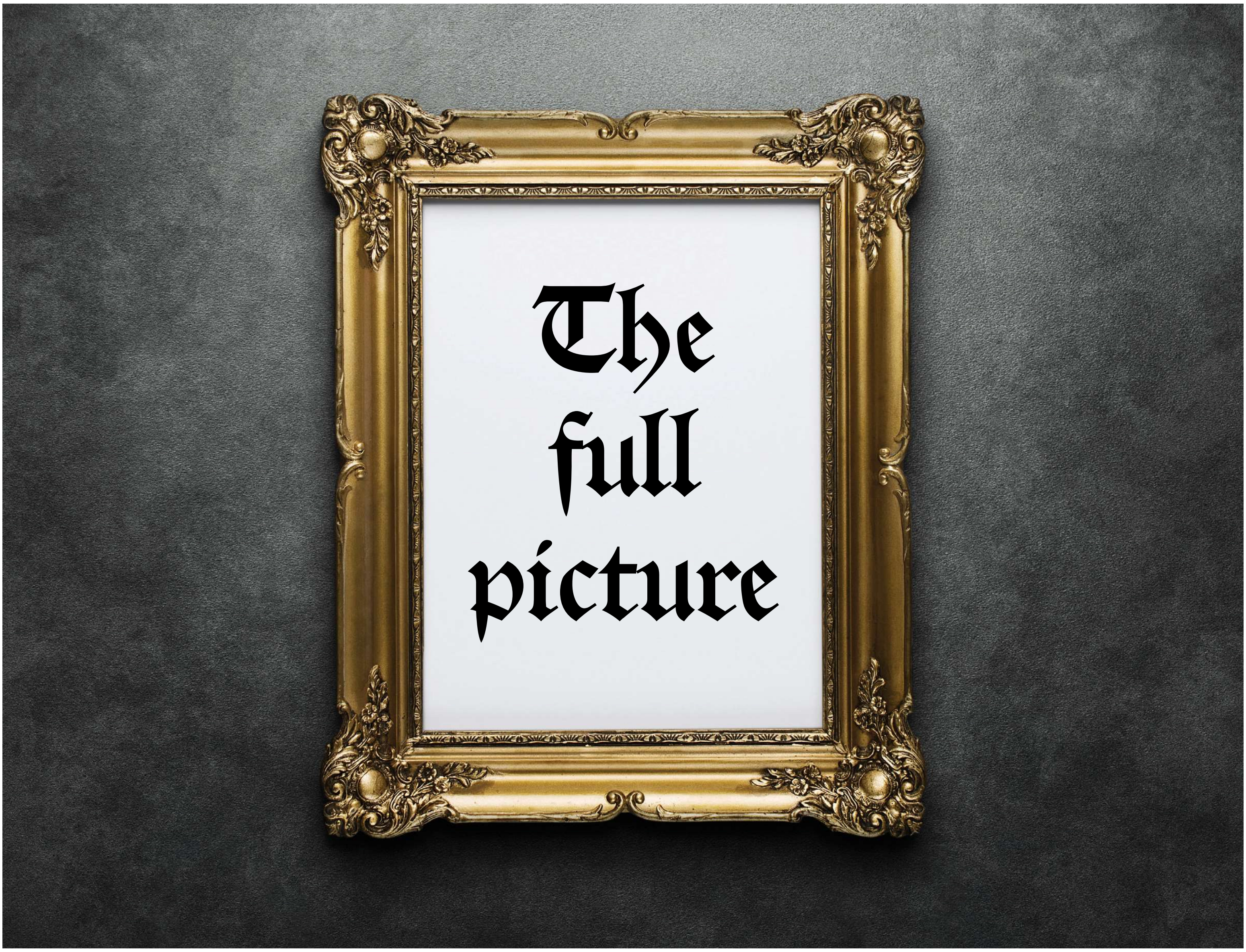

Covid-19 has had an undeniably negative overall impact on defined benefit (DB) pension schemes' deficit levels and journey plans. However, some have fared better than others and the picture is not as black and white as one might expect. Jack Gray reports

Summary

• DB scheme funding levels have declined by around 8 per cent over the year so far, as of the end of October.
• Despite the drop, some schemes were better prepared for the impact of the Covid-19 pandemic than others.
• Although the coronavirus has had a short-term impact on many schemes' journey plans, its effect may be muted over the long term.
• It could have a knock-on effect through The Pensions Regulator's (TPR's) proposed DB funding code, which it began consulting on as the pandemic hit.

In the early days of the coronavirus pandemic, it was panic stations for many DB pension schemes and their sponsors. The 2008 financial crisis had hit some schemes hard as they were unprepared for the financial shock, with the average hedging ratios for interest rate and inflation risk between 20 per cent and 30 per cent. The memory of 2008 and new uncertainty led to many

The full picture

fearing worst-case scenarios but, although some schemes have been severely affected and the threat of sponsor insolvency is still present, most were better prepared this time around. However, the impact on the overall funding levels and journey plans of DB schemes should not be understated and they are not out of the woods yet.

Rising deficits

Before the coronavirus hit the UK at the end of 2019, the Pension Protection Fund (PPF) 7800 Index estimated the aggregate deficit of UK DB schemes at £35.4 billion. The funding ratio was at 98 per cent and 3,168 of the 5,450 DB schemes were in deficit.

Fast-forward to July 2020 and the deficit stood at £199.5 billion. The funding level had fallen to 89.9 per cent and the number of DB schemes in deficit had increased to 3,685 out of 5,422. Liabilities had risen by 1.2 per cent over the month and 12.6 per cent over the year, with volatile markets and falling gilt yields affecting funding ratios.

However, July represented the worst month for DB schemes this year so far, with the most recent PPF figures at the time of writing, from October 2020, showing the deficit had decreased to £168.2 billion and the funding level had risen to 91.2 per cent. Despite the improvement, DB scheme funding is still some way off the level seen before the pandemic hit.

"DB funding levels have fallen by around 8 per cent on average over the year to the end of October, but looking beneath the headline figure, individual schemes are likely to have seen quite different outcomes," explains Legal & General Investment Management (LGIM) head of fiduciary management, Tim Dougall.

"Despite falling in March, total DB asset values have actually increased slightly over the year to date, but have failed to keep pace with the increase in liabilities, driven once again by falling government bond yields. And within return-seeking assets, performance has been mixed: for example, UK equities still haven't recovered from the falls seen in March, whereas US markets have delivered strong growth."

AJ Bell senior analyst, Tom Selby, concurs that the main driver behind surging DB deficits over the year to date was persistently low government gilt yields. He explains that as scheme liabilities are calculated based on the returns available from gilts, a lower yield leads to higher deficits.

"In this context the Bank of England's recent announcement of £150 billion more quantitative easing – deemed necessary to prop up the UK's ailing economy during lockdown – could be like throwing kindling on an already roaring pensions fire," he warns.

"The bank's decision to buy more UK gilts should push up the price of gilts and in turn suppress the yield, driving up liabilities and heaping further pain on employers already shouldering the burden of enormous historic DB pension promises as well as dealing with the fallout from the coronavirus pandemic.

Selby notes, however, that if the bank's intervention helps keep those companies afloat, it may preserve the pensions entitlements of millions of workers in the long run.

Preparing for the journey

Despite the significant impact on DB schemes, some have fared better than others. Following the 2008 financial crash, many schemes adapted and improved their risk management and investment strategies. "In 2020, we estimate that UK pension funds' average hedge ratios for interest rate and inflation risk are 70 per cent to 80 per cent," comments Insight Investment head of solution design, Jos Vermeulen.

"This compares well with history – for example, at the time of the financial crisis in 2008, we estimate that average hedge ratios were at 20 per cent to 30 per cent. This progress is a testament to the steps taken to increase the certainty of pensions being paid by schemes managing interest rate and inflation risk."

Vermeulen notes that 2020 has highlighted the relative strengths and weaknesses in schemes' investment strategies, with those relying more on growth assets or with lower hedging ratios likely to have been thrown further off course from their journey plan. However, he says that the recent recovery in equity and other risk markets may have offset the impact.

"This year has really highlighted what a difference good investment governance can make to pension scheme funding outcomes," adds Dougall. "Schemes that haven't implemented liability hedging strategies or diversified away from UK equities will have been hit particularly hard, and unfortunately this is likely to be the case for a good number of smaller UK DB schemes."

Aon head of UK retirement policy, Matthew Arends, explains that although funding levels were "significantly impaired" in spring 2020, the effect on schemes' timescales to reach long-term targets was "more muted" because, as markets fell, investment return expectations from the new, lower price levels increased, which mitigated the long-term impact.

"We estimate that the average timescale to reach targets might have increased to approximately 11 years, reversing a downward trend from 11.1 to 9.4 years between 2017 and 2019 seen in Aon's *Global Pension Risk Survey,*" he continues.

Selby explains that many schemes' sponsors' aim to secure a buyout is long term, whilst Covid-19 is a "big but relatively short-term shock". Despite this, he warns that schemes need ready cashflow to secure a buyout at the right time, which many companies hit by lockdown may have struggled with.

DB funding code and the future

TPR began consulting on its new funding code for DB schemes as the pandemic hit. Covid-19 is likely to have made the regulator's task more difficult, demonstrated by its decision to delay the submission deadline by three months as trustees may not have had time to consider its proposals due to the pandemic.

"This environment will prove a challenging one for the new DB funding code," says Dougall. "Whilst TPR reasonably wants to ensure that schemes are making progress towards a clear and secure long-term objective, lower funding levels and weaker sponsor covenants will make this a difficult ask for many trustees. There is likely to be increased pressure to work assets harder and better-control risks, which will become more challenging as schemes mature and become more cashflow negative."

Arends notes that if TPR introduces the requirement for sponsors to contribute additionally to their scheme to reach long-term targets by a fixed date if asset performance disappoints, it would reduce the average time to reach the target, but at a cost to sponsors.

Despite the challenges thrown at them, Vermeulen believes trustees have made significant progress in securing the benefits of members by progressively mitigating liability risks.

He concludes: "Whatever happens next, we would encourage trustees to continue on that path and again focus on considering the risks that remain and how best to deal with them."

Written by Jack Gray