Under pressure

Summary
- The majority of sponsors kept up deficit reduction contributions during the pandemic.
- Wider business packages such as furlough schemes helped with this.
- Uncertainty remains for some sponsors as a result of the energy crisis and consumer confidence.

Maggie Williams explores the take up of deficit recovery contribution breaks to help sponsors during the pandemic, and the new macro pressures employers face now with making pension payments

Defined benefit (DB) scheme sponsors suffered unprecedented disruption in April 2020, as the early difficult days of the Covid-19 pandemic forced businesses to lockdown and even temporarily stop trading.

The knock-on effects for the strength of sponsor covenants and deficit reduction contributions (DRCs) were potentially disastrous, but The Pensions Regulator (TPR) offered businesses a lifeline, enabling them to suspend DRC payments for up to three months.

In fact, relatively few schemes took up the option of the break in DRC payments. Anecdotally, consultants estimated that only between 5-10 per cent of their client base chose to do so. "For those companies that needed it, it was a very helpful and sensible thing for TPR to do," says Mercer chief actuary, Charles Cowling. "Lockdown was a difficult but temporary blip, and there was no point in driving companies into insolvency if they could start trading again once the lockdowns were over."

The government's business support package of employee furlough schemes and recovery loans meant that most sponsors were able to continue to make DRCs. "In general, sponsors didn't see stalling DRC contributions as an easy win, or a way to reduce outgoings," says Hymans Robertson head of corporate DB endgame strategy, Leonard Bowman. "Many realised that taking a break would effectively store up problems for the future and that there were better ways to approach the crisis. Sponsors might have less control in the years ahead if they paused contributions. So, only companies with very serious cashflow issues took advantage."

An uncertain future

However, while Covid-19 is gradually becoming part of day-to-day life, trustees and schemes are now faced with a new set of threats. These include soaring energy prices, a cost-of-living crisis driven by soaring inflation – and ongoing global uncertainty, including the Russia/Ukraine war.

The impact of these on covenant strength and sponsors' ability to maintain future DRCs will vary from scheme to scheme, based on factors such as the business sector that the employer operates in. Bowman says: "One of the reasons that companies survived Covid so well was the global stimulus from governments, including in the UK. But similar stimuli may not be there in the coming years as we endure the energy crisis, for example. Inflation is generally capped or hedged in schemes, but for some sponsors it will need careful monitoring if it causes a contraction in consumer spending."

"Employers are in varied positions," agrees Aon head of UK retirement policy, Matthew Arends. "Some have seen trading pick up as the pandemic has eased so that DRC affordability is less problematic. Other employers remain under stress from pandemic effects, price rises, supply chain issues and other factors which limit the affordability of DRCs. Funding levels in schemes have generally risen since April 2020, but some pension schemes will still have material deficits, so reductions in DRCs are a distant objective."

"Most schemes are in reasonable shape, although a few are in real trouble," adds Cowling. "Schemes should be cautious and careful, look where the big risks are, mitigate them and offload liabilities. Trustees will need to keep close watch on the strength of the employer, understand factors that will affect them and be on the front foot."

Future plans

"Covid has made many companies take a step back in their business planning," says Bowman. "Sponsors are reviewing their corporate structure and asking how to take pension risk out of the future of the business."

Trustees' attitude to DRCs payments will also ultimately shape a scheme's future approach to its liabilities. "Some trustee boards are relatively sympathetic to reducing the remaining DRCs in response to improved funding levels," says Arends. "Others take a tougher line, potentially seeing as DRCs as one part of the bridge to full funding on a low risk or buyout basis. Equally, employers themselves may be content to continue contributing in order to reach a low-risk position sooner."

Arends also points out that many scheme valuations with effective dates in 2021 may not yet have been completed "and this is the most common route to revising DRCs." He adds, "we are seeing an emerging trend among sponsors

The DB Funding Code and deficit reduction contributions

The second consultation on The Pensions Regulator's (TPR) proposed DB Funding Code is expected in late summer 2022, delayed by Covid-19 and subject to close scrutiny within TPR.

Given the long road still ahead, it's no surprise that the proposed requirements of the code have had little effect so far on sponsors' approaches to DRCs and scheme funding. "We have seen very little effect directly as a result of the code consultation," says Aon head of UK retirement policy, Matthew Arends.

However, the second consultation may have more effect: "It remains to be seen whether and how TPR's thinking about the changes as a result of the responses to the first consultation – it is only at that point that it might begin to have an impact on behaviours."

The Association of Consulting Actuaries 2021 *Pensions Trends* survey asked employers about their views on the code's proposals. It explored the relationship between contributions and investment returns in recovery plans, as well as sponsors' views on 'bespoke' and 'fast-track' routes to scheme funding.

It found that 78 per cent of employers believe that even very mature schemes should still take the covenant into account in funding requirements – and 91 per cent want to be able to allow for anticipated additional returns in recovery plans.

Crucially, 69 per cent believe that employer contributions should not be required to bridge the gap between technical provisions and long-term funding targets, where additional returns are anticipated. "Fast-track journeys must not raid employers for cash that is already expected to come from investment returns," added ACA chair, Patrick Bloomfield.

The delay of the code also raised uncertainties from schemes approaching valuations dates.

However, TPR executive director of regulatory policy, analysis and advice, David Fairs, has made it clear that the new rules will only be applied to schemes' valuations after the code has been released.

where DRC affordability is not an issue. The company will negotiate that DRCs will end as soon as the scheme becomes fully funded on the technical provisions basis, even if this is between valuations."

Where schemes have experienced improvements in their funding positions, driven by a combination of deficit reduction and strong investment markets through most of the pandemic, they have been able to think about bringing forward de-risking plans.

"Buyout pricing is favourable and it could also be a good time for schemes revisit transfer value policies," says Cowling. "We are seeing a lot of clients considering this now, even if they weren't six months ago."

"Schemes and advisers have got much better at spotting opportunities for transaction," adds Bowman. "Buyout might still be some years away for many schemes, but everyone is moving closer – even if current economics means there will continue to be a lot of unpredictability."

The impact of the pandemic on DB schemes' funding position and long-term plans is now becoming clearer. "DRCs have generally returned to stability, although there is a spectrum. It is actually remarkable how well and how quickly sponsors have stabilised DRCs, even if their wider business plans are not back to normal yet," says Bowman. "Overall the situation is much better than we might have expected."

Global uncertainty is likely to continue to put DB schemes and their sponsors under pressure for the foreseeable future. Schemes have generally succeeded in weathering the pandemic well – but the significant role that government support packages played in ensuring business survival cannot be underestimated. Schemes may need to endure future financial shocks unaided.

Written by Maggie Williams, a freelance journalist