Market Reaction
Liability-Driven Investing

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What Does the COVID-19 Crisis Mean for UK DB Schemes?

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- The worldwide public health crisis created by the COVID-19 pandemic had a significant impact on the global economy and financial markets
- The sharp market downturn will have adversely affected the funding position of most defined benefit (DB) pension schemes
- Trustees will need to re-evaluate their funding strategies and sponsor covenant and consider whether their investment strategy needs to change

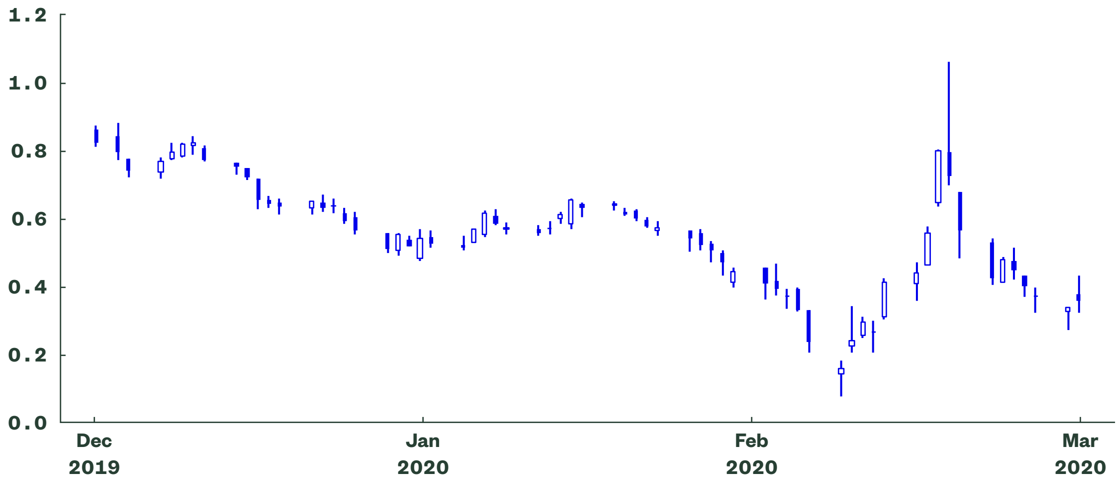
How has Funding Changed?

A typical UK DB scheme has about 37% in growth assets and 63% in fixed income and has hedged the majority — but not all — of its interest rate and inflation rate risk via liability-driven investing strategies.

Over the first quarter of 2020, global equities have fallen by 24% , while 20-year gilt yields have fallen by 48bps to 0.75%. Yields have also been very volatile as shown in Figure1. While the planned government support for the economy created some pressure for gilt yields to rise (driven by increased government borrowing), the Bank of England's commitment to buy bonds to support liquidity (quantitative easing) quickly caused yields to drop back further. At the same time, corporate bond yields have risen, largely reflecting growing fears of defaults in sectors of the economy affected by the crisis, as well as growing investor risk aversion.

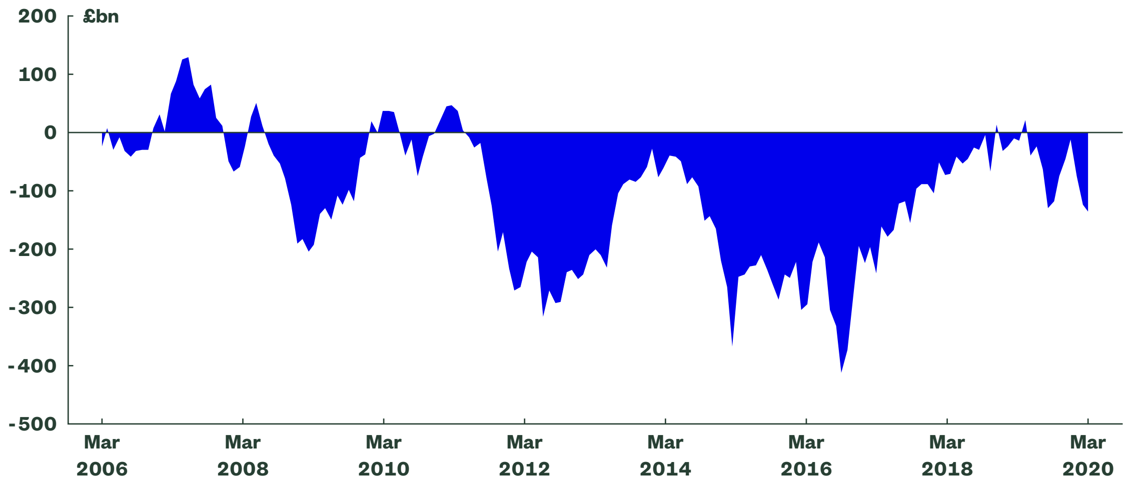
These market moves will have caused a significant deterioration in the funding of most schemes. According to Pension Protection Fund figures, the aggregate deficit on UK DB schemes has risen from £11bn at the end of December 2019 to £136bn at the end of March, and the aggregate funding ratio has fallen from 99% to 93%, measured on the PPF basis.

Figure 1
10-Year Gilt Yields



Source: Bloomberg, as at 31 March 2020.

Figure 2
Aggregate Deficit on UK Pension Schemes (PPF 7800 Index)



Source: PPF, as at 31 March 2020.

Shifting Sands: Sponsor Covenant

One of the most important assets of any pension scheme is the ability of the sponsoring employer to make ongoing contributions — the sponsor covenant. This obviously depends on the financial health of the sponsor — and many businesses are being substantially challenged by the current economic crisis. Undoubtedly, some businesses will fail, and their schemes will enter the Pension Protection Fund if they cannot run themselves on a self-sufficiency basis or secure a buyout by an insurance company.

Trustees will need to re-evaluate the covenant of their scheme and the implications for their funding and investment strategy. In the short-term, however, their situation may be unclear. The Pensions Regulator has said that it is reasonable to defer deficit recovery contributions for three months to help relieve any short-term cashflow pressures on the sponsor, though in such cases corporate dividends should also be suspended or cancelled. Thereafter, further analysis will be required on what the long-term funding outlook is.

Contribution holidays could be prolonged and this could adversely affect the liquidity management of cashflow negative schemes when it comes to paying pensions. A solution could be to make use of finance available via leveraging assets where appropriate or to allocate a greater proportion of assets to a cashflow-driven approach, in order to access more reliable contractual asset cashflows.

Re-planning the End Game

Most schemes are closed to new members and an increasing number to future accrual by existing members. It is likely the current crisis will accelerate that trend. Schemes are increasingly mature, have finite life and will have given consideration to their 'end game'. For some schemes, this will be a plan to buy out liabilities with an insurance company within the next decade or so, while others will aim for 'self-sufficiency' where the assets and investment strategy can support payment of pension liabilities with limited reliance on the sponsor.

Trustees will now have to re-evaluate their end game. Funding will have deteriorated and sponsor covenants may have weakened. At the very least, the end point is likely to have become more distant, barring a quick reversal in financial markets.

Against this backdrop, The Pensions Regulator has been consulting on a revised code of practice on DB funding. This requires schemes to set a long-term objective and aim to have a low-risk investment strategy and limited reliance on the sponsor by the time the scheme is substantially mature — perhaps 15 or 20 years from now, in most cases. The Regulator will set quantitative and qualitative criteria by which to assess each scheme's funding strategy and deficit recovery plan. Schemes that meet the criteria qualify for a 'fast track' sign off of the strategy. Schemes that can't, or that want a more flexible approach can go for bespoke approval, but will be required to provide more evidence and justification on their approach and how it provides security for members.

Investment Strategy

As noted above, the average UK DB scheme has 37% in equities and other growth assets and 63% in fixed income assets, though proportions may have changed given recent equity market falls. Most schemes will also have hedged a substantial proportion of their interest rate and inflation risks via LDI, often more than 70%, but some schemes have hedged more than others. Interest rates have been low for over a decade but the crisis means they are likely to remain lower for longer, suggesting schemes may to look to increase their hedge ratio if they've not done so already.

As deficits have increased, schemes may need to take more investment risk and improve the efficiency of their portfolios to get the returns required to improve funding. At the same time, trustees will want to maintain hedging of interest rate and inflation risks. This may mean a need to take on increased leverage. This can be done via a segregated LDI strategy for larger schemes or using leveraged pooled funds for small and mid-size schemes. For example, our seven Target Leverage Funds provide 3x leverage across equities and/or fixed income with flexibility to choose which funds to invest into and in which proportion, in a capital and collateral-efficient manner. We help our clients by offering them the ability to manage their LDI mandates, including liquidity, collateral and leverage management, on their behalf, irrespective of their sizes via segregated and pooled funds.

The significant volatility across assets classes, highlighted above, increases the need for clients to diversify their sources of leverage and address the collateral efficiency of their portfolio to improve the risk management of their leverage positions. Our Target Leverage Funds address this point by design, whilst remaining in a pooled fund format.

The crisis will also have made cash flow negative schemes aware of the risk of being a forced seller of assets to meet pension payments. One option to prevent this is to adopt a cashflow driven investing approach, investing in assets expected to produce income flows in the short and medium term to meet expected outgoings. This could, for example, be a structured portfolio of corporate bonds, including overseas bonds hedged back to sterling. The portfolio needs to be chosen to ensure that the bonds included have a high probability of delivering the required cashflows, and additionally some 'haircut' needs to be applied to cashflow forecasts for prudency in case of downgraded or defaults — particularly in these difficult economic conditions.

The Bottom Line

The outlook remains highly uncertain and it would seem unwise to take dramatic action right now. Trustees need to have a watching brief on their sponsor covenant and a good ongoing dialogue with the sponsor. As the dust settles, there will need to be a re-evaluation of the scheme's long-term objective and its timing and the journey plan for getting there. The revised funding strategy needs to sit alongside a consistent investment strategy that may involve more leverage to increase or retain growth exposure whilst maintaining or increasing LDI exposure and may include a cashflow focused element.

We would be very happy to help you think through these issues for your scheme.

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https://ppf.co.uk/sites/default/files/2020-01/Purple%20Book%202019.pdf

MSCI World net total return index in GBP (MXWOHGBP)

https://ppf.co.uk/ppf-7800-index

https://thepensionsregulator.gov.uk/en/covid-19-coronavirus-what-you-need-to-consider/db-scheme-funding-and-investment-covid-19-guidance-for-trustees

https://thepensionsregulator.gov.uk/en/document-library/consultations/defined-benefit-funding-code-of-practice-consultation

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