Pensions Committee

22 July 2020 **Part I**

Covid-19 Impact

Report by Director of Finance and Support Services

Summary

COVID-19 has had a significant impact on global populations, the investment markets, the operations and financial stability of companies and assumptions about the future. It is unclear at this stage what will be the medium and longer term impact but it is necessary for the Committee to consider the effect and the appropriate response.

Recommendation

1. The report is noted.

2. The short term risk management approach for employers set out in paragraph 10 is agreed.

Background

1. COVID-19 has led to a worldwide increase in deaths and a significant shock to the global economy with large movements and increased volatility in stock market values and financial difficulties for some employers. Whilst the short-term impact on the number of deaths and the economy is significant, it is unclear at this stage what will be the medium and longer term impact.

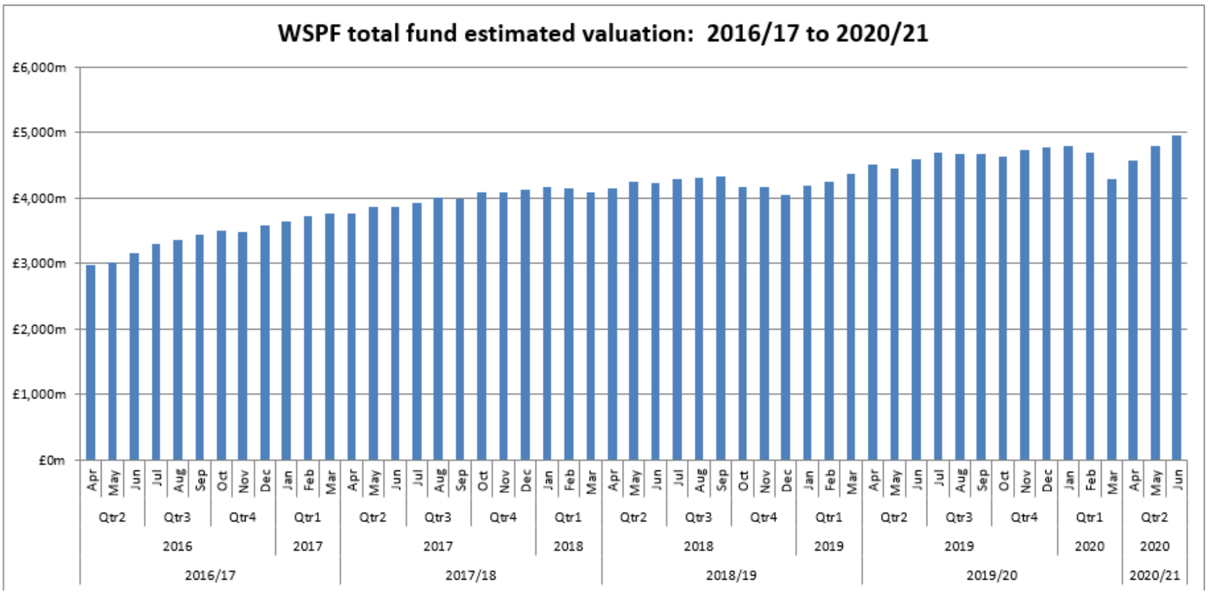
2. The paper covers:

   - Impact on investments held by and opportunities for the Fund
   - Impact on funding positions (whole of fund and employers) and any risks posed to the Fund due to changes in financial covenant of different employers as lockdown continues
   - Experience in relation to the death rates emerging and how they may impact funding
   - Impact on cash flow
   - The response and experience of the administration team
   - Risk mitigation options for the risks identified

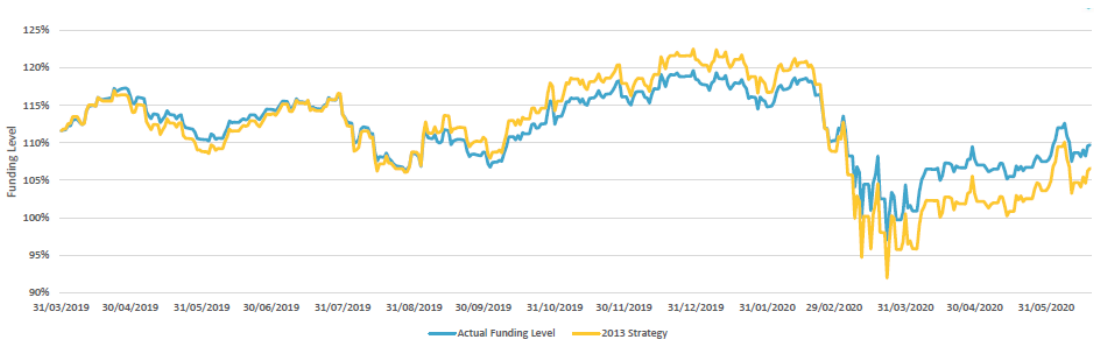
3. As the pandemic evolves, and the economic and political environment reacts, aspects of the above may also evolve. The situation and its response will therefore be kept under regular review.

Impact on investments

4. Investment markets have rebounded over the previous quarter with the total fund valuation returning to 31 December 2020 levels as illustrated in the following chart:



5. The Fund's overall strategy has been to reduce equity exposure and increase the allocations to protection and income assets to help cushion the funding level from market volatility. The chart below compares the actual progression of the funding level versus the progression had the Fund not reduced risk over the last few years. No allowance has been made for manager over/under performance over the period, and the period is covered is short. Whilst towards the end of 2019 when equity markets were performing well, the 2013 strategy would have likely produced slightly higher funding levels, the significant shifts in the markets in March 2020 were dampened for the Fund due to its lower risk strategy.



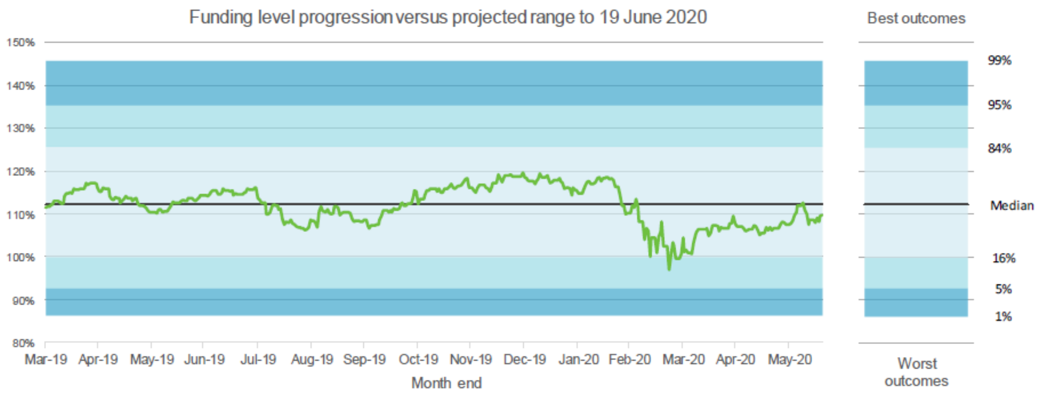
Impact on the funding position

<u>Whole Fund</u>

6. The Fund held assets of £4,374 million against liabilities of £3,919 million, equating to a funding level of 112% as at 31 March 2019.

7. The chart below shows the variation in the funding position since 31 March 2019.

- The green line in the following chart shows how the funding level has evolved since 31 March 2019 to a recent date (19 June 2020) by allowing for market movements over the period. Volatility in the funding level measure is to be expected given that the Fund is invested in assets whose day-to-day value can fluctuate significantly e.g. equities.
- The blue shading in the below chart's background represents the 'corridor of potential funding levels' predicted by the Actuary at the 2019 valuation, with the darker shading representing the less likely (i.e. more extreme) outcomes.



8. The chart shows that, at the time of writing, the funding level remains within the 'corridor' of outcomes predicted by the Actuary at the 2019 valuation. For the majority of the period of COVID-19 volatility the funding level remained within the outcomes which have a 1 in 6 chance of occurring (with a very short period when the level fell to a 1 in 20 outcome). The Actuary has provided further comments:

- The funding level became increasingly volatile from February 2020 onwards as COVID-19 started to impact global markets. In particular, the FTSE100 suffered its second largest one day crash in its history, and the biggest since the 1987 market crash.
- Whilst there has been a sharp fall in the funding level since the turn of the year, there has been some 'bounce-back' in recent weeks. It is yet unknown if this will be sustained due to the continuing uncertainty in the global economy. The timing and shape of any rebound is uncertain and depends on containment of the virus and the effectiveness of policy responses in preventing temporary disruption to businesses and consumers from causing permanent damage.

Employers and risks posed to the Fund due to changes in financial covenant of different employers as lockdown continues

9. Within the Fund there are different types of employer and therefore different approaches to calculating the funding target, the period of which this funding target should be met and the certainty required that the

employer will achieve their funding target and as a result the employers contribution strategy.

10. The contribution strategy manages funding risk over the medium and long term. However it is important to consider the Fund's shorter term risk exposure - the risk that the Fund is not able to recover an exit deficit from the employer (or an alternative source of funding) and that other employers active in the Fund will need to meet the benefits of the ceased employer's members in future (i.e. the ceased employer's assets are exhausted while there are still members collecting benefits). It is proposed that:

- Employers in surplus on a cessation basis are not reviewed.
- Those employers with comparatively small deficits are monitored by officers.
- Those employers who have an obligation to put a bond in place (or pay higher contributions) if their funding level were to drop below a certain level on a flat gilts basis and who have previously been considered lower risk in due diligence commissioned by the Authority are monitored by officers.
- Due diligence work is completed for those employers with a significant deficits on a cessation basis, who have been considered medium or higher risk in due diligence commissioned by the Authority previously.

Due diligence includes reviewing an employer's financial position and business plans to help the Fund understand the employers financial health and, importantly, what assets might be available to the Fund to cover any cessation deficit on insolvency where the risk is considered to be highest. Contextual information has been included for the Committee (Appendix A (Restricted)).

<u>Cessations</u>

11. Employers may cease active participation in the Fund as a result of the last active member ceasing participation in the Fund, the end of their contract term, insolvency or a breach of their obligations under the Admission Agreement. The recent volatility may impact funding balance sheets for those employers planning to exit the Fund in the short term. Lockdown restrictions may hasten or trigger an employer's insolvency.

12. The Regulations permit the Administering Authority to revisit an employers contribution rate between formal valuations where there are circumstances which make it likely that an employer (including an admission body) will become an exiting employer "with a view to providing that assets equivalent to the exit payment that will be due from the Scheme employer are provided to the fund by the likely exit date".

- There are two small employers who are planning to exit the Fund during the next quarter and are responsible for funding their exit position.[1] The

[1] Ridge Crest (Littlehampton Academy), due to cease 31/07/2020, funding position of 110% (£9,400 surplus) / Ridge Crest (Sir Robert Woodard Academy), due to cease 31/07/2020, funding position of 99.6% (£400 deficit).

Fund is in discussions with the admission bodies and its related employer in preparation for their exit.

- There are six 'contractor' employers who are due to exit the Scheme in the next six months where a risk sharing arrangements is in place with their Awarding Authority. The Fund assumes all liabilities and assets of employers admitted under risk sharing / 'pass through' arrangements remain with the Scheme Employer as they typically retain nearly all the pensions risks of the members involved. Therefore the exit funding risk is reduced.
- There is currently one employer who may exit the Scheme as a result of insolvency. The Authority is in close dialogue with the guaranteeing employer.

Other employer Matters

13. As a result of Covid-19 a deferral of employer contributions policy has been agreed, to assist employers who are being impacted and facing financial difficulty. The agreement to any contribution deferment will increase the risk of an employer failing to pay their required contributions within the financial year. Therefore careful consideration is made of any request. To date, one employer has applied and had their employer contribution deferment approved. Employee contributions must still be paid during this period.

14. The Fund is aware of re-structuring activity within some organisations which could result in a reduction in active membership and / or additional retirements (either voluntary or as a result of redundancy). This will be kept under review.

15. The Authority is also aware that some sectors are more at risk as a result of the impact of the pandemic than others. This will be kept under review.

Impact of death rates emerging

16. The increased death rates due to COVID-19 that is currently unfolding in the UK and globally will inevitably affect all pension schemes. The key impacts of higher mortality from a funding perspective are:

    - Higher liquidity – ensuring the Fund has sufficient cash to pay out lump sum death benefits promptly to beneficiaries.
    - Death-in-service 'strains' – the death benefits for an active member may be significantly bigger than the valuation liability. Whilst such strains tend be 'absorbed' easily by large employers, a strain for a small employer with very few active members could materially reduce its funding level. In normal circumstances, these would be very rare events, however they may increase in occurrence due to the level of excess deaths linked to COVID-19.
    - Reduced liabilities – higher deaths than expected amongst pensioners will lead to lower liabilities. Mature employers, with higher proportions of pensioner members, may be most 'affected'.

17. The evidence of deaths related to COVID-19 is emerging, but it is difficult at this stage to attach any certainty to mortality rates (not least because testing has not been widespread in the UK). From a Fund perspective:

- Death cases (including death in service cases) are slightly higher than the annual trend, however it is not considered significant at this stage.
- The membership of the Fund is predominately female, who are considered to be in the 'lower risk' category in relation to Covid-19.

18. As the majority of deaths are occurring at older ages (nationally), it is reasonable to assume that the overall impact will be a reduction in liabilities and a general improvement to funding levels, all else being equal. However the impact is unlikely to offset market movements to any material extent e.g. an infection rate of 33% across the pensioner population might reduce liabilities by around 1% for a typical employer.

19. At this stage, it is not possible to extrapolate the longer term impact of a higher death rate in 2020/21 either on future mortality or morbidity rates. There are a number of factors to consider:

- The responses to COVID-19 including social distancing, increased hygiene measures, resulting improved air quality and lifestyle changes may act to improve life expectancy.
- Whether the virus has hastened the deaths of some of the population which would have died of other causes resulting in a lower death rate over the next few years.
- Whether the virus persists over time, like influenza.
- Whether there is a long term impact on the health of those who recover from COVID-19 (which could result in future higher ill health retirement rates.

20. Data is still being collected and analysed and we will monitor any future impacts on life expectancy at subsequent valuations or sooner if necessary.

Impact on cashflow

21. The analysis below models the impact of a potential reduction in employer contributions and investment income, alongside a potential increase in benefit payment.

22.

	Current £'000 per month	**Assumed Variance**	**Adjusted £'000 per month**
Income			
Contributions	11,004	-10%	9,903
Property	1,378	-30%	965
	12,382		**10,868**

	Current £'000 per month	**Assumed Variance**	**Adjusted £'000 per month**
Expenditure			
Pension benefits	8,313	10%	9,144
Death benefits	216	5%	227
Lump sums	1,157	10%	1,273
	9,686		**10,644**

23. It should be noted:

- The reduction in contribution payments is based on the experience from the 2008 recession.
- The increase in death benefits is based on advice from the Fund Actuary.
- The reduction in property income is based on advice from the Property managers.
- No distinction between the types of retirements has been made.
- Monthly figures are a smoothed average and don't reflect payment patterns from employers.
- The analysis does not include any income from the equity and bond portfolios, or the Fund's private equity investments.
- The analysis does not take into account the Fund's current cash balances.

Impact on the administration team

24. To date the administration team have been able to fully support business as usual activity and project work. There have been some delays with end of year information and query resolutions with employers which are being managed within the team.

25. The Fund and administration partners are mindful of the potential spikes in work as a result of Statutory deadlines and changes to the Regulation (eg. McCloud). However the team remain confident that this can be absorbed and managed effectively within the team.

26. However it has been noted that continued remote working may present challenges if and when recruitment activity is required.

Risk mitigation options for the risks identified

Risk	**Mitigation**
Pressure on rental income as tenants request rent free/reduced rent periods while restrictions are in place and following the **lifting of lockdown**	Communication with Fund Manager to understand their approach and the impact on performance.

Risk	Mitigation
Risk of more overpayments due to increased number of deaths and slow flow of information.	Communication with admin team to ensure any peaks in work load are managed.
Possibility of employers not paying contributions or paying reduced contributions for either resourcing or finance reasons.	Communication with advisors to understand options regarding contribution regulations. Communication with employers to ensure they are aware of Deferral of Employer Contributions policy and to invite early discussion with regards to any workforce changes.
Possible impact on cashflow	Implement cashflow monitor and projections. Monitor on a monthly basis.
Employers exiting the Fund with little or no warning.	Covenant review discussions.
Employers unable to meet end of year deadlines which impacts on the production of ABS.	Regular contact with employers and admin team regarding expectation and timeframes.

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Appendices
Appendix A – Restricted Contextual information – For members of the Committee only.

Background Papers
None