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# COVID-19: Managing your pension risks

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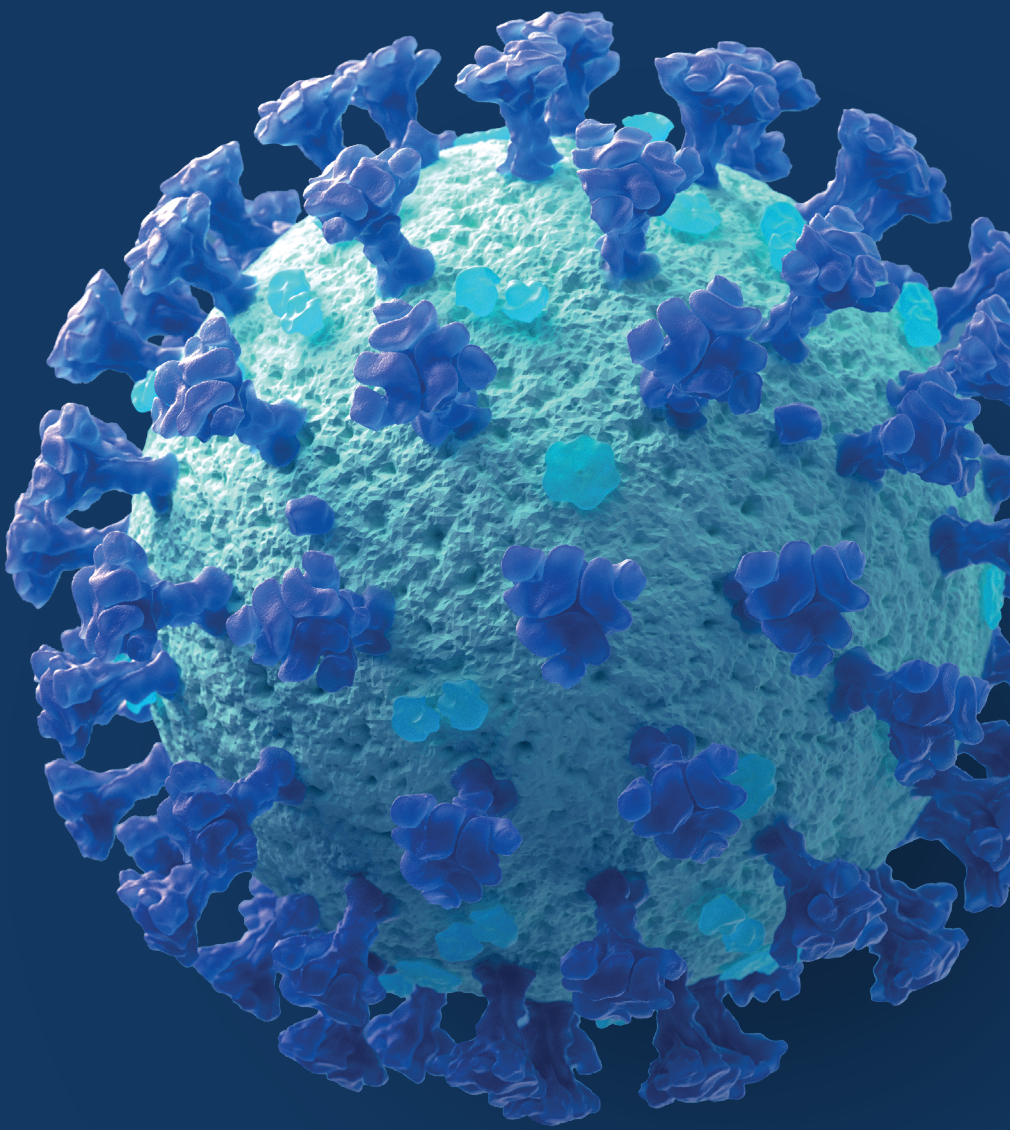

# 1. The impact to pension plans

## A black swan event

Since 20 Feb 2020, many global equity markets have fallen in excess of 30%, European corporate bond spreads have widened in excess of 1.0% and European currencies have weakened against the US dollar.

European long-term inflation expectations have fallen by more than 50 basis points this year while German sovereign yields remain at historic lows. Higher real interest rates will reduce the actuarial value of the liabilities for many pension plans, and wider credit spreads may provide some relief for accounting liabilities.

These effects may offset a part of the impact of falling asset values, but what this crisis will mean for funding and accounting valuations will depend critically on a plan's investment strategy and the nature of inflation linkage in benefits. Central banks and governments have taken significant measures to restore order to the capital markets, but volatility is likely to persist for several months to come.

As many businesses consider the economic outlook and their ability to continue trading, pension plan issues may seem far from urgent. For others, with 31 March or even 30 June measurement dates looming (be that for funding or accounting purposes), actions taken now could have a very real impact on mitigating any negative effect of the pension plan on the health of the business. Considerations such as efficient financing of benefit payments, structuring investments appropriately and ensuring robust, agile decision-making practices are in place can help your business take steps to better navigate these turbulent times.

In this note, we set out a list of actions that sponsors and fiduciaries of pension plans could take at this point. We will follow with another note that speaks to longer term considerations.

| Index | 31 Dec 2019 | 20 Feb 2020 (change from y/e) | 17 March 2020 (change from y/e) |
|---|---|---|---|
| German 10 year government bond yield | -0.19% | -0.45% (-0.26%) | -0.44% (-0.25%) |
| Eurozone 25 year inflation swap | 1.49% | 1.37% (-0.12%) | 0.90% (-0.59%) |
| MSCI World equity index (Euro unhedged, net) | 315 | 337 (+6.8%) | 243 (-22.8%) |
| iBoxx Euro IG all corporates – spread | 1.04% | 1.00% (-0.04%) | 2.20% (+1.16%) |
| USD / EUR exchange rate | 1.21 | 1.08 (-10.7%) | 1.10 (-9.1%) |

## Stress test

To help assess how market conditions might impact pension plans, we have considered the potential impact that the COVID-19 virus and other factors such as oil price wars are having on markets and have identified a range of possible scenarios. Clearly these are simple one dimensional stresses designed to help business planning, and ignore plausible nuances such as a double peak in new COVID-19 cases.

In our **severe shock scenario**, we see a prolonged recession and ineffective policy response against a backdrop of escalating spread of the pandemic. Dry powder available to central banks and policymakers are exhausted and long lasting damage is done to the global economy. Corporate earnings are severely damaged and defaults rise along with the risk premium implicit in asset prices.

In our **moderate shock scenario**, we see a peak in new COVID-19 cases in the Western hemisphere over late Q1 and early Q2. Central bank and political response is generally supportive, helping to limit corporate failures but nonetheless we see considerable strain on sovereign coffers and corporate earnings.

In our **Q2 recovery scenario**, we see dramatic improvement in the number of new cases in the Western hemisphere as social distancing and other measures take effect. Effective political and fiscal stimulus help support a return to growth as early as Q2, though policy rates are nonetheless expected to stay low and central bank balance sheets expand.

Market distress may lead to other issues, notably under the headings of liquidity and operational risk. It is not unreasonable to think that funds relying heavily on leverage and / or liquidity could experience stress, and indeed exit from certain investments may either be unavailable or available only at high cost.

We recommend that plan sponsors and fiduciaries look at what the impact of these and similar stresses would be on their plans in order to help inform any short-term mitigating actions required.

| **Returns from 01 January 2020 to 30 June 2020** | **Current 17 Mar 2020** | **Severe shock** | **Moderate shock** | **Q2 recovery** |
|---|---|---|---|---|
| Interest rates | -0.25% | *further* -0.50% shift across curve | *further* -0.20% shift across curve | rates remain at current levels |
| Inflation breakeven rates | -0.59% | *further* -0.50% across curve | *further* -0.20% across curve | long end recovers to 1.20% |
| Equities | -23% | -50% | -30% | -10% |
| Other growth assets | | -25% | -15% | -5% |
| IG credit spreads | +1.20% | spreads increase by 2.50% | spreads increase by 1.75% | spreads increase by 1.0% |
| Other credit assets | | -15% | -10% | -5% |

# 2. Actions to consider

We have developed a set of considerations that sponsors or fiduciaries of pension plans may wish to consider now, with a view to being prepared for the uncertainty of the coming months. Pension plans differ greatly in their circumstances and each sponsor or fiduciary could usefully develop an action plan relating to their unique situation. In general we would expect that actions reliant on member engagement are less likely to be effective over the coming few months, as employees and pensioners prioritise other issues. As such, we focus on pragmatic considerations that are more likely to lead to tangible benefits.

## Financing and cashflow needs

### Liquidity planning

Recognising the potential for stressed market conditions and the distinct possibility that certain funds may struggle to offer their investors liquidity, sponsors and fiduciaries could usefully develop a plan for generating the liquidity needed for pensions payroll and other known liabilities including potential derivative collateral calls. This plan should quantify the liquidity needs (recognising behavioural issues) and make prudent allowance for the liquidity offered by fund and direct investment and map out clearly the source of funds for liabilities over the coming months. Holding a cash buffer to pay benefits is a wise precaution.

### Review of potential powers and exposures

Many issues unearth themselves in crises, for example calls on valuable cash or capital relating to market movements or credit rating downgrades. Investors with commitments to private markets may be faced with higher than expected capital calls. Pension plan sponsors and fiduciaries may both have powers that could reasonably be exercised to serve members' interests, but equally could be exposed to others exercising such powers. For example, certain plan fiduciaries may have unilateral wind-up powers, which could be triggered at an inopportune moment. The ongoing COVID-19 situation may pressure the company covenant supporting certain plans, and plausibly trigger greater prudence in funding valuations. Members may elect to take transfers from plans. A review and catalogue of such powers and exposures could usefully assist in avoiding untimely financing requirements and serving member’s interests.

### Non-cash funding

As 31 March 2020 valuations loom for many pension plans, deficits requiring remediation may coincide with competing claims on valuable cash and balance sheet resources. Sponsors and fiduciaries alike should consider the long term interests of their stakeholders by using, where appropriate, alternative funding and financial support options. These might involve asset-backed funding, contingent assets or other forms of covenant support such as surety bonds or parent company guarantees. In many instances, existing recovery plans may become unaffordable, alternative approaches considered and stakeholders engaged.

## Rebalancing and restructuring

### Challenges

Investment portfolios are experiencing unprecedented volatility and are more likely to fall out of line with their strategic benchmark allocations. It is important that pension sponsors and fiduciaries carefully consider how to effectively manage transitions and rebalancing in volatile market conditions, where out-of-market risk can be significant. Clear rebalancing plans are critical as this can dramatically alter the profile of returns.

Operational risk is also important to consider in light of market conditions and business disruption risk. For example, plan sponsors and fiduciaries could usefully monitor closely whether their custodian and banking counterparties are sound and have a clear plan of action where triggers of concern are breached.

Planned strategic changes might reasonably be reviewed for appropriateness, and in some instances it may be appropriate to delay, for example if it results in a more robust liquidity profile.

For DC members with lifestyling approaches, it is important to consider whether there is sufficient diversification in the growth portfolio such that potential equity market losses are not unduly crystallised at the point of switching, to the detriment of future retirement pots.

### Opportunities

Plan sponsors and fiduciaries should give thought to whether there are buying or other opportunities. As credit spreads in particular are likely to be elevated, this may translate into opportunity to implement more affordable cash-flow matching strategies (though careful consideration of default risk is essential) or IFRS hedging. Further, risk transfer may become more affordable for plans that had high prior levels of interest rate hedging, and data preparation at this time could prove worthwhile.

### Reviewing investment strategy

Plan sponsors and fiduciaries should also consider whether long-term priorities have shifted in a way that merits implication for investment strategy. This presents an opportunity to incorporate other priorities such as ESG and private market opportunities in reviews. Reviews should clearly incorporate revised perspective on sponsor covenant.

## Managing, assessing and reacting

### Member communications

Fear levels run high through crises and members are likely to appreciate any additional comfort that can be offered in terms of their post-retirement income and security. Plan sponsors and fiduciaries could usefully consider their member communications, take measures to ease pressure on administrators and remind members in a timely manner of their protections and the long-term nature of pensions investment.

Member communication is particularly important for DC members who may be concerned about their fund values at retirement, or the impact of markets on lifestyling strategies.

### Governance review

This situation has highlighted the need for businesses to make robust, effective decisions quickly. In an economic shock environment, agile decisions can make the difference between success and failure, not just for businesses but for their pension plans too. Many fiduciary groups in particular may struggle with virtual meetings and decision making, potentially leading to reduced functionality and effectiveness. Good governance should consider the risks faced, have a clear framework for making decisions, and provide appropriate authority and accountability for those making the decisions. In times of crisis, when decisions in many competing areas need to be made quickly and under pressure, when the focus is on keeping the lights on for the business, companies may consider whether they have the full level of resource to dedicate to governance of complex issues such as pensions, benefits and investments. External delegation of governance can be full or partial, and at Mercer we can provide support in a number of areas, from full delegation of the plans investments, to help with putting together a broader governance framework to help you manage your risks around pensions, benefits and your workforce.

### Expecting the unexpected

Planning, and in particular for plausible 31 March funding valuations and 30 June accounting milestones is critical, and companies should have a clear plan that pre-thinks the decision trees across the scenarios. While we cannot predict the future, we have set out a simple scenario framework that companies and fiduciaries could usefully use with their pension arrangements, in the process ensuring effective response in a severe shock scenario while conscious of the opportunity costs in a Q2 recovery scenario.

## Looking ahead

Successful businesses evolve, adapt and learn from their experience. Over time, as the dust settles on this global crisis and we find a "new normal", it is important that companies regroup, take stock and consider how the challenges of COVID-19 have impacted on their business. Gaps will have been exposed, business objectives will have changed, and confidences will have been shaken.

In the midst of the chaos, making a note of key items to reflect upon at a later date will be important to ensure a thorough review can be carried out. Most businesses will want to think about reassessing their business objectives, and consider how this impacts on geographical presence, global policies, workforce (including workforce planning, communications and benefit provision), the risks faced, and the potential of the pension plans to impact on business objectives.

The IORP II Directive requires that most funded EU plans implement a Risk Function and we believe that the events of the last few weeks and those to come offer a great chance for pension plans to put in place robust and future-proofed risk management and governance arrangements.

We will provide more details on these and other longer term considerations in our follow-on to this note. More immediately, if you would like to understand how these or other scenarios would impact your plans or discuss any of the issues highlighted, please reach out to your Mercer consultant.

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