Employer pension briefing, Quarter 3 2020

In this briefing we highlight some of the key pension issues for employers from the third quarter of 2020, including an update on financial markets, pension scheme accounting positions, Diversified Growth Fund performance, Implementation Statements and PPF levies.

First Actuarial launches the Pension Cost Accounting Index

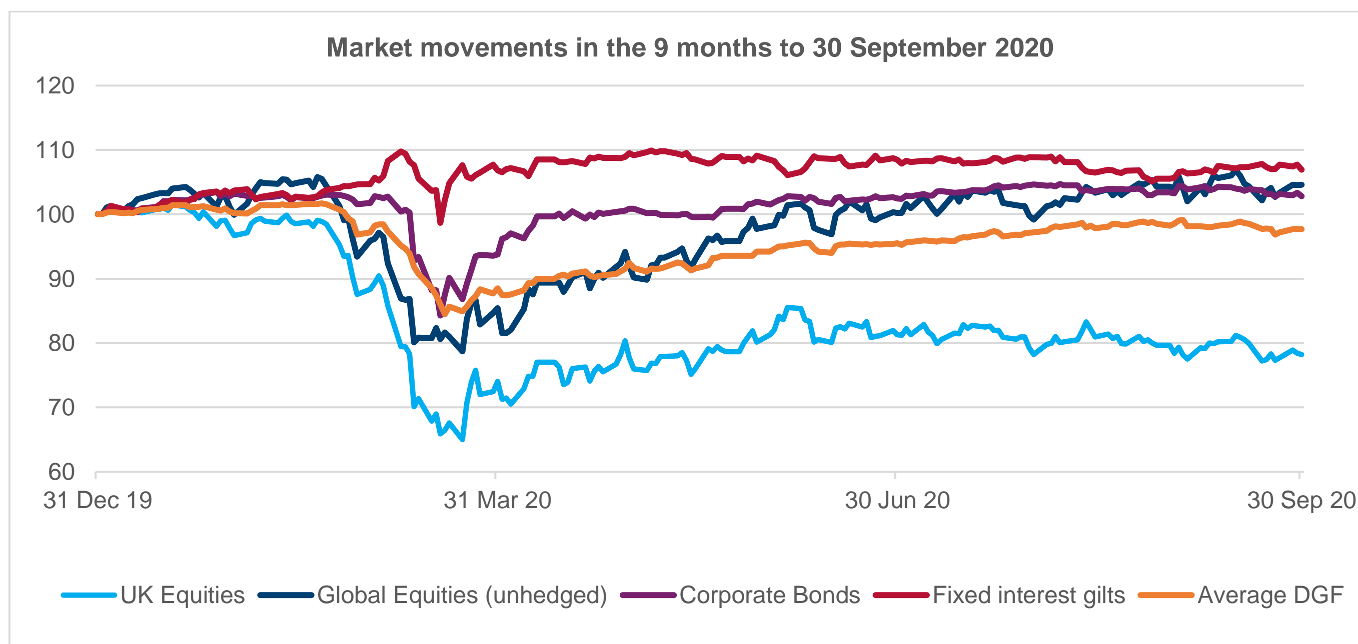
We have launched a new index to help measure the financial health of the UK's Defined Benefit (DB) schemes. The Pension Cost Accounting Index (PCA Index) shows the financial position of the UK's 5,422 DB pension funds on an accounting basis. The index will help finance directors monitor changes in financial conditions and benchmark their funding against the aggregate of UK DB schemes.

The index shows that despite an eventful 12 months, the aggregate funding level of 97% at 30 September 2020 is slightly higher than the 96% at 30 September 2019.

Take a look at the Pension Cost Accounting Index.

Markets stabilise in Q3

The third quarter of 2020 was relatively calm after the volatility of the first half. Most major equity and credit markets recorded gains of 1% to 5% over the three months. Within equity markets over Q3, the US equity market led the way (up 9.5%) while the UK market was the clear laggard, being the only market to fall in value (down 2.9%).



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We also expect accounting liabilities to have remained relatively stable over the quarter (as a small increase in corporate bonds has been offset by a small increase in future inflation expectations). Therefore, balance sheet positions are likely to be similar to the start of the quarter.

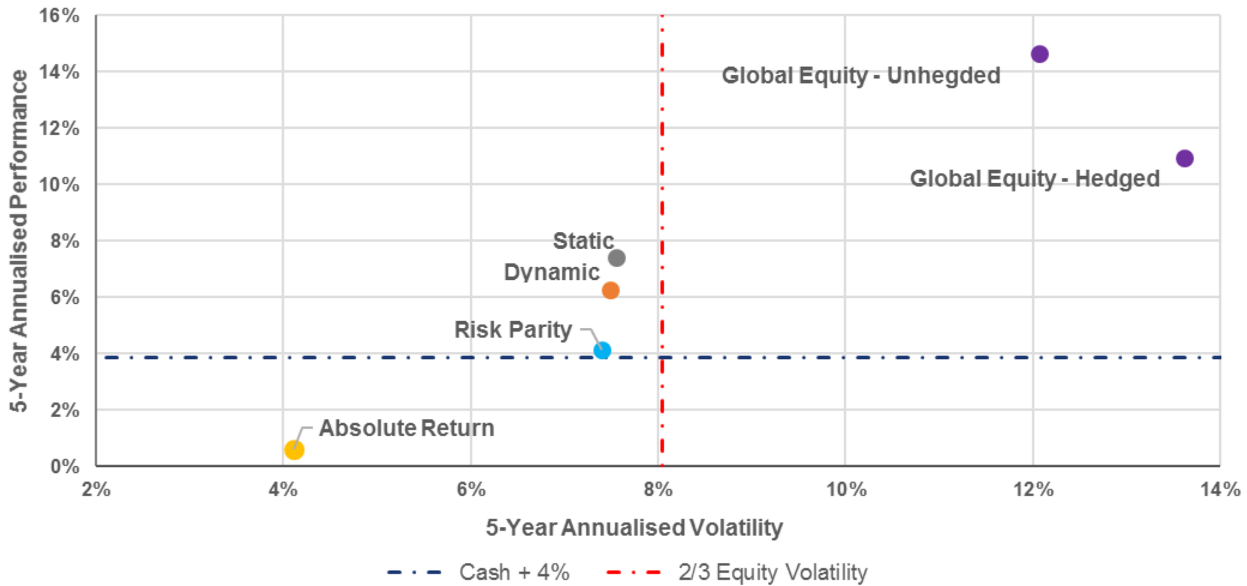
	30 September 2019	30 June 2020	30 September 2020
Corporate bond yields (AA)	1.6% pa to 1.8%	1.3% to 1.5%	1.3% to 1.5%
Implied RPI inflation[1]	3.56% pa	3.31% pa	3.39% pa

1) Market implied RPI inflation for a duration of 15 years

Focus on Diversified Growth Funds

Many pension schemes invest in Diversified Growth Funds (DGFs). DGFs aim to provide equity-like returns but with much lower volatility. We classify DGFs into four principal management styles:

- **Static:** Diversified across a wide range of asset classes, such as equities, fixed income, currencies, commodities and property, but with allocations that tend to remain relatively steady over time.
- **Dynamic:** Investments in a wide range of asset classes (like the static style, above). The manager aims to enhance returns by timing asset allocation decisions. Asset allocation can vary materially over time.
- **Risk Parity:** The allocation of the fund is adjusted in line with a rules-based approach. The objective is to maintain an equal risk exposure to equities, credit and commodity markets.
- **Absolute Return:** These operate like hedge funds and implement derivative-based strategies to exploit relative value opportunities (e.g. a manager might prefer the French equity market over the German equivalent). Performance is expected to exhibit a low correlation with the equity market, but is heavily dependent on manager skill.



The graph above shows the five-year annualised return and volatility to 30 September 2020 for a typical DGF of each manager style. The dotted lines represent typical return and volatility targets of these funds. The static and dynamic styles have typically achieved returns ahead of their stated targets, with lower than targeted volatility. On the face of it this is good news. However, comparison with equities suggest that a similar result could have been achieved by investing broadly 50% in cash and 50% in equities. Employers and trustees will also be disappointed that the higher fees associated with the non-static styles have resulted in lower returns.

Because employers that sponsor DB schemes are heavily reliant on investment returns, they need to understand and manage the risks by taking a proactive approach to investment strategy. Now is a good time to engage with your trustees to understand how the investment strategy has performed and what areas need to be reviewed.

The Implementation Statement requirement

From 1 October 2020, pension schemes with at least 100 members are required to include an Implementation Statement in their next annual report and accounts. The Implementation Statement explains how the scheme has invested in accordance with policies – such as ESG, including climate change, voting and engagement – detailed in the Statement of Investment Principles (SIP).

Watch our **Implementation Statement video** to learn more about the new requirements and how we can help.

A lower PPF levy for smaller schemes

The Pension Protection Fund (PPF) launched its levy consultation for the 2021/22 levy year on 29 September 2020. The consultation closes 24 November 2020; and the PPF intends to publish the final levy determination at the end of January 2021. Invoices are expected to be issued in Autumn 2021, based on Dun & Bradstreet's (D&B) insolvency risk scores for the months April 2020 to March 2021.

The PPF has considered the impact of Covid-19 on 2021/22 levies, but only expects a limited impact. This is due to insolvency risk being assessed on accounts that pre-date Covid-19 for the majority of employers. However, there is an expectation that insolvencies and claims will rise, and it is likely we will see an impact from Covid-19 in accounts filed for use in the 2022/23 levy.

2021/22 would be the start of the triennium review and the PPF would typically set the rules which would then remain unchanged for the next three-year period. Given the uncertainty over the pandemic, however, and the expectation of TPR's new scheme funding code taking effect in 2022, the PPF is proposing to move away from this multi-year approach, and make the review more flexible. The rules will be subject to review on an annual basis, and the PPF envisages a return to a multi-year approach in 2023/24.

The PPF is also considering the extension of an easement to the payment terms of their invoice of up to 90 days (where interest on late payments will be waived), for employers and schemes negatively impacted by Covid-19.

The PPF is currently focused on two critical aspects, aiming to:

- Strike a balance between the right amount of levy to collect, at a time when cash flows could be significantly constrained for employers and schemes
- Support schemes with high levies compared to their liabilities.

The PPF has also proposed two new measures:

- Small scheme adjustment (SSA): The uncapped risk-based levy will be cut by half for schemes with less than £20m unstressed liabilities. This reduction will be tapered to avoid cliff edges at £20m, so only schemes with £50m or more in liabilities will pay full levies.
- Risk-based levy cap: For all schemes, this will be cut from 0.5% to 0.25% of unstressed liabilities. This aims to protect schemes with high levies relative to their liabilities.

From the PPF's consultation

"We are therefore setting our levy estimate as £520m for 2021/22. This is £100m lower than the equivalent figure for 2020/21."

"Whilst these changes are modest in terms of the overall impact on the levy we collect, we believe they will provide material assistance to the schemes and employers with the most significant levies."

The PPF expects around 90% of schemes to see a risk-based levy reduction relative to their 2020/21 invoice.

Get in touch with our experts

If you would like to discuss pensions with us, contact your usual First Actuarial consultant or any of our partners: www.firstactuarial.co.uk/contact-us