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Sixty second summary

TPR COVID-19 guidance: investment implications

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In these strange times that we find ourselves, trustees of DB pension schemes are faced with some of the biggest challenges yet. The Pensions Regulator has released a statement which has emphasised the importance of considering the potential appropriateness of short-term measures to preserve longer term sustainability of scheme sponsors, which in turn feeds through to the solvency of pension schemes and ultimately security of member benefits.

We have identified 5 key actions that trustees should be taking now in light of the environment that they now find themselves in, namely:

- Understand the impact on scheme funding and agree a response to any material deterioration
- Review sponsor covenant for adverse changes – impact will be different for every business
- Consider whether your investment strategy remains suitable, including managing the timing of any planned changes, triggers and ongoing liquidity
- Review business continuity plans and manage implications for ongoing administration
- Have a strategy for communicating with members and consider impact on options such as transfer values

In this note, we have expanded on the 3rd bullet point and have provided a check list for trustees that helps them answer the question "how can I be sure I've left no stone unturned with regards to my scheme's investments?".

Cashflow and liquidity

- **Cash outflow**: Be clear on what cash outflows are essential in both timing and amount, and then stress test these in light of a potential increase in requests for CETVs, retirements etc. We would typically expect benefit payments and investment manager capital calls to be considered as essential in terms of both the timing of the payment and the amount. Cash outflows where trustees may have some degree of control over the timing of the payment includes payments such as CETVs and expenses.

- **Cash inflow**: Be clear on the expected sources, timing and value of cash inflows, and then stress test these in light of economic weakness of the scheme sponsor and markets more generally. The primary sources of income are likely to be deficit reduction contributions, future service contributions, and income or redemption proceeds distributed from the scheme's investments. The stress test should then consider the impact if contributions were to be suspended for a period of time and the income from the scheme's assets was less than expected (e.g. some direct lending portfolios may retain expected redemptions to cover FX margin calls).

- **Liquidity**: Understand the liquidity profile of the scheme's assets in terms of the speed at which cash can be raised in order to meet the essential cashflow needs. As part of this assessment, consideration should be given to the direct cost of raising cash e.g. repo costs, bid-mid spreads, dilution levies etc, and also the indirect cost of raising cash e.g. crystallising losses. This should include liquidity requirements within funds managed by portfolio managers, such as settlement of FX positions in currency hedged funds, as well as an understanding of any potential spreads or liquidity issues associated with some cash funds.

- **Collateral requirements:** Ensure a thorough understanding of the scheme's assets that could require collateral to be posted in order to maintain the intended exposure and risk controls. Where a scheme has a number of investments with collateralised positions, it is important to understand the potential order of magnitude of a collateral call, the driver of the call being made and the likelihood of that occurring.

Strategic considerations

- **Funding position:** Understand movement in the current Technical Provisions funding position and relative to the agreed long-term target e.g. buy-out or self-sufficiency, and the current plans in place to achieving this. Consideration should then be given to any changes to the current plan, including where appropriate, the possible achievement of the objective without further financial support from the sponsor. The results of this analysis will then inform decisions about whether it is in the members best interests to introduce an interim step to achieving the long term target e.g. change in target date or the potential use of risk transfer including commercial consolidator.

- **Risk management plans:** To what extent has the scheme's balance of risks shifted? Has a dominant risk now emerged that the trustees should consider putting plans in place to mitigate? Is the existing de-risking plan still fit for purpose and is there scope to de-risk now to slow the pace of/reduce the extent of further losses?

- **Expected returns:** Understand the impact on the future expected return on assets, and the extent to which this may be negatively impacted by defaults and being a forced seller and hence crystallising losses. It may also be necessary to revisit the recovery plan if there is assumed asset outperformance in this.

- **Transition activity**: Be clear on the appropriateness of planned and in-progress transition activity in light of the market conditions for trading. Consideration should be given to whether it is still relevant and if so should it be paused, accelerated or decelerated.

Underlying assets

- **Characteristics of assets**: Consider conducting a deep dive of all investment mandates to ensure a thorough understanding of the key features of the scheme's assets and any change to the initial proposition e.g. credit quality, term, diversification, counterparty exposure etc, together with the outlook for those asset classes. Consider whether there should be any impact on mandate guidelines, such as tightening or loosening constraints e.g. if there is a high yield credit limit on investment grade portfolio, should this be increased to allow for additional downgrades.

- **Concentration with sponsor**: Be clear on the level of concentration of the scheme's assets with the sponsor. This could include direct investment in the sponsor through investment in pooled funds, industry concentration or contingency assets.

Governance considerations

- **Policies and processes**: Where automated policies and processes exist as part of the trustees' governance arrangements, these should be revisited. The review should consider whether the existing arrangements remain appropriate in their current form, or whether they need to be amended e.g. introducing an interim manual intervention step or suspending the policy for an agreed period of time.

Examples of such policies and procedures include rebalancing, de-risking and re-risking (including triggers), and cashflow policies. Consideration should also be given to the approach taken for income distribution.

- **Investment sub-committees**: Terms of reference for sub-committees should be re-visited to ensure timely, effective decisions can be made and implemented.

- **Authorised signatories/signing requirements**: The signing requirements for implementing a transition of assets should be revisited and updated if required. For example, ensuring all investment managers have the latest authorised signatory list and ensuring that the trading requirements are understood. For the latter this will include being clear on notification periods, settlement periods, acceptance of electronic signatures etc.

Key questions

There is no right answer; however, by addressing each of the areas outlined in the above check list, trustees will be putting themselves in the position that they are well armed to answer the following critical, imminent questions, in the context of the scheme's longer term plans:

- Is there enough cash to meet the scheme's cashflow needs over the next 3-6 months?

- Is there sufficient sources of liquidity available to ensure that when the cash buffer runs out that there is a well to go to for further cash?

- Are the actions of the trustees consistent with stabilising the funding position and limiting further deterioration?

Get in touch

If you would like more information or wish to discuss your scheme in the context of the above, please contact your usual Hymans Robertson consultant.