COVID-19

# Awash with change

**As the second wave of Covid-19 sweeps across Europe, Laura Blows considers the effects of the pandemic on the pensions industry so far, how the sector has responded, and the future challenges to come**

**WRITTEN BY** LAURA BLOWS

A second wave of the Covid-19 pandemic is amongst us. Across Europe cases are once again on the increase, with knock-on consequences for all aspects of work and life. The pensions industry is not impervious to the flood of change; it is still 'drying out' from the first wave as this second swell continues to rise.

## Investment

Arguably first to be swept away within the European pension funds sector were much of its investment returns.

"Particularly at the beginning of the Covid-19 pandemic, the IORP sector has been heavily affected by the market turmoil, which swept away substantial value gains of 2019 from IORPs' investments," a European Insurance and Occupational Pensions Authority (EIOPA) spokesperson says.

Sweden's AP2 buffer fund certainly saw evidence of this, reporting in September that it had returned -5.1 per cent in the first half of 2020, equivalent to SEK -19.3 billion, which it attributed to Covid-19's impact.

"We saw heightened volatility in financial markets with equity exposures experiencing significant drawdown and credit spreads widening (consequently their prices falling)," SEI director for the institutional advisory team, Cyprian Njamma, says.

"Schemes with significant protection against interest rate and inflation risk (ie, highly hedged) fared quite well over the period as long-term interest rates tumbled, pushing up the values placed on liabilities. These protections on the asset side, basically liability-driven investing, performed really well and helped offset some of the impacts of negative returns from equities and credit."

Going ahead, investing in certain sectors will have to be approached with caution, Njamma warns, citing leisure, transport and real estate as examples.

In contrast, areas that provide opportunities and also allow pension schemes to take advantage of their liquidity profile are private assets and infrastructure, Njamma notes.

While many investments indubitably took a hit in Q1, by the second quarter they were already recovering quite well, PensionsEurope CEO, Matti Leppälä, states.

"Funds were able to keep their positions and rebalance after the market started to recover. There were already net increases in equity and bond investments in Q2 in comparison with Q1 and most likely that has continued in Q3," he explains.

Indeed, by the end of August, for most Danes' savings there was a small positive return for 2020 so far, Insurance and Pension Denmark reported in October.

However, according to Leppälä, while the financial markets "seem to be doing much better", the "real economy is in trouble".

EIOPA also notes that while equity markets in Europe have recovered to a significant extent in recent months, concerns on corporate bond downgrades and defaults are still looming.

"Both defined benefit (DB) and defined contribution (DC) IORPs were heavily affected by the market turmoil, which significantly affected the financial situation of DB IORPs and led to significant losses of the investments allocated to members of DC IORPs," it says.

"Investment allocations and strategies of IORPs in Europe are quite diverse, yet generally IORPs are – due to their long-term obligations – capable of investing for the long term and usually have

**"ONE ASPECT THAT SHOULD NOT BE SHORT TERM IN NATURE IS CHANGES TO INVESTMENT STRATEGY"**

some flexibility in the time horizon for re-balancing to their strategic investment allocation after a plunge that we observed in the first and second quarters of 2020."

Indeed, Njamma argues against pension funds reacting too quickly.

"One aspect that should not be short term in nature is changes to investment strategy," Njamma says.

"There is always the temptation to try to time the market (which, by the way, you have to get absolutely spot on twice, in exiting and re-entry)."

It is therefore reassuring to hear BlackRock head of UK institutional defined contribution, Alex Cave, say that the vast majority of its clients have taken very much a long-term view on their investments, believing that in time markets will recover and that members by and large have enough time in order to see the benefit.

"In short, we haven't seen a significant amount of investment activity directly as a result of Covid-19, as decision makers have trusted their long-term asset allocations."

### Industry concerns

This keeping calm in a crisis will need to continue as IORPs may not only face further market volatility in the upcoming months, and impairment of market values in a persistent low interest rate environment, but may also be subject to funding and liquidity concerns due to suspended or lowered contributions from sponsors and members, EIOPA warns.

As over 80 per cent of pension schemes in Europe are still DB, Covid-19's hit on employers may well result in problems with funding levels and solvency in DB plans and/or lowering their capability and ability to pay contributions, Leppälä agrees.

In a worst-case scenario, sponsors' insolvency may test national pension protection schemes, EIOPA warns. "The set-up, structures and design of such pension protection schemes are heterogeneous amongst member states and the potential need to use such pension protection schemes may require supervisory attention," it states.

However, Leppälä is pleased with how regulators have responded to the crisis so far.

"It was good that countries provided more flexibility on the recovery plans of DB schemes. It was also good that the supervisors in many cases extended reporting requirements and other supervisory measures and thus strengthened the operational capabilities of pension funds."

In April, PensionsEurope gave some examples of this in a statement. It highlighted how the Dutch National Bank indicated that it will temporarily relax the supervisory burden on pension funds and provide an additional three months for reporting of all annual statements will be provided to IORPs, while Germany offered flexibility for some reporting requirements.

In contrast, the OECD warned in July that several OECD countries have implemented measures, with the goal of providing short-term relief, which could have a "large negative impact on the long-term retirement saving arrangement".

This includes deferring pension contributions, reducing contribution rates, suspending contribution payments, allowing easier access to retirement savings and facilitating loans to employers and employees from pension plans, it stated.

Those many pension schemes themselves have implemented a number of short-term changes, Njamma notes, such as frequency of reporting, meetings and member communications.

Communicating with members has certainly grown in importance during the pandemic, particularly to those saving in a DC scheme.

"In DC schemes people bear the investment risk and when the markets dropped it is easy to understand that many wanted to sell their riskier investments. In order to protect the long-term interests of members and to limit the materialisation of investment losses, many pension funds warned their members about the impact of the crisis on their pension savings and about the consequences of hasty investment decision or requesting early withdrawals," Leppälä says.

He highlights how early withdrawals are a right in Italy and therefore Italian pension funds actively advised their members against getting out of their investment positions.

"Some other countries, like Spain and Portugal, opened possibilities for people to take money out of their pension savings in order to cover the losses in wages. This is understandable as people may not have other ways to manage their daily subsistence, but of course detrimental for saving for a pension that is a long-term endeavour."

Those who are tempted or need to access their savings early (for example, in their 50s) due to unemployment, need help from the pensions industry for them to understand the consequences of this decision for their income in later life, State Street Global Advisors (SSGA) EMEA head of pensions and retirement strategy, Alistair Byrne, says.

**"FOR DB SCHEMES THE CHALLENGE IN THE WAKE OF THE (ONGOING) CRISIS WILL BE FUNDING"**

"Challenges around guidance and education – the process of demystifying pensions – have been longstanding ones for the sector and Covid-19 has thrown the importance of this work into even sharper relief," he adds.

SSGA's survey of UK, Irish and Dutch DC savers in March found very few people had reduced contributions, "which is probably a reflection of the inertia we generally find in pensions", Byrne says. Instead, it found a proportion of people checking their balance more often – 10-20 per cent of people.

"The key consideration is, what message do savers get when they do so – should managers provide some reassurance, or just show them their pot is down 20 per cent for example? Pension savers are generally cautious, but we didn't find any evidence of people wanting to sell out at the bottom," he adds.

BlackRock's data found that Covid-19 has had a "significant, but hopefully short term, impact on members' confidence," Cave says, with just over half concerned that they will be unable to enjoy the retirement they want, compared to 33 per cent in 2017.

Yet Covid-19 has focused attention, Cave adds, as "86 per cent of the members we've spoken to recognise that they need to make more effort to understand their pension".

"On a more positive note many recognise this as a shorter-term challenge, with a greater number expecting to prioritise pension savings in five years' time than are able to currently."

## Looking ahead

Savers may be looking to prioritise retirement saving more in the future if they can, but they are less optimistic about what may happen to their pensions as a result of Covid-19.

For instance, a survey in July by DNB of Dutch households found two-thirds expect their pension benefits to be reduced because of the coronavirus crisis.

Meanwhile, in September, a report by Skandia found that the coronavirus pandemic could reduce the future pensions of Swedes by thousands of kronor each month, due to its impact on investments and wage growth. To compensate for this, Skandia recommended that people should save an extra SEK 500 to SEK 3,000 a month, depending on an individual's circumstances. Alternatively, people may need to work longer before retiring, it said.

Even worse may be a rise in the number of people being worse off at retirement due to fraudulent means.

"During the Covid-19 crisis we have observed a growing number of scams, frauds and cyber-attacks," Leppälä says.

"Against this background, we have noted a number of initiatives taken

## Joining the fight for the vaccine


INSTEAD OF JUST reacting to the challenges encountered by Covid-19, some pension schemes are more actively trying to tackle the disease.

For instance, in August, Finnish pension provider, Varma, joined an appeal from international investors and pharmaceutical companies to develop a Covid-19 vaccine that will be distributed fairly.

It said the joint petition had been signed by 65 investors, such as insurers, asset managers, banks and pension companies, with a total investment asset of €5,000 billion.

Varma stated that the signees had invested their assets in several different pharmaceutical companies and opened discussions about the potential pricing, availability and cooperation of some of the more than 200 candidate vaccines and drugs being tested around the world during the spring.

Commenting at the time, Varma director for responsible investment, Hanna Kaskela, said: "Varma wants to be at the forefront alongside major investors in engaging with pharmaceutical companies, as the pharma industry is in a position to resolve fundamental global problems.

"When a viable coronavirus vaccine is developed, it is essential that it is also made available to lower-income, developing countries. This requires ensuring fair allocation and reasonable pricing."

by member states or pension providers to warn and protect their members, beneficiaries, and consumers. There are big differences between countries, and it's been said that the biggest risk for pension fund members in the UK is the risk of being defrauded out of their retirement provision."

On the DB side, the impacts of the Covid-19 crisis may well lead to benefit cuts for members and/or require sponsoring undertakings to finance funding gaps, potentially creating additional pressure on the real economy and on financial institutions sponsoring an IORP, EIOPA warns.

The emergency measures brought in by governments and central banks to tackle the virus will have lasting financial strain on pension schemes and sponsors alike, Njamma adds, giving the example of the significant fall in longer-term interest rates adding billions to deficits.

"For DB schemes the challenge in the wake of the (ongoing) crisis will be funding," Byrne says. "Low funding for longer interest rates will inflate liabilities at the same time as challenging economic conditions weaken many sponsors' willingness and ability to fund their schemes."

However, those managing pension schemes have not just stayed afloat amongst these challenges, many have also changed their operations.

"The industry has been very resilient to quite a lot of the lockdown measures from an operational standpoint," Njamma says. "A lot of service providers, advisers and even trustees have adapted to the virtual world in which we operate. Perhaps this may lead to the industry embracing further technological changes that will be beneficial for the way we work and invest."

A positive change that has risen to the surface during the pandemic is the increased focus on climate change investing.

"Climate-related issues have moved up the agenda as emissions dropped significantly during the lockdown," Njamma says. "In addition, there are certain climate-related scenarios that could play out that would have a similar or more dire effect on financial markets."

This was evidenced in June, when several European pension funds signed a letter calling on European leaders to ensure the economic response to the Covid-19 pandemic delivers a sustainable recovery.

The letter stressed the need to ensure "an accelerated transition to a net-zero emissions economy in line with the Green Deal and the Paris Agreement", as well as stating that "recovery plans that overly exacerbate climate change would expose investors...to escalating financial, health and social risks".

If one positive can come out of this crisis, it may be that once the pandemic subsides we find this was the high-tide mark of pensions schemes investing without much care to the environment; instead a greener focus is now being washed ashore. ■