Press release

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Pension deficits claw back 2% in Q2 – but continued Covid covenant risks could be understated

London, 18 August 2020 – The overall health of the UK's Defined Benefit (DB) pension schemes moderately improved during Q2 2020 following the impact of the pandemic in the first quarter, but Q1-aside, it still remains at a two-year low, according to Legal & General Investment Management (LGIM).

LGIM's health tracker – a monitor of the current health of UK DB pension schemes – found that the average[1] DB scheme can expect to pay 93.5 per cent of accrued pension benefits as at 30 June 2020, up from 91.4 per cent at 31 March 2020[2]. This compares to a figure of 92.9% recorded as at 30 June 2018.

This measure of the 'Expected Proportion of Benefits Met' (EPBM) has improved by 2.1 per cent during the first three months of the year but is still down from 96.5 per cent in December 2019.

The latest quarterly analysis, which takes into account the risk that a sponsor might default and the impact that would have on scheme's members, means that 6.5 per cent of accrued pension benefits would not be paid on average across their scenarios in Q2 2020, compared to 8.6 per cent in March.

The most significant market movements behind the 2.1 per cent improvement include a rebound in growth assets during the quarter. This followed aggressive stimulus from policy makers and a general improvement in investor sentiment. However, nominal interest rates continued to fall over Q2, albeit less than during Q1. Moreover, inflation expectations have now grown, in contrast to a fall during Q1. Due to a typical scheme under-hedging their rates and inflation risk, these two factors offset some of the gains from the rally in growth assets.

John Southall, Head of Solutions Research at LGIM comments on the findings: "It's great to see things improving once more – yet these higher ratios may understate the negative impact of Covid-19 since the start of the year, due to a weakening of covenant that many schemes will have endured but that is challenging to currently estimate.

"In general, a weakened covenant can have a complicated impact on investment strategy dependent on scheme-specific circumstances. In some cases, particularly for already weak sponsors or mature schemes, it can promote de-risking. However, in other cases it may effectively shift the medium term target away from low-dependency and towards a more onerous buyout objective (given a higher chance of forced buyout in the medium term). This could promote to a higher allocation to growth assets to help close the wider gap. That said, the nature of this crisis may mean that the coming months are a sink-or-swim moment for many sponsors.

"Schemes also need to remember that size of a deficit isn't everything – and the practical manageability of a pension scheme's deficit is dependent on several factors. This includes the strength of the sponsor, the size of the deficit relative to the size of the assets, the quality of the investment strategy, and the economic and demographic risks in the scheme."

Christopher Jefferey, Head of Rates and Inflation Strategy at LGIM commented: "Investors in risk assets have been on a rollercoaster ride in the first half of the year. In sterling terms, the value of global equities fell by around a fifth in the first quarter before recovering all of that in the second quarter.

"The events of 2020 serve as a good reminder that investors of all stripes need to be clear about their risk tolerance: that applies to the largest DB pension schemes just as much as to the smallest retail investors. Those investing beyond their true risk tolerance are likely to suffer from 'path dependence' given pressure to reduce exposure when markets are at their most volatile.

"The sharp recovery in equity and credit markets has been accompanied by a further drift lower in interest rates in almost all parts of the world. The spectre of negative interest rates is now stalking the gilt market, with UK government liabilities out to 5 years' in maturity pricing below zero during Q2. Irrespective of whether the Bank of England takes the policy rate below zero, global flows and the actions of liability-hedging investors will continue to dictate pricing at the long-end of the gilt curve."

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Notes to editors

Past performance is not a guide to the future.

The value of an investment and any income taken from it is not guaranteed and can go down as well as up; you may not get back the amount you originally invested.

The philosophy underlying LGIM's approach is that schemes should focus on long-term success, defined as the assets outlasting the liability cashflows. Schemes face many hurdles to achieving this goal including covenant risk. LGIM calculated EPBM for a typical scheme as the average proportion of benefits met across the lifetime of the scheme over many different economic scenarios of the future.

[1] Based on the most recent Purple Book from the Pension Protection Fund, a typical pension scheme currently holds approximately 25% in equities, 60% in bonds/LDI, 5% in property and 10% in other assets. For illustration, we assume a hedge ratio of 50% of liabilities on a gilts basis and no future accrual or deficit contributions.

[2] As at 31 March 2020, the LGIM DB Health Tracker found that pension schemes could expect to pay 91.4% of accrued pension benefits.

About Legal & General Investment Management:

Legal & General Investment Management is one of Europe's largest asset managers and a major global investor, with total assets under management of £1.2 trillion[1]. We work with a wide range of global clients, including pension schemes, sovereign wealth funds, fund distributors and retail investors.

Throughout the past 40 years we have built our business through understanding what matters most to our clients and transforming this insight into valuable, accessible investment products and solutions. We provide investment expertise across the full spectrum of asset classes including fixed income, equities, commercial property and cash. Our capabilities range from index-tracking and active strategies to liquidity management and liability-based risk management solutions.

[1] LGIM internal data as at 30 June 2020. The AUM disclosed aggregates the assets managed by LGIM in the UK, LGIMA in the US and LGIM Asia in Hong Kong. The AUM includes the value of securities and derivatives positions.