SQUIRE PATTON BOGGS

#PensionsTensions

Exploring the Long-term Stresses and Strains on UK Pension Saving Following the COVID-19 Pandemic

#How2DoPensions

Part 4: The Investment Experience

#PensionsTensions Overview

The global coronavirus pandemic has had a seismic impact on our economy and lifestyles. Whilst some of the challenges posed by COVID-19 are expected to be short-lived, the longer-term implications of the crisis remain unclear. The slower pace of life during lockdown has given many people an opportunity for reflection, and it is likely there will be some permanent changes to how individuals live, work and save for retirement, as well as new and ongoing challenges and opportunities facing pension scheme sponsoring employers and trustees. In this series of publications we examine the key areas of pension tension, in each case exploring four aspects, assigning them a #PressureMeasure (the higher the score the greater the pressure being faced) and giving our view on where further reflection might lead to welcome change.

Strategy – Has the Pandemic Created a Perfect Storm of Competing Tensions when it comes to Investment Strategies?

#PressureMeasure: 7/10

Trustees face increasing pressure to improve their governance and stewardship, including consideration of non-financial, material considerations, and most notably environmental, social and governance matters (ESG). #PensionsTensions in relation to ESG are likely to intensify as a result of both legislative changes and regulatory scrutiny, with The Pensions Regulator (TPR) highlighting ESG as a key area of focus in its corporate plan 2020-21.

Even without COVID-19, as we highlighted in our recent blog, it is possible that trustees will have to be compliant with the recommendations of the Task Force on Climate-related Financial Disclosures by 2022.

Some trustees are more engaged than others when it comes to ESG. To some extent this is driven by the structure of their investments. For example, a typical pooled fund arrangement leaves little control over where the money is ultimately invested (but that does not mean fund providers' ESG credentials cannot be monitored).

The dramatic slowdown of international travel and industrial activity in countries in lockdown has shone an awkward spotlight on environmental and ethical issues, making many people pause for thought. As we emerge from lockdown, will pension scheme members start scrutinising the investment activities of their pension funds – prompted to some extent by the emergence of new activist groups? For trustees, formulating a strategy that balances ethics with their fiduciary duties, and facing probing member questions, may feel like an irreconcilable challenge.

Control – How Often do Trustees Look in the Mirror and Re-examine their Investment Beliefs?

#PressureMeasure: 5/10

The key to alleviating these regulatory and social pressures is the robustness of trustee governance. Many trustees have embraced fiduciary management on grounds that it can provide more efficient execution of investment strategies. However, the ESG issues raised by COVID-19 really require trustees to examine their investment beliefs before they get to the stage of implementing changes.

Such an examination could lead trustees to adopting, for example, a conscious policy that all future investments must be in sustainable investments.

Preparation – To What Extent Can These Challenges be Headed Off at the Pass?

#PressureMeasure: 3/10

Some of the challenges in this area are outside trustee control, but trustees can and should focus on the areas within their control. This includes being clear on their legal duties, putting the right structures in place (whether with advisers and/or a sub-committee) and ensuring that they devote sufficient time to understanding existing and new investment agreements to make sure that the arrangements do align with their investment beliefs.

In the shorter term, the priority should be updating SIPs to ensure that these comply with legal requirements and good governance standards.

Opportunity – How Can Pension Schemes Play a Role in Rebuilding the UK Economy?

#PressureMeasure: 7/10

The government's stated plans to reinvigorate the economy in the wake of the COVID-19 lockdown include ambitious infrastructure projects, which will require patient capital investment. Overseas pension schemes (notably large Australian and Canadian funds) have already invested significantly in UK infrastructure projects, but few UK pension plans have made comparable commitments. This is despite the bond-like qualities of infrastructure assets that produce an income stream that is so well suited to pension funds' needs. So what are the barriers to entry into this market?

The first is liquidity. This may be less of an issue for defined benefit schemes (although not those nearing buy out), but for defined contribution (DC) pension schemes, the long-term and illiquid nature of infrastructure projects conflict with the cultural norm that DC accounts must always be liquid and daily priced.

The second challenge is scale: the resources needed to carry out appropriate due diligence on an infrastructure project have dissuaded many smaller schemes from investing. The Local Government Pension Scheme (LGPS), which certainly has scale, is playing a pioneering role in this area – indeed, increasing participation in UK infrastructure projects is an explicit goal of the Government's investment pooling project for the LGPS.

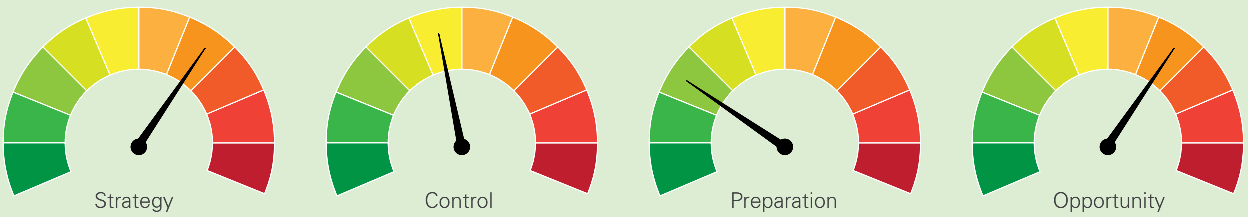
Finally (and perhaps most closely related to COVID-19) is the barrier of political risk. Remember the attractive tariffs available for domestic solar panels and their sudden disappearance? If the government wants pension funds to invest, it must look seriously at how it can guarantee operational risks.

Reflecting on these #PensionsTensions

Trustees do not yet have all of the solutions to the very real tensions surrounding investments, but we consider they are coping well with the matters that are under their control.

It remains to be seen how pension scheme investments will look in a post COVID and post Brexit world, but it is possible the pandemic may prove to be a catalyst in increasing public awareness of ESG matters, as well as new investment opportunities around supporting innovation and funding infrastructure projects.

Will fund managers find themselves under increased pressure to be more proactive on ESG matters and address issues around liquidity? Might they start facing more probing questions from trustees when pitching for new clients?



#PressureMeasure: the higher the reading on the gauge the more pressing the need for action/reform

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