TEESSIDE PENSION FUND

Administered by Middlesbrough Council

AGENDA ITEM 9

TEESSIDE PENSION BOARD REPORT

27 JULY 2020

DIRECTOR OF FINANCE – IAN WRIGHT

Impact of the Coronavirus Pandemic on the Pension Fund

1. PURPOSE OF THE REPORT

1.1 To provide Members of the Teesside Pension Board (the Board) with an initial assessment of the impact of the coronavirus pandemic on the Pension Fund.

2. BACKGROUND

2.1 As Members will be aware, a novel coronavirus (subsequently named Covid-19) was initially identified in Wuhan, China towards the end of 2019. It became apparent that human to human transmission was taking place and that individuals could spread the virus even if they displayed no symptoms. The virus is fatal for a small but significant percentage of those infected and has quickly spread across the world. Without an effective treatment or vaccine the virus poses an immediate and real threat. Many countries have enforced stringent measures to prevent the spread of the virus ('lockdowns'), including shutting down large parts of their economies and severely restricting the movement of their citizens.

2.2 The loss of life as a consequence of the virus is tragic and substantial – at the time of writing around 580,000 people have died from the virus worldwide with almost 45,000 confirmed deaths in the UK. These figures represent individuals who had been tested for the virus, the actual death figures are likely to be substantially higher (as evidenced by the statistic that over the period of the outbreak to date over 65,000 more people than expected died in the UK). The impact on the global economy caused by the lockdowns put in place to prevent the spread of the virus has also been substantial. This paper will focus on this economic impact and its potential effect on the Pension Fund, together with the potential impact on the governance and administration of the Fund.

3. IMPACT ON ASSET VALUES AND INVESTMENTS

3.1 The Pension Fund is primarily invested in equities. Although the strategic asset allocation to equities is set at 50%, this allocation was set relatively recently and the portfolio is only gradually being moved from its current allocation which is significantly higher – typically around 75% equities. The coronavirus pandemic led to a quick and dramatic fall in global stock markets, and this is reflected in the Fund valuation as at 31 March 2020. The Fund's equity holding reduced in value by around £600 million in the three months to 31 March 2020.

3.2 Stock markets to some extent recovered after hitting lows towards the end of March, with US markets in particular improving to the extent that at the time of writing (before market opening on 15th July 2020) the S&P 500 index was only 1% down compared to the end of December 2019 and was up 6% over a year. The UK stock market has not bounced back as quickly – at the time of writing the FTSE All Share index was around 18% down compared to the end of December 2019 and down a similar percentage over a year. This is a significant improvement for both markets compared with the low points since the year end, which saw the S&P 500 and the FTSE All Share indices around 31% and 35% down respectively compared to the end of December 2019.

3.3 Other assets held by the Fund have been affected to a lesser degree, partly because their illiquid nature means their valuation is not as volatile as equities. For example the Fund's private equity and infrastructure investments are likely to be adversely affected, but it will take time for any correction to take effect. The value of the Fund's direct UK property portfolio is likely to be affected by the lockdown and the pace at which normality returns. Retail assets in particular will be affected, with rent collection likely to be delayed and perhaps reduced in respect of some businesses that have been unable to trade.

3.4 Officers have been meeting (remotely) with most of the Fund's investment managers in order to understand the potential impact of the pandemic on the value of the Fund's current investments and the timing of future planned investments. Much of the Fund's commitments to infrastructure and private equity managers have not yet been invested – it typically takes a number of years for money to be fully invested in these types of vehicles. This means the Fund may ultimately benefit from any correction in asset values in these markets as it should be able to invest a substantial amount of its capital at lower, post-pandemic prices. The investment managers have all confirmed they are looking closely at the underlying investments and companies within their portfolios to ensure value is retained during this turbulent time.

3.4 The Fund is a long term investor and, provided over time asset values do recover, the drop in value will not be detrimental to long-term funding. However, there is no guarantee over how long it will take for asset values to recover and there is a real possibility that global economic growth will be flat, low or even negative for a considerable period. Consequently, equity values and dividends from equities could be considerably lower in the short to medium term than was widely expected before the pandemic.

3.5 The Fund has been particularly affected by the reduction in stock market values as a consequence of its current asset mix, with around two thirds of the Fund's assets invested in UK or global equities. Members will be aware that the Fund's target strategic asset allocation is for half of its assets to be invested in equities, and officers and advisors continue work to move the Fund towards the target allocation over time. The Fund's officers will also work with advisors to consider whether it is sensible to reduce exposure to equity volatility in other ways, such as through us if derivatives or other financial instruments.

4. IMPACT ON INCOME

4.1 The Pension Fund has for a number of years been cash negative if investment income is ignored. This means the amount paid out in pension benefits exceeds the amount collected in employer and employee contributions. This in itself is not a problem, and is quite normal for a Local Government Pension Scheme fund, particularly one which is relatively well funded and so does not require many of its employers to make additional, deficit correction contributions. Provided the additional cash requirement can be met in a planned way, which does not require the Fund to sell risk assets at an in appropriate time, a cash negative position can be well managed.

4.2 The pandemic has the potential to adversely affect the Fund's cash position in the following two main ways:

- The Fund obtains rental income from its properties – some tenants have asked to defer making rental payments, usually because they are temporarily unable to trade.
- Pension Fund employers may have difficulty making their required employer pension contributions if they have been forced to cease or reduce trading.

In practice, the property rental income position is being monitored and managed by CBRE and currently it does not look likely to result in a significant permanent reduction in income. Almost all employers in the Pension Fund are not expecting to have difficulties in paying their employer contributions.

4.3 The 2019/20 draft accounts show that expenditure on scheme member benefits, transfer values and expenses exceeded income from employer and scheme member contributions by around £55 million in the year. Around £20 million was received in rental income and interest on cash investments and (in 2019/20) around £21 million was received in dividend income – mainly in respect of equities the Fund held directly in the past but also, to a lesser extent, in respect of payments made in respect of private equity and infrastructure investments. This meant the shortfall in 2019/20 was around £14 million, however this shortfall will increase in future years as:

- Contributions from employers will be lower following the latest actuarial valuation – the actuary estimates employers will pay around £8 million a year less into the Fund.
- As the Fund continues to mature, the ratio of pensioners to active members will increase, meaning benefit payments will increase and contributions will reduce.
- Historic dividend income in respect of directly held equities will reduce to zero.

4.4 The Pension Fund has significant cash holdings and, even taking into account the future commitments it has made to invest in infrastructure and private equity, it will have sufficient cash to ensure all pension payments can be made over at least the next couple of years without having to sell any assets. Officers will work with advisors to develop a long-term approach to cash flow management within the Fund.

5 IMPACT ON ADMINISTRATION

5.1 Officers have been in regular contact with XPS (the Fund's outsourced administration provider) throughout the period of the pandemic and subsequent lockdown. XPS was able to move quickly to a position where its team could operate effectively working from home and continue to administer the Fund. The team is able to continue carrying out all of its administration functions including processing new entrants, leavers and retirements, as well as ensuring pensions continue to be paid.

5.2 Postal communication with XPS is now slower than before the pandemic, partly because XPS has reduced access to its office (in order to protect its staff) and partly because Royal Mail's service is also reduced at present. Consequently, XPS is encouraging scheme members to exchange information electronically and has a prominent notice on its scheme member website to this effect.

5.2 XPS continues to monitor work load and activity levels amongst its team and reports back to the Board and the Committee at each meeting.

6 IMPACT ON GOVERNANCE

6.1 When the UK Government announced lockdown measures on 23rd March 2020 this immediately meant all Council employees were expected to work from home if they were able. Fortunately, the whole of the Pensions Governance and Investments Team was already equipped for working away from the office, and had the hardware and software that made it possible to quickly adapt to working from home. In this respect, the monitoring of investments, governance support and oversight of the outsourced administration contract can continue during the time the team is away from the office.

6.2 One area where the Fund's governance was affected was in the cancellation of the Board meeting scheduled for 20 April 2020. Unfortunately, the Council was not in a position to ensure the meeting could be held effectively remotely and the decision was taken to cancel that meeting. Local pension boards are required to meet at least twice a year under the overriding legislation, so there was no question of the Board failing to meet that criteria by cancelling that meeting.

6.3 The Pension Fund Committee meeting that was scheduled for 17th June 2020 was able to go ahead as a Webex meeting. The technology worked well, attendance was good and the level of participation within the meeting was at least as high in this virtual meeting as it had been in previous physical meetings of the Committee. The meeting was live streamed on the Council's You Tube channel, and is currently still available to watch again. One possible effect of this is that the Committee meeting itself is more accessible to members of the public than one held as a physical meeting. The technology was able to ensure that the one item on the private part of the agenda was not live streamed to the public and is not available to watch again. That item was only visible to the meeting attendees who needed to see and discuss it.

7. MEDIUM / LONG TERM IMPACTS

7.1 As mentioned above, it is impossible to know the long term impact of the pandemic and subsequent economic effects. However, some possible impacts on the Fund are as follows:

- The outcome of the next triennial actuarial valuation (as at 31 March 2022) is now much more likely to be less favourable that the latest valuation. The Fund actuary may also be less optimistic about future long term investment returns. This in turn makes it more likely that employer contribution rates will need to increase following the next valuation. While this is not a particular problem for the Fund, it will potentially put a financial strain on the Fund's employers. All Fund employers were contacted toward the end of March and told about the potential impact of market falls. Admission body employers were advised that if market falls were sustained it was possible that their employer contribution rates could be recalculated and revised rated applied from April 2021. All other employers were told it was "now looking likely that contribution rate increases will be required from 1 April 2023 following the 2022 valuation, and you should budget for this accordingly."

- UK unemployment has increased significantly over the last few months, as has Government debt. Ultimately this could mean reduced funding for local government and fewer active members contributing to the Fund. This will serve to further accelerate the rate at which the Fund matures, and increase the shortfall between benefits and contributions. This underlines the importance of planning for cash flow provisions within the Fund going forwards.
- Moving Committee meetings online (at least temporarily) will increase visibility of the meetings and meeting agendas. This in turn could lead to greater public interest in the Fund's investments and governance.

8. NEXT STEPS

8.1 Officers will continue to monitor and review the impact of the pandemic on the Fund and will report back to the Board with updates as necessary.

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