The pensions implications of COVID-19

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Introduction

There is much uncertainty associated with the current situation, not only in terms of immediate financial impacts, but also how retirement incomes, both current and future, might be affected. The most immediate impact on pensions has been the significant falls and subsequent volatility in the stock market. This affects the value of Defined Contribution (DC) pensions for individuals, and the funding position and security of Defined Benefit (DB) pensions for scheme sponsors. The ability of both individuals and employers to make pension contributions is also likely to be impacted. Different cohorts will be affected in different ways, with younger workers at greater risk of experiencing job losses or being furloughed, while those approaching or in retirement will face difficult decisions about whether to delay or reduce the retirement income they take in order to preserve their pension pot.

This Briefing Note explores the impact that the 2020 coronavirus (COVID-19) pandemic may have on pensions now and in the future. It explores likely impacts in terms of:

- Stock market volatility and its effects on DC pot sizes and DB scheme sponsors' ability to deliver on member promises.
- Employment and the Government Job Retention Scheme.
- The effects on different age groups, including younger workers, those approaching retirement and those already in retirement.

Stock market volatility

- DC pension pot sizes have been impacted by reductions and volatility in the stock market, although they have not been as severely affected as the stock market in general because of diversification and allocation to less volatile assets.
- Volatility in the stock market will also impact the cost of delivering DB entitlements for scheme sponsors.
- The Pensions Regulator (TPR) has allowed a three month delay on DB scheme transfers to protect savers from making decisions in response to volatility in the stock market that could negatively impact their future retirement incomes.

Reductions and volatility in the stock market are impacting the value of DC pensions for individuals, and the funding position and security of DB pensions for scheme sponsors

The UK stock market, alongside stock markets around the world, has experienced significant falls and volatility as the situation has developed. By the end of March, the FTSE 100 had experienced its worst quarter since 1987, seeing a reduction of 25%, while the FTSE 250 experienced an even larger reduction of 31%.[1]

While experiencing decreases, pension funds appear to have faired better than the stock market in general because funds are diversified and hold more stable assets, such as bonds, alongside volatile equities. For example, as of late March, the value of NEST members' investments had fallen by 17.6% since the start of the year, with members who are close to retirement losing only 0.6% as their investments have been largely shifted out of equities as they approach retirement.[2]

Nevertheless, for individuals, seeing the value of your pension fund fall significantly can be understandably alarming, and waiting to see if it recovers is no less stressful. There have been concerns that volatility in the stock market could result in savers making rushed decisions to withdraw pots, if able, due to age, stop contributing, or change investment strategies within their scheme. Withdrawing or disinvesting pension savings at a time when the market is experiencing such deep reductions could result in an overall loss in fund value. Any member wishing to change investments would benefit from financial guidance or advice, and the best solution for some will be to remain invested until the market recovers in order to avoid losses arising from "selling low and buying high". With appropriate advice, some may win from re-investing, but the turbulence and unpredictability of the current market means that even advised investing will carry significant risks.

Most DC scheme members, particularly those who have been automatically enrolled are invested in their scheme's default fund, which could help to protect them from extreme losses as a result of market volatility

The vast majority of people who have been automatically enrolled are invested in their scheme's default strategy. These strategies are generally designed to withstand the ebbs and flows of the market over a long period of time, and experience suggests that there is little appetite for people to make an active decision to move their money to a different investment fund. More than 95% of members of trust-based DC schemes (including master trusts) are invested in their scheme's default fund.[3] Those who remain invested in their scheme's default fund may experience greater protection against market turbulence.

DB schemes are currently allowed to delay transfer requests by up to three months, in response to concerns that the uncertain situation could lead to an increase in transfers and scams

There were initially concerns that member fears over current stock market volatility could precipitate mass transfers out of DB schemes. At this time, such transfers would be unlikely to be beneficial to either scheme members or scheme sponsors.

Scheme members:

- Could receive lower transfer values as a result of reductions in the value of scheme assets.
- May be at greater risk of falling victim to pension scams when transferring out.

For scheme sponsors:

- Increases in transfers out could place additional strain on administrative functions.
- Large increases in the number of members transferring out could negatively impact the scheme's funding position.

In order to protect both members and sponsors, TPR announced on 27th March 2020 that DB schemes could delay member requests to transfer out of the scheme by up to three months, stabilising scheme funding positions temporarily and protecting DB members from scammers taking advantage of the current crisis to encourage them to transfer. Guidance offered by the regulator also allows schemes to delay paying pension recovery plan contributions for three months (or longer if they can prove that further restructuring of the contributions is necessary) that could have put company finances in jeopardy at this uncertain time.

Employment

- Decreases in productivity resulting from social distancing measures could lead to an increased risk of unemployment, although the Government job retention scheme mitigates this risk for many.
- In both the short and long-term some employees and employers may find it more difficult to make pension contributions.

Both individuals and employers may find it more difficult to contribute to pension savings during the crisis and the following recovery period

As well as stock market volatility, there will be longer term impacts on future pension saving behaviour. Increased unemployment and lower earnings now will reduce the capacity for pension saving, leading to lower long-term incomes.

As the spread of the COVID-19 virus has increased, the Government have introduced social distancing measures aimed at protecting lives by ensuring that the number of cases do not reach a level which would overwhelm the NHS and its available resources. These measures have resulted in a huge increase in the number of people working from home, while other businesses, particularly those such as restaurants and pubs, have shut down entirely, leaving staff either without jobs or furloughed with 80% of their salary being paid through the Government's Job Retention Scheme.

The Government has confirmed that it will cover employer National Insurance and minimum automatic enrolment contributions of furloughed workers, on top of 80% salary (up to the cap of £2,500), indicating that automatic enrolment requirements are unlikely to be lifted for employers, even in the short-term, though it remains to be seen whether opt-out rates may increase as many people find their incomes increasingly stretched.

The Government Job Retention Scheme aims to protect more workers from the risk of unemployment as productivity is reduced by social distancing measures. This means that more people will continue to receive contributions to their pension pots both during the current crisis and in the recovery period that will follow.

- Younger workers are at greater risk of experiencing unemployment or negative wage impacts as a result of the crisis, but their pension pots have a longer time over which to recover before retirement.

- Those approaching retirement could benefit from delaying access to their pension, while those who are already in retirement could benefit from pausing or reducing withdrawals from their pension pot, if possible, in order to give their pots longer to recover from current stock market volatility.

Impact on different age groups

For younger workers, pension pots have a longer time to recover before retirement, but they are more likely to experience negative income effects as a result of the crisis

Younger workers, aged under 25, are at greater risk of income being negatively impacted, as they are two and a half times as likely to work in sectors that have been shut down as a result of social distancing measures, such as the closure of restaurants, shops and leisure facilities.[4] By late March, 69% of workers aged under 30 reported working fewer hours in the last week compared to usual and 58% reported earning less, compared to 49% and 36% of workers aged 40-55 respectively.[5]

Some of those whose earnings have been affected by shut-down sectors may be able to mitigate the negative impact if they live with others, such as partners or parents, whose earnings have not been directly impacted by the lockdown. Nearly two thirds (61%) of young people who work in shut-down sectors live with their parents.[6] Although, for those living in low income households, support from other household members will be more limited.

While younger workers are at greater risk of experiencing immediate reductions in work and income during the crisis, the value of their pension pots have a longer period to recover before they come to access them at retirement, through additional contributions, future investment returns and compound interest.

Longer-term impacts resulting from increased Government spending in order to mitigate the crisis may affect savers' ability to contribute enough to their pension to provide an adequate retirement income in the future. At present, it is unclear what exactly these consequences might look like and how long they might endure. Further research on the impact of wage scarring and periods of missing pension contributions on different age groups could help to clarify the way to best support savers going forward.

Those with DC pensions who are close to retirement have experienced reductions in the value of their pots and could benefit from delaying access if possible

Savers approaching retirement with DB entitlement are protected from the effects of current market volatility. The impact is mitigated for DC savers in lifestyle type funds whose investments will have been shifted away from riskier assets such as equities towards more stable assets such as bonds. This means that pot sizes will not have been as severely impacted by reductions in the FTSE.

Though losses in pension pot value as a result of stock market volatility are likely to be proportionally smaller for those nearing retirement due to de-risking, they have a shorter period in which to recover than those of younger workers. Where possible, savers could benefit from delaying access to their pension pot for as long as possible in order to give it time to recover as much as possible. They may also want to make additional pension contributions to help restore the value.

In practice, these options (delayed access and additional contributions) will be more difficult for some than others. Those on lower incomes will find it harder to make additional contributions, and may also find it harder to postpone retirement in order to delay accessing their savings. Those on low incomes have lower levels of non-pension wealth upon which they could draw to delay accessing their pension pot. They are also more likely to experience disability or long-term illness at younger ages that can make working longer harder. At ages 60-64, only a third (33%) of those in the lowest wealth quintile have no physical limitations which can make daily activities, including work, more challenging, compared to nearly three quarters (71%) of those in the highest wealth quintile.[7]

Those who are already in retirement are at greatest risk of experiencing an immediate reduction in retirement income, but could benefit from drawing down a lower income in order to preserve the value of their pension pot

Those with DB pensions or annuities are highly protected against negative effects on income, considering both the guaranteed nature of their benefit and the provision of the Pension Protection Fund (PPF) for DB schemes and Financial Services Compensation Scheme (FSCS) for annuity holders if insolvency occurs. Retirees who are withdrawing lump sums directly from their pension pot or from an income drawdown product may see significant falls in value as a result of current stock market volatility and risks to immediate income levels as a result.

Just as those approaching retirement could benefit from delaying accessing their pension pot, those who are already drawing from their savings could benefit from temporarily pausing withdrawals if they have other sources of income to provide for expenses, while others could benefit from reducing the amount they are withdrawing, where possible. Drawdown users who choose to withdraw a specified amount each year (e.g. £2,000 each year) are likely to exhaust their pension pot more quickly if they continue to withdraw at the same level from their pot which is currently reduced in value due to stock market declines. Those who withdraw a specified proportion of their pot each year (e.g. 4%) may be able to continue to withdraw at the same rate, taking into consideration the lower value of their pot at present. However, retirees ability to reduce withdrawals is dependent on income needs, and may be more difficult for pensioners on lower incomes for whom disposable income is lower.

In terms of the State Pension, it has been suggested that replacing the triple lock with a double lock of the higher of earnings or inflation could help to share negative economic impacts more fairly between generations by reducing the financial burden on the workforce of increased Government borrowing through smaller increases to State Pension payments. Calculations suggest that this change to uprating of the State Pension could save £20 billion over the next five years.[8] However, this size of this saving would be dependent on earnings and price inflation being lower than 2.5%, which may not be the case as the economy begins to bounce back from the current situation.[9] Any changes to the uprating system would need to be carefully considered in relation to equality issues, as lower annual increases to the State Pension may disproportionately impact pensioners on lower incomes who are more heavily reliant on the State Pension. While this could be a viable short-term tool, arguments about intergenerational fairness of the triple lock often fail to recognise that it is not only today's pensioners who benefit from the current uprating system; young workers will also benefit from current increases that prevent the value of the State Pension from being eroded by the time they are of an age to access it.

Conclusions

This is a time of considerable uncertainty and it will take some time to gain a clear view of what the longer-term impacts on pensions may be. In most cases, savers could benefit from refraining from making any sudden decisions as a result of current stock market volatility.

- For DC scheme members, remaining invested in their scheme's default fund may provide some protection from large reductions in pot size.
- For DB scheme members, TPR's three month delay on transfers offers protection from decisions that could have a negative impact on future retirement incomes, including the increased risk of scams.
- Those approaching or already in retirement could benefit from delaying or reducing withdrawals from their pension pot, if possible, in order to mitigate the impact of current stock market volatility.
- Any potential increases in unemployment and lower pension contributions from employers and employees as a result of the current crisis will reduce future DC pension income, and reduce security for DB scheme members, meaning that the pensions impact could continue for many years to come.

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