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The UK decides to leave the EU: Issues for Pensions

24 June 2016

This note is in two parts. The first part looks at the referendum results, the immediate aftermath in investment markets relative to our expectations and goes on to consider a roadmap for what happens next. The second part examines the impact of an exit on pensions.

We should note that there are huge uncertainties ahead over how the exit process evolves, so comments here are fairly high level only. Once there is some clarity on the exit process and the stance of the UK government on the wide range of economic and regulatory issues that are involved, the implications will become clearer but this may be several months in the offing. A series of communications and material will be made available addressing these issues.

Summary

- The UK electorate has voted to leave the EU, which has been a surprise, particularly to financial markets.
- We expect the exit process through invoking Article 50 to begin sooner or later, though the process of negotiating a settlement with the EU will start immediately.
- Market reactions so far reflect the surprise element in the decision and conditions remain volatile and fluid at this time. We expect more market swings in coming weeks reflecting the large uncertainties involved.
- The event is generally negative for risky assets and will keep gilt and other bond yields lower than otherwise, though sterling weakness may have some impact on inflation expectations.
- Adequately hedged and diversified portfolios should not need adjustments to today's news. However, further weakness or overshoots could bring some opportunities over time.

Weak 'Leave' win but still a surprise

The EU referendum has seen a majority vote by the UK electorate in favour of leaving the EU. Though the margin of victory was small, at 51.9% to 48.1%, the result was still a surprise to most. The opinion polls, including the 'On the day' poll from YouGov, have been found wanting, yet again. They had indeed pointed to a tight race for months, and many had even pointed to a victory for Leave a fortnight or so ago. What appears to have misled many, particularly in financial markets in the past week, was the seeming move back towards Remain in the past week. Parallels were drawn, swiftly and incorrectly as it turns out, with the Scottish referendum where there had been a late swing to the safety of the status quo.

It is now apparent that the EU referendum has been very different. It has essentially been used as a vehicle by much of the UK electorate to deliver a large protest vote on a number of issues that have eroded the trust in political leadership, particularly a decade long stagnation in wages and living standards for the majority and the perceived pressure on public services. The Leave campaign's successful attribution of some of these ills to EU membership combined with the inability of the Remain campaign to articulate the benefits of EU membership have combined to drive this result.

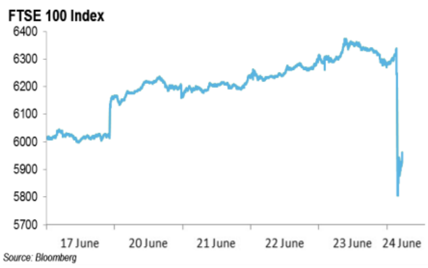
What happens now?

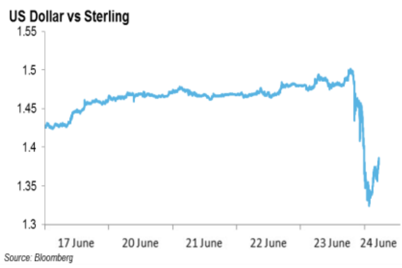
The key issue is whether and how quickly the exit process begins. The relevant mechanism is the invoking of Article 50 of the Lisbon treaty, which sets in motion the two year exit process from the EU. We now know that with the impending change of leader of the Conservative Party, the formal invoking of Article 50 could be a few months away. Additionally, we should remember that the Leave campaign has periodically argued that any decision by the UK electorate to depart from the EU could be used to re-negotiate better terms from the EU rather than automatically trigger an exit process. There has even been mention of a second referendum to decide on a final decision over membership if the EU grants better terms to the UK along the lines that the Leave campaign has wanted.

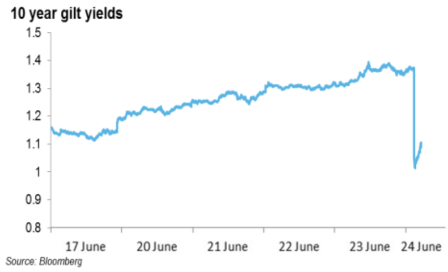
That still looks unlikely. However, it is likely that a period of negotiation with the EU is now likely to begin on the exit strategy. At present, we are working with the view that Article 50 will be invoked sooner or later and that the UK does indeed continue with the exit process it has begun with the referendum result.

Market reactions reflect surprise

At this time, market reactions are broadly playing to our Brexit script with sterling and equities down and gilts are rallying. Sterling and equities had both strengthened in the past week on an expectation of a Remain victory, and today's reactions reflect the negative surprise involved in the result. Sterling and equities are steadying a little at this time, but it is very early to gauge the full extent of market reactions.







The investment outlook

We should be prepared for much more volatility and more price swings over an extended period of time. This largely reflects the uncertainty surrounding this event, which is unlikely to go away quickly. Though the shock to the UK or globally is not of Lehman proportions or likely to trigger a global recession, it is still a fairly negative event. Key uncertainties surround the impact on the European economy – where in addition to the likelihood of at least a brief period of recession in the UK, there may well be a knock to economic growth in Europe as a whole. The key concern would be that the UK decision provides a slippery slope for further tension and fragmentation in the EU and the single currency area. Any setback in the European economy implies further weakness in global growth, which will be transmitted to the US and elsewhere through both trade and financial market channels (e.g. the strengthening of the US dollar). All told, it implies a more testing time for risky assets.

For bonds, our view is that today's events are likely to keep pressure down on global bond yields. We would expect a US interest rate rise to now be deferred till 2017, which will prevent even the very gradual upturn in yields we had earlier allowed for. For UK gilts, however, the implications of the Brexit decision are ambiguous. As allowed for in our Brexit deterministic scenario, we would expect potentially some upward pressure on inflation expectations from weaker sterling, though the likelihood of a Bank of England interest rate cut will work the other way. Today's Bank of England statement was mainly focused around ensuring adequate liquidity to keep the payments system running smoothly, not a commitment to cut interest rates. However, if the economy weakens as we expect, this becomes more likely. All told, these influences should in time steady gilt yields after the large knee jerk downward move seen above.

Portfolio adjustments?

Some damage to portfolio values is inevitable from today's setback in markets. The combined impact of falling gilt yields and declines in equities and other risky assets will, of course, pressure DB pension funds at an already difficult time. For defined contribution (DC) schemes many of the same issues apply, although the impact on individual members will depend on their time horizons; given the majority of DC savers are able to take a long term view this should be reflected in the strategy. However, a portfolio that has diversified its risks reasonably well should be able to bear the brunt of these market actions. Further market adjustments may well give rise to some opportunities in time, if markets overshoot on the downside, but there is no cause for any immediate portfolio adjustments.

Pensions implications of the UK leaving the EU

24 June 2016

Summary

- Impact on sponsor covenant will vary according to the employer's individual business outlook
- Limited immediate legislative impact where EU requirements are written into UK Law
- Provisions relying on decisions in the European Court might no longer apply

On 23 June, the UK voted to leave the European Union (EU). The referendum result will have wide implications, but many of these will depend on what replaces EU membership and the terms that the UK is able to negotiate. The result may trigger a withdrawal period of two years over which the UK would negotiate its terms of exit – although even the mechanism which will be used for withdrawal is in doubt. In this paper we consider some of the potential pensions implications of 'Brexit'.

Sponsor covenant

Aside from the general effect on investment markets, the most significant impact for many schemes will be the impact of Brexit on the scheme sponsor's covenant. This will clearly vary widely from scheme to scheme, depending on the employer's business and its interaction with customers and suppliers within and outside the EU. The medium and longer term implications here are likely to depend on what might replace EU membership, for example if the UK joined the European Economic Area (EEA) or negotiated a bespoke agreement with the EU or member states.

Trustees can consider the possible impact on their employer covenant and whether steps can be taken to mitigate any material risks identified.

Legislative change

Many of the EU requirements that are most significant for pensions have been incorporated into UK legislation. The Pensions (IORP) Directive and EU anti-discrimination requirements, for example, have been incorporated into UK Acts of Parliament. These Acts would remain in place and it is not clear that there would necessarily be calls for change in these areas.

Of course, over time, there is likely to be some divergence: the revised Pensions Directive is expected to be finalised in the near future. Whether or not the UK will need to implement the new Pensions Directive may also depend on the timing and terms of the UK's exit and, crucially, whether the UK remains in the EEA whilst outside the EU (like Iceland and Norway). However the Brexit vote may mean that the UK does not implement the revised Directive. This would mean, for example, that the additional requirements on governance and disclosure would not need to be incorporated into UK legislation.

Reliance on European Court judgments

The UK may no longer be bound by ECJ judgments such as Test-Achats (in relation to sex-differentiated insurance premiums) and it is possible that other court interpretations of equal treatment legislation could be ignored (so the legislation concerned would fall to be re-interpreted under UK law).

Similarly recent rulings on how pension schemes should deal with recovery of VAT on their costs could also possibly cease to be directly relevant.

A UK court might come to a different view from the EU court in relation to the Transfer of Undertaking (Protection of Employment) Regulations (TUPE). However revised views that seek to lessen the interests of members may not be welcomed.

Other implications for pensions

There are a number of specific areas which could be affected by the referendum result.

- Cross-Border schemes may be impacted, although (if the UK did not join the EEA) this may simply require them to set up a non-EEA section.
- The risk of an EU institution deciding that the Pension Protection Fund provides inadequate protection should be removed.
- Although the proposal for a 'Holistic Balance Sheet' for scheme funding is not expected to be included in this year's updated Pensions Directive, it is still being considered and may be added in future. Brexit will mean that the UK would not be required to incorporate this into its funding legislation.
- The prospect of a requirement to equalise for unequal guaranteed minimum pensions may become less likely (although the arguments that have been put forward to justify such equalisation may rely on UK legislation rather than EU interpretation).
- There will be potentially complex implications for data security.
- The direction of any future pension reforms, for example the review of pensions taxation that was reported to have been put on hold in the run up to the referendum, might depend on the outcome of any political reshuffle that follows the referendum result.

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