Brexit update for pension schemes

September 2018

Willis Towers Watson

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Whilst a week is a long time in politics, two years is proving to be a very short time for dealing with the almost unfathomable complexities of Brexit. No doubt part of the complication arises from the fact that many of the issues are bound up with technical and legal questions, but 'illogical' decisions might be taken, or forced, by overarching political influences.

Over the summer of 2018 the UK Government published, first, its White Paper "the future relationship between the United Kingdom and the European Union ["the EU"]" and then a series of 'technical notices' concerning the effect of a no deal Brexit – including one on banking, insurance and other financial services . We comment on each of these below. The remainder of this paper then covers some other elements for trustees and sponsors of pension schemes to consider including, importantly, the investment implications.

Timeline

As shown below, several key dates still lie ahead of us. There are other dates that may come into play. For example, there is a meeting of the European Council scheduled for mid-December and this may become important if, as appears likely, agreement is not reached during the October summit. As at the time of writing this seems a real possibility as, indeed, is a request to delay the two-year window afforded under Article 50 – although it should be noted that this requires all 27 remaining Member States to agree to a longer period

June 2016	March 2017	6 July 2018	18/19 October 2018	29 March 2019	31 Dec 2020
UK votes to leave the EU in a referendum	Article 50 triggered by the Government, formally setting the two year Brexit deadline	Government makes the last formal statement of UK's negotiating position in Chequer's agreement	The deadline for completion of negotiations (set by EU negotiator) to provide member states sufficient time to approve any deal	The date, specified under Article 50, that the UK will leave the EU (absent any agreement to postpone)	End of expected transitional period

Deal?

Amongst other things, the White Paper (often referred to as **"the Chequers plan"**) points out that, in 2017, services made up 79% of total UK **"Gross Value Added"** – worth £1.46 trillion and dwarfing that of Food and Drink manufacturing (the UK's largest manufacturing sector) which accounts for £27.8 billion.

The UK seeks to build a new Free Trade Agreement based on the World Trade Organisation's **"General Agreement on Trade in Services"** to ensure that **"service suppliers and investors are allowed to operate in a broad number of sectors without encountering unjustified barriers or discrimination, unless otherwise agreed"**.

Amongst specific proposals, the UK wants a system that commits to:

- guarantee that foreign service providers are treated the same as local providers (with any exceptions kept to a minimum)
- the free and timely flow of financial capital for day-to-day business needs
- deep market access with no restriction on the number of service providers from one country that can operate in another

The UK is also seeking an ambitious system for some mutual recognition of professional qualifications, including, among many others, those of accountants, actuaries and lawyers.

The main pillar of the UK proposal is for **"a new economic and regulatory arrangement for financial services"** with treaty-based commitments designed to ensure transparency, financial stability and promote cooperation.

The two parties would have autonomy over decisions regarding market access, but subject to a structured consultative process and any decision to withdraw equivalence would be subject to a formal timetable.

This proposal seeks to improve on the existing **"third country equivalence"** provisions and makes the case that at the end of the implementation period (31 December 2020) the UK and EU systems will be identical and reciprocal recognition should be assured. In effect, the UK appears to be proposing a form of the existing passporting regime for the provision of services across borders in all but name.

The UK/EU agreement would set out a "shared intention to avoid adopting regulations that produce divergent outcomes" and commit to a framework of regulatory/supervisory cooperation. Key to this would be the ability to "comment on each other's [regulatory] proposals at an early stage". This would provide the voice to influence developments and is not dissimilar to the arrangements in place for those countries in the European Economic Area.

In summary, the UK is proposing a bilateral Treaty with the EU to implement an ongoing and long-lasting single-market style supervisory regime; albeit with a get-out clause (a "structured withdrawal process") exercisable by either side should divergence be considered necessary in any given area.

It remains to be seen whether the EU agrees to this proposal. If it does then, in practice, we would expect financial services institutions to remain subject to EU-wide regulatory and supervisory rules, albeit that the UK Government chooses to replicate them.

[1] The future relationship between the United Kingdom and the European Union.
[2] How to prepare if the UK leaves the EU with no deal
[3] Banking, insurance and other financial services if there's no Brexit deal

Or, no deal?

A few weeks after the White Paper, the Government published the first tranche of technical notices setting out "information to allow businesses and citizens to understand what they would need to do in a 'no deal' scenario, so they can make informed plans and preparations".

One of the technical notices covers banking, insurance and other financial services. In essence, the Government intends unilaterally to permit entities from the European Economic Area (EEA) to provide services to the UK (under the existing 'passporting' provisions) for three years post Brexit. This will allow them time to apply for regulatory approval from the relevant UK authorities.

Regarding the provision of services by UK-based entities to EEA based individuals, the Government is **"committed to working with EU partners to identify and address [the risk of not being able to service these contracts]"**. Included in this group will be pensioners who have retired to other parts of the EU who are in receipt of annuities from or hold personal pensions with UK-based insurers. In July[4], Huw Evans, the Director General of the Association of British Insurers, advised the **"Exiting the European Union Committee"** when questioned about the consequences for pensioners, **"if UK citizens retire to an EU country and they have an insurance-based pension that is paid to them in the domestic bank account of the country in which they reside, that may also be deemed illegal"**. However, he went on to note **"not least to avoid panic"**, that there was unlikely to be a blanket risk across all 27 Member States because each country of the EU has slightly different arrangements and that it **"is a classic issue of the type that requires regulators with political blessing to sort ...out themselves and put in place the types of arrangements that are perfectly common"**. Furthermore, providers (and occupational pension schemes) typically pay pensions into a UK account leaving individuals to arrange any necessary cross-border payments.

[4] Exiting the European Union Committee Oral evidence: The progress of the UK's negotiations on EU withdrawal, HC 372 Tuesday 24 July 2018

Implications for those running or sponsoring pension schemes

Given the uncertainty regarding the outcome of negotiations, it is impossible to predict exactly what action is required and by when. However, in some areas there are actions that can be taken – particularly in relation to considering the investment implications.

Legislation

We do not expect any significant change in relation to legislation affecting pension schemes in the immediate aftermath of Brexit – irrespective of whether there is a deal or no deal. However, Brexit could lead to divergence in the future; with such divergence being likely to be more significant, more quickly under a 'no deal' scenario. The Government has stated that it would still be possible to send personal data from the UK to the EU.

Data transfers from the EU to the UK should be permitted although, in the short-term, these may need to be explicitly provided for in contracts between data controllers and processors. The EU allows the free flow of personal data to countries outside the EU provided that the European Commission is satisfied that adequate protections are in place. The UK has, in the main, replicated the requirements of the General Data Protection Regulation in the Data Protection Act 2018, so one might expect all parties to be satisfied that this affords adequate protection.

The UK is committed to implementing the requirements of the IORP II (or Pensions) Directive and further detail is available in a separate publication.

Actions

None (immediately)

State pensions

The UK is currently included in EU-wide legislation on the co-ordination of social security schemes, which will cease to apply on Brexit. As set out in the Chequers plan, the UK is expected to incorporate some of these measures into its domestic legislation including regarding pension entitlements and to ensure that people only pay social security contributions in one country at a time, but this will be effective only if other EU countries reciprocate. The UK also has existing bilateral agreements with other (non-EU) countries, so there is a model for a future arrangement even if continued inclusion in the co-ordination legislation is not possible. Further, some bilateral agreements with EU countries that pre-dated the UK's entry to the European Economic Community remain; these may apply in the event of no-deal, so there could be some reduced degree of co-ordination.

In the longer term, bilateral agreements may need to be made, assuming an EU-wide agreement cannot be reached; failing which UK nationals living in the EU may be subject to any local legislation of the relevant Member State including any EU directives on the status of third-country nationals. Whether the UK Government uprates State pension payable to individuals living in the EU appears to depend on whether the UK and EU agree to continued reciprocity.

Actions

None (immediately)

Sponsor covenant (for defined benefit schemes)

Changes to any given sponsor's covenant will be affected by many different elements. These include the following

i. the company's reliance on cross-border suppliers and/or customers

ii. the ability (if at all) to change to domestic suppliers and/or customers

iii. tariffs affecting the price and ease of movement of goods (both components and finished). Sponsors with complex 'just-in-time' supply chains or those trading perishable goods across borders may be particularly prone to adverse disruption, which simple stockpiling can only temporarily alleviate

iv. the effect of Brexit on the value of £GBP against other currencies will affect the price of components, services and finished goods noting that this can potentially be positive

v. group sponsors may have the ability to change their European operations base or operate from dual hubs to retain EU single market (and UK) access – albeit with increased costs. Certain sectors, such as financial services providers, airlines and pharmaceuticals may be particularly affected by relevant supervisory approval requirements and the removal of existing access rights.

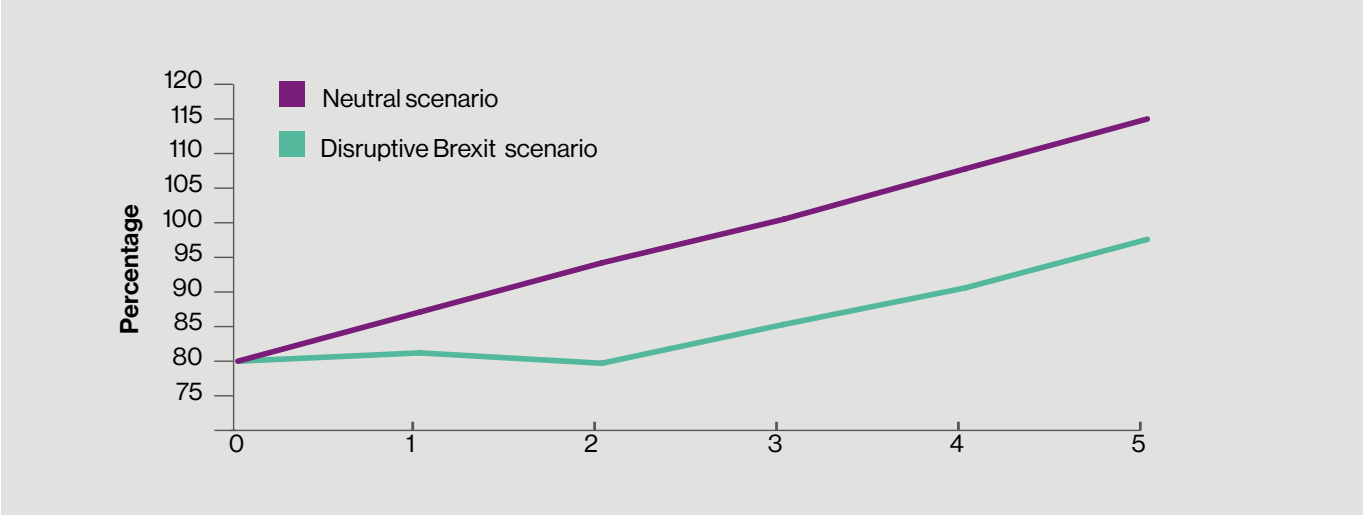
Any trustees with an existing group/parental guarantee from one or more entities in the EU will also need to consider the effect of Brexit on the ability to enforce guarantees, including those used in managing levies under the Pension Protection Fund.

Actions

Trustees should continue to be aware of the sponsors' assessment and contingency plans for Brexit and review their own integrated risk management plans and triggers.

Investment implications

Effects on funding level



We have used our Disruptive Brexit scenario to illustrate the uncertainty around the impact of Brexit on the funding position, with the above graph showing the 5-year funding level projection based on a neutral and disruptive Brexit scenario for a typical UK scheme.

The disruptive Brexit scenario has a reasonable impact on the scheme. It is expected that the UK will experience significantly lower growth in years 1 and 2 pushing down asset returns and causing the funding level to fall marginally. The UK economy recovers in year 3, and the relative strength of the global economy helps to recover the losses for the scheme through higher return seeking asset returns and by the end of the five year period the funding position is expected to be above that in year 0 at 95%.

Full details on the disruptive Brexit scenario are available on request from your normal Willis Towers Watson consultant.

Foreign exchange and liquidity

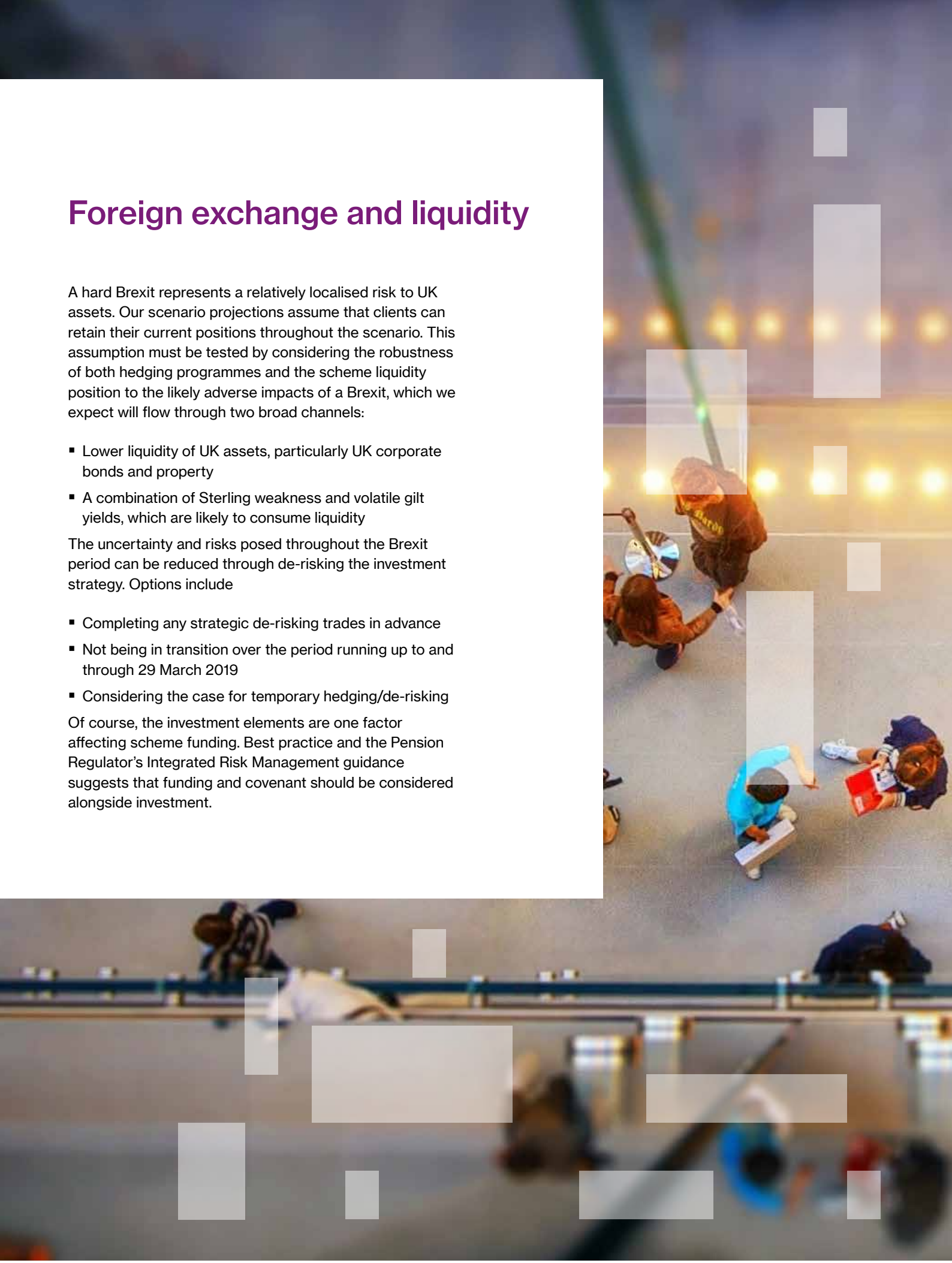
A hard Brexit represents a relatively localised risk to UK assets. Our scenario projections assume that clients can retain their current positions throughout the scenario. This assumption must be tested by considering the robustness of both hedging programmes and the scheme liquidity position to the likely adverse impacts of a Brexit, which we expect will flow through two broad channels:

- Lower liquidity of UK assets, particularly UK corporate bonds and property
- A combination of Sterling weakness and volatile gilt yields, which are likely to consume liquidity

The uncertainty and risks posed throughout the Brexit period can be reduced through de-risking the investment strategy. Options include

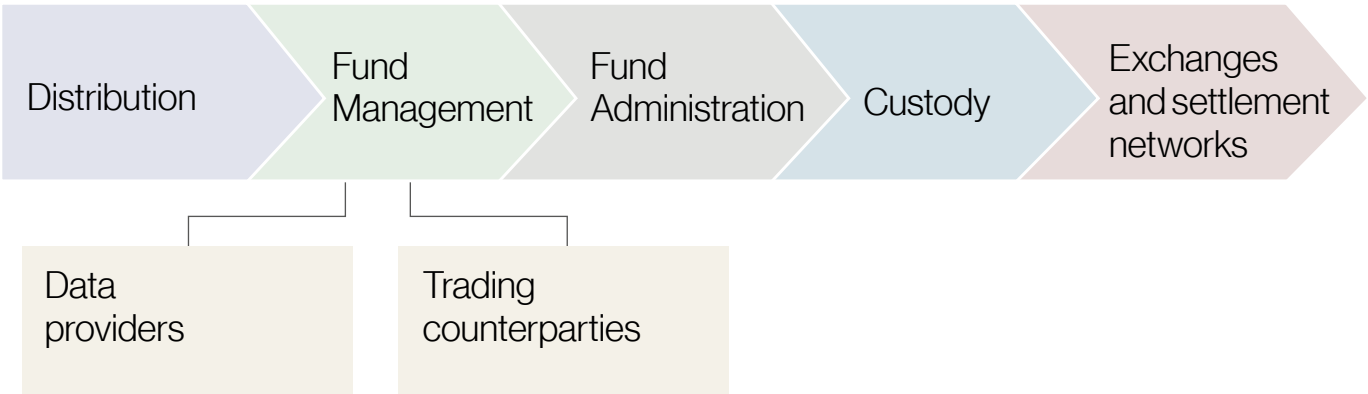
- Completing any strategic de-risking trades in advance
- Not being in transition over the period running up to and through 29 March 2019
- Considering the case for temporary hedging/de-risking

Of course, the investment elements are one factor affecting scheme funding. Best practice and the Pension Regulator's Integrated Risk Management guidance suggests that funding and covenant should be considered alongside investment.



Operational implications for investment

There is a complex supply chain for investment management that is often cross-border. Data, money and intellectual capital flow through this supply chain, with – for example – assets being held in Luxembourg or Dublin, but with key decision-makers in London. The components of a typical investment management supply chain are illustrated below



Where the entire supply chain is under UK law, there can be greater certainty that it will be robust to whatever form Brexit takes, although even here there may be unintended consequences that everyone has missed.

Similarly where the entire supply chain is outside the EU (eg a US manager using a Cayman-domiciled fund), there should be a lower risk. However, where large parts are in different EU jurisdictions and therefore currently governed by EU law, there is considerable uncertainty.

If investment managers fail to prepare properly for Brexit, or their mitigating actions are not completed in time, or if Brexit takes an unexpected form at the last minute, there is a risk that their supply chains temporarily fail.

This could impose additional costs on investors. For example; opportunity costs whilst a fund amends its arrangements, transaction costs if UK investors instead switch to alternative arrangements to avoid these opportunity costs, reduced liquidity whilst custodians/ administrators are replaced and more generally significant governance costs involved with navigating a pension scheme through the Brexit period.

Actions

Given the uncertainty and complexities involved with the Brexit process, clients should focus on assessing how robust and comprehensive their managers planning appears to be, rather than attempting to second guess whether they have the right plans in place. The Financial Conduct Authority has encouraged the firms it regulates to review their supply chains in this way and we suggest that pension funds do the same.

Any attempt to opine on whether plans are correct would require detailed knowledge of a manager's operations, the legal aspects of Brexit and perhaps more insight into the final shape of the Brexit deal than is possible. Ultimately, managers are best placed and indeed incentivised to solve any problems that Brexit brings, but the priority attached to these preparations and their quality may vary across different managers, necessitating a monitoring approach.

Willis Towers Watson can help clients develop an approach to monitor managers and prioritise which represent a larger risk in the first instance.

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