Willis Towers Watson

No deal Brexit special

September 2019

Although not inevitable, recent events indicate that the UK's departure from the European Union without a deal has moved from being a possibility to being highly plausible. Last month, Michael Gove – the minister in charge of no-deal Brexit planning – sought to allay concerns about consequential disruption following a leaked Government report on its preparations for no deal; referring to such disruption as mere "bumps in the road". Quite how bumpy the road will be for trustees and sponsors of UK schemes will depend on their unique circumstances.

To date, sponsors and trustees have had to contemplate a raft of possible outcomes – no deal, Theresa May's oft-rejected deal, another hypothetical deal, a second referendum or, even, no Brexit. Perhaps unsurprisingly, particularly in light of the experience of the 'postponed Brexit' of 29th March, many have been unwilling to take decisive action. Indeed, in the absence of certainty of any deal it has been difficult to see what actions to take. Now, however, the Government is urging businesses to plan for no deal.

In this paper, Willis Towers Watson sets out some comments on potential issues together with, where possible, some concrete measures that we consider sponsors and trustees could and should be taking. In broad terms, they divide between

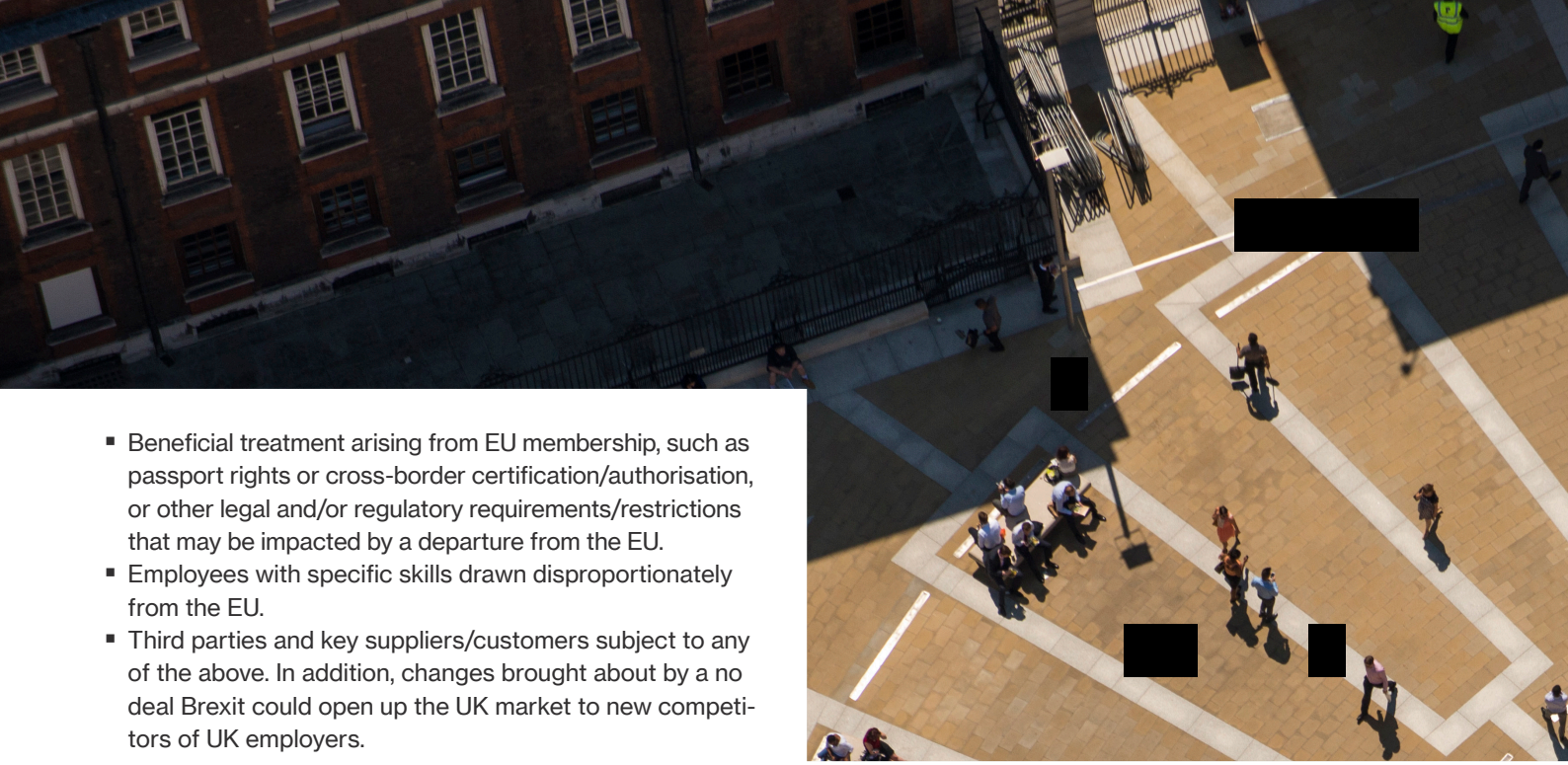
- actions that trustees of UK pension plans and domestic sponsors should be taking and
- wider considerations for multi-nationals

These overlap, of course, in the cases of trustees of UK pension plans where the sponsor is a subsidiary of a multi-national or is a potential acquisition target.

Questions that trustees should ask their sponsor

It's almost all to do with the covenant. This may relate to the strength of Sterling relative to other currencies - for example, manufacturing businesses benefit from cheaper exports of finished goods, but may incur higher input costs on imported raw materials – or wider issues. Trustees need to consider, in addition to any impact from the weakening pound, how dependent the sponsor is on:

- Supply lines from the EU – and whether they are particularly time sensitive; either because they involve perishable goods, whether food, medicine or otherwise, or because the UK company is operating a just-in-time system with no additional stock-piling capacity. Furthermore, the introduction of tariffs on certain goods could materially increase input costs.
- Customer lines within the EU – similar issues on time sensitivity and tariffs (increasing the relative costs to customers) apply.



- Beneficial treatment arising from EU membership, such as passport rights or cross-border certification/authorisation, or other legal and/or regulatory requirements/restrictions that may be impacted by a departure from the EU.
- Employees with specific skills drawn disproportionately from the EU.
- Third parties and key suppliers/customers subject to any of the above. In addition, changes brought about by a no deal Brexit could open up the UK market to new competitors of UK employers.

Whilst Brexit will no doubt provide opportunities for some employers, where any of the above are potentially problematic, trustees need to ask their sponsors about their contingency plans for a no-deal Brexit.

Weakening Sterling

Last year, in our publication, "Brexit – an update for pension schemes[1]" we highlighted the potential for "Sterling weakness and rising gilt yields to consume liquidity". The potential actions to manage this are unchanged, for example:

- Retain some exposure to overseas currencies (USD especially) to provide protection against a fall in Sterling.
- Manage the amount of leverage used in LDI portfolios to ensure that the Scheme has enough capital to withstand large shocks to interest rates and inflation.
- Ensure that currency hedging and repo positions are not due to roll or settle around the end of October to minimise the risk of a call on liquidity at potentially the worst time.

Of course a weakening of Sterling is a double-edged sword and can bring benefits. Assets priced in Sterling, including shares, can look cheap. As at the time of writing, hospitality and brewery company, Greene King, has recently been sold to a Hong Kong-based conglomerate. Further acquisitions of historically cheap UK businesses may follow.

For other multi-nationals with existing UK subsidiaries, costs denominated in Sterling – such as buyout costs or 'section 75' Employer Debt costs - may seem comparatively cheap and the next few months could represent an historic opportunity to either transact a buy-in/buyout of liabilities or to settle a section 75 debt in relation to a planned restructure.

In addition, multi-nationals may find the weakening of Sterling presents an opportunity to bring forward key strategic negotiations that might arise during the next valuation. For instance, if contingent assets such as escrow accounts or guarantees are likely to be offered to trustees, then these will probably be cheaper in the current environment – and, at the same time, sponsors can also consider the indirect benefits that can be derived from such packaged offers. For example, providing guarantees or additional funding outside the scheme can be made conditional on the sponsor having a greater say in

- investment decisions
- agreements on how discretions operate
- discussions on closure to accrual or
- how funding targets will be set.

Sponsors might also find undertaking liability management exercises attractive as individual member advice costs appear relatively cheaper. In addition, there may be scope to accelerate the current schedule of contributions, if affordable, and at the same time accelerate de-risking to protect against potentially volatile markets.

Of particular note, sponsors preparing for year-end pension scheme accounting disclosures may also want to undertake additional monitoring of positons, especially if preliminary numbers are undertaken around the Brexit deadline.

[1] https://www.willistowerswatson.com/en-gb/Insights/2018/09/brexit-update-for-pension-schemes

Investment matters

UK schemes may be getting to grips with the increased focus on Environmental, Social and Governance matters and changes to their Statements of Investment Principles that come into effect in October 2019. Some may have deferred making the additional changes that are required from October 2020, planning to revisit this in the next 12 months. When doing so, it may be appropriate to seek to address wider concerns as outlined in the table below.

Concern	Steps taken to address these concerns
Lower liquidity of UK assets, particularly UK corporate bonds and property	▪ Reduce exposure to domestically-focussed UK assets and ensure portfolios are highly international and well diversified. ▪ Given the extreme chance that market infrastructure may not function over 31 October 2019 and potential heightened volatility, clients should avoid being in transition over the period, also consider any other factors that could cause a liquidity requirement around this period, e.g. expected liability management exercises, buy-in, large drawdowns from illiquid assets etc.
Uncertainty regarding the path of UK interest rates and inflation could result in significant volatility in the value of the liabilities	▪ Prioritise risk management through hedging interest rate and inflation risks. ▪ Subject to the above point on risk management, small deviations could be made to hedge ratios based on an assessment of current bond prices. For example, we think that shorter-dated and intermediate bond yields (e.g.10-years) are moderately too low. This is not a Brexit-specific view but more a view about near-term upside risks to global yields.

Brexit and other global downside risks are elevated in our view and compounding	▪ Portfolio positioning in relation to Brexit and other downside risks (e.g. US-China trade conflict) could consider tail risk hedges. For example:
	  ▪ equity options can provide downside protection while allowing some upside exposure to be retained;
	  ▪ US Treasury bonds provide good tail hedge characteristics against negative economic growth shocks. However, recent falls in bond yields means they are currently expensive in our view.

Of course, not to do anything on investments in consideration of potential volatility should be a conscious decision. We also refer readers to the comments we made last year regarding Investment operational matters[2].

The road ahead?

With a change in the likelihood of a no deal Brexit, trustees and sponsors should firm up on their planning for such an event. It is particularly important for trustees to understand the potential downsides to the sponsor's business and its contingency planning measures. There is, of course, also the prospect that such a no deal Brexit presents specific opportunities for some.

The aim of this document is to help smooth the potential bumps in the road. Please contact your usual Willis Towers Watson consultant to discuss any of the above. In particular, you may wish to consider the pros and cons of initiating some immediate de-risking activity, triggered by the potential volatility from a "No Deal Brexit" on 31 October and to make use of our newly updated Brexit Scenario modeller.

[2]https://www.willistowerswatson.com/en-gb/Insights/2018/09/brexit-update-for-pension-schemes

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