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UK chooses Brexit: what pension schemes and sponsors need to know now

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The UK has made its choice, and has voted to leave the EU. What does that mean today for occupational pension schemes and sponsors?

Immediate impact – legal perspective

From a legal perspective, nothing has changed as a result of the vote.

The referendum outcome is not legally binding on the UK government, and there has been much speculation about whether and when the government might serve the notice which is required under Article 50 of the Treaty on the European Union to trigger negotiations with the EU about the terms for the UK's exit. It may be some time before there is clarity about the government's intentions and the Parliamentary process which will be followed.

A two-year period is allowed for the exit negotiations (this period can be extended). In the absence of agreement or an extension, EU directives would cease to apply to the UK at the end of the two-year period triggered by the notice. Until that point, current law continues to apply just as it did before the referendum.

In any case, a substantial amount of EU pensions law has already been incorporated into UK legislation, and these laws remain unchanged. In the longer term, we may see alterations in some areas, but much will depend on the framework negotiated for the UK's ongoing relationship with the EU. It is the terms negotiated for exit, rather than the fact of voting to leave, or later actually leaving the EU, which are likely to determine the extent to which other areas of EU law – for example, the new General Data Protection Regulation (GDPR) – will affect UK pension schemes post-Brexit. Under several of the potential models which have been discussed in recent months, the UK is likely to remain bound by EU laws in key areas.

Does leaving the EU mean that equalisation of guaranteed minimum pensions will never become a reality? This is a possibility, since the government's view that schemes should equalise GMPs for the effect of historically unequal state pension ages is based on its interpretation of EU equality laws. The answer remains unclear. What is certain is that reconciling and rectifying GMPs, in light of the abolition of contracting-out and the introduction of the single-tier state pension, is still necessary, irrespective of the Brexit vote.

Immediate impact – market volatility and investment risk

Financial and economic volatility is expected during the negotiation period. This could be a significant issue for schemes – for example:

- Any detrimental impact on the UK's credit rating could lead to falling bond prices and rising gilt yields, with direct implications for scheme funding levels. Within existing investment arrangements, deterioration in a counterparty's credit rating could trigger termination rights.
- The value of collateral posted under derivative or swap contracts could be reduced, leading to margin calls from counterparties. Does the scheme's current investment strategy allow for enough liquidity to meet any such margin calls?
- Conversely, schemes may need to make margin calls in relation to collateral they have received. Schemes should ensure they are monitoring the difference between collateral values and collateralised liabilities to accurately assess their ongoing exposure, and should check their agreed terms as to the frequency of posting and the nature and liquidity of assets permitted as collateral.

The overall investment strategy of DB schemes may need to be reviewed in light of market conditions – for some schemes this may also be appropriate in response to additional monitoring of the employer covenant (see below). We recommend that DB trustees should carry out due diligence in relation to existing investment arrangements to highlight relevant triggers and risk areas, and should actively monitor investment risk to mitigate market volatility.

Trustees of DC schemes should monitor the performance of current investment options and the ongoing appropriateness of the range of options available to members. Trustees may wish to remind members of the importance of reviewing their investment choices, and may also want to provide reassurance about the level of protection applicable to scheme assets (for example, in the event of provider failure).

Immediate impact – sponsor strength

The legal obligation of a scheme sponsor to support its pension scheme will remain unchanged by the vote, but some employers may find that their financial ability to support the scheme in the medium to long term is (or could be) detrimentally affected. This could result from volatility in the financial markets, for example, or in the longer term if the business can no longer rely on free movement of goods, capital or people throughout the EU.

It will be important for trustees to understand how exposed their sponsor and the wider group is to market volatility generally, and to potential changes to trading patterns. Whether a full covenant review is required will depend on the circumstances of the scheme and the employer – the Regulator encourages a proportionate approach – but relevant considerations could include:

- How sensitive are the employer's forecast cash flows and financial performance to market or other changes linked to the exit negotiations?
- Could the group be affected structurally – for example, if part of the business, or even the group headquarters, moves out of the UK in response to the changed circumstances? What is the outlook for the industry and the employer's competitive position within it?
- When might any reporting or funding obligations under existing contingent assets be triggered (for example by a negative change in corporate credit ratings)?
- Could changes to the employer’s or group's business needs have an impact on future valuation negotiations or planned deficit/risk reduction activity? Is the current level of contingent security (including any group company guarantee) adequate to mitigate funding risk where there is a strong perceived threat to the sponsor?
- In view of other uncertainty, is the level of risk within the scheme's investment strategy still appropriate?

Trustees and sponsors should work together within their integrated risk management framework to ensure that funding, covenant and investment risk remain appropriately balanced. In particular, trustees will need to model different scenarios for the scheme’s reliance on the employer over time, capturing investment risk, employer covenant strength and the maturing of the scheme. The Regulator’s guidance is to 'engage early and often' about funding issues.

More frequent or detailed ongoing monitoring of both covenant and investment risk may be appropriate. Where the monitoring process identifies material changes in the covenant or new risk factors, trustees should have contingency plans in place so they can react appropriately. This should be a collaborative process between the trustees and employer, so that both parties are ready to respond quickly if a trigger is breached.

Action Points

	Sponsor	Trustee
Covenant strength/corporate risk analysis	Corporate risk analysis should include impact of risks on pension scheme arrangements	Request information from sponsor/guarantor and review implications for covenant strength – seek additional covenant advice if appropriate
Funding/existing contingent security	Could reporting or funding requirements under existing contingent security arrangements be triggered by detrimental change resulting from Brexit vote?	Is any additional comfort/security required to mitigate investment/covenant risk?
Investment issues	Review strategic issues (e.g. approach to risk) with trustees as appropriate	DB: is the overall strategy still appropriate (in terms of risk, liquidity, etc)? DB: Carry out due diligence on existing arrangements to clarify when termination rights could be triggered DC: monitor performance and ongoing appropriateness of options available for member selection
Communications	Liaise with trustees to ensure that any member communications tie in with wider employer approach	Consider whether/how to communicate with members to provide reassurance

To read more about the implications of the Brexit vote in other areas, including our specialist paper on exit mechanisms, please visit www.allenovery.com/Brexit.

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If you would like to discuss the issues raised in this paper in more detail, please get in touch with any of the contacts above or your usual Allen & Overy adviser.