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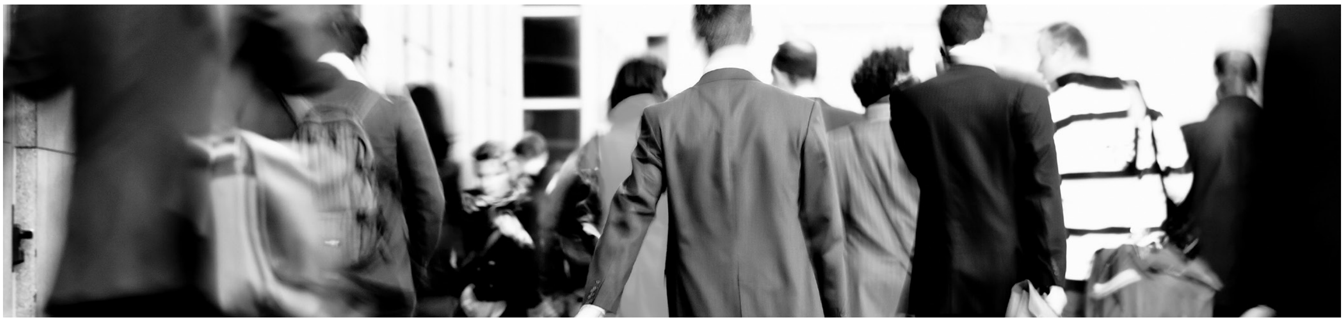

Pensions briefing

Brexit and pensions issues – an update

Briefing

July 2016

Following the UK's vote to leave the EU, there is uncertainty about the effects on the pensions industry. This briefing looks at some of the issues for pension schemes, trustees and employers, including consideration of possible changes to the statutory framework relating to pension schemes and issues relating to potential market volatility.

Introduction

In the referendum on EU membership on Thursday 23 June, a majority of voters voted to leave the EU. This briefing looks at some of the main issues for pension schemes as a result of this vote to leave the EU.

For further information on other legal and regulatory areas relating to the vote to leave the EU, please follow this link to our Brexit site.

The UK's future relationship with the EU

The vote to leave the EU does not automatically trigger the UK's departure from the EU. The UK Government will first need to invoke Article 50 of the Treaty on the European Union and serve formal notice on the European Council. Following this, there will be a two-year period of negotiations between and UK and other members of the EU as to the UK's exit terms and its future relationship with the EU. This negotiation period can be extended |if all the members of the EU agree.

The UK Government will need to negotiate the structure of the UK's future relationship with the EU. The consequences of the UK leaving the EU will vary depending on what type of relationship the UK seeks to establish with the EU. There are various options which are broadly as follows:

European Economic Area (EEA) and the European Free Trade Association

The UK could seek to join the EEA and the European Free Trade Association. In this scenario, the UK would continue to have unrestricted access to the EU market. However, the UK would have to comply with EU regulations and it would still have to allow the free movement of persons, goods and services. The UK would not have a say in creating EU legislation and would therefore not have any influence over making the regulations which it would nevertheless have to adopt.

Customs Union

The UK could enter into a customs union with the EU, which would enable the UK to continue to export goods to the EU without being subject to tariffs or customs restrictions. The UK would still be subject to some aspects of EU trade policy and it is likely that the customs union would apply only to specified industry sectors.

Trade Agreements

The UK could agree sector-specific trade agreements with the EU. The UK's access to each sector of the EU market would depend on the UK negotiating a separate agreement in relation to that sector, and therefore it is likely that the UK would not have unrestricted access to the whole EU market.

Free Trade Agreement

The UK could agree a single free trade agreement with the EU (rather than negotiating a series of sector-specific agreements).

World Trade Organisation Rules

The UK could decide not to negotiate a deal with the EU and could rely on existing World Trade Organisation Rules. This scenario would allow the UK to have full control over its trade policy, but it would have to pay import tariffs on all goods exported to the EU and would have to comply with any other restrictions imposed by the EU.

Possible effect on the UK statutory framework

Areas unlikely to change

Once the UK leaves the EU, the UK Government will not be under an obligation to retain any legislation derived from EU law. However, any UK primary legislation which has implemented EU law will not automatically fall away. For example, the provisions of the Pensions Act 2004 relating to scheme-specific funding and the Equality Act 2010 relating to discrimination will remain in force, unless and until the Government decides to repeal or re-write them. It is likely that it will take the Government years to work through all EU-derived primary legislation to decide which parts to retain and which to repeal.

Practically, it seems unlikely that the UK Government will decide to repeal the relevant provisions of the Equality Act 2010. In addition, the scheme-funding regime under the Pensions Act 2004 is well-established and is generally accepted to be more effective than the previous minimum funding requirement regime at reflecting the actual funding position of defined benefit schemes.

In addition, if the UK negotiates, for example, to join the EEA, it will have to continue to comply with certain EU standards and requirements. These are likely to include much of EU-derived employment law and possibly other areas, such as data protection and the cross-border pension scheme requirements.

Areas of change

Once the UK leaves the EU, the European Court of Justice will no longer have jurisdiction over the UK courts, and UK legislation will no longer need to be interpreted in the context of EU law. In addition, even if in the short-term the UK Government decides to retain much of EU-derived legislation, over the long-term, there will be greater flexibility for UK legislation and case law to diverge from EU law.

Future changes which are being proposed by the EU which would affect UK pension schemes may fall away. For example, it is possible that UK pension schemes may not be required to equalise guaranteed minimum pensions (the Government's view being that it is EU law which drives the requirement to equalise), and the new disclosure, governance and risk assessment obligations which are being proposed by the IORP II Directive, which is expected to be finalised later this year, may not apply to UK schemes.

Some considerations for pension scheme trustees

There has already been some market volatility in the wake of the "leave" vote. This volatility may continue for some time, although it is uncertain for how long. In light of this, trustees may wish to consider the following points.

- Trustees should monitor the risk that these uncertain market conditions pose to the financial stability of their scheme's employer and should consider seeking additional security if the employer's ability to fund the scheme appears to be significantly affected.

- Trustees may wish to consider, in consultation with their investment advisers, reviewing their investment strategy in light of the market volatility. However, trustees would perhaps be advised not to react too quickly to the market volatility and seek to change their investment portfolio substantially in the immediate aftermath of the vote to leave the EU. Trustees of pension schemes are long-term investors and it is possible that after the initial shock, the markets may return to or close to their previous position.

- Trustees may decide to consider how their schemes' hedging arrangements might be affected if corporate issuers had their credit-ratings downgraded (which could affect the value of any collateral posted by schemes).

- If financial institutions are detrimentally affected by market conditions, trustees may wish to examine how exposed they are to particular financial institutions as counterparties to swap transactions.

- If the UK Government's borrowing costs increase as a result of the UK leaving the EU, trustees may wish to monitor the price of gilts and, if these decrease, consult with their investment advisers about the possibility of de-risking by investing to replace shares with gilts.

- It is predicted that some financial institutions which are currently headquartered in the UK may decide to re-locate outside the UK. If this occurs, and if the financial institutions are counterparties to hedging arrangements with pension schemes, the trustees of these schemes may wish to review their documentation and seek advice as to whether the documentation needs to be revised.

Conclusion

There is uncertainty about the consequences of the vote to leave the EU and there are clearly areas of concern for trustees (and scheme sponsors). However, despite this, there are unlikely to be any significant legislative or regulatory changes until the end of the two-year negotiation period. However, market volatility is likely to be an issue for trustees' investment decisions and trustees should be alert to the risks posed to their schemes by the financial instability and seek to prepare themselves if these risks materialise.

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