At 11pm on 29 March 2019, the UK will leave the European Union. For over 46 years, our economic and political landscape has been shaped by being part of the European project. With less than three months to go until exit, the UK faces a period of uncertainty and possible instability. As politicians grapple with the terms of Brexit, investors and businesses are trying to navigate the new geopolitical landscape.

What does Brexit mean for pensions in the UK? How will a no-deal Brexit differ from a more orderly transition? What should trustees and employers be thinking about, discussing or even doing?

In this Insight, we'll explain the legal framework for Brexit and the options open to the UK and examine the impact of Brexit on:

- the legal framework for pensions;
- pension scheme investments;
- scheme funding; and
- employer or sponsor covenant strength.

We'll then consider practical and commercial next steps and actions for trustees to consider.

The impact of Brexit on pensions in five key points
1. How big an impact Brexit will have will depend on whether there is a deal

The impact of Brexit on defined benefit pension schemes seems likely to be more pronounced if there is no deal. If a deal is in place, this will create more certainty which is likely to lead to less market volatility, smaller impacts on the value of schemes’ assets and funding levels, and fewer surprises in relation to the strength of the employer covenant.

2. No change to the current legal framework for pensions

Whether or not there is a deal, there will not be any immediate change to the legal framework governing occupational pensions in the UK, following Brexit. It is unlikely there will be a material change in the short to medium term. Any longer term impact will depend on how the UK exits the EU and how pension policy develops.

3. Scheme investments - Increased risk and volatility

The current political uncertainty means that pension schemes probably face increased volatility in the immediate and short-term. Certain investments will have a higher level of risk under a no deal scenario than if the UK leaves with a deal.

4. Negative impact on scheme funding

It is widely held that anything which damages trade or causes uncertainty weakens trading companies, so that their share prices (and the ratings of the bonds they issue) could fall. So there could be a negative impact on scheme funding if there is a no deal Brexit. Trustees should ensure that they can cope with an increase in their schemes’ deficits.

5. Potential impact on employer covenant strength

Trustees should already be monitoring employer covenant strength and should be prepared to act to safeguard the scheme’s financial position if necessary. Certain types of employer and sectors are potentially more vulnerable to market volatility and the UK’s exit from the EU and therefore be monitored more closely.
Next steps and actions in four key points

1. Talk to professional advisers

Trustees and employers should engage with their professional advisers as an immediate 'next step' and use this to gauge whether more urgent action is required.

2. Dialogue between trustees and employers

Trustees may also want to engage with employers to better understand what steps they are taking in respect of Brexit. Trustees and employers should discuss whether it would be appropriate and sensible to issue a communication to members.

3. Integrated risk management

Trustees can use Integrated Risk Management (IRM) principles to help identify, discuss, prioritise and manage risks.

4. Review investment strategies and options

Trustees and their advisers should consider the suitability of investment strategies, investment options (for defined contribution members) and the terms of current investments (generally, but perhaps in particular swaps and derivatives, and the counterparties to them).

What is the legal framework for Brexit?

The UK has given notice of its intention to leave the European Union under Article 50 of the Treaty for the Functioning of the European Union. The UK’s Article 50 notice expires on 29 March 2019.

The European Union (Withdrawal) Act 2018 (the Withdrawal Act) establishes the legislative framework for the UK’s withdrawal from the EU. The key provisions of the Withdrawal Act are to:

- repeal the European Communities Act 1972;
- preserve EU law as it stands at the moment of exit into UK law; and
create powers for ministers to make secondary legislation to ensure the continued functioning of the UK’s statutory framework.

In order to prepare for a no-deal Brexit, the government is making secondary legislation which will come into force when the UK leaves the EU.

If the UK leaves the EU as envisaged under the Withdrawal Agreement and Political Declaration, there will be a transitional period during which existing and new EU law will apply in the UK. If this happens:

- the preservation of EU law under the Withdrawal Act will be postponed until the end of the transition period (so changes to EU law during that period will apply in the UK); and
- much of the secondary legislation made as part of no-deal preparations will not be needed. This legislation will need to be revoked, deferred and/or amended.

What will happen next?

On 6 December 2018, the Prime Minister summarised her view of what would happen next in respect of Brexit: "There are three options: one is to leave the European Union with a deal ... the other two are that we leave without a deal or that we have no Brexit at all."

Since then, five main options have emerged for what will happen next in respect of Brexit:

1. the UK leaves under the terms of the deal negotiated with the EU as set out in the Withdrawal Agreement and Political Declaration;
2. the UK leaves without a deal;
3. the UK leaves with a different deal in place (e.g. membership of the European Economic Area (EEA));
4. a second referendum is held (following which one of the other four options would still happen); or
5. the UK does not leave the EU.

Pensions legal framework and Brexit

What role does the EU play in the legal framework for pensions in the UK?

The legal framework for pension systems is largely the responsibility of Member States. The EU regulatory framework in respect of pensions is focused on:
establishing an internal market for funded occupational pension schemes;
setting minimum standards to protect pension scheme members;
requiring minimum guarantees on accrued rights in occupational pension schemes in the event of the insolvency of the sponsoring employer; and
anti-discrimination rules.

Pensions in the UK have been affected by developments in this space, both from EU legislation (e.g. Institutions for Occupational Retirement Provision (IORP)\(^1\), European Market Infrastructure Regulation (EMIR)\(^2\) and the Equal Treatment Directive) and decisions of the European Court of Justice (e.g. Grenville Hampshire v The Board of the PPF on the legality of the PPF's minimum levels of compensation).

**Will Brexit change the legal framework for UK pensions?**

The legal framework for pensions in the UK will not be materially impacted by Brexit in the short term. If the UK leaves with a deal in place, transitional arrangements will apply so that EU law will continue to apply.

Even if there is no deal between the UK and the EU, the impact on pensions will be minimal as the bulk of applicable European legislation has already been transposed into UK legislation. This has been confirmed by the Financial Conduct Authority (the FCA), which, following the vote, stated:

"Much financial regulation currently applicable in the UK derives from EU legislation. This regulation will remain applicable until any changes are made, which will be a matter for Government and Parliament."

In addition, the FCA expects that organisations should "continue with implementation plans for [EU] legislation that is still to come into effect." This was reflected by the Department for Work and Pensions (DWP) in its work to transpose the requirements of IORP II into UK legislation.

**Will Brexit change the regulatory framework for UK pensions?**

The FCA is keen to ensure stability in the UK's financial regulation. After the vote, the head of the FCA stated that there would be no "great bonfire of regulations" as many regulations are:
How will pensions policy develop once the UK leaves the EU?

If the UK maintains a close economic partnership with the EU, with high levels of access to the single market, the legal framework governing UK pensions may not see a material change. The UK would still be required to implement most, if not all, of the EU’s legislation covering pensions and employment.

A more complete break with the EU may result in the UK developing its pensions legislation and regulation in a very different way to the remaining 27 member states of the EU.

In such circumstances, a more radical UK government could legislate to fundamentally change the established legal framework for pensions.

There could be positive developments for the UK’s pensions industry. The Pension and Lifetime Savings Association is particularly keen to avoid certain EU regulations, such as a solvency-based regime for pension funds, from applying in the UK.

Pension schemes and risk

Trustees and their advisers will have to consider how Brexit will impact on the scheme’s ability to fund accrued liabilities. In particular, trustees will need to think about:

- scheme investments;
- scheme funding levels; and
- the strength of the employer / sponsor covenant.

In addition, trustees need to consider, with their advisers, whether risk registers need to be updated because of the specific nature of their own business. If they have concerns (such as a cash sweeping mechanism which leaves a UK sponsor with a minimal overnight bank balance every evening, or a sponsor’s supply chain which is heavily reliant on Dover-Calais), they should enter into a dialogue with the sponsor before updating the risk register - contingency planning may already be in place.

Note: We are legal advisers, not actuaries, investment consultants or covenant specialists. From a governance and legal perspective, these are the steps and thought processes which
trustees ought to be going through as they consider the impact that Brexit will have on their schemes.

**Pension scheme investments and Brexit**

**What have been the macroeconomic reactions to the UK’s vote to leave the EU?**

The Bank of England has identified the following macroeconomic reactions to the UK’s vote to leave the EU (all stated in comparison to the likely scenario if the vote had been to remain, rather than in absolute terms):

- slower growth in GDP;
- depreciation of sterling;
- increase in the level of inflation;
- decrease in the level of productivity growth; and
- freezing the growth in real incomes.

**What are the predictions for the macroeconomic impact of Brexit?**

The Bank of England has modelled the impact of Brexit under various withdrawal scenarios on the UK economy. The Bank has made clear that these are possible scenarios rather than predictions. Broadly, the scenarios fit into the two main types outlined above - deal or no deal.

If the UK leaves the EU with a deal, the Bank of England predicts that the macroeconomic impact will be far less pronounced than if the UK leaves without a deal. In particular, the Bank of England's scenarios estimate that unemployment and inflation will both spike (see table below).

<table>
<thead>
<tr>
<th>Economic indicator</th>
<th>What is the peak impact under the Bank of England's scenario for an economic partnership with the EU under the Withdrawal Agreement and Political Declaration?</th>
<th>What is the peak impact under the Bank of England's scenario for an economic partnership no deal with the EU and no transition period?</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP in 2023</td>
<td>-1.25% to -3.75%</td>
<td>-7% to -10.5%</td>
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</table>
How should trustees approach their investment strategies?

Trustees will have set their investment strategies and outlined their tolerance for risk before the terms of Brexit are known. How the UK leaves the EU may represent a material change in the investment and risk landscape. Trustees will need to consider whether:

- their scheme will still have access to the investment opportunities and service providers available in the EU-wide Single Market;
- their scheme's investment strategy is still appropriate in light of developments. (Have trustees discussed this with their investment advisers?); and
- their scheme's investment strategy is still meeting their objectives for risk tolerance. If not, the trustees will need to reconsider either their risk tolerance or their investment strategy.

More specific issues relating to investments include:

- counterparty credit rating downgrades which could trigger termination rights in stock lending or derivatives contracts;
- the value of collateral posted under derivatives and swaps reducing in value resulting in margin calls (from both sides); and
- the range of defined contribution investment options and whether it is still appropriate and
Pension Scheme funding and Brexit

After the vote, the UK's credit rating was reduced, with Standard & Poor removing the UK's last Triple-A rating. Since 2016, the UK's credit rating has stabilised but has not returned to the top tier.

Somewhat counterintuitively, the downgrades reduced UK gilt yields and increased corporate bond yields. Despite the reduction in the UK's credit rating, its sovereign debt is still seen as a safer haven than other investments.

This had a direct impact on scheme funding levels, with aggregate pension scheme deficits rising sharply. Since 2016, however, aggregate deficits have fallen, with rising interest rates being one of the key factors behind the improving situation. In December 2018, the Pension Protection Fund's Purple Book stated that the aggregate funding level of all DB schemes had hit a record high of 95.7%.

What will the impact of Brexit be on scheme funding?

The immediate impact of Brexit on scheme funding may vary markedly according to the way in which the UK leaves the EU.

In December 2018, analysis carried out by risk manager Cardano was published predicting that a no deal Brexit could increase the aggregate buy-out deficit of UK pension funds by £219 billion. Conversely, the analysis says, if the UK left the EU with a deal, the aggregate buy-out deficit could fall by £138 billion.

Employer covenant strength and Brexit

Brexit is an additional consideration for trustees and will be factored into employer-specific, sector and macro-economic forecasts. It does not, in and of itself, necessarily require immediate action from trustees.

Some of the factors which trustees can consider in this respect include whether the employer / sponsor is:
heavily reliant upon smooth supply chains which flow into and out of other EU counties, especially via principal sea routes such as Dover - Calais;
exposed to fluctuations in listed markets and commodities;
exposed to volatility and a longer-term weakening in sterling;
based in or outside of the UK;
moving employees, assets, tax residency, stock market listings or headquarters out of the UK;
operating in a sector or markets that is commonly believed to be vulnerable or exposed to Brexit. Commentators in the financial press have identified these sectors as ones to be aware of:
  a. banking and insurance
  b. other financial and professional services;
  c. manufacturing, especially with large European exports or complex supply chains which cross EU borders several times;
  d. chemicals and pharmaceuticals; and
  e. construction (especially homebuilders).

Pensions and Brexit - next steps for trustees

So, when faced with turbulent markets and an uncertain future, what should trustees do next? What are the practical and sensible steps that those involved with UK pension schemes should consider?

- Prepare to be able to respond quickly
- Scheme specific issues on Brexit
- Integrated risk management
- Engaging with professional advisors
- Dialogue between trustees and employers
- Scheme investments - review and risks
- Due diligence on existing investment contracts
- Communications

Prepare to be able to respond quickly

As we enter 2019, it is still not clear how the UK will leave the EU. Trustees should prepare to be able to respond quickly. This might take the form of agreeing in advance that there can be calls with advisers and/or additional trustee meetings held by video or telephone conference.
Scheme specific issues on Brexit

There are three specific issues that will only apply to certain pension schemes.

Access to financial services and pooled funds

Currently, financial services may be provided in the UK by firms based in other Member States under the passporting regime. In addition, UK pension schemes can access pooled funds that are domiciled in other Member States (e.g. Luxembourg and Ireland).

On Brexit, the passport may fall away, requiring EU-based financial service providers to stop providing services or access to EU-domiciled pooled funds to UK-based pension schemes. This is more likely to be an issue in the event of a no deal Brexit, as transitional provisions will not apply.

Financial service firms are taking steps in line with guidance issued by the FCA. If schemes have EU-based advisers or investments, trustees should contact their investment providers and ask what contingency plans are in place to deal with Brexit and, in particular, a no deal Brexit.

Cross-border occupational pension schemes

EU legislation provides for cross-border pension schemes. These are schemes located in one Member State that have members working and contributing in another.

There are very few cross-border pension schemes (CBSs) in the UK - just 19 in 2016. These schemes will receive guidance from The Pensions Regulator. (Incidentally, we believe that one of the reasons for their being so few CBSs is the nature of the relevant EU legislation. It is possible that once that is eventually disapplied in the UK, there may be greater scope for schemes with a UK and EU member state aspect. The analysis of this issue is obviously at a very early stage.)

Scheme payments to members

Trustees have two options for dealing with payments to members based overseas:

- payment to the member’s UK bank account; or
payment to the member’s overseas bank account.

Many schemes insist on paying pensions into UK bank accounts to avoid administration costs and regulatory burdens (e.g. enhanced anti-money laundering checks). If this applies, any issues arising from Brexit (e.g. transfer fees and fluctuations in exchange rates) will have to be dealt with by the member.

If the scheme does make payments to the member’s overseas bank account, trustees will need to keep an eye on developments and check with their administrators as to whether such payments can continue post-Brexit.

Integrated risk management

Fortunately, there is already a mechanism in place by which trustees can engage with risk in the form of integrated risk management (IRM). The Pensions Regulator has made this a key focus since it published guidance on it in December 2015. Brexit represents a real test for the methodology.

IRM asks trustees to focus on risks in relation to:

- investment;
- funding; and
- employer covenant strength.

It is important to note that IRM is not a panacea or a solution in and of itself. It is a set of tools that enable trustees to identify risks and make better decisions in relation to those risks.

As part of IRM, this should be a standing item on trustee agendas. Brexit doesn’t need to be a separate heading - it can be considered as part of the overarching risks outlined above.

Engaging with professional advisers

Because of the current level of uncertainty, trustees generally do not need to commission covenant assessments, revise their statement of investment principles or attempt to negotiate on increased funding.

It would, however, be very sensible for trustees to engage with their professional advisers to ensure that:
• those professional advisers are monitoring developments and are committed to providing the
trustees with information as needed;
• channels are opened to enable the trustees to take prompt action if this is required.

Employer and trustee engagement

The Pensions Regulator is keen that trustees and employees discuss issues early and often. This does not mean that the trustees need to take precipitative or provocative action such as questioning covenant strength.

It does, however, serve to remind employers that the pension scheme is a key consideration in relation to their planning for Brexit. If the trustees are considering amending their risk register due to Brexit concerns relating to the sponsor (or sponsor group), it would seem wise to us that trustees should discuss that issue with the sponsor first.

Trustees should ensure that they have sufficient information from the employers to enable them and their professional advisers to be able to monitor covenant risk. In cases where the covenant is made up of a group which spans the EU and the UK, especially if there is formal or informal reliance on group companies based in other EU, a specific enquiry of the sponsor group to seek its assurance as to its view on the future working of such arrangements seems sensible.

Suitability of investment strategies and options

As part of their engagement with investment advisers, trustees should consider whether their investment strategies are still appropriate. Trustees will have adopted a certain tolerance for risk when deciding their investment strategy. Does the investment strategy still reflect that risk tolerance in light of current and extended market volatility?

In addition, trustees may need to consider the suitability of the range of investment options that are available for defined contribution members (including those making additional voluntary contributions). Providers should be able to confirm whether the fund selection remains appropriate for various risk thresholds or if any changes need to be made.

Please note our comment above on stock lending and derivative contracts.

Due diligence on existing investments and contracts
Trustees with derivatives or swaps in place may want to ask their legal advisers to confirm whether there is any counterparty risk and ratings downgrade triggers which could become relevant in the short and medium term?

They should also ask their investment managers whether any collateral posted under such contracts has reduced in value because of falls in currency or equity prices such that a call may be made from counterparties.

Does the scheme have sufficient liquidity in its current investment strategy to deal with any such issues?

In the longer term, trustees may need to consider issues around financial services passporting for any non-UK banks and financial service providers.

**Communications**

Finally, we've had reports of a spike in queries from members who are concerned about the safety of their pension savings. Trustees may want to consider issuing a statement to members in order to reassure them that they are taking appropriate steps, monitoring the situation and reminding them that the fundamental system of safeguards and protections remain in place.

Trustees may want to discuss this with the employer to ensure that messages to employees and members are consistent.

**Key contacts**

If you have any questions about the impact of Brexit, please speak to your client service team. Alternatively, you can contact Glyn Ryland and Ian Chapman-Curry who are both members of the Pensions team and [Gowling WLG's firm-wide Brexit Unit](#).

**Footnotes**

[2] European Market Infrastructure Regulation on derivatives, central counterparties and trade repositories
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