What next for UK pensions after Brexit?

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Introduction

On 23 June 2016, the UK voted to leave the EU by 52% to 48%. Whilst Britain, the EU and the rest of the world come to terms with what this might mean going forwards, we look at some of the questions now facing trustees and employers of UK pension schemes.

Key points

- The immediate ramifications of the vote for "Brexit" are overwhelmingly political and economic.
- Trustees should not panic, but continue to monitor investment performance generally, and, in the case of DB, their funding and investment positions in line with their established integrated risk management (IRM) processes.
- Any changes to legislation affecting pension schemes will depend on the terms of the future relationship to be agreed between the EU and the UK and will take some time to filter through.

The immediate aftermath

Funding and investments

Since the result of the referendum was announced, markets have shown significant levels of volatility in response to the uncertainty over the future direction of the British economy. Looking at the legal and political challenges of disentangling a relationship of over forty years, we expect the uncertainty over the final settlement to continue for some time to come.

Although markets are likely to remain volatile as the Government negotiates the terms of the UK's exit from the EU, pension schemes should generally be equipped to weather this latest storm.

Whilst volatility can have a material impact on a DB pension scheme's reported funding position, trustees should consider with their advisers the extent to which changing market conditions affect their longer term view of expected risk and returns, and how this interacts with their funding plans and risk appetite, rather than concentrating on short-term market movements. Trustees should also review their scheme's hedging strategy, including counterparty credit ratings and the scheme's ongoing exposure to derivative and swap contracts against the collateralised liabilities.

To help them navigate these choppy waters, trustees and employers should ensure their IRM plans are up-to-date. IRM is an ongoing process under which risk assessments should be carried out at regular intervals. Trustees should also consider now whether any contingency plans need to be invoked.

Trustees of DB pension schemes, particularly those which are currently going through a valuation process, should take account of TPRs latest funding statement. Trustees need to understand the impact of changes in market conditions since their valuation date and consider whether to take post valuation date experience into account when setting an appropriate recovery plan.

Employer covenant

DB pension scheme trustees should also keep an eye on the strength of the sponsor's covenant. Although the changing trading environment could have an impact on the business of sponsoring employers, much will depend on the relationship ultimately agreed between the nature of the employer's business, including its exposure to EU trade and ability to trade with non-EU countries.

Contingent assets

Contingent asset reporting requirements and funding triggers also need to be checked to see whether these might come into play. Those governed by the legislation of another Member State should be reviewed carefully to ensure they can continue to be enforced.

DC arrangements

Where members are responsible for their investment choices, employers should:

- review investment options, including any default funds, to ensure these remain appropriate
- consider additional communications to remind members of the importance of diversity in their investment choices.

What next after Brexit?

Exit options for the UK

The extent to which UK pension schemes need to comply with EU legislation in the future will depend on a number of factors. These include the nature of the relationship framework agreed between the UK and the EU and the continuing need to deal with the remaining Member States.

There are four existing models from which the UK could draw inspiration in agreeing a new relationship framework with the EU (although, in theory, it could negotiate its own set of terms). With each option, once agreed, it would then be up to the UK government to decide whether, and if so how, to reshape pensions legislation.

EEA membership – "Norwegian model"

Norway, Iceland and Lichtenstein are the existing members of the European Economic Area (EEA), through which they can access the single market. Whilst EEA members retain control over certain policy areas (including fishing, agriculture, security, justice and tax), they have the power to veto the introduction of certain EU laws. To date, however, this power has not been exercised.

The existing pensions directive became part of the EEA agreement in July 2006, coming into effect in the EEA in April 2007. By adopting such a model, the UK is therefore also likely to have to comply with the new directive, which Member States need to adopt by 2018.

EFTA membership – "Swiss model"

Alongside Norway, Iceland and Lichtenstein, Switzerland is a member of the European Free Trade Association (EFTA). Switzerland's relationship with the EU is governed by both the EFTA agreement, and a series of bilateral treaties. Switzerland does not currently need to comply with the pensions directive.

Customs union

Another option is a customs union, such as the model Turkey has had with the EU since 31 December 1995. The Turkish customs union covers all industrial goods but does not address agriculture (except processed agricultural products), services or public procurement. Turkey is not part of the EEA or EFTA.

Free trade model

A further alternative would be for the UK to operate completely outside the EU, on the basis of a free trade deal, like the one which is still under negotiation with Canada – some seven years since negotiations first began. The Canadian deal is set to cover goods and some services, but not financial services.

The default?

If none of these models (or a variation) is used, the default position is that the UK would operate under World Trade Organisation rules, under which tariffs and trade restrictions would apply between the UK and the EU, as currently apply to the rest of the world.

Future considerations

Depending on the exit option ultimately agreed, there will be a number of longer term considerations for UK pension schemes and the pensions industry generally. These include:

Cross-border arrangements

Pension schemes operating cross-border currently need to be fully funded at all times, on a scheme specific, "technical provisions" basis. This will continue to be the case whilst the Government negotiates Britain's exit from the EU and could continue into the future, as the cross-border requirements also apply to EEA members, not just full EU Member States.

TPR and the PPF

Given the focus in recent years by UK legislators and regulators on measures for improving standards for workplace and personal UK pension schemes, it seems unlikely that existing regulatory protections for pension scheme members would be stripped away purely because of their origins in EU law. As such, we would expect that the remits for TPR and the PPF will continue largely unaltered.

Equality legislation

Protections for individuals against discrimination (such as age, sex or disability) also largely stem from EU law. A move away from these would be seen as a retrograde step, and one which the UK Government is unlikely to choose. However, there could be challenges to some existing provisions, such as survivor benefits for same sex spouses and civil partners. Survivor benefits are currently restricted to service from 5 December 2005 (and from 6 April 1988 for contracted-out benefits) (see our Alert for more details). With "Brexit" now a reality, we could see fresh challenges for greater parity, along the lines of the Walker v Innospec case.

Data Protection

Whilst the new General Data Protection Regulation, which will apply to Member States from 25 May 2018, may not apply directly to the UK following its exit from the EU, it will remain relevant for pension schemes and others, wherever data is transferred between the UK and the remaining EU Member States. The UK's Information Commissioner has said that if the UK wants to trade with the single market on equal terms, it would have to prove "adequacy", by showing that UK data protection standards are equivalent to the new EU data protection framework.

Financial sector regulation

The financial sector is subject to heavy regulation by the EU. Pension schemes are mostly indirectly affected by this regulation through their investment activities and dealings with financial institutions, asset managers and insurers. The pace and scope of regulation has picked up in response to the global financial crisis and consumer mis-selling scandals. It seems unlikely that Brexit will significantly lighten the regulatory burden for the financial services sector.

A new pensions directive

A new occupational pensions directive has been in the making since March 2014, with the final text being formally approved on 30 June 2016. The directive will now be published in the Official Journal of the EU and will come into force 20 days later. Member States will then have 24 months to bring the directive into their national legislation. This means that the timetable for implementation is likely to run in close parallel to the Brexit negotiations and the extent to which the UK will ultimately need to comply with the directive will very much depend on its exit terms.

The directive itself is much less prescriptive than earlier iterations and, with its main focus on governance and transparency, is unlikely to mean significant changes for UK pension schemes should its provisions be introduced here (the existing pensions directive is part of the EEA agreement). But the directive no longer contains measures on solvency and there do not seem to be any immediate plans in this respect.

Negotiating the next steps

The much talked about "Article 50" of the Lisbon Treaty provides that "any Member State may decide to withdraw from the Union in accordance with its own constitutional requirements". To trigger the exit process, the UK is required to "notify the European Council of its intention" to leave; it will then have two years to agree its future relationship with the Union.

There is no set form for the notification and, as we tread these unchartered waters, there seems to be disagreement at all levels as to how this should work in practice. Whilst the UK Government views this as a "sovereign decision" for the UK alone, some commentators have suggested that the referendum result is of itself the trigger.

In terms of establishing the UK's new relationship with the EU, it will be up to the EU Council to authorise the opening of negotiations, adopt negotiating directives and authorise the signing of agreements and their conclusion. The new framework will then need to be agreed by the EU Council, acting by a qualified majority, after obtaining the consent of the EU Parliament.

From the date on which the UK's withdrawal agreement comes into force, the EU Treaties will no longer apply to it. But if agreement has not been reached, the Treaties will cease to apply two years after the date of the formal notification, unless the European Council, in agreement with the UK, unanimously decides to extend this period.

It is therefore in the UK Government's interest to ensure that, once the exit process has been formally triggered, agreement on a new framework for its relationship with the EU going forwards is reached sooner rather than later.

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