BREXIT: WHAT NEXT FOR UK PENSIONS?

Following the UK's vote to leave the EU, what's next for UK pensions? Our briefing published on the day after the result considered in general terms the impact of a Brexit on UK pensions. This briefing now takes a look in more detail at the key issues pension schemes and employers should be thinking about both now and in the long-term, pending the UK's formal withdrawal from the EU.

Key issues

- DB scheme trustees to engage with employers to understand impact of Brexit on their business and knock-on impact on employer covenant. In particular, review any agreements in place with 'covenant triggers'.
- Potential increase in DB scheme funding deficits due to market volatility likely to be of more immediate relevance to schemes with triennial valuation dates in the next few months.
- DB scheme trustees to review and consider revising investment strategy.
- DC scheme trustees / providers to review investment options offered to members and default strategies / funds and consider whether changes are appropriate.
- Investment documentation to be reviewed to identify any potential issues which need to be addressed in advance of Brexit.
- Keep an eye out for progress on longer-term issues, including the implementation of IORP II, the scope of the Regulator's powers and the potential for Scottish independence.

INTRODUCTION

There has been no immediate legal change as a consequence of the Brexit vote - the UK remains a member of the EU until it formally exits.

Once the UK has formally exited, the extent to which UK law (including pensions law) will be impacted will depend on the terms of the UK's exit and any agreement reached regarding a future framework with the EU; although the alternative models thought to be under consideration are likely to involve the UK being bound by EU law to some extent. For example, if the UK were to remain in the European Economic Area (**EEA**) and the European Free Trade Area (**EFTA**) then, like other EEA/EFTA states, it's likely the UK would be obliged to accept the majority of EU legislation (with less influence over its formation).

There is therefore a great deal of uncertainty (and speculation) about what this could mean for the future. However, notwithstanding this uncertainty, pension scheme trustees and employers will want to know what issues they should be thinking about - both now, and in the long-term. This briefing covers these issues. In particular, we consider (i) employer covenant; (ii) funding; (iii) investment issues: (iv) IORP II; (v) corporate transactions; and (vi) Scottish independence.

What should we be thinking about now?

There are three key things to be thinking about now: employer covenant, funding and investment issues.

The UK Pensions Regulator has also stated that these are things for trustees to keep a watch over following the UK's Brexit vote and, on 14 July, issued a guidance statement to this effect. This statement emphasises that trustees should be regularly reviewing the circumstances of their scheme as a matter of course and that trustees should remain focused on the longer-term and not be overly influenced by short-term market fluctuations. The Regulator says it will continue to monitor the markets and other economic developments and will provide more guidance to trustees as necessary.

1. Employer covenant

As touched upon in our previous briefing, a key issue for defined benefit (**DB**) schemes following the UK's vote to leave is the effect (if any) that this may have on the sponsoring employer's business; as this will have a direct impact on the employer covenant (the legal obligation, ability and willingness of an employer to fund its pension scheme).

This is something to keep a close eye on in the long term (when the UK withdraws from the EU), but also now and in the coming months, as the market volatility and general uncertainty flowing from the Brexit vote on 23 June is likely affecting some businesses already. The extent to which an employer will be affected will necessarily be sector (and within that, employer) specific.

The issue of employer covenant following the Brexit vote (and subsequent Brexit) is really two-fold: (i) has it had any impact on the strength of the employer's business generally? (For example, has the employer lost custom and/or are they facing significant increased costs as a result of the Brexit vote?); and (ii) has the Brexit vote prompted the employer to consider restructuring its business? (For example, relocating operations to another EU member state in preparation for Brexit).

The regulator expects DB scheme trustees to review their employer covenant to understand how the Brexit vote could affect it.

It's also possible that schemes may have previously entered into agreements with employers which contain triggers that could be invoked as a result of any material deterioration in covenant - for example, a funding agreement which agrees that a deterioration in covenant (typically assessed by reference to agreed covenant triggers) would result in the provision of additional funding or security to the scheme. Such agreements should be reviewed in light of any changes to the employer covenant flowing from the Brexit vote (and subsequent Brexit).

Covenant is not something which will be new to DB scheme trustees (or employer(s)) as trustees are required to assess it as part of their obligations under the scheme funding regime. The Pensions Regulator expects DB scheme trustees to assess the employer covenant as part of an integrated approach to managing scheme risks (which also looks at investment and funding risks). The Regulator's guidance states that, as a minimum, trustees should carry out a full covenant review at each triennial valuation, but should also be monitoring the covenant "regularly" between formal reviews.

The Regulator's Brexit statement published on 14 July says that the Regulator expects DB scheme trustees to review their employer covenant to understand how the Brexit vote could affect it. The Regulator expects trustees to have an open and collaborative discussion with their sponsor and the possible effects on their business. The statement lists a number of example areas for trustees to consider regarding the impacts on covenant, including: currency cost base, reliance on imports and exports (particularly to the EU), plans for investment and the impact on changes in the strength of sterling and interest rates.

Trustees may well want to open dialogue with the scheme employer(s) to gain an understanding of how the Brexit vote (and subsequent Brexit) is likely to affect their business and therefore the covenant offered to the scheme.

2. Funding

It is evident that, so far, the Brexit vote has resulted in market volatility. The short term has seen a fall in bond and gilt yields in particular (asset types which pension schemes will typically be invested in to some extent). Indeed, some reports have suggested an increase in UK DB pension scheme deficits "overnight" as a result.

However, this is only the immediate impact and the longer-term impact remains to be seen. Indeed, for many schemes this "overnight" increase in deficit will not have an immediate practical impact (e.g. those with triennial valuation dates some way away).

Again, the general message is for scheme trustees to take a longer-term view here. The Regulator's Brexit statement published on 14 July says that DB scheme trustees should consider how market volatility has impacted their scheme's funding position and investments, but notes that trustees should not be overly focused on short-term market movements. The statement lists a number of example areas for trustees to consider in this regard, including: interest rate and inflation risks, concentration of investments, currency exposures and managing liquidity and counterparty risks.

3. Investment issues

Investment strategy

The impact of the Brexit vote (and subsequent Brexit) on the financial markets may also be cause for DB scheme trustees to review their investment strategies, as this plays an important part in determining a scheme's funding position. Trustees should consider obtaining specialist advice from their investment advisers to help them identify risks and potential opportunities.

Defined contribution (**DC**) schemes and providers should consider the investment options made available to members (as well as reviewing their default investment strategy and funds) in case these are no longer appropriate. This is also an action point identified in the Regulator's Brexit statement published on 14 July, in which it says that DC scheme trustees may consider it appropriate to make changes to investments and flags that poor value for members is a key risk that trustees need to manage.

Investment documentation

The Brexit vote itself has not triggered any immediate legal changes and so investment documentation (for example, investment management agreements (**IMAs**)) currently in place should be unaffected for the time being. However, it remains advisable to review investment documentation sooner rather than later in case there are issues which need to be addressed well in advance of Brexit.

Key things to look out for could include the following:

- In an IMA, how are the investment strategy / policy and investment restrictions drafted? In particular, how are "European" investments defined and will Brexit change this?
- How are Material Adverse Change (**MAC**) clauses drafted? These are clauses which could, for example, allow the investment manager or provider and/or the trustee to terminate the agreement on the occurrence of certain events. For example if there's a collapse in sterling or political turmoil which has a significant impact on market conditions, could this change a provider's obligations?

Collateral

If a scheme has entered into financial contracts which involve the posting of collateral (for example, certain types of derivative / swap or buy-in contract), these may need to be reviewed in light of the market volatility flowing from the Brexit vote. There could be issues for scheme trustees and/or the bank/insurer counterparty where they have posted collateral in the form of UK bonds or gilts and the issuers of those bonds are then downgraded/their creditworthiness is affected, meaning that the value of the collateral is reduced. This could result in the relevant counterparty issuing margin calls on the other to post more collateral.

Market volatility could also impact on a bank/insurer's ability to meet its regulatory and other capital requirements meaning it has the ability to/is required to terminate the contract.

Passporting issues

Generally, we would expect passporting/licensing issues to be more of a primary concern for investment managers/fund providers/insurers as trustees will be only one of many types of customer with whom they contract.

We expect that this issue will therefore be high on the agenda for some providers, who will already be thinking about reviewing their licensing positions and analysing the fund structures they offer (are these dependent on the UK's current rights as an EU member state?)

However, it's still something for scheme trustees to be aware of so they can ask the right questions and monitor any action taken by the financial institutions with which they have contracted.

A key question will be *"on what basis is the fund/investment manager/provider operating?"*

- If it's a UK manager/provider which invests in/offers solely UK funds, this is unlikely to be an issue.
- If it's a UK manager/provider which invests in/offers EU funds, are they relying on passporting to do this?
- If it's a non-UK (e.g. Luxembourg, Irish) manager which invests in/offers UK funds, are they relying on passporting to do this?
- If it's a non-UK (e.g. Luxembourg, Irish) manager which invests in/offers EU funds, are they relying on passporting to do this?

Also important to ask will be "in what type of funds are the scheme assets invested?"

For example, UCITS (or 'undertakings for collective investment in transferable securities') can only be established (or 'domiciled') in the EU. For those currently relying on passporting, this is not an immediate concern as it will continue to be permitted under current arrangements until the UK has withdrawn from the EU. However, after this, it will depend on the terms the UK manages to negotiate with the EU for the passporting of financial services.

Looking further ahead, if the UK were to lose access to the single market for financial services, firms might need both a UK hub and an EU hub in order to operate across the UK and the EU. For some types of fund (like the UCITS mentioned above), unless there's an agreement that these funds can continue to be established in the UK, they might need to be migrated to an EU member state.

Looking further ahead, if the UK were to lose access to the single market for financial services, firms might need both a UK hub and an EU hub in order to operate across the UK and EU.

Both of these issues could result in less competition. If the UK loses access to the single market for financial services, it's also possible this would trigger force majeure provisions in current contracts.

However, these are longer term issues and the extent to which issues arise will depend on what agreements can be put in place with the rest of the EU.

WHAT OTHER ISSUES SHOULD WE BE AWARE OF LONGER-TERM?

4. IORP II

The revised draft text of the IORP II Directive was published at the end of last month. The text still needs to be formally approved by the European Parliament (which is expected to happen later this year); following which it will be published in the Official Journal and will officially enter into force. Member states will then have 24 months to transpose the Directive into domestic law.

Timing wise, this could therefore run very closely to the timetable for the UK to negotiate its withdrawal from the EU (depending on when notice under Article 50 of the Treaty on European Union is given) and raises questions over whether or not IORP II would need to be implemented into UK law. The extent to which this will be the case will depend on the terms of any future framework agreed between the UK and the EU. For example, if the UK were to remain an EEA state, then IORP (and IORP II) would likely continue to apply. Even if the UK were to exit the EU and EEA completely, it's certainly possible, given the timing, that IORP II could be required to be implemented, even if only for a very short time.

If IORP II does have to be implemented, this raises the question of what this means from a UK pensions perspective. Based on the latest draft of the text, it would seem that some of the key problems identified with earlier versions have been addressed, such that IORP II may well not cause significant issues in practice. In particular:

Funding

The previous draft replaced the requirement for cross-border schemes to be fully funded at all times with a requirement for full funding "at the moment" the IORP "starts operating a new or additional scheme"; which raised new concerns over whether this would catch domestic schemes in circumstances where, for example, there is a scheme merger or sectionalisation. This issue has gone away in the latest draft which returns to the requirement for cross-border schemes to be fully funded at all times, but does now contemplate the scenario where this is not possible; stating that if this condition is not met, the member state must promptly intervene and require the IORP to draw up appropriate measures and implement them without delay "in a way that members and beneficiaries are adequately protected". This would seemingly permit cross-border schemes to have deficits and address these by putting in place recovery plans.

Solvency II

Recitals to make clear that the further development of a solvency models is not realistic and no quantitative capital requirements should be developed at an EU level in relation to IORPs have been retained in the latest text.

"Fit and proper" requirements

The latest text does not impose a requirement for all those running schemes to have "professional" qualifications and instead requires such persons to have "qualifications", knowledge and experience which are "collectively adequate", with those performing key functions (risk management, internal audits and actuarial functions) to have adequate knowledge and experience and "where applicable" adequate professional qualifications.

Pension benefit statements

Whilst the requirement for schemes to draw up a pension benefit statement remains, much of the prescription around its form and content remains absent from the latest text.

5. Corporate transactions

If the long-term impact of Brexit is to increase the magnitude of DB scheme deficits whilst simultaneously weakening the strength of sponsoring employers, the consequences are difficult to predict.

It's possible it could make pensions schemes more of a stumbling block to corporate transactions and restructurings (where a UK DB scheme is involved). The British Steel Pension Scheme has already been one of the biggest issues on the sale of Tata Steel's UK steel business and this may be a trend that continues.

There could also be a reform of the powers given to the UK Pensions Regulator and/or the Pension Protection Fund (**PPF**). On stepping down from her position as chair of the PPF recently, Lady Judge gave a statement suggesting the Pensions Regulator should be given powers to block corporate deals so that employees and pensioners are better protected in the wake of events such as the recent collapse of BHS.

There's also a question around the potential impact of Brexit on the ability of the UK Pensions Regulator to exercise the powers it currently enjoys; in particular its 'moral hazard powers' pursuant to which the Regulator can issue a Contribution Notice (**CN**) or Financial Support Direction (**FSD**) to require entities/individuals other than the scheme employer to provide a financial contribution or other support to the scheme where they are 'connected' or 'associated' with the scheme employer. In principle, this includes entities in the employer's wider group overseas.

Whilst there is a certain amount of debate around the ability of the Regulator to enforce a CN or FSD overseas, the Regulator itself has expressed the view that it can target non-UK entities in this way and that it is relatively straightforward to enforce CNs and FSDs in the EU (seemingly on the basis that the enforcement of judgments granted by a court or tribunal in one EU or EFTA state in another EU or EFTA state is expressly governed by the Brussels Regulation/Lugano Convention). Whether this position is legally correct is arguable and there are a number of issues which arise in this context (e.g. is a CN/FSD a 'judgment' for these purposes? Is the Regulator a court or tribunal for these purposes?).

However, assuming this view were correct, then Brexit could have an impact. Again, the extent of the impact would depend on the terms of the UK's future framework with the EU. For example, if the UK were to remain in the EEA as an EFTA state, the position is unlikely to be materially different. However, if the UK were to exit the EU and EEA completely, a different analysis may apply for each individual country.

6. Scottish independence

While there is a question mark over the process and powers needed for the Scottish government to hold a second referendum regarding its participation in the UK, it seems this is something which could be on the cards (with the First Minister of Scotland recently indicating that a second referendum could be a possibility if the Scottish government is not on board with the UK's exit negotiations).

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If Scotland were to become its own country independent of the UK and become a member of the EU in its own right, what would be the impact for UK pensions?

Again, the answer to this would very much depend on the nature (and terms) of the UK's exit and the terms of its future dealings with the EU. For example, if Scotland gained independence before withdrawal from the EU, or if the UK were to leave the EU but remain a member of the EEA, this would raise the same kinds of issues considered in the lead-up to Scotland's 2014 referendum. In particular, the concern that schemes operating in both the UK and Scotland would automatically become 'cross-border' schemes under the IORP Directive (as a scheme with members in more than one EU or EEA Member State) and therefore need to be fully funded at all times (although note that this may be less of a concern if IORP II is implemented as currently drafted as the requirement for full funding at all times has been weakened to some extent in the latest text - see above).

If the UK were to leave the EU without remaining a member of the EEA then the known difficulties around cross-border schemes would disappear, but it's possible that a host of new issues could arise in their place.

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