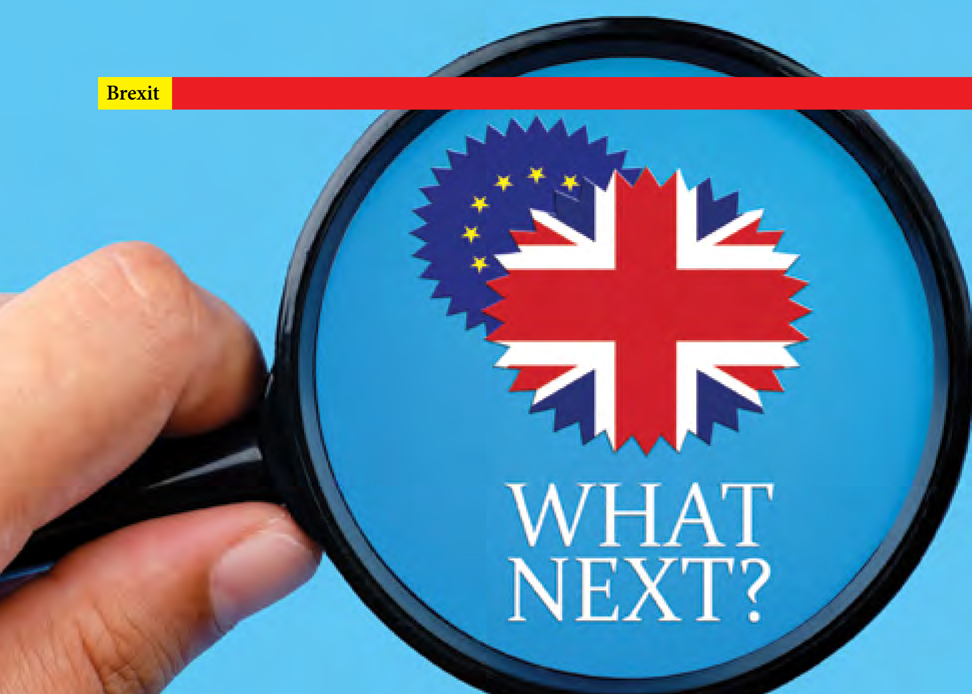

Summary
• Brexit threatens the covenants of many DB funds, particularly those sponsored by companies in the manufacturing sector.
• Funding levels could be significantly dented in the case of a no-deal exit, but many schemes are well diversified today.
• Buy-ins and buyouts could become cheaper post-Brexit.
• Employers and individuals will be likely to seek out extra advice once the UK leaves the EU.

The Brexit effect

Brexit means Brexit. Theresa May's mantra since she moved into 10 Downing Street has been a familiar one. But what does it mean for the pensions sector?

Nine days after MPs rejected Theresa May's Brexit deal by a historic majority of 230 votes, XPS Investment's chief investment officer Simeon Willis delivered a thinly-veiled admonition to the government. If the UK were to leave the EU on 29 March with no deal, he said, then DB scheme overall funding levels could be reduced by 5.3 per cent. At the same time, he warned that a soft Brexit also contained its own dangers. A sudden relief-driven boost in the pound, for example, would likely leave some trustees kicking themselves for not going the extra mile with their currency hedging.

His prognoses encapsulated the dilemma that Brexit poses for the pensions sector. No matter how or when the UK chooses to leave the EU, the event will signify a major geopolitical shift. And that can only mean one thing – an amplification of risk.

Project (covenant) fear

Of all the threats that Brexit poses to pensions, it is its impact on business prospects that appears to be the most immediate and direct, particularly if a no-deal departure becomes a reality. Should the worst happen and the UK suffers a prolonged recession, then DB covenants will be strained, as will the requirement on employers to increase DC contributions in line with the auto-enrolment regime.

The British Chambers of Commerce recently decried the absence of clarity and precision from the government over a no-deal scenario. It said that the absence of adequate no-deal planning in Whitehall had already stifled investment and growth, resulting in unnecessary costs and a loss of business.

According to J.P. Morgan Asset Management's head of pension solutions and advisory within EMEA, Sorca Kelly-Scholte, there is already a precedent that can be used to predict which covenants will be under the most stress. Since the referendum, it is companies with predominantly domestic customer bases that have languished. "In a no-deal scenario those heavily domestically exposed could potentially experience a good deal more pain," she says.

Another indicator lies in the health of funding and covenants within certain business sectors. As Kelly-Scholte explains, schemes sponsored by manufacturers tend to have weak funding. They are also more exposed to local conditions, and will likely be feeling very vulnerable if the UK leaves the EU without a deal.

Avoiding the much-feared no deal does not necessarily mean that DB schemes are out of the woods, however, as Quantum Advisory's principal investment consultant, Amanda Burdge, points out. Should the UK secure an extension to re-negotiate the Prime Minister's deal, swift closure to proceedings would be needed as a prolonged period of excruciating negotiation would hurt confidence in the economy.

"The longer uncertainty persists the worse it will be for UK companies, as investment is postponed, or cancelled, whilst international businesses consider taking their investment overseas," says Burdge.

"These are VUCA *[volatile, uncertain, complex and ambiguous]* times and the strength of the sponsor's covenant could change quickly. In these circumstances, trustees may need to act quickly to take investment risk off the table."

Crashing out

The market volatility that uncertainty will bring is also a clear concern, with its effect on DC pots and DB funding levels.

"From our research on geopolitical shocks, we know that the most immediate impact will be through exchange rates, with secondary effects on equities and bonds," says SSGA's official institutions group's head of research and insight, Elliot Hentov.

"A sudden depreciation or appreciation *[in currency]* typically becomes permanent, as seen with the pound post-June 2016. Knock-on effects on equities tend to be shorter lived."

Bonds, however, says Hentov, are harder to forecast, with each debt market having a particular type of supply and demand dynamic.

Agreeing with Willis, Kelly-Scholte views a transitional deal as the safest path to take if the UK wishes to avoid shocks to DB funding levels. "We do see something of a Brexit premium in markets at the moment," she says. "And if we do steer towards a soft deal, then we may see a bit of relief to funding levels and that will come through principally from a small rise in interest rates as people are relieved that we don't have a no-deal scenario. We estimate that there may be some funding level relief for pension funds of the order of 2 per cent."

Should the reverse happen, the good news, says the PLSA's policy lead engagement and EU, James Walsh, is that many schemes are well prepared for negative market sentiment as previous market downturns have been good teachers.

"Many of our members are now significantly hedged," he says. "Their assets are invested globally and very diversified. And actually, if the pound were to go down a little further, that would improve the look of some firms' balance sheets."

Even if schemes are not as prepared as they could be, time remains a healer. "Although Brexit is a macro event with very extreme possible outcomes, over the very long term, even the most extreme outcomes can be smoothed out," says Hentov.

Another long-term result of Brexit may be improved pricing for buy-ins and buyouts. K3 Advisory's managing director, Adam Davis, explains: "Currently bulk annuity insurers are hampered in their pricing by the risk margin they have to hold. The size and sensitivity to interest rates of the risk margin has been larger than originally intended and this makes the writing of some products, particularly annuities, less attractive to insurers and potentially more expensive to pension schemes.

"The Bank of England post-Brexit will have greater flexibility to change this which could lead to reduced costs for schemes doing buy-ins and buyouts."

Taking back (regulatory) control

When looking at more mundane matters, such as regulation, most of the potential hazards involved with leaving the EU lie in wait later down the road.

"We've just had IORP II come into effect on 13 January. So nobody expects that framework to suddenly change," says Walsh.

"But the interesting point will come when we get to IORP III. If that would include a solvency regime for pensions – the kind of thing that the PLSA and its allies in Europe have been successfully resisting in recent years – then that's the point at which you could see some significant divergence in the UK's and EU's pension regulatory regimes. That all depends on, what, if any deal the UK gets, of course."

If the UK finds itself in a transitional deal where it no longer has a voice with the EU but must still adhere to its rules, then that could mean that pension funds would simply have to adhere to damaging solvency requirements, says Kelly-Scholte. She views such a result as an outlier, however.

"The more important thing for pensions is as a buyer of investment services," she says. "Funds will still want to have access to providers outside the UK and will also want to see UK providers being strong and having passporting rights through Europe."

Walsh expects the issue to be tackled sensibly, no matter what exit the UK takes.

"Service providers such as investment managers, are international companies that are operating across Europe," he says. "So there are a whole set of issues such as will the City of London continue to play by the rules of MiFID II and regulation on derivative markets? And most people expect the answer to that is going to be yes."

Any disruption to service providers should be minimal, in Burdge's view. "Arguably, the financial services sector is one of the most well-prepared sectors for the UK leaving the EU in March 2019," she says.

"Most investment managers have been preparing for a potential hard Brexit in earnest for at least 12 months. In addition, the investment industry is used to working in multi-jurisdictions and has been able to seek new domiciles for funds where necessary to ensure services can be maintained post-March 2019."

New opportunities

And then there are the opportunities.

Analysis by the Centre for Organisational Intelligence (COI) has found that 86 per cent of companies believe that they will need to review their pension schemes after Brexit, with 70 per cent looking at their investment strategies and 70 per cent undertaking a rewards and benefits review. And in separate research, Aegon has said that Brexit scores highly as an opportunity for advisers to both employers and individuals.

Nobody know what Brexit will end up meaning, but it is certain to keep everyone in pensions busy.