Brexit: The end of the world as we know it?

24 June 2016

In the run-up to the referendum we have seen claim and counter-claim by the "Remain" and "Leave" campaigns, but contrary to their rhetoric, the votes have been cast and counted and the sky has not fallen in (so far)!

In fact, many people expect their day to day business lives to carry on in a very British way, much as they always have done, as we remain a member of the EU during the negotiated exit period, which could last two years. In this article we look at what the vote could mean for UK pension schemes and their investments in the short, medium and long-term following the referendum.

Short term issues

Investment

It should be noted that markets have a tendency to over-react to unexpected news and given that they had begun to price in a "Remain" decision the falls will, initially, appear more pronounced.

Markets had begun to rally in the week prior to the referendum, as they began to price in the expectation that we would vote to remain in the EU, with Sterling reached a one-year high as the polls closed. Following the vote to leave, we expected Sterling to weaken significantly (the currency fell to $1.35 against the US $ overnight – Sterling has fallen to a level not seen since 1985 and has experienced a greater fall than we saw when the UK fell out of the Exchange Rate Mechanism in 1992).

UK equities are likely to be adversely affected in coming weeks – the FTSE fell 7% at the start of trading this morning. We expect financials and domestically focused companies that do not have global revenue streams to be hardest hit.

The big question for Gilts is whether yields will rise or fall. We expect yields to fall in the short-term, as markets react to the fear of uncertainty, until an equilibrium is eventually reached – Gilt yields opened lower this morning. Longer term expectations are less certain, but one would expect higher yields if the cost of borrowing for the UK government increases over the longer term (Standard & Poor's already having suggested that the UK may lose its AAA status as a result of the vote). We expect increased levels of volatility as markets adjust to our post Brexit world and the Conservative Party leadership contest gets underway.

The Governor of the Bank of England has already stated that the Bank will not hesitate to take any additional steps required to meet the UK's obligations – we would expect this to potentially include further Quantitative Easing and a possible interest rate cut. Meanwhile, banks are well capitalised and there remains sufficient liquidity in the market. Gold also began to rally – the ultimate fear gauge.

Other areas of the market expected to be affected are UK properties. Property transactions had already slowed significantly (down c.40% year on year in the first quarter) and whilst the referendum result provides certainty on the outcome, this will be an interesting area to watch – any rise in transactions may be as a result of pent up demand, rather than an endorsement of the outcome.

Overseas investments will likely see greater volatility due to currency movements, which may have a substantial impact on short term returns, unless they are hedged.

Pensions

For pension schemes more generally, we expect funding levels to be impacted in the short term and this may lead to interesting discussions with the sponsoring employer. However, active fund managers will be poised to take advantage of opportunities where they arise and we do not believe any action is required in the short term for those clients with diverse portfolios. However, there is much to consider in the medium and longer-term.

Medium term issues

Investment

Focus in financial markets will continue to centre on the UK, with Janet Yellen of the Federal Reserve showing concern that Brexit may lead to a wider global slowdown. European markets have also been adversely affected following the result and a wider issue will emerge as to the continued viability of the European project in its current form – the far right in France and the Netherlands having already called for their own EU referendums.

Sterling weakness may lead to inflation in the short to medium term, as the price of imported goods and services increases. This is an area to watch with interest.

Markets will now also move to consider the US Presidential elections, the Federal Reserve's planned interest rate rises, China's slowdown, European elections (particularly in Germany), the long drawn out Greek financial crisis and the EU's response to Brexit.

Pensions

Despite a vote to leave the EU, the new IORP II Directive for pension schemes which is due to be published shortly will still likely be incorporated into the Pensions Act 2017. Whilst a number of the provisions are expected to have been watered down, trustees can expect to see requirements for:

- Additional member communication
- Appointment of a designated risk manager
- A policy on remuneration of trustees

Issues still to be resolved concern the continued role of lay trustees, which could be a game changer for some trustee boards. Whilst the solvency requirements for DB schemes have been removed, the Pensions Act 2017 will likely incorporate the additional administrative requirements for trustees.

As for the Data Protection Regulation (expected 2018), things are less certain. We may well still be negotiating our exit from the EU at the point that the Regulation comes in to force, so it is less certain whether the additional requirements will apply directly in the UK, or if we would draft our own version of the legislation, or simply not apply the additional requirements. The Regulation will impose additional obligations on pension scheme administrators (data processors) and also allow greater scope for fines.

For DB schemes, de-risking and funding level monitoring may need to be reviewed to take into account any changes in medium and longer term expectations.

A question also arises on any parental guarantee in place with an EU based parent company. UK schemes will not want this guarantee prejudiced by the UK leaving the EU. Careful management will be important.

Long term issues

Investment

Over the longer term, one would expect volatility to subside and fundamental economic issues to drive markets. Economists are split over the longer term implications for the UK economy and there are suggestions of both lower and higher GDP growth, which will likely play out in the FTSE 250 market, as this market is more domestically focused. On the other hand, FTSE 100 companies will likely see greater profits as Sterling depreciates to a new equilibrium and exports become cheaper boosting their earnings potential.

As for Gilt markets, one might expect higher yields over the longer term if the UK's credit rating falls. However, much will depend on global risks, the value of Sterling and pension schemes' insatiable demand for longer-dated bonds – all of which may supress substantial yield increases.

Pensions

With Scotland backing "Remain" (as was expected), this leaves the UK in a precarious position, not least in terms of a second referendum on Scottish Independence and the possible break-up of the United Kingdom. Could we yet see cross-border scheme issues between England and Wales with Scotland and, if so, what are the implications for the additional administration and funding requirements?

There is a question also for our ex-pats who have retired to other EU countries – how will their state pension be affected in future? Will annual increases in the state pension cease as they do for many other non-EU countries? How does this change retirement planning for your members – will they seek greater security on an increasing pension rather than the traditional tax-free cash sum?

Will insurers be able to begin to discriminate on grounds of sex again (over-turning the ECJ ruling of 2012) and could this mean less beneficial terms for female annuitants? Or will the additional operational costs of being outside the "passport" arrangements for EU insurers increase all insurance premiums and reduce annuity rates?

How will equalisation be treated following Brexit? This is after all derived from EU law. It could be argued that equalised benefits are now accrued rights under UK law and as such are not likely to be able to be removed. As for GMP equalisation, expect further discussion on whether this happens and possible further legal challenges.

Conclusion

Time will tell if the margin of victory was sufficient to shelve the European question for a generation, or whether momentum will now build for a second vote, perhaps at the end of a two-year exit negotiation? In any case much uncertainty awaits us and we shall be living in unprecedented (if not interesting) times for some years to come! We should bear in mind too that volatility creates opportunity for investors, particularly where market falls are perceived as an over-reaction to the underlying fundamentals.

In the meantime, we are working with clients to ensure that they:

- Stay invested
- Remain diversified
- Consider the frequency with which pension scheme funding levels are monitored
- Continue to stress test their portfolios

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