THE SOCIETY OF PENSION PROFESSIONALS
leading pension thinking

Would Brexit benefit or be detrimental to UK pensions?

April 2016

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Introduction

The Brexit vote may represent one of the biggest threats or biggest opportunities facing UK pensions in a generation. No one in the industry can afford to be complacent: the numbers are just too big. Estimates differ on the potential investment losses to pension funds, if any, resulting from pre-Brexit uncertainty and an actual 'Leave' vote.

Let's assume, however, that Brexit would increase or reduce longer-dated gilt yields by 0.3%, with all other factors held equal. According to The Pensions Regulator (TPR) and the Pensions Protection Fund (PPF), the combined pension deficits of UK defined benefit pension schemes would then change by £70bn. Specifically, if yields were to rise by 0.3%, combined deficits would improve by £70bn. However, if Brexit resulted in yields falling by 0.3%, combined deficits would worsen by £70bn. In either case, the impact of Brexit would be considerable.[1] But then there are the longer term opportunities – for example it has been suggested that freedom from EU regulation could result in the UK pensions industry avoiding potentially crippling future measured deficits of at least £450bn.[2] This is itself a baseline scenario; in stressed scenarios the figure could be much greater.[3] Further, the issue of Guaranteed Minimum Pension (GMP) equalisation is estimated to cost in the region of £10bn.[4] More broadly, Brexit would mean the UK did not have to pay net budget contributions to the EU, estimated at around £8bn-£10bn a year.[5] On the other hand, it has been suggested that Brexit could cost the UK a 7% drop in GDP over the next 15 years.[6]

1 Pensions Regulator, The; Pension Protection Fund, The Purple Book: DB Pensions Universe Risk Profile 2015 (3 Dec 2016), p.42, fig. 5.9 (http://www.pensionprotectionfund.org.uk/DocumentLibrary/Documents/purple_book_2015.pdf)

2 DWP April 2013 https://www.gov.uk/government/news/eu-figures-show-high-cost-of-its-plans-for-new-rules-on-defined-benefit-pensions-pensions-minister

3 EIOPA stress tests January 2016 (https://eiopa.europa.eu/Pages/News/Results-of-the-first-EU-stress-test-for-occupational-pensions.aspx)

4 Mann, N., 'GMP pension equalisation method 'could cost £10bn', The Actuary (24 Jan 2012) (http://www.theactuary.com/news/2012/01/gmp-pension-equalisation-method-could-cost-10bn/)
Buchanan, D., Clucas, J., 'People who live in glass houses', Pensions Age (May 2011) (http://www.pensionsage.com/pa/people-who-live-in-glass-houses.php)

5 Morrissey, H., 'Calculating the cost of Brexit', Pensions Europe (8 Feb 2016) (http://www.professionalpensions.com/professional-pensions/feature/2446034/calculating-the-cost-of-brexit)

6 Neill, M., 'Brexit could hit GDP by up to 7%: Axa Investment Managers', Insurance Insider (4 March 2016), (http://www.insuranceinsider.com/brexit-could-hit-gdp-by-up-to-7-axa-investment-managers)

Against this background, The Society of Pension Professionals (SPP) is uniquely placed to provide an unbiased view, drawing on the expertise of its members from across the whole spectrum of pension provision and administration.

This paper has been prepared in order to explore the key issues in the upcoming UK referendum. The intention is neither to lobby for a 'Remain' or 'Leave' vote (the latter being widely known as Brexit) but rather to stimulate debate by presenting what in our view are the main consequences for pensions in the event of either decision. We aim to draw attention to the key issues that will need to be fully and carefully considered before the ballots are cast and negotiations finalised.

To create this paper, insights have been sought from several SPP committees:

- Administration;
- Defined Contribution;
- European;
- Financial Services Regulation;
- Investment;
- Leglisation.

Each has been able to provide insight upon their particular specialism as regards UK pensions.

The paper has been designed to explore the likely structure that Brexit might reasonably be expected to take should a "Leave" vote be forthcoming, before exploring the implications for pensions specifically. The longer term implications of a "Remain" vote are also considered.

The purpose of this paper is therefore to:

- **Provide an overview of the various forms that Brexit might take, based on models currently in place**
- **Outline the wider implications for pension schemes – both the pros and cons – likely to result from a 'Leave' or 'Remain' vote**
- **Provide details of specific pension issues connected to membership of the EU**
- **Look at how things might play out in the short and longer term following a Brexit decision**
- **Draw some tentative conclusions and consider next steps**

Executive Summary

We summarise our key findings regarding the impact of a Brexit on UK pensions below

- The UK may not be subject to EU pension legislation / regulation. This may well be of benefit to UK pension schemes, who are subject to a great deal of regulation already. We say 'may' as it is likely that if the UK joins the European Economic Area (EEA) then adoption of EU pensions legislation may still be required.

- In particular, it is possible that the risk of a ruinous imposition of insurance style reserving on UK pension schemes by a future "IORP" Directive can be removed.

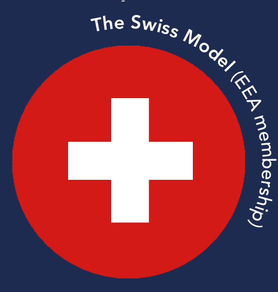
- The UK will not be directly subject to EU financial services legislation. This may have a mixture of positive and negative effects.

- EU employment law, including equality legislation, may cease to apply. The effect of this could be very wide-ranging.

- GMP equalisation – a process driven by EU law – is expected to cost the UK as much as £10bn but which could potentially be avoided.

The Brexit vote may represent one of the biggest threats or biggest opportunities facing UK pensions in a generation.

The Norwegian Model (EEA membership)


The Swiss Model (EEA membership)

The Turkish Model (Customs Union)

The Free Trade Model

The Four Models

There are currently four established models by which non-EU states maintain various degrees of integration with EU member countries.

The 'Norwegian Model' – EEA membership

Norway, Iceland and Lichtenstein are members of the EEA, which represents the closest link with the EU, short of actual membership, currently in existence. These countries have access to the single market through the EEA agreement, a development of the European Free-Trade Association (EFTA).

EEA members retain control over certain areas of government policy. These include: Agriculture and Fisheries, Taxation, and Security and Justice – though crucially *not* Pensions. Theoretically, they have a veto on EU law implementation, but this has never been exercised. The EEA is subject to the freedom of movement principles built into the single market.

The 'Swiss Model' – EEA membership

Switzerland, together with the three EEA states, is a member of the European Free Trade Association (EFTA). EFTA has a free trade agreement with the EU and this, together with a series of bilateral treaties, governs the relationship between the EU and Switzerland.

In this model, Switzerland is not obliged to adopt EU pensions law such as the IORP Directives. With the important exception of insurance (where Switzerland has equivalence status under the Solvency II Directive), Switzerland is not subject to EU financial services law. This restricts both Switzerland's access to the single market and the impact of EU law and regulation on its financial sector. Switzerland also pays less financially into the EU than it would under full membership.

While the EEA represents an established model of what is effectively 'second-tier' membership, and one with which the EU seems satisfied, the same cannot be said for the bilateral agreements of the Swiss, or for Turkey's interim status prior to its achieving full membership.

The 'Turkish Model' – Customs Union

Turkey benefits from a customs union with the EU, though the nature of its agreement does not cover all goods, and its service industries do not fall under the agreement.[7] The country remains free to negotiate external trade agreements in the areas not covered by the customs union, and exercises control over its social and employment law. The Services sector currently accounts for 79% of the UK economy[8] (financial services comprising around 12%),[9] so the UK would probably want FS firms included in the terms of any similar deal.

As a non-EU country, Turkey also has no vote on EU law, although the recent migration agreement between it and the member states shows it has at least some influence on certain aspects of the wider Union (e.g. free movement of people). Conversely, the country is not currently tied to 'ever-closer union', maintains control over its Justice system and Home Affairs, and does not contribute to EU financing.[10] On a point of trade, EU foreign trade partners do not have to provide Turkish businesses with preferential access to their own markets, though they have full access to the country via its agreement with the EU.

The 'Free Trade Model'

Should Brexit occur, it would be possible for the UK's relations with the EU not to follow any established models – the country could remain entirely outside of it. Like Canada and the US, Britain would be able to pursue free trade agreements from this position. However, it is uncertain as to whether the terms secured would be better than those achieved through having at least partial integration with the EU member states. Tellingly, the EU's extensive trade deal with Canada does not extend fully to level the playing field for financial services firms.[11]

7 Confederation of British Industry, The Turkey Option, http://www.cbi.org.uk/global-future/case_study06_turkey.html

8 HM Government, Policy Paper: Budget 2016, March 2016 https://www.gov.uk/government/publications/budget-2016-documents/budget-2016; and HM Government, Alternatives to membership: possible models for the United Kingdom outside the European Union (March 2016)

9 https://www.prospects.ac.uk/jobs-and-work-experience/job-sectors/accountancy-banking-and-finance/overview-of-the-finance-sector-in-the-uk

10 HM Government, Alternatives to membership: possible models for the United Kingdom outside the European Union (March 2016) https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/504661/Alternatives_to_membership_possible_models_for_the_UK_outside_the_EU_Accessible.pdf

11 HM Government, Alternatives to membership: possible models for the United Kingdom outside the European Union (March 2016) https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/504661/Alternatives_to_membership_possible_models_for_the_UK_outside_the_EU_Accessible.pdf

Broad Considerations

The Anticipated Pros and Cons of Brexit

Pros

Freedom from future EU pension regulation (IORP Directives etc.), so allowing the UK to have complete control over design and regulation of its pension regime

Wide-ranging EU Directives in the fields of financial crime, financial services, solvency, data protection etc., may no longer apply

Removing the burden of complying with future EU regulations may generate significant medium to long term savings for pensions The impact of the 100 most costly European Union regulations for British business has been estimated at £33bn annually[12]

Potential to repeal existing EU laws, and not implement new ones, may remove significant financial liabilities e.g. £10bn for GMP equalisation

A 'stay in' vote may weaken the UK's ability to opt out of the EU drive towards closer harmonisation of financial, regulatory and legal regimes and expose UK pensions to an increasing regulatory burden

Cons

The possible cons are heavily dependent on the nature of Brexit. If modelled on Norwegian or Swiss models, UK would lose influence on policy while still being subject to it

Potential loss of the benefits and customer protections which are derived from such supranational governance and regulatory structures

Short term effect on financial markets caused by an 'Out' vote and the uncertainty of model to be adopted could seriously affect gilt yields.

Not having to implement EU law, such as that on equity in pension schemes, does not mean that such adoption would not be essential for interaction with Europe

Not leaving the EU, and being seen as an enthusiastic participant, may increase UK influence over future EU policy in pensions as well as other areas. Further, opponents of Brexit might point out that Cameron's draft deal with the EU contains the necessary safeguards to act as an emergency brake to excessive regulation

12 Open Europe, Top 100 EU rules cost Britain £33.3bn (London, 2015), quoted in The economic impact of 'Brexit', (2015) https://woodfordfunds.com/economic-impact-brexit-report/

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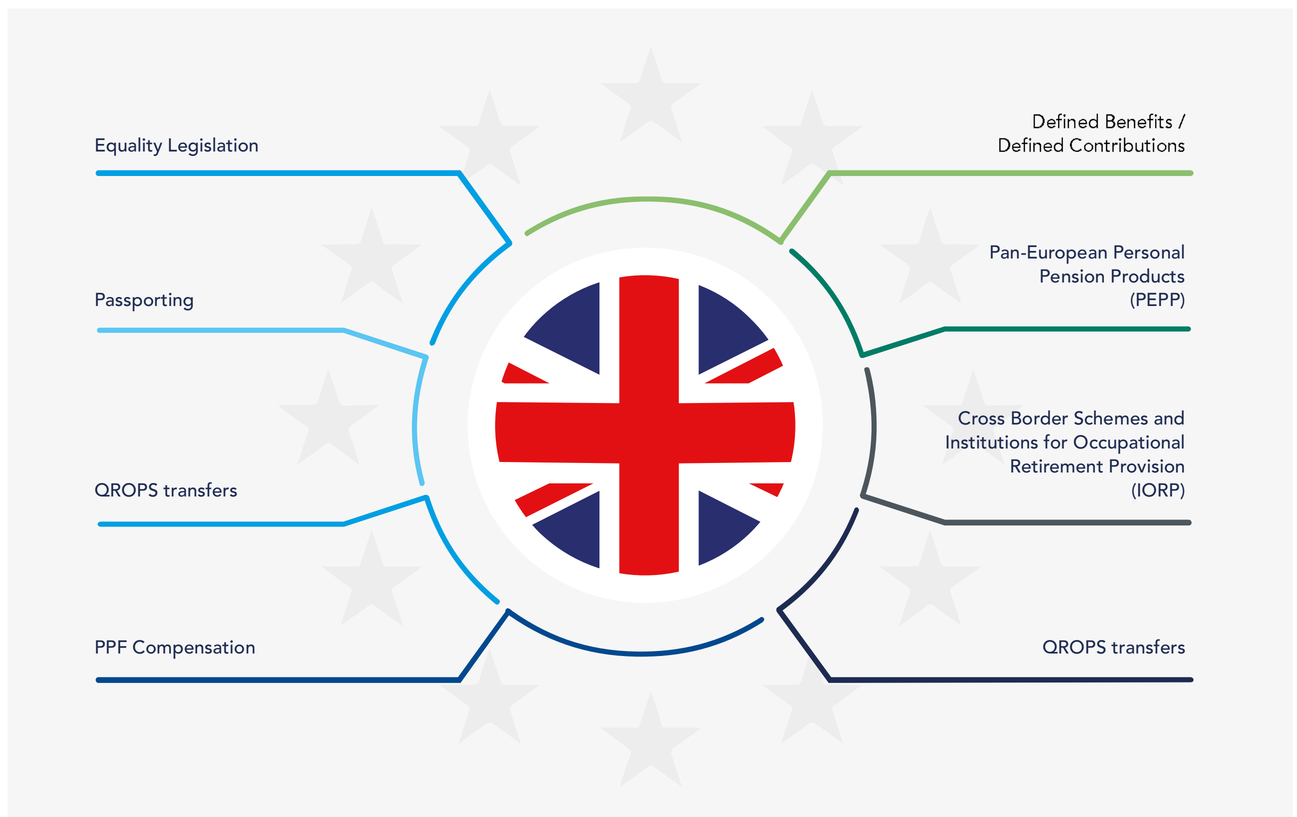
Detailed Pension Considerations

From a legislative point of view, the corner stones of UK pension policy are trust and contract law – and neither is significantly impacted by EU law.

In a similar manner, law around contracting-out, indexation and revaluation, preservation and results of domestic occupational benefits are typically home-grown.

Nevertheless, there are certain EU policies and regulations which materially affect the operation of UK schemes. We discuss some of the most prominent.



Prominent EU policies and regulations affecting the opearion of UK pension schemes

Equality Legislation

Much of the UK's equality and discrimination legislation has its roots in EU Directives or ECJ decisions. The EU Gender Directive came into force at the end of 2012, changing the UK annuity market from one using gender-specific annuity rates – with the aim of a gender neutral outcome to reflect male versus female mortality experience – to one that required annuity rates themselves to be gender-neutral. The effect was to worsen annuity rates for men and their dependents. These dependents are at present most likely to be women, for whom rates improved. Many commentators at the time felt this was the wrong decision and that the use of gender-specific rates to aim at equality of output was preferable. This change might be open to review following Brexit.

In addition, the need to equalise Guaranteed Minimum pensions (GMPs) has existed in theory since 1990, but nobody has ever been clear on how to do it. Indeed there is still uncertainty over whether it is legally required and what it would actually mean in practice. Proposals from DWP have been regarded as expensive, complex and have not been tested in court. The costs of equalisation have, as referenced at the outset of this piece, been estimated at around £10bn. Brexit could conveniently remove this issue.

Defined Benefits / Defined Contributions

Previously, the EU's impact has been greatest in relation to occupational defined benefit schemes, as European law and many of the ECJ's decisions are difficult to reconcile with the UK's defined benefit pension scheme structures. But defined contribution schemes are also impacted by EU membership, though to a lesser degree. For example, since 2005 it has been the case that any age-related contribution rate structure must fall within a narrow exemption set out in the Equality Act (Age Exceptions for Pension Schemes) Order 2010.

Pan-European Personal Pension Products (PEPP)

In late 2015, the European Insurance and Occupational Pensions Authority (EIOPA) undertook an initial consultation on establishing a 'harmonised legal framework' to create an 'internal PEPP market'. The aim is to provide an easy to understand, transparent, and cost-effective product for EU citizens. Nevertheless, the proposals have been criticised for potentially introducing yet more regulation not tailored to the UK pensions market, impacting Group Personal Pension (GPPs), and has generally been met with a lukewarm reception from Britain.

Cross Border Schemes and Institutions for Occupational Retirement Provision (IORP)

The operation of UK Cross-Border Schemes is likely to become more complicated and, under some of the Brexit scenarios, schemes may have to be restructured. UK / Republic of Ireland cross-border schemes are, at present, the most prevalent type of EU authorised cross-border scheme, and the future of such schemes, should Brexit occur, is unclear.

IORP Directive

The IORP Directive of 2003 (implemented by all EU states in 2007) aims to allow pension funds to operate across multiple EU states. It means that pension schemes have only to satisfy the prudential framework of the home country, although these schemes are still required to observe the social and labour requirements for all states in which they operate.

But the IORP Directive imposed a number of requirements on UK pension schemes operating across national borders and accepting contributions from a European employer in respect of European members.

Accordingly, 'cross-border' schemes were compelled to:

- be fully funded at all times on their technical provisions
- be authorised and approved by the Pensions Regulator
- observe the social and labour laws of the EU member state in which the European members are based.
  Note: IORP II does include exceptions in relation to Recovery Periods to partially mitigate these requirements

"… the corner stones of UK pension policy are trust and contract law – and neither is significantly impacted by EU law…Nevertheless, there are certain EU policies and regulations which materially affect the operation of UK schemes."

If Britain were to subsequently join the EEA in the event of Brexit, these requirements need no longer apply. Brexit might therefore open up Britain as an appealing country with which an EU or EEA member state could operate a cross-border arrangement.

IORP II

IORP II (currently under negotiation) potentially contains various measures that UK pension plans would find problematic. Solvency II style requirements on DB funding – strongly opposed by many in the industry – have been shelved, at least in terms of inclusion in IORP II. It did however soften some of the previous directive's requirements, for example in regard to a Recovery Period. However, other potential requirements, for example on stricter qualification/ knowledge requirements for trustees, requirements for the appointment of a depository and prescriptive member statement requirements, have drawn objections from the UK.

Whether IORP II would apply to the UK after Brexit would depend on the terms of the UK's relationship to the EU. If the UK remained in the EEA, IORP II would almost certainly apply to the UK but we would not be in a position to influence its terms (or the terms of any future changes to the Directive).

Also, should IORP be further revised in the future – for example implement the shelved Solvency II style requirements originally intended for IORP II, any post-Brexit relationship that saw the UK accessing the EEA would probably oblige it to adopt such an 'IORP III'. Switzerland, outside the EEA, has also adopted the existing IORP legislation.

"…it seems unlikely that the Government would decide to reduce PPF levels of compensation below their current levels in response to Brexit."

However, if the UK left the EU and IORP no longer applied, we may have the problem of the OPS Investment Regulations 2005 carrying over the terms of Article 18 (the investment rules). It may be that TPR and the Department of Work and Pensions would want to keep the Investment Regulations as they are, for they certainly work and to a large extent codify existing trust law without causing additional compliance problems.

Capital Markets Union (CMU)

In September 2015 the EU Commission adopted an ambitious action plan of 20 measures to achieve a true single market for capital in Europe. The overall aim is to make European capital markets less reliant on banks and unlock capital for investment in SMEs and infrastructure projects.

Pension funds are among the EU's key institutional investors and CMU is designed to bring opportunities for both long-term and cross-border investing. The UK government has voiced strong support for CMU but access to it would be limited to states within the EEA.

PPF Compensation

PPF compensation was written into UK law in response to Article 8 of the EU Insolvency Directive, the law requiring EU member states to take measures to protect employees' and ex-employees' occupational pension rights in the event of a sponsoring employer's insolvency. Cases around the level of compensation required have been decided in reference to the ECJ judgment in Case C-278/05 Robins v Secretary of State for Work and Pensions [2007] Pens LR 55, the decision being reached that members' interests were not adequately protected where members received less than half the pension they would have received under their pension scheme.

Nevertheless it seems unlikely that the Government would decide to reduce PPF levels of compensation below their current levels in response to Brexit, although it may make it less likely that the provisions extending the cap enacted in Pensions Act 2014 would be brought into force. The government estimated, at the time of passing that Act, that the 'value of increased levy payments over the period to 2030 will be £139.3 million', with the assumption that the costs of the higher cap would be passed on in full to levy payers. It did however note that 'there are significant uncertainties around this'.[13]

QROPS transfers

A Qualifying Recognised Overseas Pension Scheme (QROPS) is a pension scheme – meeting certain requirements of Her Majesty's Revenue and Customs (HMRC) – which can receive transfers of UK Pension Benefits without the member or the transferring scheme incurring an unauthorised payment and scheme sanction charge. HMRC tends to take a softer approach to QROPS established in EU / EEA member states. This has been to the advantage of jurisdictions such as Malta and Gibraltar. Brexit could probably adversely affect such arrangements, even if they did not disappear entirely.

Passporting

In broader financial services terms, nearly all domestic UK regulation is based on EU directives. From a customer perspective, whether the universe of available products were to be restricted by virtue of EU / EEA product providers (ie managers, funds and banks) would presumably depend on whether the existing passporting regime for those providers was recognized by the UK.

13 Pensions Act 2014: Impact Assessment Summary of Impacts, (Department of Work & Pensions, May 2014), p.19 (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/310896/pensions-act-ia--summary-of-impacts.pdf)

Vote Leave,
take control

BRITAIN
STRONGER
IN
EUROPE

The cost of Brexit

How might Brexit change the finances of a typical UK pension fund?

To answer this question, we must enter the realm of macroeconomic projections – an inexact science. That said, we would expect a change in finances to be transmitted through impacts to three main financial factors:

The UK's credit rating

The market could perceive Brexit either way. It could welcome the opportunity that comes from a loosening of unwanted regulations, or it could fear the UK distancing itself from its main trade partner. Of the two outcomes, we see the latter as the more likely, at least in the short term, although we do not expect the impact to be sizeable. Despite being hard to assess today, the risk over the longer term should be a watch-point for all pension funds that seek to invest over many decades.

The value of Sterling

Balancing the points above, it is plausible that Sterling might weaken a little in the short term. Again, whilst this arises from market concerns, it would benefit most pension schemes that have also not fully hedged their international asset exposure.

Long-dated index-linked gilts

(i.e. the asset that best mimics the liabilities of a typical UK pension fund)

Given our comments above, we expect Brexit to increase market uncertainty and raise questions about whether the UK's long-term financial strength has weakened slightly. In this event, yields on index-linked gilts would likely rise a little. Whilst this would reflect concern in the markets, it would benefit most pension schemes, as they have not completely hedged their liabilities. This is why the SPP has long advocated a less incremental approach from the UK Treasury on the issuance of these gilts. After all, it would satisfy the huge unmet demand of pension funds for these gilts, whilst raising long-term finance at the best rate ever seen for UK taxpayers.

Taking these three points together, we expect that Brexit would provide a slight boost to pension finances in the short term, although the longer-term impact is harder to gauge.

Conclusion

In theory, the examples of the EEA, Switzerland and Turkey all offer possible models for a re-ordering of UK-EU relations, as do those countries entirely outside of the union. However, their actual availability as templates for Brexit is less certain.

While the EEA represents an established model of what is effectively 'second-tier' membership, and one with which the EU seems satisfied, the same cannot be said for the bilateral agreements of the Swiss, or for Turkey's interim status prior to its achieving full membership. In the first case, it seems more likely that the EU will move to consolidate and formalise Switzerland's relationship, rather than offer such a bureaucracy-generating relationship to other nations. In the second, Turkey's customs union is very clearly intended as a stepping stone to full membership of the EU.

Of course, the UK could pursue a post-Brexit relationship that – though potentially owing its basis to one of the above models – is unique to itself and its own requirements, in essence a new 'Britain Model.' This might itself influence relations between member states within the EU, providing an alternative centre of gravity which could become a catalyst for change.

The problem with this is – as mentioned in our opening – that no-one can know the details of this unless a vote has been cast to leave. This is a risky position, certainly, but at least in regard to UK pensions we can identify priorities for negotiation. For instance, a guaranteed opt-out from any future iterations of IORP could potentially be a red line. In order to preserve the competitiveness of Britain's vital financial services sector, the UK would want to protect 'passporting', and avoid any other impediments to cross border access.

In the short term

However, regardless of the alleged benefits and drawbacks, it is worth emphasising that Brexit would not be a quick fix in any case, or result in sudden freedom from Brussels-devised legislation. In all likelihood, a vote to leave would change nothing material in the short term. Rather, it would be the trigger for the Government to enact Article 50 of the Lisbon Treaty, designed to allow a member state to begin exit talks. This process is expected take a minimum of two years, and potentially more than five. Even these timings are uncertain however – as is the entire process – for no EU member has ever caused the Article to be enacted.

The resulting period of uncertainty would likely have a detrimental impact on financial markets – and therefore pension funds. On the other hand, the assumption that a 'stay' vote would entirely remove uncertainty about Britain's continuing membership of the EU is open to question. As with the Scottish independence referendum, a close vote to stay in is unlikely to take this issue off the political agenda and may engender further uncertainty from now until the next general election.

In the long term

Brexit could potentially create new opportunities for UK pensions to avoid potentially crippling liabilities in the future, but the exit strategy is key. No one in the pensions industry can afford to be complacent because the possible outcomes range all the way from 'business as usual' to 'make or break'. How it plays out could translate into some of the most profound changes to UK pensions in a generation.

The Society of Pension Professionals
Quantum House, 22-24 Red Lion Court
London EC4A 3EB
United Kingdom

Tel +44 (0)20 7353 1688
Fax +44 (0)20 7353 9296

www.the-spp.co.uk