Turbulent times ahead for pension funds?

Brexit and Pensions

The issue
The UK's vote to exit the European Union on 23rd June caused unprecedented short term market volatility and will have far reaching implications over the coming months and years. Defined benefit pension schemes are already feeling the effects of the Brexit vote and face a 'triple whammy' of exposure to financial markets, the fortunes of the sponsoring employer and changes in government policy. The full ramifications for pension funds will not be known for some time, however trustees and sponsors should take a pro-active approach to manage the immediate volatility and longer-term uncertainty.

Impact of financial market volatility

In the immediate aftermath of the vote, financial markets reacted sharply:

- £ down 10% vs €
- £ down 20% vs US$/ Yen
- Gilt yields at new lows
- $/€ bond yields at new lows
- FTSE 250 down 10%

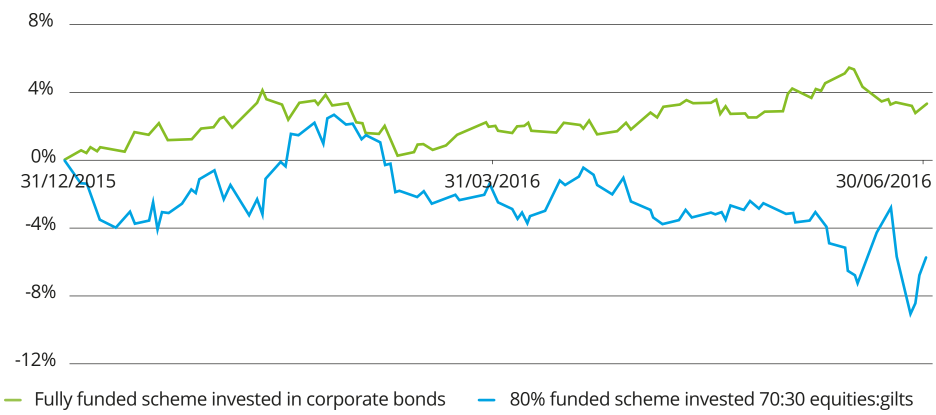
As has been widely reported in the media, the market reaction (in particular the drop in gilt yields) is likely to increase overall pension deficits. However, in fact, the position is nuanced – many schemes will have seen a significant rise in the deficit, whilst others may have witnessed little change and indeed some schemes may have observed an improvement in financial position.

The key determinant of the relative movement will be the investment strategy adopted – those schemes with a low-risk, defensive strategy will have outperformed.

The graph below illustrates the expected movement in financial position for two pension schemes with differing investment strategies in the months prior to, and two weeks following, the vote.

This illustrates that, although the general direction following the vote has been negative for most pension schemes, there is a divergence and some schemes have performed well. When assessing the next steps on pensions strategy, trustees and sponsors need to know into which camp their scheme falls.

Movement in funding position



The market reaction has, on average, led to an increase in pension deficits – but the position is nuanced

We believe that trustees and sponsors should consider the impact on th

Investment strategy

- The established view that pensions are bond-like led to the approach of valuing liabilities by reference to bond yields. The subsequent rise of the liability driven approach to investment reflects the desire of trustees to reduce the volatility of their funding level by holding assets that match the movements in the assessed liability value.
- This has been an approach that has grown in popularity with many trustees seeking to reduce volatility in their funding level at the possible expense of return. Many of these decisions and policies were put in place when bond yields were considerably higher than current levels, reflecting a desire to remove risk but still deliver a reasonable level of return to deliver pension benefits.
- However, the fall in bond yields means that, in current markets, the desire to reduce funding volatility now comes at a significant opportunity cost of higher return from other asset classes.
- Whilst we would not suggest trustees re-risk their strategies, given the current yields available on gilts, trustees and sponsoring employers that can take a longer term view may not wish to further hedge short term volatility at current rates.
- Equity markets offer a significant yield advantage, even before considering the potential for capital growth. There is significant price risk and the possibility of dividend cuts, but there would have to be swingeing cuts for the current equity dividend yield to fall to gilt yield levels. There are also opportunities to deliver higher yields across investment markets by capturing a liquidity premium. Again, these asset classes are not without risk, especially short-term, but may be more efficient at delivering pension benefits in future.

1%

Current yield on 10 year gilts

3%

Current dividend yield on FTSE100 equity market

Key action:
The strategic desire to de-risk will be very much dependent on covenant strength and the appetite of the sponsor to take risk in their investment strategy. Trustees and sponsors should work together to review any established de-risking strategy and agree whether to continue, pause or even reverse course.

Employer covenant

- It is important to take a rounded view when assessing employer covenant in the "post-vote" world, considering the potential opportunities for corporates alongside the potential threats.
- The impact on sponsor covenant will depend crucially on the nature of the revenue and cost base. Trustees should engage with their sponsor to understand their assessment of the impact of Brexit on the business and their response to navigate through some potentially difficult months ahead. In parallel with this, we would expect many businesses to be preparing revised financial projections which the trustees and their advisors should review closely to further assess the impact on the sponsor's ability to fulfil its obligations to the scheme and the extent of the covenant impact.
- The heightened uncertainty also underlines the importance of covenant monitoring. The Pensions Regulator's guidance that trustees should monitor the covenant regularly between valuations to enable them to react quickly to changes in covenant has never seemed more relevant. We would expect trustees may consider increasing the frequency and the extent of covenant monitoring.
- Key areas of focus should include:

What is the extent of the sponsor's trade with EU countries?	What is its competitive position in EU markets?
Is the sponsor a subsidiary of an EU parent or a global group?	Does the sponsor rely on foreign labour?
What proportion of purchases/sales are in foreign currency?	What currency hedging arrangements are in place?
Are any of the sponsor's assets domiciled in EU countries?	What is the sensitivity to consumer confidence?

Key action:
Trustees and sponsors should work together to consider the likely short-term impact on covenant. This is likely to be an iterative process as the outcome of negotiations with the EU becomes clearer, with more frequent covenant monitoring.

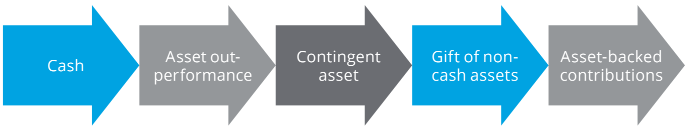
There are opportunities to deliver higher yields across investment markets by capturing a liquidity premium. These asset classes are not without risk, especially short-term, but may be more efficient at delivering pension benefits in future.

eir pensions strategy and their next steps through four key lenses...

Scheme funding

- For many pension schemes, the fall in gilt yields and the equity market following the Brexit vote has led to a substantial increase in the funding deficit – for most schemes the deficit is likely to now be at or close to an all-time high. Deteriorating economic conditions may add to the challenges facing corporates as increased cash contribution demands from trustees come up against constrained corporate cashflow.
- We expect that non-cash funding solutions and security packages will be key to bridging this gap between the demands of pension trustees and the constraints on scheme sponsors. During the period following the financial crisis, where similar conflicts prevailed, the concept of 'asset-backed contributions' were developed and ultimately implemented by c.50 large pension scheme sponsors. These 'ABCs' gave the pension scheme a right to a stream of future payments, backed by specific corporate assets, and hence allowed sponsors to plug deficits over an extended period of time whilst enhancing the strength of the covenant provided to the pension scheme.
- Other security measures (which can be used to support a longer cash funding period) include parent company guarantees (implemented by close to 1,000 pension schemes to date) and escrow accounts/charges over assets. All these measures are expected to look more attractive in times of uncertainty and volatility.
- Finally, the continued fall in gilt yields will further increase pressure on trustees and pension scheme actuaries to move away from assessing liabilities by a simple reference to current gilt yields. The previous Pensions Minister, Baroness Altmann, has expressed her frustration with the valuation approach adopted by many schemes and voiced support for changes in legislation that would facilitate alternative valuation approaches.

Key action:
Trustees and sponsors should work together to assess the current funding position and consider whether traditional approaches to measurement of liabilities and funding of deficits remain appropriate and viable.



Operational efficiency

- Faced with economic uncertainty, it is more important than ever that trustees and sponsors consider the ongoing costs associated with pensions, both in terms of the cost of the underlying pension provision and the operational costs.

Area of focus	Key considerations
Future benefit accrual	As the expected cost of defined benefit pension accrual has steadily increased in recent years, so has the rate of closure of defined benefit schemes to the build-up of new benefits. For the decreasing number of schemes that remain open to future accrual, closure of the scheme is a key (although not pain-free) lever to reduce pension costs.
Liability management	Employers looking to reduce short-term cash outlay may find the upfront costs of bulk liability management exercises unappealing. However, a business-as-usual option for members to transfer out at the point of retirement does not incur these upfront costs, so provides a way for the employer to begin gradually shrinking the size of the scheme.
Scheme governance	The day-to-day running costs of a scheme, which are in the hands of the trustees, are often left unchecked by the sponsoring employers who pay them. A governance review can identify areas where trustee practices and procedures for procuring services may fall short of what the employer would expect to see and ensure value for money. Companies should also ensure that their defined contribution arrangements allow members to benefit from new Freedom and Choice regulation and publicise this, to avoid the situation where a member blindly purchases their annuity on disadvantageous terms.
PPF levy	Employers facing a material PPF levy should take steps to optimise their position. The levy, although calculated in March each year, is assessed over the whole year, so action should be taken sooner rather than later. This would include considering structural changes that could have a material impact on the levy.

Key action:
Trustees and sponsors should work together to ensure the pension provision is aligned with the sponsor's reward strategy and operational costs of administering the pension plan are minimised (subject to maintaining an acceptable quality of service).

Other areas of uncertainty

- The complexity of untangling the web of connections between the UK and the EU mean that there are many other areas where the pensions industry now faces significant uncertainty. The lengthy time period over which exit negotiations are expected to be conducted suggests that clarity will not be forthcoming in the near- or medium-term.

- Areas of uncertainty include:

GMP equalisation	IORP II Directive	Funding regime	VAT on pension fund expenses	Disclosure requirements
Cross-border schemes	Data protection rules	Accounting requirements	Benefit changes	Overseas transfers

Contact us

Deloitte has an extensive network of professionals working in an integrated way to bring cutting edge pensions advice and solutions to our clients. If you would like to speak to us about any of the issues raised in this note, please feel free to make contact with us using the details below or directly through your usual Deloitte contact.

Mark Jones
London
020 7007 2363
markjones@deloitte.co.uk

Richard Slater
Edinburgh
0131 535 7602
ricslater@deloitte.co.uk

Tom Partridge
London
020 7007 4011
tompartridge@deloitte.co.uk

Helen Draper
London
020 7007 2810
hdraper@deloitte.co.uk

Tony Clare
Manchester
0161 455 8392
tclare@deloitte.co.uk

Harry Morgan
London
020 7007 8512
hamorgan@deloitte.co.uk

Mark McClintock
Belfast
028 9053 1429
mamcclintock@deloitte.co.uk

Andrew Mewis
Birmingham
0121 695 5071
amewis@deloitte.co.uk

Paul Geeson
London
020 7303 0878
pgeeson@deloitte.co.uk

David Robbins
London
020 7007 2810
drobbins@deloitte.co.uk

Deloitte.

Registered office: Hill House, 1 Little New Street, London EC4A 3TR, United Kingdom. Registered in England No 3981512.

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