CONTINGENCY PLANNING FOR BREXIT A GUIDE FOR TRUSTEES

"By failing to prepare, you are preparing to fail"

Benjamin Franklin

In a **Hard Brexit,** the aggregate buy-out **deficit** could **increase** by

£219bn[1]

(37% increase)

In a **Soft Brexit,** the aggregate buy-out **deficit** could **decrease** by

£138bn[1]

(24% decrease)

IN FOUR MONTHS, THE UK WILL LEAVE THE EUROPEAN UNION

Whilst the terms of the UK's departure, including the extent of any transitional arrangements, remain the subject of fierce debate, the only certainty is that UK sponsors and funds must be ready to react to the consequences.

In the same way that UK corporates have reached a point where action is required, prompting many to enact their contingency plans, trustees should take action now to protect their members.

While it may be the right decision for some schemes and sponsors to conclude that, with all the uncertainty, nothing useful can be done at this time, this should be a decision that trustees take actively.

In such cases, we advise clients to debate and document their rationale for that decision. If the sponsor could reasonably expect to be materially impacted by a 'no deal' Brexit, and this scenario is not considered by the trustees when assessing whether the funding or investment risks need adjusting under IRM, then arguably the trustees would have failed to follow guidance issued by The Pensions Regulator.

In this brief guide we set out actions that trustees should be taking to understand and react to the potential impact on their schemes from both covenant and investment perspectives.

[1]Figures in this document have been calculated using data from The Pension Protection Fund's 'The Purple Book' 2018

INVESTMENT ACTIONS

Despite the recent news that a deal has been agreed, we still do not know what form Brexit will take. In line with most commentators, we see two major scenarios; a hard Brexit and a soft Brexit. However, it is still unclear which scenario will come to fruition and what a soft Brexit might look like. We believe that Brexit has negative consequences for the economy on balance, but the impact is dependent on the type of Brexit and the government policies that would follow. In this context, a hard Brexit is worse than a soft Brexit for the UK economy.

The two scenarios[2] have many sub-scenarios, which largely rest contingent on whether the Prime Minister and government is able to ratify a Brexit deal with the EU. The most extreme scenario would be a General Election resulting in a new Labour government and a Jeremy Corbyn premiership.

HARD BREXIT

We expect a Hard Brexit scenario to initially lead to some Bank of England policy easing and lower growth expectations, which would likely precipitate lower Gilt yields and declining Sterling. On the back of a weaker currency, inflation would rise and the FTSE100, which includes a lot of international companies, would also gain in value.

SOFT BREXIT

In this scenario, uncertainty will be largely removed, enabling growth to improve. Given that there is little slack in the British economy, the Bank of England will need to increase its pace of rate hikes and Sterling should strengthen. We would expect higher Gilt yields and a slightly weaker FTSE100.

We suggest trustees:

1. Adjust investment strategy based on the impact of a hard Brexit on the sponsor
2. Hedge interest rate and inflation risk using a LDI toolkit
3. Make sure the impact of the different Brexit scenarios on the growth portfolio is limited by having enough diversification and only limited risk in UK assets

The key for pension funds is to keep the impact of either outcome on investment results limited.

[2] Scenario assumptions:

Market	Current	Hard Brexit	Soft Brexit
GBP/USD exchange rate	1.29	1.15	1.40
Gilt yields (10Y)	1.4%	1.0%	1.9%

COVENANT ACTIONS

In broad terms, all sponsors are being required to underwrite Brexit risks as they affect them and their pension scheme.

Amidst the uncertainty, there are a number of 'known unknowns': over the next four months we might see ratification of Theresa May's draft agreement with the EU, fresh elections, a new referendum to break a UK political impasse or a 'no deal' Brexit.

We have been considering the potential impact of each scenario on different types of sponsor. The impact of each scenario will not be uniform across all sponsors, and it is entirely plausible that some sponsors could be strengthened by Brexit.

We, therefore, believe that all trustees should, as a minimum:

1. Understand the potential immediate impact on the sponsor and what actions management is taking to reduce it

2. Consider whether changes to the investment strategy are warranted, considering the potential impact on the sponsor, for instance, to reduce positive correlations between the covenant and investment strategy

3. Develop actionable contingency plans if the impact is more detrimental than expected, such as accelerated funding

4. Comprehend the possible impact on the sponsor over the longer-term, including the effect on competitiveness and access to key markets

5. Reassess whether the scheme's longer-term strategy would remain appropriate depending on different Brexit outcomes

In addition, where schemes are in the middle of the triennial valuation process, trustees should consider whether it is appropriate to sign-off a valuation until the dust has settled on the immediate impacts of Brexit. Where the statutory deadline requires finalisation of the valuation prior to Brexit, trustees may need to consider calling a new valuation should circumstances change materially.

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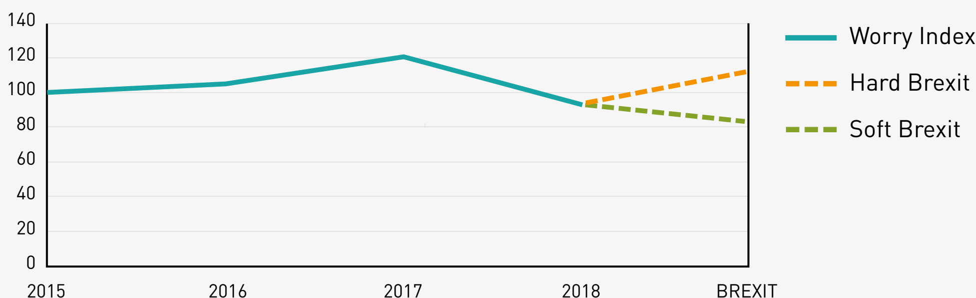
WHAT DOES THE WORRY INDEX[3] SHOW US ABOUT BREXIT?

Our recent update of the Worry Index showed that risk had significantly reduced during 2017/18. This was a welcome improvement but could be easily reversed by changes in market conditions.

We have updated our analysis to illustrate a range of views of the potential short-term impacts of Brexit. This analysis shows that the current Worry Index score could move in either direction, depending on the outcome, within a range of 80-110 (2015 = 100).



This scenario planning shows that although the outcome of Brexit cannot be known in advance, the health of UK pension schemes could be materially affected as a result of Brexit.

Contact Kerrin Rosenberg or Darren Redmayne to find out how we can help:

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[3] The Worry Index provides a single integrated risk measure provides guidance on the ability of FTSE 100 companies to support their pension promises. Our analysis tests the robustness of these schemes in a stress scenario, such as an economic or market shock – providing schemes and sponsors with a key tool to help answer the critical question for members: **how safe is my pension?** Read more on The Worry Index at www.theworryindex.com

Using proprietary methodology and modelling tools, we have calculated a Worry Score for each company in the FTSE 100 based on its ability to meet its commitment to members during times of stress. The aggregate of these scores is The Worry Index. A higher Worry Score represents more risk for trustees.

Information in this document is correct as of 07.12.18