PENSIONS AND LIFETIME SAVINGS ASSOCIATION

January 2017

BREXIT AND PENSION SCHEMES: *GETTING THE RIGHT DEAL FOR BRITAIN'S SAVERS*

PENSIONS AND LIFETIME SAVINGS ASSOCIATION

CONTENTS

I. EXECUTIVE SUMMARY

- **UK has the largest pensions sector in the EU**. The PLSA's members provide pensions for 20 million workers, savers and pensioners. Auto-enrolment has brought 7 million more people into pension saving – a great British success story that many other EU Member States are looking to emulate. UK pension funds provide important capital flows to the UK economy, as well as to those of the EU27. It is therefore important to British savers, and to the employers supporting those pension funds, that the UK economy gets a good Brexit.

- **The ability of UK pension schemes to deliver good pensions to British savers depends on: (i) the success of the British economy; (ii) having the right regulatory regime; and (iii) ready access to efficient financial services.**

  - *Employers that sponsor defined benefit pension schemes* are under an obligation – 'the sponsor covenant' – to ensure their schemes are properly funded. The post-referendum interest rate cut and renewed Quantitative Easing have increased scheme deficits, increasing the pressure on employers and the risk of savers' pensions not being paid in full. In the immediate aftermath of the referendum, a survey of PLSA members indicated that 74% were concerned that the outlook for pension schemes had deteriorated.

  - *In addition, nearly all new pension saving is in defined contribution schemes*. Current levels of contributions to these pensions are too low to provide adequate retirement incomes for Britain's savers. Therefore, it is essential that contributions increase in the near future. If the OBR's forecast of faltering wage growth proves correct, it will be difficult for employers and employees to increase contributions. The vast majority of the population would then have to expect a poorer retirement.

  - *Pension schemes are subject to EU legislation* – both as institutional investors affected by EU financial market regulation and, very significantly, directly under the IORP Directive on workplace pension schemes. IORP II is due to be implemented in the UK by January 2019.

  - During the negotiation of IORP II, the UK was successful in warding off the *threat of an EU solvency regime for pensions,* which could have resulted in a bill for British business of up to €650 billion. This remains on the agenda of EIOPA, the EU-level pensions regulatory body. While we believe high levels of access to the Single Market are very important, it is also essential that any future moves by the EU to propose a new EU solvency regime should not apply to defined benefit schemes in the UK, unless they also operate outside the UK.

- *Pension schemes need full access to global markets and to the world-class expertise* currently available from the UK's successful financial services sector. Any dilution of the City's strength would have a negative effect on pension saving.

- **Pensions concentrated in strategic sectors.** The UK's pension liabilities are concentrated in parts of the economy that have been identified by the Government as key strategic sectors for the Brexit negotiations, especially financial services, manufacturing and the wider services sector. Brexit particularly needs to work for pension schemes in these sectors, as well as for the companies that sponsor them.

- **What does success look like?** From the pension scheme perspective, a successful outcome from the Brexit negotiations would include the following:

  - **for a strong economy***:* replication of both the current UK-EU framework for free trade in goods and existing EU free trade agreements with third countries. Also, a new immigration policy that continues to allow flows of talent and labour from the EU for the good of the wider economy in general and pension schemes in particular.

  - **for the right regulation***:* the maximum possible access to the Single Market in services – while also exempting pension schemes that operate only in the UK from damaging EU pensions regulation, such as a potential solvency-based regime for pension funds.

  - **for strong financial services***:* continuation of the passporting regime so that pension funds can invest efficiently.

- **A bespoke model.** These features indicate that the best outcome would be a bespoke set of arrangements covering free movement of goods, services and financial services. This would protect pension schemes from a damaging EU solvency regime in the future, while preserving most of the economic benefits of an open trading relationship and maintaining ready access to global markets via the UK's financial services sector.

- **Transitional regime.** If negotiating the new arrangements takes longer than the two years available under Article 50, then a transitional system will be essential to avoid major economic disruption – both to pension schemes as investors and to the companies that sponsor them as employers.

- **WTO-only would cause major disruption.** On no account could the pension fund industry support a regime based only on WTO rules. This would be likely to cause economic harm, create regulatory barriers and undermine essential pensions support services.

2. THE PLSA

The Pensions and Lifetime Savings Association is the national association with a ninety-year history of helping pension professionals run better pension schemes. Our membership includes over 1,300 pension schemes with over 20 million members and £1 trillion in assets, and over 400 supporting businesses. They make us the leading voice for pensions and lifetime savings in Westminster, Whitehall and Brussels.

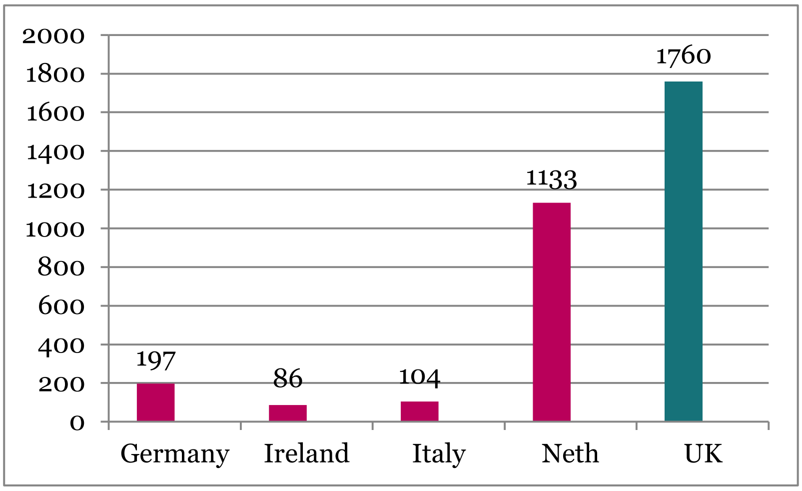
Our purpose is simple: to help everyone to achieve a better income in retirement. To do this we spread best practice among our members, challenge regulation where it adds more cost than benefit and promote policies that add value for savers.

3. UK - THE LARGEST PENSIONS SECTOR IN THE EU

The UK has the largest pensions sector in the EU. The PLSA's members provide pensions for 20 million people – people working and saving towards their retirement and pensioners already receiving their benefits. They have a direct interest in pension schemes remaining strong. The key Brexit risk for them stems from a potential reduction in economic growth.

Auto-enrolment has brought 7 million more people into pension saving – a great British success story that many other EU Member States are looking to emulate.

EU Member States with over €50 billion of workplace pensions assets[1]



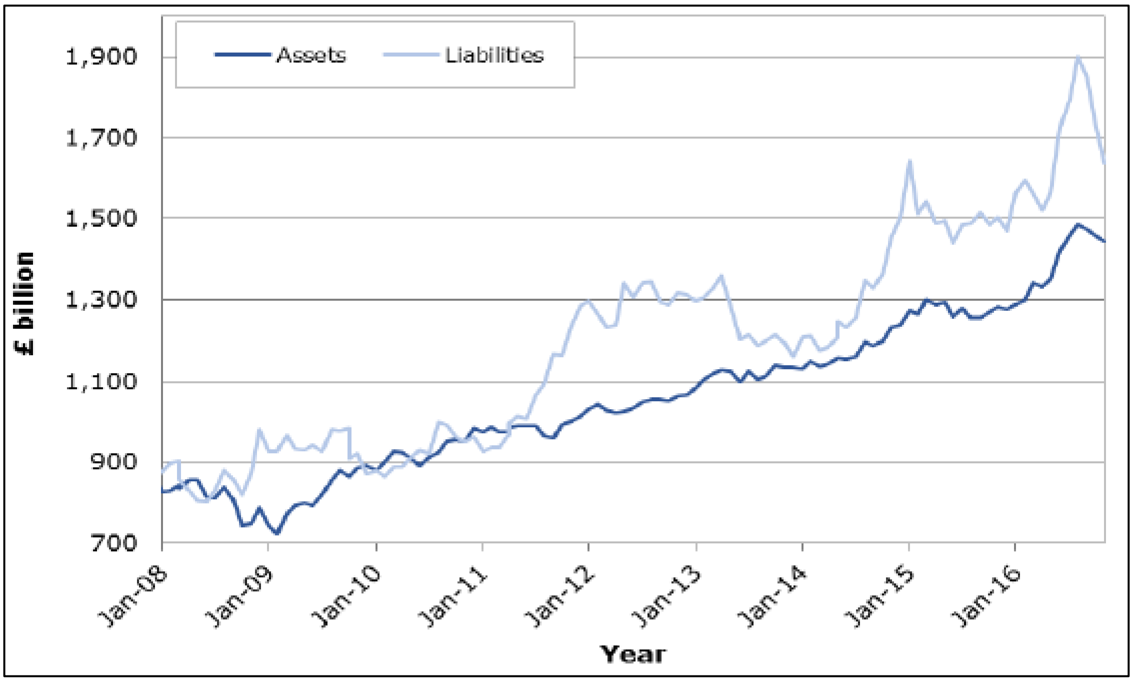
MAJOR INVESTORS

With over £1 trillion of assets under management, UK pension funds provide important capital flows to the UK economy, as well as to those of the EU27. It is therefore important to British savers and their pension funds - and to the employers supporting those funds - that the UK economy gets a good Brexit.

At present the majority of UK pension assets are in defined benefit pension schemes, although newer, defined contribution schemes are growing rapidly as auto-enrolment brings millions more people into workplace pension saving.[1]

The chart below, drawn from the Pension Protection Fund's monthly '7800 Index', shows DB assets (across all DB schemes – not just PLSA members) roughly doubling over the past 8 years, to over £1.4 trillion, although liabilities have increased even more rapidly over the same period.

Assets and liabilities of defined benefit pension schemes[2]



Approximately 9% of our defined benefit members' assets are invested in European equities (5.5% in the UK and 3.5% elsewhere in Europe)[3], with further allocations to UK Government bonds (23.5%) and Eurozone sovereign bonds (0.3%).

Assuming these figures are broadly reflected across all funded UK defined benefit schemes,[4] this indicates that UK defined benefit schemes have around £40 billion invested in equities in Europe outside the UK.

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[1] Assets in DB pension schemes currently total £1.44 trillion (Pension Protection Fund *7800 Index*, October 2016), compared with DC assets of £324 billion in 2015 (Pensions Policy Institute *Future Book* 2015).
[2] Pension Protection Fund monthly *7800 Index*, 30 November 2016.
[3] PLSA *Annual Survey 2016*, p.32

UK pension schemes make further contributions to EU economic growth through their allocations to corporate bonds, property, infrastructure, private equity and venture capital, but Europe-specific figures are not available for these asset classes.

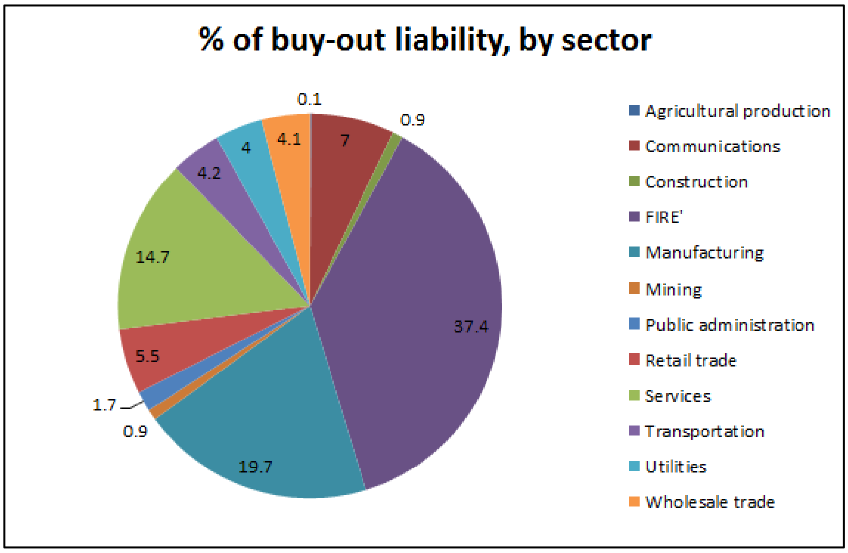
PENSIONS CONCENTRATED IN KEY STRATEGIC SECTORS

Calculations by J. P. Morgan demonstrate that the UK's DB pension liabilitiies are disproportionately concentrated in certain sectors, especially:

- financial services ('FIRE' – finance, insurance and real estate);
- manufacturing; and
- the wider services industries.

The analysis finds that, although these 3 sectors represent 30% of the UK's GDP, they account for 60-70% of total DB pension liabilities.[5]

Sectoral concentration of DB pension liabilities



[4] The asset allocation percentages in the PLSA's *Annual Survey 2016* cover the 148 schemes that responded to the survey – together representing 48% of the UK's total DB assets, which amount to £1.3 trillion. The absolute figures for equity investment given here are calculated by assuming that the asset allocation of PLSA members is replicated across the whole UK DB universe, and should be treated as approximations.

[5] To arrive at this conclusion, J.P.Morgan started with the assets and Section 179 liabilities from the Appendix of chapter 4 in the Pensions Regulator's *2015 Purple Book*. They then estimated the buy-out liabilities for each sector by scaling up the s179 figures. The scaling factor is the average buy-out to s179 ratio (also found in the appendix of the *Purple Book*) multiplied by the ratio of each industry's average wages to the national average wage (sourced from the *Annual Survey of Hours and Earnings*). Having calculated the percentage of both types of liabilities accounted for by each industry, J.P.Morgan then sourced the GDP for each industry and calculated the percentage of the total accounted for by each one.

This sectoral distribution corresponds closely with the 6 key strategic sectors identified by the Government as key considerations in the Brexit negotiations:

- financial and professional services;
- advanced manufacturing;
- aerospace;
- life sciences;
- creative industries; and
- technology.

If Brexit is to be a success, then it needs to work for pension schemes in these sectors, as well as for the companies that sponsor them.

In summary, the scale of the UK's pensions sector – in terms of the 20 million people it serves, the £1 trillion of investments it makes and its salience in strategic sectors of the economy – means a good Brexit deal is vital for Britain's savers, employers and wider economy.

4. WHAT PENSION SAVERS NEED FROM A BREXIT DEAL

The ability of UK pension schemes to deliver good pensions to British savers depends on: (i) the success of the British economy; (ii) having the right regulatory regime; and (iii) ready access to efficient financial services.

This chapter will explain why each of these is vitally important for pension schemes before discussing the potential impact of Brexit and identifying what pension schemes need from the new UK-EU deal.

(i) A STRONG ECONOMY

WHY BREXIT MATTERS: THE ECONOMY AND THE 'SPONSOR COVENANT'

A strong economy is vital for pension schemes. If the economy is growing steadily and sustainably, then this means employers have the strength to give strong support to the pension schemes that they sponsor – whatever form the scheme takes.

Employers that sponsor defined benefit pension schemes are under a legal and moral obligation to ensure their schemes are properly funded. This is known as the 'sponsor covenant'.

Anything that weakens the sponsoring employer (as the lower exchange rate has for net importing businesses) or that reduces the funding level of the scheme and increases the pressure on the sponsor (as lower interest rates and renewed Quantitative Easing have done) reduces the strength of the sponsor covenant.

In a survey of PLSA members conducted shortly after the referendum, 74% of respondents said that the prospect of Brexit had weakened the outlook for pensions. The sponsor covenant is at the heart of these concerns.

WHY BREXIT MATTERS: THE RISK TO DEFINED CONTRIBUTION PENSIONS

Lower GDP growth inevitably means that both employers and employees have less money available for pension contributions. In DC schemes, this means smaller pension pots – and lower incomes in retirement.

The PLSA's recent research into pensions adequacy[6] highlights how salient these risks are for workers and employees in DC schemes.

- The report rated only 2% of workers in DC schemes as 'green'. In other words, these people have a 60% or better chance of achieving the 'Target Replacement Rate' level of retirement income identified by the Pension Commission.

[6] *Retirement Income Adequacy: generation by generation*, PLSA. November 2016

- DC savers clearly cannot afford is any reduction in pot size compared with current expectations. So getting Brexit right – and avoiding the reduction in GDP growth currently expected by most forecasters – is hugely important for DC savers.

BREXIT IMPACT: PENSION SCHEMES' PERSPECTIVE

Referendum 'roadshows'
In a series of 'referendum roadshows' held in London, Edinburgh, Cardiff and Manchester, PLSA members reported time and again that the key post-referendum issues for their schemes were:

i) economic uncertainty;
ii) increased deficits for many schemes as a result of interest rate reduction and further QE; and
iii) impact on sponsoring employers' ability to support their pension schemes.

- The typical post-referendum situation for DB schemes is an increase in assets outweighed by a bigger increase in liabilities, resulting in higher deficits overall. A minority of DB schemes, however, report an improvement in their funding. These tend to be schemes with extensive hedging against currency risk.

- Schemes emphasise, however, that they are not rushing to change investment strategies. Pension schemes take the long-term view.

PLSA member survey
These views were echoed in a survey answered by 42 fund members and 10 business members.

- 74% of fund members thought the outlook for pensions had got worse under Brexit; 12% thought it remained the same, 12% did not know and 2% thought it had got better. 8 out of 10 thought the economy had got worse.

- 79% of fund members thought that the UK's economy would become weaker over the next 12 months.

- 36% of fund members thought the UK's economy would be weaker in the long term (from 2010 onwards), with 26% stating that the economy would remain the same, and 17% believing the economy would be stronger. 21% did not know.

THE IMPACT OF BREXIT: MONETARY POLICY AND DEFINED BENEFIT PENSIONS

Quantitative Easing

The most obvious immediate policy consequence of the referendum for pension schemes has been the Bank of England's announcement of a 0.25% reduction in the base rate and further £60 bn of quantitative easing (QE) announced on 4 August.

QE, in particular, has undoubtedly contributed to pension fund deficits. Analysis by the PLSA (then the NAPF) suggested that the first £200 bn of asset purchases pushed down gilt yields by around 100 basis points, which would have increased liabilities, calculated by reference to gilts, by around 20% (or £180 bn) compared to the position in 2009.

The second round of asset purchases - £125 bn – was estimated to have increased liabilities calculated by reference to gilts by another £125 bn. These gilt movements alone, despite some off-setting increases in the value of assets (around £30 bn), meant that the aggregate deficits of DB schemes increased by around £90 bn as a direct result of QE.

No detailed calculations are available for the impact of the most recent (August 2016) interest rate reduction and renewed QE round, but we can see that conventional 15-year gilt yields fell by 21 basis points during August 2016, with much of the fall happening immediately after the Bank's announcement.[7] The Bank's own analysis identifies a 17 basis point fall in 10-year gilt yields in the day after the announcement and a 15 basis point fall over two days.[8]

The Pensions Regulator's *Purple Book 2015* states that, as a rule of thumb, 'a 0.1 percentage point (10 basis point) reduction in gilt yields raises aggregate scheme liabilities by 2.0 per cent and raises aggregate scheme assets by 0.6 per cent'[9]. This is consistent with the changes seen during August 2016, when assets increased by £37.5 bn (1.9 per cent) but labilities by £110.2 bn (6.1 per cent).

Interest rates staying lower for longer

In the normal course of events, UK interest rates could have been expected to track the upward progression of US interest rates over the near-term. However, analysis by J.P.Morgan indicates that post-Brexit effects are likely to keep interest rates lower than they otherwise would have been.

The J.P. Morgan estimate is that Brexit has introduced an additional 50 basis points of difference in expectations between the two countries, which would result in pension funds requiring of the order of £100-£150bn of additional assets in order to pursue a liability-matching strategy at the end of five years, relative to what they might have required otherwise.[3]

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[7] PPF 7800 Index, 31 August, p.4

[8] *Staff Working Paper no. 624 – QE: the story so far*, Bank of England, October 2016, p.18

[9] *Purple Book 2016*, the Pensions Regulator, p.32

Note that the PLSA expects a generally rising interest rate environment to bring *some* relief to pension funds, but if rates rise more slowly than they might otherwise have done, then this relief will be less than it otherwise might have been.

The extra pressure that QE and low interest rates are imposing on pension schemes provide further grounds for ensuring that the new UK-EU deal takes full account of pension schemes' concerns.

THE IMPACT OF BREXIT: LOWER GDP GROWTH EXPECTED

The Office of Budget Responsibility has downgraded its GDP growth forecasts for the next two years since the referendum.

- In its last forecast before the referendum, in March 2016, the OBR was forecasting GDP growth of 2.0% in 2016, 2.2% in 2017 and 2.1% in 2018.[10]

- In its latest forecast, issued at the time of the Autumn Statement in November 2016, the OBR had amended these forecasts to 2.1%, 1.4% and 1.7% respectively.[11]

The same pattern of reduced growth expectations is repeated across most (although not all) City forecasts – as shown in the table below.

[10] *Economic and Fiscal Outlook*, Office for Budget Responsibility, p.57, March 2016
[11] *Economic and Fiscal Outlook*, Office for Budget Responsibility, November 2016, p.58

Studies of long-run impact of EU exit %-pt impact on level of GDP			
	Medium term (beyond 5 yrs)		
	Worst case	Central case	Best case
HM Treasury (WTO, 2016)	-9.5	-7.5	-5.4
Bertelsmann Stiftung** (2015)	-14.0	-7.3	-0.6
HM Treasury (FTA, 2016)	-7.8	-6.2	-4.6
CEP (dynamic, 2014)	-9.5	-5.85	-2.2
OECD (2016)	-7.7	-5.1	-2.7
HM Treasury (EEA, 2016)	-4.3	-3.8	-3.4
PwC/CBI (2016)	-3.5	-2.35	-1.2
Pain & Young (2004)		-2.25	
CEP (static, 2014)	-3.1	-2.1	-1.1
Oxford Economics (2016)	-4.0	-2.05	-0.1
Open Europe (2015)	-2.2	-0.3	1.6
Institute of Directors (2000)		1.75	
Minford & Mahambre (2005)	3.2	3.5	3.7
Economists for Brexit (2016)		4.0	
Civitas (2004)	1.5	4.0*	5.2

Sources: Sources: HM Treasury and stated above, *This refers to the most probable outcome rather than the average of best and worst case scenarios, **These estimates refer to GDP per capita. Table compiled by J.P.Morgan

WHAT PENSION SCHEMES NEED FOR A STRONG ECONOMY

Free movement of goods

The key economic issue in the UK-EU negotiations is trade. Continued tariff-free trade in goods is high on the PLSA's wish-list because of its significance to employers that sponsor pension schemes across the manufacturing sector. Free trade promotes stronger flows of exports and imports, strengthening competition, rewarding innovation and promoting economic growth.

Free movement of services

The EU Single Market in services remains a work in progress, and it is not clear that its loss would change the trading environment for pension scheme sponsors in the marked way that a loss of free trade in goods would.

- There are important sectors, however, where the Single Market is well established and loss of access would be a major change for the worse. Passporting of financial services is the classic example. (See below for more detail on this point.)

- From the pension scheme perspective, the Single Market in services is less significant. UK pension schemes operate almost exclusively within the UK, providing pensions for

UK-based workers, and the market in cross-border pension schemes has never really developed[12].

Free movement of labour
The Government has committed itself to regaining 'control' over movement of labour from the EU.

- However, loss of access to labour and talent from Europe could have a significant impact on many UK employers and would weaken sponsor covenant.

- Many City firms, in particular, have a hugely international workforce. It is vital that London continues to be a global centre for economic and business expertise, and this means keeping it easy to recruit talent from around Europe and the rest of the world.

What pension schemes need for a strong economy:
Free trade in goods and free movement of labour
The PLSA wants to see replication of both the current UK-EU framework for free trade in goods and existing EU free trade agreements with third countries. Also, a new immigration policy that continues to allow flows of talent and labour from the EU for the good of the wider economy in general and pension schemes in particular.

[12] *2015 Market development report on occupational pensions and cross-border IORPs*, EIOPA, 9 July 2015

(ii) THE RIGHT REGULATION

WHY BREXIT MATTERS: IORP II AND PENSIONS SOLVENCY

Pension schemes are subject to EU legislation – both as institutional investors affected by EU financial market regulation (such as MIFID II and the EMIR legislation on the derivatives markets) and, very significantly, directly under the IORP Directive on workplace pension schemes (Directive on Institutions for Occupational Retirement Provision, to give its full name).

A revised version of the IORP Directive, 'IORP II', has recently been approved by the European Parliament and ECOFIN and will reach the EU's statute books in early 2017. The implementation date – when Member States will be required to have IORP II in place - will fall on 12 January 2019.

The final text of 'IORP II' is much less complex and prescriptive than the EC's original proposal and is largely acceptable to UK pension schemes, although there would be some unwelcome extra compliance burdens.

It is difficult to see much benefit for UK pension schemes from implementation of IORP II perhaps just weeks before the UK leaves the EU, but this is not the most crucial issue for pension schemes. Schemes would welcome clarification from the Government on whether they will have to implement IORP II and, if so, what this will mean in practice in the UK.

THE IMPACT OF BREXIT: POTENTIAL SOLVENCY RISK

The greater concern for pension schemes is exposure to potential EU legislation on a solvency-based funding regime for pension schemes, which would be damaging to the funding position of UK DB schemes, leading to further scheme closures and – almost certainly – less generous pension provision.

The EU's own insurance and pensions authority, EIOPA, which supports the solvency agenda, has estimated that the Holistic Balance Sheet would increase the funding requirement for UK schemes by €650 billion.[13]

The UK has been successful in blocking these proposals in their various guises over recent years, acting in partnership with Germany, the Netherlands, Ireland and Belgium. With the UK out of the EU, the risk of solvency being brought forward again would increase. The worst case scenario for UK pension schemes would be to find themselves more vulnerable outside the EU to the damaging regulation that was successfully blocked when the UK was inside the EU.

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[13] *Annex 2 to Opinion: Results of the quantitative assessment*, EIOPA, April 2016, pp.96 and 99

Whatever model the UK adopts for its future relationship with the EU, it is important that it should protect pension schemes that operate only in the UK (the overwhelming majority) from any potential pension solvency system that might be introduced in the longer term.

This issue would come into sharp focus if the new UK-EU deal were to involve continued supervisory powers for the European Supervisory Authorities over UK-based institutions. Some press comment has speculated that the EBA and ESMA could retain powers over UK-based banks and financial institutions as part of an agreement on 'equivalence' and 'passporting' . The PLSA would be concerned if this were to involve no change in EIOPA's role and continued exposure to potential EU solvency rules; hence the PLSA's view that UK-only pension schemes should be exempt from any such solvency regulation.

What pension schemes need for the right regulation:
Protection from damaging solvency regulation
Pension schemes want the maximum possible access to the Single Market in services – while also exempting pension schemes that operate only in the UK from damaging EU pensions regulation, such as a potential solvency-based regime for pension funds.

THE IMPACT OF BREXIT: PENSION SCHEMES AND SCOTLAND

Many large pension schemes have significant numbers of members both north and south of the Scottish border. The pension schemes of the banks, supermarkets, universities and privatised utilities (telecoms, rail etc) are good examples.

These schemes are particularly concerned about the potential ramifications of Brexit for Scotland, where momentum appears to be building behind a second referendum on independence from the UK.

- If Scotland were to part from the UK before the UK leaves the EU, then many schemes would become 'cross-border' under the IORP Directive's rules. Although the new IORP Directive effectively removes the prospect of full funding at all times, there is still a risk of increased regulatory complexity.
- If Scotland were to go independent once the UK has departed, then many schemes would be faced with two diverging regulatory regimes – one run from London and another from Edinburgh (with input from Brussels if Scotland were to become an EU Member State). Schemes would have to be split or restructured.
- An independent Scotland would have implications for asset-backed funding of pension schemes, since these arrangements commonly use Scottish Limited Partnerships as their legal basis.

(iii) STRONG FINANCIAL SERVICES

WHY BREXIT MATTERS: ACCESS TO GLOBAL MARKETS AND WORLD-CLASS EXPERTISE

Pension schemes need full access to the global financial markets, both for investments that will give them the resources to meet their pension commitments and for derisking and hedging purposes so they can manage their risks.

Schemes want to undertake these activities as efficiently as possible. Money wasted means lower pensions for individual workers or higher pension costs for employers, leaving them with less money for job creation and investment in the business.

It is not just about access to the right assets and instruments; pension schemes also need ready access to the best professional advice. Running a large pension scheme is a complex and technical challenge, requiring input from actuaries, investment consultants, asset managers and lawyers. Obtaining these services at a competitive price is a further challenge for pension scheme managers and trustees.

At present, the UK's strength in financial services, particularly the world-class agglomeration of expertise found in the City of London, is a huge benefit for UK pension schemes. Any dilution of the strength of the UK's financial services would have a negative effect on the pension schemes that they support.

WHY BREXIT MATTERS: A STRONG FINANCIAL SERVICES SECTOR

The PLSA is very concerned that the new UK-EU relationship should allow the UK's financial services sector to continue flourishing. The PLSA is also anxious to see stability and continuity; the system we have at the moment is successful, so a minimum amount of disruption to it would be desirable. We share the view of The City UK:

> 'access to the Single Market on terms that resemble as closely as possible the access the UK currently enjoys is at the top of our list'[14].

Even outside the EU, it is likely that the UK will have to (and may wish to) continue complying with EU legislation such as MIFID II and EMIR in order to participate in EU markets (just as UK institutions comply with Dodd-Frank when trading with the USA). As The City UK has said:

> 'In order to maintain and further enhance the UK's position as the leading global financial centre, UK financial services will need to continue to be regulated in accordance with leading global standards'[15].

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[14] *Brexit and the Industry*, The City UK, September 2016, p.3

[15] See https://www.thecityuk.com/research/brexit-and-the-industry/

THE IMPACT OF BREXIT: PASSPORTING

The most significant investment regulation issues relate to passporting of financial services.

- Continuation of passporting is not a direct concern for pension schemes, but it is a major issue for their asset managers.

- Loss of passporting would cause major business disruption for these crucial service providers to the pensions industry, as they would have to go through the time-consuming process of securing country-by-country authorisations for each of their business lines. This would push up costs – with a risk that these would be passed onto their pension fund clients. This would come at a time when there is intense political pressure to bear down on pension charges, with the maximum charge in default funds for auto-enrolment pension schemes now set at 0.75%.

- It is possible that major institutions with offices across Europe might be less affected than smaller operators based entirely in the UK, although this is largely speculation. Even so, loss of passporting might drive the largest institutions to base new business lines outside the UK, leading to a gradual shift away from the UK over time.

- It is important to note that passporting can be obtained without being a member of the Single Market. ESMA has recently confirmed that a number of countries (eg Australia, Japan and Singapore) have the necessary regulation and consumer protection to warrant being brought within the EU's passporting regime. Obtaining this 'equivalence' is not straightforward; it requires exhaustive checks and negotiations with ESMA, and equivalence is not available across the full range of financial services. However, some commentators suggest that, given the UK already has an EU-based regulatory regime in place, proving 'equivalence' could be easier than for other nations.

In summary, continuation of passporting is a key concern for pension schemes. Maintaining it should be a key feature of the new UK-EU relationship.

What pension schemes need for strong financial services:
Continuation of passporting
Pension schemes want to see continuation of the passporting regime so that pension funds can invest efficiently.

5. OPTIONS FOR THE NEW UK-EU RELATIONSHIP: ASSESSMENT OF MODELS

The Government has indicated that it is looking for:

- a deal unique to Britain, not an 'off-the-shelf solution';
- UK control over laws, borders and taxpayers' money;
- ending the supremacy of the European Court of Justice over UK courts;
- the freest possible trading relationship;
- access to the Single Market but not membership of the Single Market;
- controls on the number of people who come to the UK from the EU; and
- maintaining or strengthening co-operation on security and defence.

These very broad-brush statements leave a wide range of potential outcomes in play. The PLSA's assessment of the current debate indicates that a range of potential outcomes is possible (although some are more likely than others). These include:

- *'Canada-plus'*. This would be similar to the EU-Canada Comprehensive Economic and Trade Agreement ('CETA'), which will provide free trade in goods and key services sectors. Unlike CETA, a UK-EU version might add extensive provisions on free flows of financial services (including passporting), with the UK committing to continued compliance with EU financial legislation.

- *EEA*. Some commentators predict the UK will simply become a member of the European Economic Area, like Norway, in a 'Soft Brexit'. On the face of it, this is not attractive politically, as it would maintain some of the features widely regarded as key factors behind the vote to leave, such as free movement of labour, substantial payments into the EU budget and full subscription to Single Market regulations – without voting representation to influence those rules. Furthermore, the Prime Minister's commitments to ending the supremacy of the European Court of Justice and to reasserting control over the UK's borders appear to rule out membership of the Single Market. The more likely scenario is that EEA membership could be used as a transitional phase after Brexit has occurred – a 'holding position' while a new relationship is negotiated.

- *'EEA-minus'*. This would replicate the 'Norway' model, but without free movement of labour – thereby addressing one of the political 'hot potato' issues. Some commentators suggest that the EU would not agree to such a deal. Others argue that the EU's balance of trade surplus with the UK would mean it would be in the EU's interest to do so. As discussed above, it could serve a useful purpose as a transitional system.

- *EFTA*. Together with Norway, Iceland and Lichtenstein, Switzerland completes the European Free Trade Area (EFTA). The 'Switzerland' model is based on 140 sector-by-sector agreements with the EU that together deliver barrier-free access to the Single Market for most goods and services – although there is no passporting for financial services. The Swiss arrangement also involves continued free movement of labour, although the Swiss people voted in a 2014 referendum to bring this aspect of its relationship with the EU to an end. The European Commission has refused and the two are now in a stand-off on this sensitive issue.

- *Customs union*. Turkey is in a customs union with the EU, which means there is tariff-free trade in goods and the EU sets Turkey's external tariffs on trade in goods with the rest of the world. The political downside of this arrangement is that it would block the UK from striking the new free trade agreements with third countries such as India, China or Australia that are seen by Brexit supporters as one of the potential 'prizes' now available as a result of the referendum. Like the rather different EEA arrangement, it might, however, offer potential as a transitional arrangement.

- *Free trade deal – goods only*. The EU's deal with South Korea is a wide-ranging free trade agreement covering 98% of goods (but not services). Those few items not subject to a nil tariff are subject to interim arrangements that will see tariffs phased out over 10 years.

- *WTO terms*. Perhaps the least attractive of these scenarios, this is nonetheless where the UK would find itself if no 'bespoke' deal is reached.

PROS AND CONS OF THESE MODELS FOR PENSION SCHEMES

Each of these models has its pros and cons for pension schemes.

Existing EU-third country relationships – pros and cons	
'Canada plus'	
Pros	○ maintain free flows of business in both services and goods – including vital financial services; ○ potential for new free trade deals with non-EU countries; and ○ could protect UK-only pension schemes from a future EU pensions solvency regime.
Cons	○ UK would lose political influence over future legislation that would affect UK businesses; and ○ would most likely take years to conclude full agreement, necessitating a transitional arrangement.
Issues	○ New 'work permit' EU immigration system would need to work seamlessly and quickly.
EEA	
Pros	○ maintain the economic benefits of Single Market membership; and ○ retention of full free movement of labour might be seen as a benefit for the economy, but would be unpopular politically.
Con	○ would leave the pensions sector exposed to the key regulatory risk of pensions solvency; and ○ continued membership of Single Market appears incompatible with (a) Prime Minister's commitment to end jurisdiction of European Court of Justice in UK and (b) continued free movement of labour.
'EEA-minus'	
Pros	○ maintain the economic benefits of Single Market membership.
Cons	○ work permit system for EU nationals might generate extra administrative costs for employers; ○ would leave the pensions sector exposed to the key regulatory risk of pensions solvency; and ○ continued membership of Single Market appears incompatible with Prime Minister's commitment to end jurisdiction of European Court of Justice in UK.
EFTA	
Pros	○ maintains free trade in goods and many services; ○ maintains free movement of labour (although Switzerland is

	attempting to end this); and o no risk of unwelcome pensions solvency regime.
Cons	o no passporting for financial services.
Customs Union	
Pros	o maintains free trade in goods; and o no risk of unwelcome pensions solvency regime.
Cons	o no free movement of services; no passporting; o no free movement of labour; and o no freedom to negotiate new free trade deals with third countries.
Free trade deal – goods only	
Pros	o maintains free trade in goods; o potential for UK to negotiate free trade deals with third countries; and o no risk of unwelcome pensions solvency regime.
Cons	o no free movement of services; no passporting; and o UK would have to 'start from scratch' in negotiating free trade agreements – could take years.
WTO terms	
Pros	o potential for UK to negotiate free trade deals with third countries; and o no risk of unwelcome pensions solvency regime.
Cons	o no automatic free trade in goods or services; and o UK would have to 'start from scratch' in negotiating free trade agreements – could take years.

The table below gives summary assessment of each model.

Pension Schemes Assessment: Options for the new UK-EU relationship

	'Canada-plus'	*'EEA*	*'EEA-minus'*	*EFTA*	*Customs Union*	*Free trade deal: goods*	*WTO terms*
'Right Regulation'	√	X / √ (exemption for solvency needed)	X / √ (exemption for solvency needed)	√	√	√	√
'Strong economy'	√ (work permits)	√	√ (work permits)	√	√ / X	X	X
Strong City of London'	√	√	√	X	X	X	X

THE BEST MODEL

On the basis of the assessment above, a bespoke set of arrangements covering free movement of goods, services and financial services would be the best outcome for pension schemes. This would protect pension schemes from a damaging solvency regime, while preserving most of the economic benefits of an open trading relationship and maintaining ready access to global markets via a strong City of London.

On no account could the pension fund industry support a regime based only on WTO rules. This would be likely to cause economic harm, create regulatory barriers, and undermine the essential services provided to pension funds from the City of London.

AVOIDING THE 'CLIFF EDGE' – A TRANSITIONAL REGIME

Uncertainty and volatility make business planning more difficult for pension schemes and their sponsoring employers, so stability and continuity are key concerns.

For this reason, the 'nightmare' scenario for pension schemes would be a sudden 'cliff edge' change from full membership of the Single Market to access on basic WTO terms. This would end free trade, free movement and passporting overnight – a major shock to the economic system.

If – as may well be likely – the future UK-EU relationship has not been agreed by the end of the 2-year Article 50 period, then the Government should ensure there is a transitional or interim arrangement to minimise disruption.

6. CONCLUSION

Keeping workplace pension schemes strong is important for millions of British citizens and for thousands of businesses, and it is vital that the Brexit negotiations take full account of the concerns highlighted in this paper.

It is particularly important that pension schemes are not just 'swept up' in decisions about financial services in general: pension schemes are unique in character and require a regulatory framework to suit their distinctive nature.

In particular, it is essential that schemes operating only in the UK should not be subject to any future EU rules on scheme funding.

This paper suggests that a bespoke set of arrangements covering free movement of goods, services and financial services would best deliver what pension schemes need from the negotiation, but much would depend on its precise content and – crucially – on how long it would take. A transitional arrangement might well be necessary.

Ultimately, pension schemes rely on the health of the economy. As £1 trillion investors, the PLSA's members can make a major positive contribution to the UK's economic future, but they are affected in turn by the strength of the businesses and other economic players around them.

So, whatever shape the new UK-EU relationship takes, it is vital that it provides the conditions for a strong and sustainable economy within which safe, adequate and secure pension schemes can thrive.

PENSIONS AND
LIFETIME SAVINGS
ASSOCIATION

ANNEX A. KEY RESULTS FROM PLSA MEMBER SURVEY

42 fund members and 10 business members responded to a PLSA member survey on Brexit issues, with the following headline results:

Fund members

- 74% thought the outlook for pensions had got worse under Brexit; 12% thought it remained the same, 12% did not know and 2% thought it had got better.

- The top three main areas of concern as a direct result of the referendum were:
    - Economic uncertainty (38%)
    - Interest rate cuts (31%)
    - Outcomes of scheme valuations (14%)

- Other areas of concern were:
    - Reduced global growth (45%)
    - Risks to DC scheme members approaching retirement (31%)
    - Further round of quantitative easing (29%)

- The survey asked about the long-term and short-term economic outlook:
    - 79% thought that the UK's economy would become weaker over the next 12 months
    - 36% thought the UK's economy would be weaker in the long term (from 2010 onwards), with 26% stating that the economy would remain the same, and 17% believing the economy would be stronger. 21% did not know.

- 45% thought it was important that passporting arrangements should continue as they are, with 17% stating neither important nor unimportant, 17% stating this was not important, and 21% not knowing.

- 50% thought that their pension schemes would be best supported by the UK retaining access to the EU Single Market, 40% did not know. The remainder thought they would not be best supported with access to the EU single market.

Business members

- 8 out of 10 thought the economy had got worse.

- 5 out of 10 thought the main concern facing pension funds was economic uncertainty, followed by 2 out of 10 stating the sponsor's covenant risk will worsen.

ANNEX B: UK AND EU PENSIONS REGULATION

Although pensions policy is a Member State competence, the UK's pensions system is closely connected to the EU through legislation and regulatory activity.

EIOPA's role. From the pension scheme perspective, the European Insurance and Occupational Pensions Authority (EIOPA) is the most significant of the three European Supervisory Authorities (which also include ESMA and the EBA).

Based in Frankfurt, EIOPA's role is to protect the stability of the financial system, to increase the transparency of financial markets and products and to protect consumers. It does so by developing technical standards, by co-ordinating national supervisors (including TPR), by identifying and analysing trends and risks and by advising the European Commission.

The UK's Pensions Regulator plays a key role in EIOPA's work; its staff sit on many of EIOPA's working groups and committees.

EU PENSIONS AND EMPLOYMENT LAW

UK pensions law is extensively intertwined with EU law, regulation and court rulings. There is no need to dismantle this framework – and very little to gain from doing so. In fact, the overwhelming message from PLSA members is that they do not want major regulatory upheaval.

The key EU law in the workplace pensions area is the *Directive on Institutions for Occupational Retirement Provision or 'IORP Directive' (2003)*. High-level in nature, it nonetheless sets the framework within which UK pensions law sits. A much more detailed new version of the IORP Directive ('IORP II') has recently been finalised and became part of the *acquis* in mid-January 2017. Member States will then have 2 years to implement its provisions, putting the deadline in mid-January 2019[16].

No solvency regime, please. For many years UK pension schemes have been battling against the prospect of an EU solvency regime for pension schemes, closely based on the insurance industry's *Solvency II Directive*. Faced with opposition from

EU pensions & employment law:

- 'IORP Directive' (2003)
- IORP Directive Mk II imminent
- Directive on Acquisition & Preservation of Supplementary Pension Rights (2004)
- Equal Treatment Directive (2006)
- Insolvency Directive (2008)

EU investment markets law:

- MIFID I (2004)
- MIFID II & MIFIR (2014)
- EMIR (2012)
- Shareholder Rights Directive

Future EU initiatives:

- Capital Markets Union
- Pan-European Personal Pension
- EU rules on standardised securitisation

[16] The deadline looks likely to be 12 January 2019, although this has not been officially confirmed.

Member States including the UK, EIOPA has revised this into a 'Common Framework for Risk Assessment and Transparency', but even this has now been completely dropped from the European Commission's agenda.

It is vital that the future UK-EU relationship protects UK pension schemes from any renewed EU push for a solvency regime. If new EU Single Market legislation is to apply to UK pension schemes after Brexit, then, due to the distinctive nature of UK provision and the fact that the UK will not be at the table to influence negotiations, it is essential that schemes operating only in the UK are exempted from any future EU rules on scheme funding.

EU legislation on equal treatment. The Equal Treatment Directive (2006) on equal rights for men and women in employment matters has a direct impact on UK pension schemes – most notably through the European Court of Justice ruling in the 1990 *Barber* case, which underpins HM Government's view that pension schemes must equalise Guaranteed Minimum Pensions. Many in the pensions industry are hoping that Brexit might sweep away this potential regulatory burden on UK pension schemes, which would be hugely complex and costly to introduce and would make very little difference to pensions that people receive. However, it is likely that the UK's own Equality Ac 2010 and continuing participation in the European Convention on Human Rights will prevent this outcome.

*EU investment markets law. A*lthough the EU's extensive body of financial markets legislation falls directly on banks and asset managers, it is of direct relevance to pension schemes in their role as end-client investors. If regulatory changes increase (or reduce) the costs of investing and transacting, then pension schemes are likely to feel the impact in the fees they pay for asset management, hedging and other market activities.

Legislation such as MIFID (and now MIFID II), the EMIR legislation on derivatives markets and the Alternative Investment Fund Managers Directive (AIFMD) on hedge funds, private equity and other asset classes all shape the environment in which pension funds invest.

ANNEX C: PENSION SCHEMES AND THE ECONOMY- A CLOSER LOOK

Chapter 4 above discusses the importance of a strong economy for pension schemes. This Annex gives examples of the different ways in which the strength of the economy has an impact on pension schemes.

- The health of the UK economy directly affects the ability of *sponsoring employers* to support their company pension schemes.

- Employers that sponsor defined benefit pension schemes are under a legal and moral obligation to ensure their schemes are properly funded. This is known as the 'sponsor covenant'.

- Anything that weakens the sponsoring employer (as the lower exchange rate has for net importing businesses) or that reduces the funding level of the scheme and increases the pressure on the sponsor (as lower interest rates and renewed Quantitative Easing have done) reduces the strength of the sponsor covenant.

- Of course, not all scheme sponsors are UK-based companies. Some are subsidiaries of overseas-based multinational parents or part of multinational corporate groups. The strength of these sponsors is sometimes determined by economic conditions across all of their centres of operation. However, very often, the sponsor covenant is only linked to the UK business.

- DB schemes' *liabilities* are directly affected by events in the UK, given the close link between UK monetary policy, gilt yields and the discount rates used to calculate scheme funding requirements. Low interest rates and Quantitative Easing make for higher liabilities. The Pensions Regulator's rule of thumb is that , 'a 0.1 percentage point (10 basis point) reduction in gilt yields raises aggregate scheme liabilities by 2.0 per cent and raises aggregate scheme assets by 0.6 per cent'.

- From the perspective of pension schemes as *investors*, the health of the global (not just the UK) economy is a key consideration. DB pension schemes have nearly four times more money invested in overseas equities than in UK stocks (25.8% and 6.9% of their asset allocation respectively), so their investment focus is truly worldwide – at least in terms of their assets.

- In general, DC schemes have a higher exposure to UK equities, with an average of 25% of their money in this asset class. Although they have larger sums - 41% - in global equities, we might expect lower UK growth to have a more pronounced impact on DC pot sizes than on DB schemes' investments. (These figures are drawn from *Schroders' FTSE Default DC Schemes Report* (p.3, May 2016) and cover the default schemes of FTSE 350 companies.).