RSS Briefing

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Prospect Pensions Briefing Note 2016/01732 September 2016

Brexit – The Impact on Pensions

The true impact of leaving the European Union will not be known for some years to come. In light of the circumstances that have developed over the summer, it is useful to look at some of the early signs of how the world of pensions has been bearing up. The below is based on what has happened and also includes some political commentary indicating how policy makers see the future of pensions panning out.

It should be noted that this is for information only and that none of this should be construed as financial advice.

Occupational Defined Benefit Schemes

DB Schemes have been under extreme funding pressure for much of the last decade. This has resulted in large deficits linked to the cost of paying promised pensions that have already been built up as well as higher costs of keeping a scheme open and allowing members to build up further service. There is a legal requirement for past service deficits to be paid off whilst a sponsoring employer is still solvent. Generally speaking there is no legal requirement for an employer to keep a scheme open to future service, although there are notable legal protections in some industries which state that pension schemes cannot be changed.

Key to the increase in costs has been changes to the discount rate. This is an assumption used by an actuary in assessing the cost of a defined benefit pension scheme. It is the measure used for putting a present value on future payment streams through reverse compounding. For example:

Barbara is owed £10,000 in 10 years' time – what is the present value of that promise?

If we used a discount rate of 5%, then the present value of the promise would be £6,139 (effectively we are dividing by 1.05 ten times).

If a discount rate of 2% is used then the present value would be £8,203, about one-third higher

So a lower discount rate makes the current cost of a pension scheme look much higher.

The law says that in arriving at an appropriate discount rate, actuaries and pension trustees should take account of measures such as the interest payable on government bonds, company bonds and expected returns on investments in the future.

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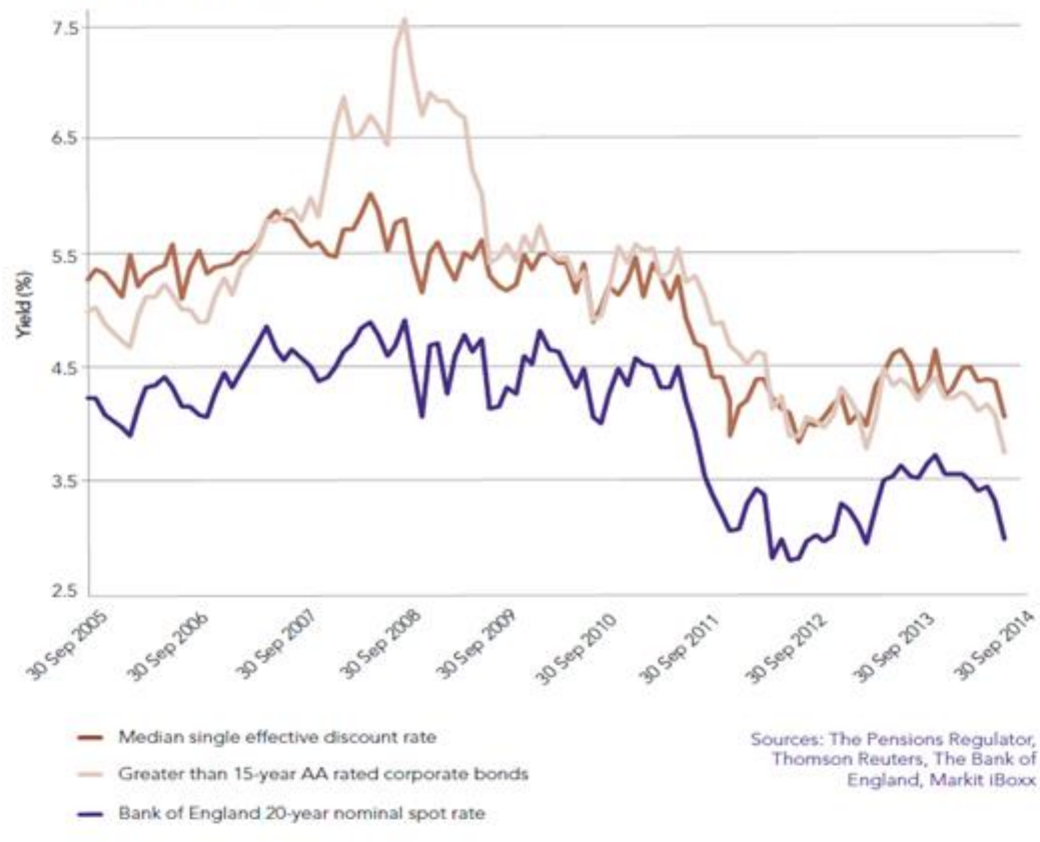

Figure 4: Median (nominal) SEDR, Bank of England 20-year nominal spot rates, greater than 15-year AA rated corporate bonds

More recent figures for yields on government bonds (shown by the blue line above) indicate[1]

Date	Gilt Yield - 20 yr nominal spot rate (%)
30/09/15	2.51
04/01/16	2.65
31/03/16	2.32
01/06/16	2.22
23/06/16	2.25
24/06/16	2.00
01/07/16	1.75
29/07/16	1.57

If a drop in discount rates (equivalent to the drop in bond yield which are attributable to Brexit) on 0.75% feeds through to valuations, it is likely to push up pension liabilities by an order of at least 10%.

[1] http://www.bankofengland.co.uk/statistics/Pages/yieldcurve/archive.aspx

Defined Contribution (DC) Schemes

In such arrangements, members have an individual pension pot, which is invested and used to provide a source of income in retirement. As the level of retirement income is heavily dependent on the level of investment returns built up, members will be keenly focussed on stock-market performances in the post-Brexit world. After the initial dip, there are no signs at present that markets are set for any prolonged period of depression.

Royal London have published fund information showing that most of their standard funds have seen growth in the year ending 31 July 2016[2] at levels higher than the previous two years. NEST unit prices[3] have consistently risen since early June to late July 2016, indicating that DC savers are not seeing any detrimental impacts that could be immediately linked to Brexit.

This is in keeping with reports showing that despite an initial dip, the main stock markets have not suffered to date as a consequence of the vote.

Annuities

Annuity prices have long suffered under the same pressures that have been heaped on defined benefit schemes, primarily as a result of increase longevity and most noticeably, lower interest rates. It was the continued reduction in annuity rates that meant that George Osborne's pension freedoms were met with such open arms.

SharingPensions.co.uk report that annuity rates have dropped by up to 8% in the wake of the Brexit vote[4] – in effect saying that a new annuitant would lose one month's pension income for every year of retirement compared with an identical person who bought an annuity just before the vote. This does not impact on anyone with an existing annuity, rather on savers who may buy an annuity now or in the near future. The reality is likely to be individuals seeking to access their pensions as cash sums or to instigate drawdown – the market for which is not fully developed or tested on a large scale.

Public Sector Unfunded Pension Schemes

The unfunded schemes, primarily Civil Service, NHS and Teachers arrangements have undergone significant changes in recent years, with benefits reduced, member contributions increased and pension ages increased. Pressure is likely to arrive in the funding of these arrangements. The deals that were done place an artificial cost cap on the cost of benefits. To assess the costs against this cap a specific actuarial valuation is done. Broadly, volatility in "member costs" arising from changes to "member" assumptions (e.g. life expectancy) or membership profile will be included and could result in changes to scheme benefits/member contributions (either increased or

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[2] http://www.royallondon.com/GlobalAssets/Docs/shared/performance/9914-life-funds-performance.pdf

[3] http://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/Fund-prices-July_2016,PDF.pdf

[4] http://www.sharingpensions.co.uk/annuities-yields-2016-july-brexit-vote-results-in-collapse-in-gilts-and-rates.htm

reduced). Other variations in "financial" assumptions, most notably changes to discount rate, are excluded as member costs.

However the true assessment of costs done by the main valuation will result in overall costs being changed, with any change in benefits /member contributions only being triggered by the process above. At the time of reform implementation, the discount rate was set at 3% above the prevailing CPI level. However Budget 2016 reduced this, so that discount rates are now set at 2.8% above CPI. With valuations due in 2016, and having an impact in 2019, it is expected that this change will cost public sector employers £2bn+ a year in extra pension contributions.

Any changes to assumptions for future CPI inflation arising from Brexit are likely to have an impact. There are conflicting reports on the consequence to inflation, but there seems to be a consensus that it will be pushed upwards – this will serve to reduce the cost of the schemes to employers. Whilst it is too early to identify any trends on CPI inflation, the July figure of 0.6% was the highest since November 2014.

Any squeeze on finances is likely to act as both a barrier to spending elsewhere (e.g. pay) and increase pressure on the deal that was done on public sector costs.

Public Sector Local Government Pension Scheme

As a funded scheme, the LGPS has the same pressures as occupational Defined Benefit schemes, although the reliance on gilt yields is perhaps not quite as strong. As it is sponsored, largely by public organisations, it faces the same threats to capital resources as the public sector unfunded schemes do.

In terms of the regulatory position, it is reported that DCLG have put out the following statement:

"The question of how, if at all, the result in favour of 'Brexit' will impact on the LGPS has been raised by scheme members and employers as well as the press and other 'commentators' on all things LGPS.

"The vast majority of EU legislation which impacts either directly or indirectly on the LGPS (e.g. IORP) is already written into UK legislation. Accordingly the scheme will need to continue to comply with such legislation until such time as Britain leaves the EU after which it would of course be the prerogative of a future UK government to seek to repeal some or all of this legislation subject to the terms of any new trade arrangements made with the EU.

"With regard to UK government policy and legislative plans for the LGPS the situation is 'no change'. Regulatory changes, policy objectives and the timescales for implementing them remain as they were before the vote."

State Pensions

The state pension system has just undergone a widescale change, implemented in April 2016, with everyone accruing state pension at a common rate.

An independent review of State Pension Age is being carried out for DWP and the Secretary of State. George Osborne previously stated the intention that no more than

1/3rd of adult life (designated as starting at age 20) should be spent in retirement but these proportions and ages are at the discretion of the Secretary of State. Whilst the review looks at these things the Secretary of State also has discretion to consider relevant factors – it is possible that any worsening of the UK economy could feature as a factor used to reduce expenditure by increasing State Pension Age. As State Pension Age is also the basis for normal pension ages in the reformed public sector schemes (this link in itself should be the subject of a review), changes to State Pension Age will have a knock on effect for public sector workplace schemes.

The biggest issue in the short term is the rate at which state pensions increase; particularly the Basic State Pension and the new State Pension which have the Triple Lock applied. David Cameron said in June: "*if we had a big black hole, we could struggle to justify this special protection any longer. In fact, even if we could justify it morally, it wouldn't actually be affordable. Not when pensions represent a huge portion of public spending – over £90 billion this year – and when inflation is forecast to hit 4% if we leave Europe. So here is the reality: if we leave, the pensioner benefits would be under threat, and the triple lock could no longer be guaranteed in the long term.*"

The ex-Pensions Minister, Ros Altmann, has also criticised the Triple Lock since her departure, although there is no indication that this criticism is in any way linked to the Brexit vote. Theresa May is reported to have backed the continuation of the Triple Lock.

Regulations linked to Pensions

There is no indication that Brexit in itself will result in any changes to pension regulation, but we are mindful that government could use it as a smokescreen to make changes. For instance the pressures placed on DB funding are resulting in reports that DWP are considering mechanisms by which protection of accrued rights can be diluted (contrary to the current provisions of Pensions Act 1995). Other potential areas for attack might include:

- equal treatment in pension provision,
- restriction on state aid (e.g. the recent Tata consultation, and in subsidies given to NEST),
- cross border funds – not hugely common, but there is an issue that any of these involving UK employers would have to become full funded at all times
- state pension increases for ex-pats – unlikely to change for EU residents, although it is a possibility
- working out state pension benefits – EU countries take account of periods spent working (and paying national insurance) in sister states when calculating entitlement to state pensions. Workers contributing to more than one system could find that they lose out.