HEALTH WEALTH CAREER

IMPLICATIONS OF BREXIT

JUNE 2016

The electoral commission announced this morning that the result of the UK's referendum on its membership of the European Union was a victory for the "leave" campaign.

But the UK hasn't woken up to find itself outside the EU. The government must first decide how to react to the outcome. Some Brexit campaigners thought an "out" vote would enable the government to negotiate better membership terms with the EU rather than necessarily lead to an exit, but it now seems clear this will not happen.

If the government decides that an "out" vote means out, then the formal procedure begins when the UK government officially notifies the European Council of its intention to leave the EU. This triggers Article 50 of the Lisbon Treaty, which provides for the exiting country and the European Council to negotiate the terms on which exit will take place. If agreement is not reached within two years, membership will cease (that is, the relevant treaties will no longer apply to the exiting country) unless the negotiating parties agree unanimously to extend the process.

Although this process could be started in the very near term, the government could decide not to invoke Article 50 immediately, as this starts the clock ticking towards the two-year deadline. Instead, the government might prefer to decide upon its exit strategy before initiating the official negotiations. Somewhat ironically, the UK is due to hold the Presidency of the Council of the European Union (a six-monthly rotating position) from July 2017, which seems problematic given the "out" vote.

THE MOST IMMEDIATE IMPLICATIONS OF THE REFERENDUM RESULT ARE LIKELY TO BE:

- The potential for significant market volatility across UK and European markets as participants weigh up the likely implications of Brexit.
- Significant uncertainty in terms of the economic impact on the UK and European economies in particular, but also globally. The source of uncertainty is likely to persist for some time, while the nature of the UK's trading relationship with the EU and elsewhere is negotiated and employers decide whether they need to alter their business objectives.
- Legislative uncertainty for those organisations that operate cross border, for example, because of the way their employee benefits are structured or because of the markets they trade in.
- The leadership election in the Conservative party, now that David Cameron has announced he will step down, can only add to the uncertainty, particularly given the nature of the debate before the referendum.
- The possibility of further referenda on EU membership in other countries across Europe. Since UK citizens have been given the opportunity to vote on EU membership, electorates across Europe might demand the same right. Should this sentiment take hold, it is possible that European markets will be plagued for some time by the possibility of one member or another voting to leave the union.
- Scotland did not vote to leave the EU, so there is the possibility of another referendum on Scottish independence. This is by no means certain: the Scottish National Party may choose not to push for another referendum (especially if it thinks it won't win) and the UK government might not agree to allow one.

In short, Brexit creates significant political, economic, legislative and market uncertainty unlikely to clear in the near term. Given the speed with which markets typically react to such events, we are not suggesting that employers or pension scheme trustees need to take any immediate action solely as a result of the referendum. However, it will be important to monitor events closely and to consider the impact of the referendum and any significant market moves on funding positions and sponsor covenants. The significance of the result will also require some trustees and sponsors to review their current strategy over the coming weeks.

SPECIFIC AREAS TO KEEP UNDER REVIEW INCLUDE:

- Investment governance arrangements, to ensure they continue to be robust enough to react appropriately to market volatility.
- How increased investment volatility could affect the funds of defined contribution members, particularly those close to retirement.
- Exposure to currency risks, how that might affect future investment strategy and current funding levels.
- The effect of leaving the EU on the employer's covenant, both in the short and longer term, and the consequences on trustees' risk management plans.
- Overall covenant effects; for example, where the employer is part of a group headquartered in the EU or has significant trading relationships with EU countries.
- Covenant effects for employers that trade internationally or have other global relationships.
- The extent to which scheme funding levels are vulnerable to changes in interest rates and whether thresholds triggering financial action might be crossed.

Longer term, the Article 50 negotiations will have to unwind more than 40 years of joint working and establish an alternative model, which might reflect existing arrangements (such as those of Iceland, which is in the European Economic Area (EEA), and Switzerland) or be unique to the UK. The UK will also have to negotiate separate trading relationships with non-EU countries. As the proposals become clearer, it will be easier for trustees and employers to understand what actions might need to be taken to help address the consequences.

TO FIND OUT MORE

For further information please contact your local consultant or:

DEBORAH COOPER
Partner, UK
+44 (0)20 7178 7184
deborah.r.cooper@mercer.com

PHIL EDWARDS
Principal, UK
+44 (0)117 988 7548
phil.edwards@mercer.com

Visit our website at:

www.mercer.com

QAS Institute and Faculty of Actuaries®
Quality Assurance Scheme

MARSH & McLENNAN COMPANIES