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Brexit and Pension Transfers?

Technical Note IX

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Introduction

The "Brexit" outcome of the 23 June 2016 referendum on Britain's membership of the European Union came as a huge surprise to many. In the aftermath of Brexit, the entire economic and political landscape has suffered a seismic upheaval. But, what effect might the ensuing political and economic fallout have on the pension transfers market, particularly in relation to expats and the future of QROPS?

Purpose of Note

This Note covers:

A. The impact of Brexit on transfer values; and

B. What Brexit might mean for QROPS.

Background

On 23 June 2016 the UK voted to leave the EU by a margin of 52% to 48%. This result was generally unexpected by investment markets and politicians alike. In the run up to the referendum, the exchange rate between the Pound and the US Dollar peaked at $1.50, but in the early hours of 24 June it fell below $1.35, hovering at just above $1.31 on 5 July. The Pound has fared no better against the Euro, where the exchange rate has fallen from near €1.40 to less than €1.18. Brexit has caused a Sterling drop to a 31-year low on currency markets. For the expat with pension assets and / or income denominated in Pounds this is a big hit to value in their local currency.

Post-Brexit stresses on the UK economy are noticeable in other areas too. Gilt yields (which are fundamental to the valuation of debt) have fallen dramatically. As at 5 July the 10-year Gilt yield was at 0.8%, and even the 30-year Gilt yield was at a paltry 1.63%. These are depths which have never been plumbed before. If, as expected, the UK base rate reduces to as low as zero, we may even see some Gilt yields fall into negative territory.

All of this has a major effect on the expat community and on pension transfers generally.

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A. The impact of Brexit on transfer values from Defined Benefit ("DB") Pension Schemes.

The cash equivalent transfer value ("CETV") of deferred pension rights in a DB scheme is intended to represent a fair valuation of those deferred rights. So far as DB schemes are concerned, these rights form a part of scheme liabilities.

The CETV is a value determined using actuarial principles, which require assumptions to be made about the future course of events affecting the scheme, and the member's benefits in the scheme.

In straightforward terms, the CETV is calculated by estimating the amount of a member's future pension payments (benefits accrued to pension age within the scheme), taking account of the amount of the entitlement which the member built up to the date of ceasing to receive benefits, assumed rates of future pension increases (before and after pension age) and life expectancy.

This estimated pension is given a lump sum value as at pension age by reference to life expectancy of scheme members and gilt yields. As there is a finite period of time the member is expected to live for, the value of the expected benefits as at pension age is akin to an annuity purchase price.

As DB schemes (just like annuities) have to provide a fixed and known structure of pension income in retirement, the most important investment return factor in the calculation used by actuaries to work out a CETV is the 'risk free' investment return based on gilt yields. Gilts provide a guaranteed fixed return to their maturity date.

As gilt yields fall, the cost of annuities and the value of the expected benefits at pension age rise. The reverse is true if interest rates and gilt yields rise.

The second step of the calculation involves discounting the cash value at pension age of these expected future payments to a present day value. This represents the amount which, if invested now, the scheme would expect to be sufficient on the assumptions made to meet the benefit payments as they fall due. The discount rate used should therefore broadly equal the return expected from the assets held by the scheme to back the member's pension entitlement.

As gilt yields fall, the cost of meeting DB scheme liabilities increases, and so therefore does the fair value of DB rights as represented by the transfer value.

Another way of looking at this is to consider annuity rates. Annuity rates are the amount of fixed pension income that may be provided by the member's pension pot. Since Brexit, annuity rates have fallen by around 8%. This means, broadly, that to provide a given amount of monthly pension, a pension scheme fund must be rather more than 8% greater in value now than it needed to be before Brexit.

So, all told, from the perspective above the current effect of Brexit is such that transfer values from DB schemes are likely to increase.

That said, the risk remains present that scheme actuaries may take account of increasing scheme deficits in calculating transfer values. In certain circumstances, trustees are permitted

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to offer transfer values which are less than the 'normal' CETV. One permitted reduction is reduction by reference to the funding situation of the scheme. However, trustees may not reduce CETVs for this reason unless they have obtained an assessment by the actuary of the funding of the scheme, using the transfer value assumptions, known as an 'insufficiency report'. Reductions to CETVs to take into account scheme funding must not exceed a maximum reduction that is identified in the insufficiency report.

According to one leading firm of actuaries, the immediate aftermath of the vote and a rush into Gilts on the Friday morning caused the collective UK DB scheme funding deficit to balloon by £80bn to £900bn. In the days following Brexit, a further fall in Gilt yields to record lows pushed that collective funding deficit to around £935bn.

So, although CETVs may increase in principle because of the drop in gilt yields, equally the risk of schemes seeking to reduce CETVs because of a deteriorating funding position has increased. Accordingly, where a DB scheme is offering a full transfer value (that is: not actuarially reduced) then it may be a tempting proposition.

B. What Brexit might mean for QROPS.

Although the availability of pension transfers between EU Member States is not currently compulsory by virtue of a Pensions Directive, the government's position is that, as part of the single market in goods and services, products must be open to all individuals across the EU wherever they live or work. For example, a pension scheme in Malta must be open to membership for a UK resident.

As a consequence, QROPS legislation provides for a transfer of pension rights between UK pension schemes and those in other EU Member States. It would be both illogical and discriminatory if, following Brexit, this freedom to transfer continued to apply to countries outside the EU, but ceased to apply to transfers to EU Member States.

HMRC have historically stated that the intent of the QROPS legislation is to enable people to simplify their affairs by transferring their pension rights to a scheme in their country of residence, whereas currently it is possible to transfer to a scheme in (more or less) any country. Once the UK eventually leaves the EU then, unless the UK remains a part of the single market, it would be a simple matter for HMRC to reintroduce the requirement, which applied up to April 2006, that transfers of pension rights may not be made except to a country where the individual is actually resident.

This scenario remains a distinct possibility, but until negotiations are in place the future remains very unclear.

Please ask us if you need more information relating to any of the above points, or indeed of examples of their application

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