Agenda item 6

Impact Assessment of the Vote for the United Kingdom to Leave the European Union

Director of Corporate Services Briefing Paper to London Borough of Merton Pension Fund Advisory Panel (PFAC) on Wednesday 29 June 2016

Following the historic vote for the United Kingdom to leave the European Union at the Referendum last Thursday 23 June 2016, the purpose of this Paper is to discuss the immediate impact on the London Borough of Merton Pension Fund, the Local Government Pension Scheme and the implications of the uncertainty for the UK and wider global economy in the near and medium to long-term.

UK Economic Outlook

In the immediate aftermath of the Referendum result, equity prices fell in the domestic UK and foreign markets, Credit Default Swap (CDS) rose and the value of Sterling fell sharply. Already, the credit rating agencies are reviewing their outlook for the UK economy. Moody's has downgraded its outlook from stable to Aa1 negative. Standard & Poor's (S&P) rating for the UK remained AAA with negative outlook until Monday 27 June when it was downgraded due to S&P's concern about "a deterioration of the UK's economic performance, including its large financial services sector". Also, Fitch's rating was unchanged at AA+ with stable outlook but this has been downgraded to AA, predicting an "abrupt slowdown" in growth in the short-term. The key issues for the rating agencies are:

- Likelihood of long period of uncertainty for the UK economy with real implications for growth
- Strength and resilience (effectiveness and predictability) of UK economic policy-making; and
- UK's public finances

As a result of uncertainty, negative outlook and investors' flight to safety of Government bonds, yield on UK Government bonds and index-linked bonds have come under a lot of pressure.

Implications for London Borough of Merton Pension Fund

The vote for the UK to exit the EU could present significant political and economic challenges and opportunities but it is too soon to understand the full impact on UK pension funds although the coming periods will be characterised by increased market volatility. Against this background and likely environment, it is important to note the following:

- To put last week's market volatility in context, equity markets returned to where they were the previous fortnight. The FTSE All-Share remains above its lows for 2016 but at the time of writing, the index of leading stocks was expected to fall further. Also, the decline in financial markets reduces the value of the Fund's assets and, to some extent, its liabilities.
- L B Merton Pension Fund investment assets are managed by external managers with full discretion to manage the assets as appropriate giving regard to the Investment Management Agreement. Faced with heightened market volatility, fund managers will be mindful of threats and opportunities.
- There is no need for knee-jerk reaction on investment strategy. It is fortuitous that we will be reviewing the long-term investment strategy in the post-Brexit environment where the financial circumstances of the pension fund is forensically understood from the 2016 actuarial valuation perspective and in the context of global markets. In reviewing the investment strategy, the emphasis will be to strike the right balance between growth assets,

income based assets and some downside protection appropriate to the pension fund's need. This will ensure that the Fund is more resilient to risk.

- The Fund actuary's valuation approach adopts a "smoothed" economic model whereby the financial assumptions are based on the average financial conditions over the period from 1 January 2016 to 30 June 2016 for both assets and liabilities. Intuitively, there are a few days of the 6 month "smoothing" period remaining therefore it is likely there will be no significant impact on the 2016 valuation results.
- Yield on corporate bonds which support the valuation of accounting liabilities is not immune to the downward pressure. As such there is the possibility of accounting deficits rising significantly over the short-term with consequences for colleges, universities and academies.
- L B Merton Pension Fund is cashflow positive and there is no requirement to sell assets (in the current volatile markets) to meet pension payments. Also, as a long-term investor, the Pension Fund is well placed to ride out short-term volatility.
- The fall in the value of UK equities will have been partially offset by overseas equities where currency gain will have added value.
- At the time of writing, it is unclear whether the Referendum result and the evolving UK political landscape have any ramifications for the ongoing LGPS asset pooling. In this regard, it is important to note that the LGPS is underpinned largely by UK regulation rather than EU's. Therefore, the current LGPS governance, membership, benefits and investment arrangements are unaffected.
- The Pension Fund completed a bulk transfer prior to the Referendum. Officers, in consultation with the Fund actuary, will ensure that crystallisation events post-Brexit will be negotiated taking account of increasing market volatility.
- Persistent falls in gilt yields could exacerbate the pension fund deficit. Officers and the Fund actuary are in the process of developing their thinking around assumptions for the 2016 actuarial valuation. In the current environment, the outlook for inflation expectations and the impact on funding is increasing uncertain.

Conclusion

The result of the Referendum has caused significant market volatility and economic uncertainty but the full impact on the funding position of L B Merton Pension Fund longer-term is difficult to ascertain. Market volatility presents risk and opportunity. Therefore, it should be viewed from the perspective of the Fund as a long-term investor.

Officers will continue to monitor the situation and will update PFAC on any developments.

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