Croydon Council

REPORT TO:	**Local Pension Board** **26 March 2018**
SUBJECT:	**Brexit Risk Scenarios**
LEAD OFFICER:	**Nigel Cook, Head of Pensions and Treasury**
CABINET MEMBER	**Councillor Simon Hall** **Cabinet Member for Finance and Treasury**

1 RECOMMENDATIONS

1.1 The Board is asked to note the contents of this report.

2 EXECUTIVE SUMMARY

2.1 The report sketches, in broad terms, risk scenarios around the UK leaving the European Union at the end of March or some other time. The report invites the Board to consider mitigations for the impact of these scenarios.

3 DETAIL

3.1 At the time of writing this report the Prime Minister's so-called Chequer's deal on the UK leaving the European Union has been voted down by Parliament twice. The European Union will next meet at a summit called to discuss relationships with China. This summit represents the next opportunity for the UK Government to influence this process. The options open to the UK seem to include: a third meaningful vote on the Prime Minister's deal, (including the backstop agreement); to return to the EU to attempt to persuade the other 27 states to revisit and ultimately re-open the negotiated agreement; or to ask for an extension, either short, up to the May EU elections, or longer, perhaps two years. None of these options will resolve the uncertainty generated by the exit event. This report attempts to set out the key areas of risk, the impact of those risks, and the potential mitigations available.

3.2 The current regulatory environment, as it applies to financial services, has been largely developed by the UK and enacted by EU Directives. Interim arrangements will see these arrangements persist but, as capital outflows from many significant banking entities show, the City of London's pre-eminent position is under threat, from Dublin, Paris and Frankfurt. The likeliest impact for the Pension Fund would be on the resources required to ensure compliance with the regulatory framework and associated costs. As an illustration, the work involved in ensuring the Council was compliant with the MiFID framework took several months and involved around 30 counter-parties to the Council. In the longer term the likely impact on the Pension Fund would be an increase in the marginal costs of maintaining investments and possible a dampening of returns.

3.3 The current global macro-economic picture hasn't been impacted by the Brexit negotiations directly but indirectly there is a significant risk that, outside of the EU, the UK's position on the global stage would be weakened. Those global headwinds would include the US / China trade wars and the impact on those country's respective economic growth; unresolved problems within the Eurozone; unwinding quantitative easing; and the continuing impact of the Global Economic Crisis. These risks are mitigated by the strong global diversification of the Pension Fund's investments.

3.4 Much emphasis has been put on fees and charges levied on the Local Government Pension Scheme. At present there are arrangements that effectively limit the impact of these on performance and many of these facilities will persist, such as collective negotiating, but without any perspective on future arrangements, after any transitional arrangements have fallen away, Funds must assume there is a risk that returns will suffer as fees and charges are deducted from gross returns. Steps to ensure more transparent reporting will help to control fees and charges but this may prove to be a drag on performance.

3.5 At present Pension Funds have unfettered access to opportunities across the globe in most asset classes. Many of the Funds in which the Pension Scheme is invested are European – Private Equity and Infrastructure, for example – and several are denominated in Euros. Whether the Scheme will enjoy the same range of options in the future is open to question. Of course it is entirely possible that returns in line with the Council's long-run expectations will continue to be achievable but this risk should be noted. The question of where Funds are domiciled will possibly continue to be significant. In terms of mitigation, other Pension Schemes illustrate that it is possible to generate adequate returns investing in a focused range of investments but experience suggests that moving investments during a period of uncertainty and hence volatility can be costly.

3.6 The Scheme will want to take account of the potential impact on Scheme members and in particular those drawing benefits. The key factors are interest rates, inflation and currency exchange rates. These are inter-related and will have positive and negative impacts that are difficult to forecast. The design of the Pension Fund should mitigate against the most extreme impact. For example, high levels of inflation will be reflected in indexation of benefits but will probably result in depressed interest rates, which will impact on the fixed interest part of the portfolio and also exchange rates which impacts on the equity portfolio. Members who have retired to live overseas, for instance in Ireland, Spain or Portugal will be particularly exposed.

3.7 Finally, there is a significant risk of something else happening that risk models did not foresee. By its nature such an event will be difficult to predict, describe and evaluate. Nevertheless, the frequency that such events occur (often described as Black Swan events) suggests that it would be unwise not to expect something. Clearly it would be difficult to prepare for such an unpredictable event but managing the Fund in line with industry best practices will help.

3.8 Those mitigations available to the Pension Fund are already largely in place: diversifying investments by region, sector and scope; careful choice of fund managers; and close monitoring of performance. The Fund has set itself achievable return goals over a reasonable period of time. Officers are actively engaged in understanding these scenarios and working with advisors with experience of previous difficult investment challenges. The Fund is a long-term investor and the ability to ride out these temporary difficulties should not be under-stated.

3.9 The Board is invited to consider these, and other, scenarios and to discuss whether there are options available to the Pension Scheme that would better address these issues.

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