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Brexit: What It Is and Its Impact on Retirement Plans

The UK referendum vote in favor of leaving the European Union has had a negative effect on world markets both in terms of equity losses and interest rate declines. Despite some positive upside on the value of bond portfolios, the net effect will likely be a large decline in funded status for underhedged defined benefit plans. The market upheaval of the past several days has affected defined contribution plan participants as well. Rebalancing and staying the course will be key.

Background

A referendum vote was held on Thursday, June 23, to decide whether the United Kingdom (England, Scotland, Wales and Northern Ireland) should leave the European Union, or "EU." The vote has been termed as "Brexit," for **BR**itain **EXIT**ing the EU. The results of the vote were 52% for "leave" versus 48% for "remain," with over 71% of the UK-wide population turned out for the vote.

The EU is an economic and political partnership involving 28 European countries. Its founding dates back to the post World War II period with the original intent to foster economic cooperation among neighboring countries and to reduce the risk of war in the region. While the EU has expanded and morphed over time, it has now grown to be a single market allowing goods and people to move freely.

For the UK to formally leave the EU, British Parliament has to invoke Article 50 of the Lisbon Treaty. While there is much speculation about whether a second vote will take place, it is uncertain at this time and widely believed Parliament will carry out the will of UK voters and invoke Article 50. The UK will in theory have two years from the date Article 50 is invoked to depart fully from the EU, although some members are calling for a faster exit and some for a slower timeline. To add to the uncertainty of the situation, British Prime Minister David Cameron (who heavily campaigned to remain) announced his decision to resign as PM by October of this year. Several other leading figures in the British government have resigned, as well. It will be Cameron's successor's duty to carry out the intricate process of winding down the UK's membership in the EU. Scotland and Northern Ireland are now clamoring to decide their fate, and votes to become independent from the UK and re-enter the EU are under consideration in these areas. Since it

was widely expected the UK public would vote to “remain,” there is much uncertainty surrounding the timeline and next steps at this time.

Impact on Defined Benefit Pension Plans

The UK’s decision to vote in favor of an exit from the EU has already had a negative effect on world equity markets. Since the vote was unexpected by the equity markets, a broad-based sell-off ensued on Friday, June 24, erasing over $2 trillion in wealth from global equity markets. Interest rates declined in the US, with a roughly 15-20 basis point parallel shift among all maturities in the Treasury yield curve. Interest rates are important to defined benefit (DB) plan sponsors that are subject to US GAAP and or IFRS accounting rules, because decreases in interest rates create corresponding increases in liability amounts, which are generally not fully hedged by the assets. Volatility indices jumped and credit spreads widened on the news. The US dollar and Japanese yen both strengthened along with precious metals due to their perception as safe havens. The British pound sterling sold off heavily versus the dollar, reaching exchange rates not seen in decades.

> **Comment.** For a sample of our US clients, single-equivalent Treasury discount rates declined 19 basis points on Friday, June 24, for their liability profiles. Double-A credit spreads widened by approximately 9 points, leading to a drop in account discount rates of approximately 10 basis points in a single day.

Bond ratings agency Moody’s said the vote to leave the EU was “credit negative,” and currently rates the UK one notch below triple-A status at AA1. Standard & Poor’s downgraded their rating on UK sovereign debt from AAA to AA. Despite these downgrades, British Gilts rallied on the news with yields declining in a parallel fashion. Experts disagree on the next move by the Bank of England (BoE): one camp believes the BoE will cut rates from the current 0.5% level to spur growth and provide liquidity, while another believes the BoE will eventually raise rates to shore up the pound and fend off inflation. It is now widely believed that any increase to short-term interest rates by the US Federal Reserve will be put on hold for the remainder of 2016.

Economists are predicting a 0.5% reduction in global GDP and a high probability for a UK recession into 2017. US Treasury Secretary Jacob Lew and his global counterparts have released statements committing to use all the necessary tools in their arsenal to support financial stability. Retirement plan sponsors are keenly concerned with what this event will mean for their financial reports and funding requirements.

Plan Funded Status

Money from both the sell-off of equities and bonds held in UK instruments may be diverted to US Treasuries (flight to quality) resulting in higher prices and lower yields. Underhedged plans will see a large decline in funded status (the 10-year Treasury was as low as 1.46% mid-day Tuesday, June 28). This will be troublesome for sponsors with off-calendar reporting periods, particularly those with June 30 fiscal years. Assets impacted by the decline in global equity markets combined with liabilities impacted by lower interest rates will lead to deteriorating funded ratios. All plan sponsors should carefully monitor their funded status through this period of uncertainty and discuss with their actuary potential consequences due to a decline in the plan’s funded status. There may be a need to increase or accelerate plan funding. In addition, consider more frequent checks regarding your plan’s risk exposure to see if any adjustments may be required in 2016.

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Stay the Course

While the Brexit vote is significant today, plan fiduciaries should not lose sight of longer-term horizons. Consider all the events of the past ten years — trouble for the financial sector, the crisis surrounding sub-prime mortgages, global terrorism, medical threats, etc. And yet the S&P annualized return over the past 10 years through March 31, 2016, was 7.01%. We strongly urge patience and discipline to stay the course and not make decisions based on emotion.

Plan fiduciaries will need to monitor investments and ensure their plan's asset allocation is remaining consistent with their Investment Policy Statement. Rebalancing after a given asset class dips will allow a plan to reap some benefits of dollar cost averaging.

Pension Risk Navigator

This crisis highlights the need for frequent monitoring of funded status. By monitoring their pension funded status more frequently, plan sponsors can make sure they are not exceeding their risk budget.

Xerox's Pension Risk Navigator™ tool is designed to offer a quick snapshot of a plan's funded status on a daily basis.

Impact on Defined Contribution Plan Sponsors and Participants

Naturally, the market upheaval of the past several days has affected defined contribution (DC) plan participants as well. The same equity losses affecting DB plans have affected DC plan participants' accounts. To the extent that individual asset allocations are not well diversified, losses could be greater than DB plans experience. Participants nearing retirement age and who are overweight in equities may see losses that cause them to rethink their retirement readiness.

Events such as Brexit reinforce the need for asset diversification and a personal glide path by which an employee adjusts his/her asset allocation with age, to reflect changing risk tolerances. Plan participants may find that target date funds, which adjust asset allocations automatically as the target date approaches, can play an important part in properly managing investment risk. Plan sponsors may wish to review their lineup of investment options to ensure that the target date funds offered are appropriate for their plan participants.

For participants who do not use target date funds, they should be mindful that their asset allocations may change due to decreases (or increases) in individual asset class investments. Therefore, it may be time to consider rebalancing their portfolios to ensure that their DC assets are invested as they intend.

One final note: Those tempted to move the bulk of their assets into cash should keep in mind that market timing is notoriously difficult. A participant sitting on the sidelines in cash may miss market upswings and thus lock in their losses. Participants will also want to maintain their contribution levels, and plan sponsors should keep auto-features in place. Participants and plan sponsors are highly encouraged to stay the course, keep a long-term focus and not make any emotional decisions based on current market conditions that might jeopardize retirement readiness.

In Closing

The immediate aftermath of the referendum is just a first chapter in this story. Political and economic unrest will prevail in the UK for the foreseeable future. There remains the possibility for additional turmoil within the EU with similar votes possibly taking place in the Netherlands and Greece; Scotland may revisit independence from the UK and re-admittance to the EU. If the UK leaves the single market, adhering to additional regulations and

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bureaucracy may increase the cost of doing business in the UK and cause companies to find other areas for capital investment.

Now more than ever it is strongly recommended that plan sponsors stay in close touch with their investment consultants and/or plan actuaries. With interest rates dropping further, funded statuses and hedge ratios need to be carefully monitored and managed.

To reinforce previous comments, now is not the time for DC participants or plan sponsors to become emotional. A long-term view is strongly encouraged.

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