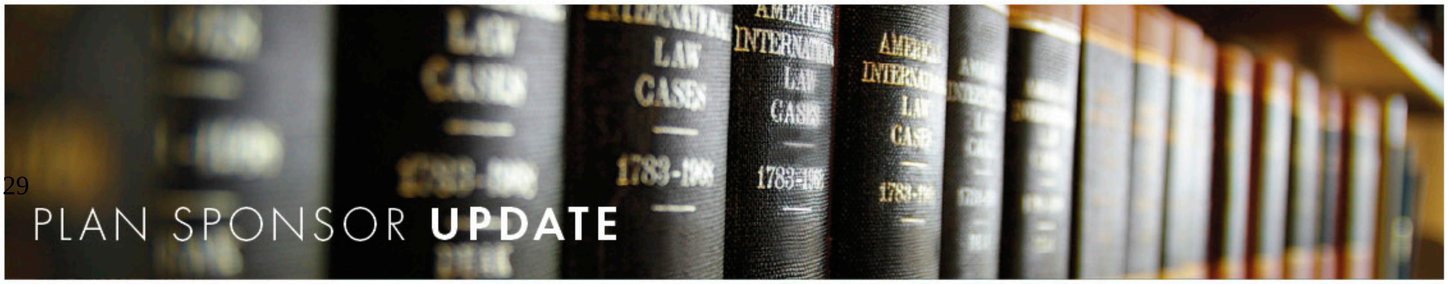

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AN ANALYSIS OF LEGISLATIVE AND REGULATORY ISSUES AFFECTING PENSIONS

July 2016

BREXIT: IMPLICATIONS FOR DB PLANS

Northern Trust is dedicated to helping you succeed in today's fast-changing environment. We are pleased to offer you access to this publication by Plan Advisory Services, to share regulatory developments that may be of interest.

Summary of the situation

The vote by the United Kingdom to exit the European Union (Brexit) has created a lot of turmoil in financial markets. In this article we briefly discuss its possible effect on defined benefit plans.

Who is most impacted by this?

Sponsors of DB plans.

Key takeaways for clients

- *Effect of Brexit on interest rates generally*: For all critical purposes – minimum funding, accounting, PBGC variable-rate premiums and lump sum valuation (which affects the cost of derisking) – DB plan benefits are valued based on the rates on high-quality US corporate bonds. We are still finding out what effect Brexit will have on US corporate bond yields. It's fair to say that it will drive yields down – indeed it already has. But it's unclear by how much.

    - The downward trend in bond yields since the beginning of the year may be more significant than the effect of Brexit itself, although we don't really know at this point. For example: the Moody's Seasoned Aaa yield is down around 60 basis points for the year (at 3.40% as of June 27, 2016). Brexit represents around 20 basis points of that drop – if you just focus on the last week. If yields remain at current levels, plan liabilities (valued at market interest rates) will increase significantly. For a plan with a duration of 10 years, a 60 basis point drop translates into a 6% increase in liabilities.

  - We also note that there is widespread speculation that as a result of Brexit the Federal Reserve will put possible 2016 increases in interest rates on hold. Howeveer some have observed that the recent Fed short-term rate increase seems to have had the effect of lowering (rather than raising) medium- and long-term rates.

- *Effect on DB plans*: Currently, DB minimum funding requirements are determined based on a "floor rate" of 90% of a 25-year average of interest rates. The Bipartisan Budget Act of 2015, signed into law by President Obama in November of 2015, extended that 90%-of-the-25-year-average floor three years: it was supposed to begin phasing down in 2018; under BBA 2015 it will not begin phasing down until 2021. As a result, generally, variations in interest rates over the next five years will have only a marginal effect on the interest rates used to determine minimum funding requirements. Continued use of the 90% factor will mean that the rates used to determine minimum funding requirements will be much higher than market interest rates.

  - In contrast, the calculation of the value of liabilities for purposes of financial disclosure, PBGC variable-rate premiums and lump sums is generally made using current market interest rates.

- *Valuation rate doublethink*: Thus, a DB plan sponsor is faced with a disjunction between the valuation interest rates it is allowed to use for purposes of ERISA minimum funding, on the one hand, and the rates it must use for pretty much everything else, on the other. The spread between those two rates – the rates used for minimum funding and the rates used for everything else – is currently around 200-300 basis points.

- *Different types of sponsors – different concerns*: *Cash-sensitive DB sponsors* are generally protected from swings in market interest rates by the ERISA minimum funding interest rate stabilization rules. For them, the fallout from Brexit is generally irrelevant (except for its effect on PBGC premiums, discussed below).

  - *Earnings-sensitive sponsors* are not. Market interest rates were, pre-Brexit, already significantly down for the year. Brexit is driving them down further. If these lower rates continue to year end, liabilities for financial disclosure purposes will increase significantly.

  - *Sponsors of plans with unfunded vested benefits* (UVBs) must pay PBGC variable-rate premiums, generally determined as a (seemingly ever-increasing) percentage of the plan's UVBs. UVBs are also valued using market interest rates. Pre- and post-Brexit decreases in interest rates (again, if they continue to year end) will increase the value of UVBs and thus increase PBGC variable-rate premiums.

  - And, if interest rates continue at their current (lower) levels, then *the cost of derisking in 2017 is likely to be higher than in 2016*. That's because many companies peg lump sum valuation rates at the end of the prior year; thus lump sum valuation rates for 2016 are based on end-of 2015 interest rates; those rates were considerably higher than current rates.

- *Assets*: The other major variable in the funding equation is assets. In that regard, we note that the equity markets have generally been flat for the year. Brexit has resulted in some losses, but, thus far at least, not on the scale we saw in 2008-2009.

What's next?

It still appears that the DB funding story for 2016 will be interest-rate driven increases in liability valuations and (perhaps) marginal losses on assets. These interest rate "losses" may be more a function of long term trends than of, e.g., Brexit or even (for that matter) Fed policy. We will continue to follow these issues.