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MARKETS

Brexit Adds to Pension Funds' Pain

Drop in interest rates that followed British vote to hurt 2016 returns

Colorado Treasurer Walker Stapleton says pension funds' interest-rate problem is 'snowballing.' *PHOTO: GETTY IMAGES*

By **TIMOTHY W. MARTIN, VIPAL MONGA** and **HEATHER GILLERS**
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The retirement savings of tens of millions of people have come under new threat since the surprise U.K. vote to leave the European Union, thanks to a plunge in global interest rates.

A post-Brexit scramble for safer bonds pulled yields lower and upended global markets just as many public pension funds wrapped up their fiscal year on June 30, eating into any annual gains and widening already-large deficits. Many public pensions that were already having a bad year are expected this month to report their worst annual performances since the last financial crisis in 2008-09.

"We could see some pretty ugly 2016 financial statements," said Matt Fabian, a partner at research firm Municipal Market Analytics.

A sustained period of rock-bottom rates in the U.S. and negative rates overseas is contorting financial plans for investors and consumers globally, from insurers that rely on bond income to retirees who have to live with lower returns on their certificates of deposit.

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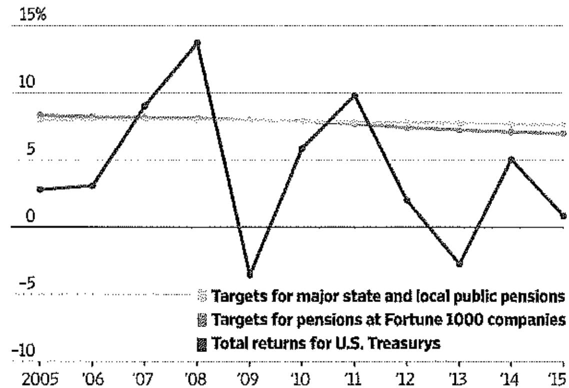
For officials who manage retirements of public and private-sector workers, Brexit exacerbated problems that have been roiling pensions around the world for years. The low-rate environment has pulled down returns, inflated funding gaps, encouraged larger investment risks and prompted plan officials to scale back future investment assumptions.

Now "this problem is snowballing," said Colorado Treasurer Walker Stapleton.

Pensions determine their assets and liabilities through formulas that depend heavily on the fluctuation of interest rates. When those rates fall, investment returns suffer and obligations to future retirees become larger.

While lower rates do boost the value of existing bonds, the negatives outweigh the positives for many funds. Pensions lose money when bonds with bigger payouts purchased years ago mature and are replaced with lower-yielding securities.



The consequences of any losses are real: Large companies must compensate for weak returns and mounting obligations by pumping money into their plans, thereby devoting less to capital expenditures, acquisitions and research.

At public plans, underperformance often means taxpayers or workers are asked to pay significantly more to account for liabilities that are expected to rise as lifespans increase and more Americans retire.

"Brexit should be a wake-up call for pension plans because it means interest rates are going to stay low or go lower and it makes it even less likely [the plans] are going to achieve the 7.5% rate of return that most of them are assuming," said former San Jose, Calif., Mayor Chuck Reed.

New York City reduced its return target to 7% in 2013, but that assumption is likely still unrealistic, said Lawrence Golub, a financier and member of the New York State Financial Control Board, which monitors the city's finances. The assets returned 3.5% in fiscal 2015.

"The 7% is too high for planning purposes," he said. "It's not conservative."

A spokeswoman for the New York City Comptroller's Office said that the city calculates its returns over several years, which tempers the impact of any one bad year.

The Colorado Public Employees' Retirement Association last lowered its estimate to 7.5% from 8% three years ago, but Mr. Stapleton said the number needs to go lower. The state treasurer said the impact of Britain's vote to leave the EU only increased that conviction because it made clear the extent to which pension funds are at the mercy of international forces.

"You can't control global events," said Mr. Stapleton, who is a member of PERA's board. "Clearly there's a lot of uncertainty in the marketplace."

A spokeswoman for PERA said 7.5% is "a long-term objective," not an annual target and that reforms enacted in 2010 have lowered the fund's liabilities by $15 billion.

Ted Eliopoulos, the investment chief for the nation's largest public pension fund, the California Public Employees' Retirement System, told his board 10 days before Brexit that performance for the fiscal year ending June 30 was "likely to be flat, which is a nice way of saying zero." The system's consultant also dropped

predictions of returns over the next decade to 6.4% annually, compared with a 2013 prediction of 7.1%.

The next three to five years will "test us," Mr. Eliopoulos said on June 13.

Corporate pension plans are also bracing for lower returns and higher deficits even though low rates affect them differently. Corporate pension funds use high-quality bonds to calculate their liabilities; if rates rise, those liabilities can fall. The sustained period of low rates has kept those pension obligations unexpectedly high.

Most corporate plans complete their funding calculations at the end of the calendar year, which gives them about six months to recover from the first half's turmoil.

However, there are early signs that upheaval during the first half of the year made things worse. The combined pension deficit for S&P 1500 companies ballooned to $568 billion at the end of June, meaning the value of their assets wasn't enough to cover future benefits for workers, according to Matt McDaniel, U.S. head of the defined-benefits risk consulting business at Mercer. That is a $164 billion increase in the deficit from the end of 2015.

Some companies are expected to pump more money into the plans to close the funding gap, and some have already borrowed money in the bond market at low rates to do so.

But there is no guarantee that approach will solve the long-term funding problem. Companies with large pension funds such as Verizon Communications Inc., Raytheon Co. and Lockheed Martin Corp. have been funneling billions into their pension plans in past years, with little to show for it.

Verizon, for example, has contributed $7.7 billion into its plans since 2008. In that time, its pension deficit has more than doubled to $5.9 billion from $2.6 billion. Although Verizon doesn't officially measure its obligations until the end of the year, in its financial disclosures, the telecom firm notes that every 0.50 point drop in the rate it uses to measure its liabilities will increase its pension obligations by $1.3 billion.

The typical rate used by companies fell 0.77 point in June from the end of last year, according to Mercer, meaning Verizon could see an increase of roughly $2 billion in its pension obligations if things remain as they were at the end of June.

A spokesman for Verizon said that the company has strong cash flows and has taken several steps over the past few years to reduce its pension risk. Lockheed Martin and Raytheon declined to comment.

Companies are "running in place," said Michael Moran, a pension strategist at Goldman Sachs Asset Management. "If the companies hadn't put that money in, it would have been even worse."

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