Market insights

Liability-Driven Investment Team

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Five reasons to fund your pension now

Andy Hunt, FIA, CFA
Co-Head of WFAM Global Fixed Income,
Head of LDI and Global Credit

Robert McHenry
Product Specialist,
Liability Driven Investment

Jonathan Hobbs, CFA, FSA
Head of U.S. Portfolio Solutions,
Multi-Asset Solutions

As 2017 draws to a close, we highlight below important benefits that may be realized by increasing funding to your pension plan now (rather than later):

Increasing Pension Benefit Guarantee Corporation (PBGC) premiums in 2018 and beyond

The PBGC assesses mandatory insurance premiums (that is, taxes) on the sponsors of U.S.-based defined benefit (DB) pension plans. The variable rate portion of these premiums is determined by the amount of pension funding shortfall, and is set to rise significantly in 2018 and following years, thereby increasing sponsor costs per dollar of underfunding. The fixed rate portion, based on the number of plan participants, is also set to rise sharply. In light of these higher pension costs, an increasingly attractive strategy is to fund-up the pension plan to attempt to reduce or eliminate the variable rate premiums and to offer lump sums for participants with low balances to reduce flat rate premiums.

U.S. corporate tax rates may be reduced

A widely held view is that the top corporate tax bracket will be reduced in forthcoming tax reform, perhaps from 35% to 20% in tax year 2018 or soon thereafter. Depending on how this headline rate reduction is funded—for instance foreign earnings repatriation, interest deductibility limitations, etc.—the impact will likely vary from one business to the next. But one unambiguous benefit for shareholders would be reaping the full tax-benefit for making pension contributions now while tax rates are higher. So while there can be no assurance about the outcome of corporate tax reform, on balance it is likely a good strategy to accelerate pension plan funding to attempt to take advantage of the certainty of current tax law.

Return-seeking assets are richly valued

The strength and length of the bull market in equities has improved the funded status of many plans over the past several years. But will that last, or is it a good time to lock into some of those gains? The hope of future funding improvements is often baked into the glide path strategies of most underfunded plans. To our minds it makes sense to reappraise those strategies regularly, and if it is deemed appropriate it might be useful to step ahead of the natural de-risking timeline if the outlook for uncertainty and downside risk is elevated. Such a de-risking strategy can be conveniently executed by adding incremental funding to the plan, thereby moving ahead on the planned glide path and thus helping reduce funded status volatility.

Financial Accounting Standards Board (FASB) guidance will change reporting of Net Periodic Pension Costs (NPPC)

Beginning in 2018, NPPC that are reported in operating income on plan sponsors' income statements will reflect only accrual of plan benefits earned during the period. Legacy pension costs that are part of the current NPPC calculation will move to non-operating income, and importantly, the plan sponsor's estimate of Expected Return on Assets (EROA) will no longer directly act as an offset of pension expense. In most situations this is likely to increase the pension cost component reported within operating income, thus reducing operating income. We believe a dollar of operating income is given greater weight by capital markets than a dollar of non-operating income in measurements of business performance. Because of this, there may be a reason to review the plan's investment strategy, and the result might be a decision to fund-up and de-risk the pension plan.

Borrowing rates remain near record lows

Why lock-in a liability that is currently highly valued by instigating a liability hedge when discount rates are so low? Our answer: it can be done cheaply as borrowing costs for many plan sponsors are also at historically cheap levels. The net result is that this is not overall an expensive proposition. To summarize, exceptionally low borrowing rates allow an underfunded plan to fund-up the pension plan, avoid escalating variable rate PBGC premiums, realize an important tax benefit from pension contributions, avoid the risk of drawdown, and mitigate uncertainty of pension plan impact on the calculation of key operating and balance sheet metrics. Our research has found that pension plans with access to inexpensive capital and/or those that face higher marginal tax rates may benefit most from a borrow-to-fund strategy.

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