Executive Summary

Over the past decade, a number of plan sponsors have embarked on de-risking programs for their corporate defined benefit (“DB”) plans to reduce funded status volatility and/or shrink their overall plan obligations. As pension plans continue to face the following headwinds, we believe a borrow-to-fund approach will be an increasingly effective strategy for plan sponsors in the years to come.

- Many plan sponsors aspire to reduce funded status volatility by better aligning plan assets and plan liabilities through a higher allocation to liability-matching fixed income. However, the current market environment of low interest rates and consequently low plan funded status, has led some sponsors to place these anticipated actions on hold.

- Despite low funded levels, many sponsors have little or no mandatory contribution requirements in the near term due to various funding relief measures enacted by Congress in recent years.

- Sponsors, therefore, may be electing to “wait out” the low interest rate environment, delaying de-risking activities until interest rates and funded levels rise, if ever.

- The regulatory environment has raised the cost of waiting, as increases to Pension Benefit Guaranty Corporation (PBGC) variable-rate premiums, assessed on the deficit of the plan, mean the cost of being underfunded is rising for most plan sponsors. As seen below, these premiums, less than 1% of any deficit as recently as 2013, have risen to 3% in 2016 and will exceed 4% by the end of the decade.

A borrow-to-fund strategy can enable a plan to accelerate a de-risking program while at the same time reducing variable-rate premium expenses. In recent years, a number of plan sponsors have executed the borrow-to-fund strategy. We believe this strategy can be an effective tool in the pension risk management toolbox for some plan sponsors, and one that more sponsors may consider as legislated PBGC premium increases come into force in future years.

Exhibit 1: The cost of carrying a deficit has been rising for plan sponsors

Source: Pension Benefit Guaranty Corporation; for illustration, projected figures (P) assume 2% annual increases for applicable indexation in addition to already scheduled increases.
A borrow-to-fund strategy may help a plan with its de-risking goals

For many corporate sponsors, DB plan management has evolved from an investing exercise into a risk management exercise. In the past, some plans may have been primarily focused on plan asset returns in relation to peer returns and asset benchmarks.

Today, many sponsors have turned their focus to asset-liability matching strategies that seek to reduce funded status volatility, or even to shrinking their overall plan obligations, both of which would reduce the impact of the plan on the sponsor’s balance sheet, income statement and cash flow. Factors driving this shift have included stricter regulatory and financial reporting rules and greater focus on DB pension issues by external constituents, including credit rating agencies. In addition, some sponsors are becoming less confident that they will be able to earn their way out of current deficits, or that interest rates will rise enough to alleviate the funding need. One very visible result of these pressures is an increasing tendency for plan sponsors to close and freeze their pension plans.

A final issue, and the subject of the remainder of this article, is the rising expenses associated with operating a corporate defined benefit plan. The increases to PBGC variable-rate premiums, highlighted on the cover of this paper, have raised the cost of being underfunded for a plan sponsor, thereby providing greater incentive to increase funded levels and better align plan assets with plan liabilities. Consequently, as part of their overall de-risking strategies, some plan sponsors have contributed to the plan voluntarily, or are considering doing so, to increase funded levels and reduce PBGC variable-rate premium expenditures.

Pension deficits are debts to employees

It is important to understand the economic nature of pension obligations.

- Pension benefits are a component of compensation. Specifically, they are a form of deferred compensation. When an employer offers a pension plan, other components of employee compensation, like cash remuneration, may be lower than would otherwise be needed to remain competitive in the market for labor.

- Pension obligations therefore represent an obligation to employees which result, effectively, from deferring a portion of the employee’s current compensation.

- Pension assets represent tangible evidence of these deferrals in the form of capital set aside specifically to pay future plan participant obligations.

- When plan assets are not sufficient to cover the plan’s future benefit obligations (i.e., when the plan is underfunded), then the deficit represents the plan sponsor’s promise to pay that benefit if and when assets are exhausted – i.e., a debt of the plan sponsor.

Major credit ratings agencies treat pension underfunding as debt although there are, at times, differences in the way any underfunding is reflected in their analyses. For example, Standard & Poor’s adds back unfunded pension obligations to total debt on an after-tax basis, while Moody’s approach is to consider these liabilities on a gross of tax basis. This treatment, combined with the fact that pension funded status has been explicitly recognized on US GAAP balance sheets for over a decade, supports the view that pension debt is reflected in the stock price and credit spreads of traded corporations.

A pension obligation is a real debt which, for practical purposes, is often more senior than other types of debt. Many companies that go through bankruptcy reorganization have retained their full pension obligations even as other creditors were not fully paid back. Were a sponsor to issue a debenture, for example, the proceeds of which are used to fund the pension plan, no new net debt has been created. Rather, one form of debt is issued to pay down another form.
Pension debt incurs PBGC variable-rate premiums

Annual PBGC premiums consist of two parts: (1) a per capita charge for every plan participant, referred to as the flat-rate premium, and (2) a premium calculated as a percentage of any underfunding referred to as the variable-rate premium. Both premiums are set by Congress and increase with the US Average Wage Index published by the Social Security Administration, which, assuming some level of productivity increases over time, will tend to exceed price inflation.

PBGC levies are officially referred to as premiums, although economically they might be thought of as a tax. The PBGC variable-rate premium represents an incremental expense of the plan proportional to pension underfunding. The most direct way to avoid this expense is by funding the pension plan up to the point where the liability, as measured for PBGC premium purposes, is fully funded. As discussed below, the liability measure used for calculating variable-rate premiums is generally higher than the liability value used for funding requirements.

During the four years spanning 2012 through 2015, Congress significantly raised PBGC premiums on three occasions. Exhibit 2 details how PBGC variable-rate premiums have been increased under recent legislation.

Exhibit 2: Congress has raised PBGC premiums multiple times in recent years

<table>
<thead>
<tr>
<th></th>
<th>Pre-MAP-21</th>
<th>MAP-21 (2012)</th>
<th>BBA 2013</th>
<th>BBA 2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variable-rate premium</td>
<td>2016</td>
<td>0.90%</td>
<td>2.00%</td>
<td>3.00%</td>
</tr>
<tr>
<td>(% of deficit)</td>
<td>2017E</td>
<td>0.90%</td>
<td>2.10%</td>
<td>3.10%</td>
</tr>
<tr>
<td></td>
<td>2020E</td>
<td>0.90%</td>
<td>2.80%</td>
<td>3.20%</td>
</tr>
</tbody>
</table>


When considering the impact of PBGC variable-rate premiums, plan sponsors should keep in mind several important points.

- The liability value used for the variable-rate premium calculation is similar to the measure used for minimum required funding, but the PBGC measure does not reflect the adjustments in the recent legislation that lowered the funding measure. Therefore, the PBGC liability measure is generally higher than the funding measure, which has been legislatively lowered with the same frequency as PBGC premiums have been increased. In other words, Congress has lowered funding requirements, but sponsors that take advantage of the lower funding requirements will, in most cases, pay higher PBGC variable-rate premiums because underfunding, as measured for PBGC purposes, will be worse.

- The IRS has announced its intention to update the mortality assumptions that are used for minimum required funding calculations, which are also used for PBGC premium liability. The timing is not finalized, but the IRS recently indicated that it expects final regulations with revisions to mortality rates to apply beginning in 2018 (see IRS Notice 2016-50). We note that when mortality adjustments were incorporated into US GAAP accounting in 2014, the median impact on the plans in our sample was a 4.2% increase to the gross obligation with over 40% of the plans posting an increase of greater than 5%. For underfunded plans, a mortality revision that increases the present value of plan liabilities will increase PBGC variable-rate premiums by an even larger percentage.

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1 For additional information, please see GSAM’s March 2015 report “2014 Pension Review ‘First Take’: The Reporting is Done, Now Comes the Aftermath.”

2 For example, if a plan has $1,000 in PBGC premium liability and $900 in assets, variable premiums will be calculated on the deficit of $100, equating to a total of $3 in premiums using 2016 rates. If the mortality update increases the premium liability by 5%, to $1,050, the premium will be calculated on a deficit of $150 for a total premium of $4.5, a 50% increase in premiums.
The variable-rate premium is capped at a dollar amount currently equal to $500 per participant, regardless of the size of the plan’s deficit, and the cap is indexed similarly to the other components of the premium. This can complicate the choice of contribution policy. For purposes of the hypothetical examples that follow in this paper, we assume the cap does not come into play (i.e., we assume the PBGC variable-rate premium is, on a per-capita basis, less than $500).

Sample case study: Issuing debt to fund pension

As illustrated in Exhibit 3, ABC Corp borrows $100 to contribute to its pension plan and realizes $3 to $4 of potential savings. Several factors provide sponsors with, effectively, an arbitrage opportunity associated with borrowing to contribute to a pension plan. These factors include the potential tax deductibility of contributions, tax-exempt earnings in the trust, the tax deductibility of interest paid on corporate debt, and the potential for reductions in PBGC variable-rate premiums.

Exhibit 3: Illustration of a $100 debt issuance by ABC Corp to fund ABC’s pension plan (versus no contribution)

Assumptions:

- ABC’s tax rate: 37.5%
- ABC’s bond rate: 5.0%
- PBGC variable premium rate: 3.0%
- Expected return on plan assets: 6.5%
- Debt issued = plan funding: $100

Illustrative mechanics of transaction and illustrative balance sheet impact:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities and Net Worth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Step 1: Issue $100 of debt</td>
<td>Cash $100 Bond Debt $100</td>
</tr>
<tr>
<td>Step 2: Contribution to pension plan</td>
<td>Cash ($100) Pension Debt ($100)</td>
</tr>
<tr>
<td>Step 3: Assumed tax deduction for the $100 contribution</td>
<td>Deferred tax asset Cash ($37.5) $37.5</td>
</tr>
<tr>
<td>Step 4: Use the assumed tax savings of 37.5% of issuance proceeds to retire other debt</td>
<td>Cash ($37.5) Bond Debt ($37.5)</td>
</tr>
</tbody>
</table>

Illustrative savings:

<table>
<thead>
<tr>
<th>EROA = 5%</th>
<th>EROA = 6.5%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bond interest paid (5% of net debt increase of $62.5MM)</td>
<td>($3.1)</td>
</tr>
<tr>
<td>Income to pension plan EROA (6.5% of $100)</td>
<td>$5.0</td>
</tr>
<tr>
<td>PBGC premium savings (3.0% of $100)</td>
<td>$3.0</td>
</tr>
<tr>
<td><strong>SUBTOTAL</strong></td>
<td><strong>$4.9</strong></td>
</tr>
<tr>
<td>Tax provision (37.5% of $6.4)</td>
<td>($1.8)</td>
</tr>
<tr>
<td><strong>GRAND TOTAL (after–tax basis)</strong></td>
<td><strong>$3.1</strong></td>
</tr>
</tbody>
</table>

Source: Goldman Sachs Asset Management. These examples are for illustrative purposes only and are not actual results. If any assumptions used do not prove to be true, results may vary substantially.

1 The rate is 3% for 2016, increasing to over 4% by 2019.
2 Leaves net debt of $62.5.

For illustrative purposes only, GSAM does not provide legal, actuarial, accounting or tax advice. Companies should consult their own legal, actuarial, accounting and tax advisors. This illustration is not representative of any actual company and all numbers shown are hypothetical only and may not be achieved.

Performance results vary depending on the client’s investment goals, objectives, and constraints. There can be no assurance that the same or similar results to those presented above can or will be achieved. These examples are for illustrative purposes only and are not actual results. If any assumptions used do not prove to be true, results may vary substantially.
In Exhibit 3, ABC Corporation borrows $100 to contribute to its pension plan.

Steps 1 and 2: Assuming that pension debt is treated as corporate debt, issuing debt and funding the pension has no impact on total indebtedness, although it will affect the type of indebtedness as pension debt is replaced by bond debt in this illustration. If the assumed tax deduction is used to repurchase debt, as it is in this illustration, then total indebtedness falls.

Step 3: In this illustration, under GAAP accounting, the receipt of the tax deduction reduces the deferred tax asset associated with the reduction in the pension deficit.

Step 4: Here, the cash made available from the tax deduction is used to retire a portion of the debt issue (or retire other debt). In the illustration, the net result is that $100 of contributions, the earnings on which are assumed to grow without tax, have been funded with a net debt issuance of $62.5, the interest on which is assumed to be tax deductible.

An improvement in corporate income from such a transaction can come from two sources:

First, the net difference between (a) the increase in the expected return on assets component of pension expense, because there are more pension assets to invest, and (b) the interest paid on the bond issued to fund the pension plan.3

Second, the reduction in the PBGC premium can effectively be viewed as a reduction in taxes. That reduction is 3% of the deficit reduction in 2016, and is projected to grow to 4.5% by 2020 with additional increases in future years.

Whether this “tax reduction” is temporary or permanent depends upon whether the deficit is permanently reduced by the pension contribution, or only temporarily reduced. That, in turn, depends upon how the capital contributed to the pension plan is invested, and the results of that investment strategy. Investing the pension contribution in liability matching fixed income (i.e., LDI strategies) might present the best opportunity to keep the pension deficit, and PBGC premiums, low in future years.

There may also be benefits even for non-taxpaying entities, such as not-for-profit organizations or companies with large current or historical net operating losses, for example when the plan is underfunded on a PBGC liability basis by an amount greater than or equal to the additional funding.

**Investing the pension contribution in liability matching fixed income (i.e., LDI strategies) can help keep the deficit low in the future.**

**Borrowing to fund a pension plan may be more advantageous to EPS than borrowing to buy back stock.**

### Capital allocation decision: Buyback versus funding and de-risking

In recent years, a number of organizations have issued debt to effectuate stock buyback programs. When considering the option to use the proceeds of a debt offering to fund and de-risk a defined benefit pension program, some corporate managers may resist on the grounds that, in their view, using the cash to buy back corporate stock would be more accretive to earnings.

For taxable companies that sponsor pension plans, the tradeoffs between funding the pension plan or buying back shares may not be clear.4 The example in Exhibit 4, building on the previous example, compares three alternatives (1) borrowing to fund a stock buyback, (2) borrowing to fund a pension contribution, with the pension assumed to earn the cost of debt (5.0%) and the assumed tax deduction from the contribution used to fund a (smaller) stock buyback, and (3) the same scenario as (2) except the pre-existing assumed EROA of 6.5% is maintained. While every situation is different, and projected impacts may differ under other scenarios, this simplistic example demonstrates that borrowing to fund may, in certain circumstances, be more earnings accretive than borrowing to buy back equity.

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3 It can be debated whether changes in reported pension income or (loss) due to changes in the expected return of plan assets (EROA) is a “true” economic benefit. Nevertheless, many plan sponsors do consider EROA when making settlor decisions.

4 Here we are only discussing share repurchases in the context of their earnings and increase in leverage. There could be other advantages or disadvantages which are beyond the scope of this paper.
Exhibit 4: Comparing borrow-to-buyback stock to borrow-to-fund strategies

<table>
<thead>
<tr>
<th>Assumptions</th>
<th>Scenario 1</th>
<th>Scenario 2</th>
<th>Scenario 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax rate:</td>
<td>37.5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bond rate:</td>
<td></td>
<td>5.0%</td>
<td></td>
</tr>
<tr>
<td>PBGC variable premium rate</td>
<td></td>
<td>3.0%</td>
<td></td>
</tr>
<tr>
<td>EROA = Cost of Debt (Scenario 2)</td>
<td></td>
<td></td>
<td>5.0%</td>
</tr>
<tr>
<td>EROA = Return on diversified portfolio (Scenario 3)</td>
<td></td>
<td></td>
<td>6.5%</td>
</tr>
<tr>
<td>Shares Outstanding</td>
<td></td>
<td>2,500</td>
<td></td>
</tr>
<tr>
<td>Additional debt issue</td>
<td>$2,000.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share price</td>
<td></td>
<td>$10</td>
<td></td>
</tr>
<tr>
<td>Pre-transaction net income</td>
<td></td>
<td>$1,750.00</td>
<td></td>
</tr>
<tr>
<td>Pre-transaction EPS</td>
<td></td>
<td>$0.70</td>
<td></td>
</tr>
</tbody>
</table>

Illustrative Impact on Balance Sheet:

<table>
<thead>
<tr>
<th></th>
<th>Scenario 1</th>
<th>Scenario 2</th>
<th>Scenario 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt issued</td>
<td>$2,000.00</td>
<td>$2,000.00</td>
<td>$2,000.00</td>
</tr>
<tr>
<td>Decrease in Pension Debt</td>
<td>0.00</td>
<td>(2,000.00)</td>
<td>(2,000.00)</td>
</tr>
<tr>
<td>Dec. in deferred tax asset: -37.5%</td>
<td>0.00</td>
<td>(750.00)</td>
<td>(750.00)</td>
</tr>
<tr>
<td>Assumed tax deduction (potential refund): 37.5%</td>
<td>0.00</td>
<td>750.00</td>
<td>750.00</td>
</tr>
<tr>
<td>Decrease in equity from share repurchase</td>
<td>(2,000.00)</td>
<td>(750.00)</td>
<td>(750.00)</td>
</tr>
<tr>
<td>Decrease in liabilities plus net worth</td>
<td>$0.00</td>
<td>($750.00)</td>
<td>($750.00)</td>
</tr>
<tr>
<td>Shares repurchased (at $10/share)</td>
<td>200</td>
<td>75</td>
<td>75</td>
</tr>
<tr>
<td>Remaining shares outstanding</td>
<td>2,300</td>
<td>2,425</td>
<td>2,425</td>
</tr>
</tbody>
</table>

Illustrative Impact on EPS:

<table>
<thead>
<tr>
<th></th>
<th>Scenario 1</th>
<th>Scenario 2</th>
<th>Scenario 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of debt: 5%</td>
<td>($100.00)</td>
<td>($100.00)</td>
<td>($100.00)</td>
</tr>
<tr>
<td>Assumed tax deduction (37.5%) on debt interest</td>
<td>37.50</td>
<td>37.50</td>
<td>37.50</td>
</tr>
<tr>
<td>After-tax cost of debt</td>
<td>($62.50)</td>
<td>($62.50)</td>
<td>($62.50)</td>
</tr>
<tr>
<td>Expected earnings (EROA) for pension expense</td>
<td>N/A</td>
<td>5.0%</td>
<td>6.5%</td>
</tr>
<tr>
<td>EROA: Trust earnings on pension contribution</td>
<td>0.00</td>
<td>100.00</td>
<td>130.00</td>
</tr>
<tr>
<td>Assumed tax adjustment on EROA</td>
<td>0.00</td>
<td>(37.50)</td>
<td>(48.75)</td>
</tr>
<tr>
<td>PBGC prem. savings: 3.0% of pension contribution</td>
<td>0.00</td>
<td>60.00</td>
<td>60.00</td>
</tr>
<tr>
<td>Assumed tax adjustment on PBGC premium savings</td>
<td>0.00</td>
<td>(22.50)</td>
<td>(22.50)</td>
</tr>
<tr>
<td>After-tax increase in net income</td>
<td>($62.50)</td>
<td>$37.50</td>
<td>$56.25</td>
</tr>
<tr>
<td>Pre-transaction net income</td>
<td>$1,750.00</td>
<td>$1,750.00</td>
<td>$1,750.00</td>
</tr>
<tr>
<td>Post-transaction net income</td>
<td>$1,687.50</td>
<td>$1,787.50</td>
<td>$1,806.25</td>
</tr>
<tr>
<td>Post-transaction EPS</td>
<td>$0.7337</td>
<td>$0.7371</td>
<td>$0.7448</td>
</tr>
</tbody>
</table>

Source: Goldman Sachs Asset Management. These examples are for illustrative purposes only and are not actual results. If any assumptions used do not prove to be true, results may vary substantially.
In Scenario 1, ABC Corp issues $2,000 of debt and uses all of the proceeds to buy back its own stock. At $10 per share, the $2,000 is able to repurchase 200 shares of ABC Corp. stock. Total shares outstanding have therefore declined from 2,500 to 2,300.

At a 5% coupon rate, the interest expense related to the incremental debt is $100. However, the interest expense is assumed to be tax deductible. Given ABC Corp’s 37.5% tax rate, the after-tax cost of the incremental debt is $62.50. This reduces ABC Corp’s net income from $1,750 to $1,687.50. The result is a post-transaction earnings per share (EPS) of $0.7337, greater than the $0.70 before ABC Corp. effectuated its borrow-to-buyback stock transaction.

In Scenario 2, ABC Corp. has again issued $2,000 of debt. However, it now takes those funds and contributes all of it to its pension plan. As seen in Scenario 2 of Exhibit 4, $2,000 of pension debt has been replaced with $2,000 of issued debt. At a 37.5% tax rate, the contribution of $2,000 generates a $750 tax deduction, which reduces the company’s deferred tax asset by the same amount. The cash received from the tax deduction is then used to buy back stock which, at $10 per share, results in the repurchase of 75 shares. Net shares outstanding in this scenario has been reduced to 2,425.

As in Scenario 1, the after-tax cost of debt is $62.50. However, in Scenario 2, the pension records expected return income (EROA) of 5% on the $2,000 pension contribution, equivalent to $100. Also, the contribution reduces the deficit by $2,000, resulting in a savings on PBGC variable-rate premiums of $60. As seen at the bottom of Scenario 2, taken together, after the effect of taxes, net income has actually increased by $37.5 and EPS equates to approximately $0.737, marginally higher than that of Scenario 1.

Whether the savings on PBGC variable-rate premiums is temporary or permanent depends upon whether the deficit is permanently reduced by the pension contribution, or only temporarily reduced. That, in turn, depends upon how the capital contributed to the pension plan is invested, and the results of that investment strategy. Investing the pension contribution in liability matching fixed income (i.e., LDI strategies) might present the best opportunity to keep the pension deficit, and PBGC premiums, low in future years and is the basis for the lower (5%) EROA assumption.

Scenario 3 is exactly the same as Scenario 2, except the pension EROA remains at 6.5%. Accordingly, the change in shares outstanding, the after-tax cost of debt and the savings in reduced PBGC variable-rate premiums are all exactly the same as in Scenario 2.

However, the higher assumed rate of return results in assumed income of $130, higher than that of Scenario 2. The increase in net income in Scenario 3 equates to $56.25 and an EPS of almost $0.745 per share. This higher EPS may be less sustainable in this scenario, as the higher EROA may not be achievable if the pension contribution is wholly invested in LDI strategies. The higher risk taking implied by the higher EROA may, in adverse markets, cause deficits to increase and the savings from reduced PBGC premiums would be lost.

Whether funding the pension plan results in a higher post-transaction EPS than a stock buyback is dependent on the sponsor’s market capitalization, the sponsor’s cost of debt and debt capacity, the sponsor’s tax status, the funded status of the plan, and the applicable PBGC variable-rate premium including the effect of the cap. In the assumptions of Exhibit 4, contributing to the pension plan potentially leads to a higher post-transaction EPS than a stock buyback. Plan sponsors who are considering a stock buyback transaction should consider their own circumstances in the context of Exhibit 4 to see if their capital might be better employed as a pension contribution.
Several sponsors have utilized a borrow-to-fund strategy

Issuing debt to fund a pension plan has, at times, been attractive to corporations. The increases in PBGC variable-rate premiums that have occurred in recent years may make it more attractive today. Earlier this year, General Motors issued over $2 billion in debt and used the proceeds to make a voluntary contribution into its DB plans. More recently, International Paper issued debt and indicated that approximately $500 million of the proceeds would be used for pension fund contributions. Over the past several years, a number of other corporations have taken similar actions with the contribution often being of a discretionary nature. Exhibit 5 details some of the activity we have observed in this area in recent years. When reviewing the information in the exhibit, it is apparent that this strategy has applied to companies spread across different industries, as well as through varying offering sizes.

Why would a sponsor issue debt to fund its pension plan? Several potential factors are highlighted below.

- PBGC variable premiums continue to increase and funding the plan can result in the ability to potentially avoid these premiums
- For taxpaying enterprises, a $100 contribution can potentially be funded with less than $100 of debt issuance, given the tax-deductible nature of the contribution
- Interest payments on debt are potentially tax deductible, and earnings in the pension trust are not taxed
- Allows a sponsor to take advantage of low market interest rates, which often translate to relatively low borrowing rates for sponsors
- Under the right circumstances, a borrow-to-fund strategy may be accretive to reported US GAAP earnings
- The plan sponsor does not lose the benefit of higher interest rates; if interest rates increase, the debt issue can, in principle, potentially be reacquired at a lower price
- Pension contributions would increase the funded status of the plan and potentially reduce required future contributions
- Voluntary funding can hasten planned de-risking actions, such as increasing allocations to liability-matching fixed income, reducing exposure to equity risk, increasing a plan’s hedge ratio, and/or allowing plans to take advantage of potentially attractive annuity pricing
A significant opportunity to adopt or accelerate a de-risking program

Funding and contributing accompanied by de-risking actions

Once a sponsor has voluntarily funded its pension plans, how much de-risking should take place? Consistent with glide path strategies that have been adopted, we believe that the higher level of funding achieved by voluntary contributions represents a significant opportunity to adopt or accelerate a de-risking program, and to hedge more of the liability risk than previously.

Importantly, when the pension contribution is being made largely for the purpose of reducing PBGC variable-rate premium expenditures, investing the contributed assets in an asset-liability risk management strategy might offer the best opportunity to preserve the premium savings.

Examples of objections to funding and/or de-risking

Objection 1

Interest rates are at record lows and are bound to increase. By hedging interest rates, opportunities to close the remaining funding gap are foregone. It would be better not to fund the deficit and let rising interest rates take over.

Potential Response

Interest rates have remained low for long periods of time, and there is no guarantee they will rise anytime soon. Many central banks around the world remain committed to low-interest-rate policies. If a plan sponsor really wants to position for rising interest rates, it may be more beneficial to do so outside the pension plan by issuing debt, funding the pension plan (potentially attaining the benefits described earlier), and then, when and if interest rates rise, a sponsor may act to buy the issued debt back from the market at a discount. This would allow for any potential gain to take place at the sponsor level, where it can be more effectively used for the business.
Objection 2
If we hedge our interest rate risk, the lower amount of growth assets that would remain would not allow us to meet our portfolio return objectives by removing the possibility that appreciation in growth assets can be used to fund the deficit.

Potential Response
By borrowing in the debt markets and contributing to the plan, the plan assets invested in growth assets can remain unchanged, even if all the new plan contributions are invested in LDI strategies (i.e., growth assets might be a lower percentage of total plan assets, but the dollar size of growth assets need not be reduced). When returns are measured in dollars, the potential profits from favorable economic conditions may not be reduced. Plans can also hedge interest rate risk with derivatives (i.e., use leverage), increasing the asset-liability matching without reducing growth rate targets.

Objection 3
De-risking our plan means that our pension expense increases, as the expected rate of return (EROA) for accounting purposes would decrease when hedging assets constitute a larger and larger percentage of plan assets.

Potential Response
A pension contribution would increase the amount of assets to which the EROA assumption is applied. Even if the EROA of those assets is lowered, due to a shift towards more liability-matching fixed income investments when measured as a percent of total assets, applying the lower EROA to a higher asset base might result in an approximately equivalent amount of expected return income (measured in dollars) and therefore potentially no increase in pension expense.

More importantly, many pension plans have adopted a strategy of reducing risk taking and therefore EROA as pension deficits decline and the plan’s funded status rises to reach or exceed 100%. Whether or not such funded status increases occur because of voluntary contributions by the plan sponsor or organic growth of plan assets, taking less risk when deficits decline can remain an appropriate strategy.

Objection 4
The cash outlay to fund would eliminate the ability to better deploy the cash elsewhere in the sponsor’s business, and borrowing to fund the pension deficit would eliminate borrowing capacity that could be better used for other purposes.

Potential Response
We recognize that each corporate sponsor situation is different, and an organization’s particular circumstances will determine which contribution policy is most appropriate. Generally, plan sponsors with strong free cash flow and ample borrowing capacity may find a borrow-to-fund strategy potentially attractive.
Objection 5
The equity and debt markets will not reward de-risking, and do not view pension debt as equivalent to other types of debt.

Potential Response
Many plan sponsors believe that markets may punish them for funding and de-risking a pension plan. These sponsors believe that the market may view pension deficits as a “soft” debt relative to an unsecured bond issue. However, the increased focus on pension deficits by credit rating agencies over the past several years, combined with more transparent accounting on the balance sheet, has increased the attention paid to pension liabilities and may have provided plan sponsors with a greater incentive to take active steps. We notice, for example, that markets generally do not respond negatively when a sponsor closes or freezes a DB plan and replaces it with an enhanced DC plan, another form of de-risking.

Conclusion
Over the past several years, a number of plan sponsors have embarked on de-risking programs for their DB pension plans. As part of such de-risking programs, there may be potential benefits for plan sponsors who fund and de-risk their plans, even where the funding may be enabled by issuing debt. Companies that are paying PBGC variable-rate premiums are incurring incremental costs that they otherwise can avoid, to the benefit of both the plan and plan sponsor. While every situation is different and the specifics of both the plan sponsor and the plan itself will dictate whether a particular contribution strategy makes sense, for a number of organizations this can be an effective tool in the pension risk management toolbox.
Risk Considerations

The strategy may include the use of derivatives. Derivatives often involve a high degree of financial risk because a relatively small movement in the price of the underlying security or benchmark may result in a disproportionately large movement in the price of the derivative and are not suitable for all investors. No representation regarding the suitability of these instruments and strategies for a particular investor is made.

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