Does a Borrow-to-Fund and De-Risk Strategy Still Make Sense?

Overview

In light of recent discussions around US corporate tax reform, Michael Moran, Chief Pension Strategist at Goldman Sachs Asset Management, addresses some of the frequently asked questions we have received on the impact of the reform on corporate defined benefit ("DB") plans.

Q: Interest rates may be rising. Corporate tax rates may be falling. Foreign-held cash may be more accessible. Does it still make sense for corporate DB plan sponsors to consider a borrow-to-fund and de-risk strategy?

A: The overall case, which we had previously outlined in our October 2016 report, "Should Sponsors Borrow-to-Fund and De-Risk Their Plans?" remains largely the same in our view. Eliminating Pension Benefit Guaranty Corporation (PBGC) variable-rate premiums of 3.4% of underfunding in 2017, which will rise to at least 4.2% by 2019 and head still higher thereafter (based on current law), is equivalent to getting a risk-free, tax-deferred return of the same amount, in addition to investment earnings, on pension plan contributions. With the recent jump in interest rates, the case for hedging has strengthened, as there is more room for rates and funding levels to potentially fall. While it is true that lower tax rates would partially reduce the value of tax deductions and deferrals, the math may still be compelling and plan sponsors may consider it worthwhile to at least evaluate the economics of such a potential transaction.

Q: Long-term interest rates have risen about 100 bps since summer 2016. If interest rates are expected to continue to rise, should a plan sponsor just wait for that to occur, which would help to cure deficits?

A: If the market expects rates to rise, the expected increase is already baked into the current yield curve, and thus the current level of liabilities. Profits from increasing rates, in the form of reduced pension liabilities, will only occur to the extent that rates increase by more than what is already priced into the market. "Waiting for rates to rise" is effectively making a market call on interest rates. If corporate sponsors wish to express that view, deeming the risk acceptable, it may likely be more economically efficient to issue debentures and contribute the proceeds to the pension plan (i.e., borrow-to-fund). Total indebtedness remains the same, as pension debt is replaced with general corporate debt, and if rates rise, the issued debt can be reacquired at a lower price and the profit can be realized outside the pension plan.

Q: Corporate tax reform appears to be on the table. If corporate tax rates are lowered, or if interest deductibility is eliminated, would the value of the tax benefits from a borrow-to-fund strategy decrease, potentially making it less attractive?

A: Yes. However, as noted earlier, the math may still be compelling. This is largely due to the fact that PBGC variable-rate premiums have increased significantly over the past several years, and eliminating this cost would create an opportunity for significant savings. In addition, we note that any potential amendments to corporate tax rates or the deductibility of interest on corporate debt are still uncertain at this time, and it remains unclear exactly which corporate tax changes may be enacted. Furthermore, even if changes are passed, they may not be effective until future periods. However, plan sponsors that are considering discretionary contribution activity (funded by borrowing or not) may want to take action sooner in order to capture a potentially larger tax deduction.

Q: As part of tax reform, trillions of dollars of foreign-held cash may become eligible for repatriation at a lower tax rate. If that occurs, should a plan sponsor use that cash to plug deficits rather than raise new capital through the debt markets?

A: Perhaps. It is important to remember that pension debt is a real debt obligation, and is often more expensive to carry than other forms of debt. For this reason, a borrow-to-fund strategy is often effective. PBGC variable-rate premiums add to financing costs, and should be factored into management's decisions around capital structure. While borrowing to fund often involves replacing more expensive debt with less expensive debt, there may be more efficient ways to eliminate expensive debt. The key is that reducing expensive pension debt has the ability to add value for shareholders, even if it is replaced with other (less expensive) debt.

Q: The Department of the Treasury and the Internal Revenue Service (IRS) have finally gotten around to proposing changes in the mortality tables that are used to calculate liabilities for funding and PBGC premium purposes. If that change is finalized as proposed, how would that impact the attractiveness of a borrow-to-fund strategy?

A: The size of transactions that would be considered attractive would likely increase. The pending change, which we believe is likely to be adopted as proposed or in some form with similar effect, would increase the liability measure which determines PBGC variable-rate premiums. Recall that when mortality changes were enacted for Generally Accepted Accounting Principles (GAAP) reporting purposes in 2014, many plans saw their gross pension liabilities increase around 4%-6%. All else equal, measured funding levels would decline and unless the plan is, and remains, overfunded on this basis, PBGC variable-rate premiums would likely increase, as would the contribution needed to eliminate them.

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