US Corporate Pension Mid-Year Update: Domino Effect

The first half of 2018 was one of the most active periods for corporate defined benefit (DB) plans in recent years. The impact of corporate tax reform, combined with rising Pension Benefit Guaranty Corporation (PBGC) premiums, helped to spur notable voluntary contribution activity from sponsors. Increased contribution activity has created a domino effect as this has been a catalyst for some sponsors to consider additional actions with their plans, including asset allocation shifts and risk transfer. In this mid-year update, we provide some thoughts and observations around the current state of play in the US corporate DB system. We also share some of the most common questions we heard from clients in the first half of 2018.

1. Corporate Tax Reform Leading to Significant Voluntary Contribution Activity

This has been the number one topic of client conversations since late 2017. In general, sponsors can make a contribution up to mid-September 2018 and still be eligible for a tax deduction at the previous 35% tax rate as opposed to the new 21% rate.[1] Combined with PBGC variable rate premiums, now generally assessed at 3.8% on any deficit, and increasing to over 4% by the end of the decade, this has provided a powerful incentive for sponsors to fund their pensions sooner rather than later. Whereas in the past a sponsor's contribution strategy may simply have been to contribute only the ERISA-required minimum amount, the economics of making a voluntary contribution have become more attractive given the change in tax law and rising PBGC premiums.

Our work on the US plans of S&P 500 companies indicates sponsors contributed about $63 billion in 2017, the highest amount of contributions since 2003, even though many had little to no mandatory contribution requirement last year. We project about $60 billion of contributions for S&P 500 companies to their US plans in 2018, with once again much of it being of a voluntary nature. Already in 2018, companies such as FedEx ($1.5bn), PepsiCo ($1.4bn), Verizon ($1bn), Deere ($1bn) and Alcoa ($500mn) have all publicly disclosed sizable voluntary contributions. We would expect that additional sponsors may consider making discretionary contributions as the window of opportunity to potentially capture the higher tax deduction quickly begins to close.

[1] For additional information, please see GSAM's Pension Solutions note "US Tax Reform Impact on Corporate Pensions" January 2018.

2. Higher Funded Levels Enable Plan Sponsors to Take Additional Actions

Over the past 18 months, the combination of significant voluntary contribution activity, strong returns by risk assets and, more recently, rising interest rates has led to a notable upward move in funded levels. Our work would indicate that the aggregate GAAP funded status of the US corporate DB system has risen from 81%, as of the end of 2016, to an estimated 89%, as of June 2018. As a result of this increase in funded levels, some plan sponsors have hit triggers on their glide paths and enacted shifts in asset allocation towards more fixed income as a means to better hedge their liabilities. (We note, however, that some plans have expressed a hesitancy to move more into fixed income at this point in the cycle, a topic we address in our 'Take 5' section below.)

Higher funded levels may also encourage some plan sponsors to effectuate an annuitization. In the past, some sponsors may have wanted to annuitize a portion of their plan but perhaps did not want to make a contribution in order to complete the transaction. Now, as noted earlier, more sponsors are willingly making sizable contributions, which could make an annuitization transaction easier to complete. According to data from LIMRA, 2017 saw the highest dollar amount of group annuity sales since 2012. FedEx's May 2018 $6bn annuitization announcement would seem to indicate that 2018 may be another robust year for risk transfer, in particular due to higher funded levels.

3. Looking Beyond Bonds – De-risking Entails More Than Just Fixed Income

While many plans have put glide path strategies into place to reallocate plan assets into fixed income as funded status rises, increasingly more are also examining what the return-generating portion of their portfolio should look like in a de-risked strategy. Despite the reality that many plans have been reducing equity allocations and increasing fixed income allocations over the past decade, equity risk still dominates the risk profile of most plans.

While equity beta has been a great place to be post-financial crisis, current valuations have led some to consider allocations to other alternatives such as defensive equity and/or low volatility equity strategies or hedge funds, as a way to de-risk the returning-generating side of the portfolio. Many glide path strategies may still have around 10% - 20% of the portfolio allocated to return seeking assets even when they reach their end state point. We expect more plans to take a closer look at the makeup of their return-generating portfolio as they move along their glide path, especially as we get into the late innings of the current economic expansion.

4. Take 5: Top 5 Questions We Have Heard Over the Past Few Months

I. Our funded status has moved higher. However, with the Fed raising interest rates, signs of inflation increasing, and credit spreads still historically tight, is now the right time to be moving into longer duration fixed income?

Every plan's situation will be different, and will be enlightened by such factors as whether the plan is still open and accruing new benefits or closed/frozen, as well as the materiality of the plan to the sponsor. In general, however, we view the decision to increase allocations to long duration fixed income as funded levels rise as a risk management exercise, not a tactical investment decision. Many plans already have a sizable "short" fixed income view when plan assets are considered in the context of plan liabilities. Increasing the allocation to fixed income, and consequently increasing a plan's hedge ratio, reduces that short position and the volatility of the plan's funded status, a key goal as a plan's funded level rises. This is in many ways irrespective of the current level of interest rates and credit spreads.

II. Many plans do seem to have been increasing allocations to fixed income. Has all of this demand from pension plans contributed to the flattening of the yield curve?

Quite possibly. US corporate DB pension plans have been, and will continue to be, significant buyers at the long end of the curve. Our work would indicate that US corporate DB plans may purchase about $150 billion of high-quality, long duration fixed income each year for the next several years. Although investment grade corporate bond issuance has been quite robust in recent years, future issuance may be lower in that (1) many organizations have already issued a lot in recent years, (2) higher rates may deter future borrowing, and (3) tax repatriation changes may provide US multinationals with increased flexibility around their cash holdings, potentially lessening the need to issue bonds to fund buybacks, dividend increases, M&A, etc. In addition, 30-year issuance has comprised a greater percentage of total issuance in recent years than historical averages. Reversion to the mean for 30-year issuance would place further downward pressure on supply at the long end, just as demand remains strong from US corporate DB plans.

III. Does it make sense to engage a completion manager as part of our de-risking program?

Plans increase their allocations to fixed income and extend the duration of their fixed income holdings, to better match the characteristics of their assets with the characteristics of their liabilities. This, in turn, helps to reduce funded status volatility and protect gains in funded levels. As more capital is allocated to fixed income, ensuring those assets are doing what they are intended to do takes on increased importance. A completion manager can serve to increase the effectiveness of a hedge, seeking to eliminate the gaps between the hedge exposures and the risks of the plan liabilities. A completion manager can also help to ensure that unforeseen declines in funded levels due to mis-aligned yield curve and credit spread positioning are avoided.[2]

IV. Our plan is not closed or frozen, so why would we want to engage in de-risking activities like increased hedging or risk transfer?

Having a plan that is accruing new benefits and taking de-risking actions are not mutually exclusive. The goals of de-risking actions often revolve around reducing funded status volatility and the potential related negative effects such volatility could have on the plan and sponsor, including on its balance sheet, profit and loss, and cash flow. De-risking actions may also often attempt to address reducing costs associated with the plan, such as premiums paid to the PBGC. These goals can be, and often are, pursued even as a plan is accruing new benefits.

V. Much of what we would like to accomplish with our plan – borrow in the capital markets to fund the plan, increase our hedge ratio, use derivatives to increase the efficacy of our hedge, annuitize a portion of our participants, find a strategic partner to help with all of this – involves doing some things we have not done in the past. How do we get all of our internal constituents on board?

As plans move through the various stages of their life cycle, they will increasingly be considering strategies that they may not have needed to evaluate in the past. This is especially true for sponsors that are exploring “end game” strategies. For some plans, this can become a communication challenge as getting all of the key stakeholders up to speed and in agreement can be difficult. This highlights the importance of having a holistic strategy and framework in place that has been coordinated with various stakeholders such as HR, accounting and finance before undertaking any individual actions. Attempting to get varied stakeholders to agree on a particular action without first putting an overarching framework in place can be a slow, difficult and costly exercise as various constituents may not have the full context around how an individual action fits into the bigger picture goal for the plan.

[2] For additional information, please see GSAM’s Pension Solutions note “Pension De-Risking: Seizing the Inflection Point” June 2018.

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