PENSION SERIES

TIME FOR A RESET?

RETHINKING CONTRIBUTIONS POLICY

It is well known that corporate plan sponsors have until mid-September to make deductible contributions under the more favorable 35% corporate tax rate. This is an attractive proposition and one that many corporations are looking to leverage, if they haven't already. But, with the boost in funded status from these voluntary contributions, perhaps less obvious is that minimum required contributions may rise over the next several years. Addressing this issue should be a key focus for most plan sponsors so that unexpected pension contributions don't disrupt strategic company initiatives.

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THE END OF THE VACATION?

Many plan sponsors have preemptively made voluntary contributions recently to take advantage of the tax law or to lower PBGC premiums. However, those who haven't—and even those who have—may still see higher minimum required contributions in the coming years. This is the case for a few key reasons.

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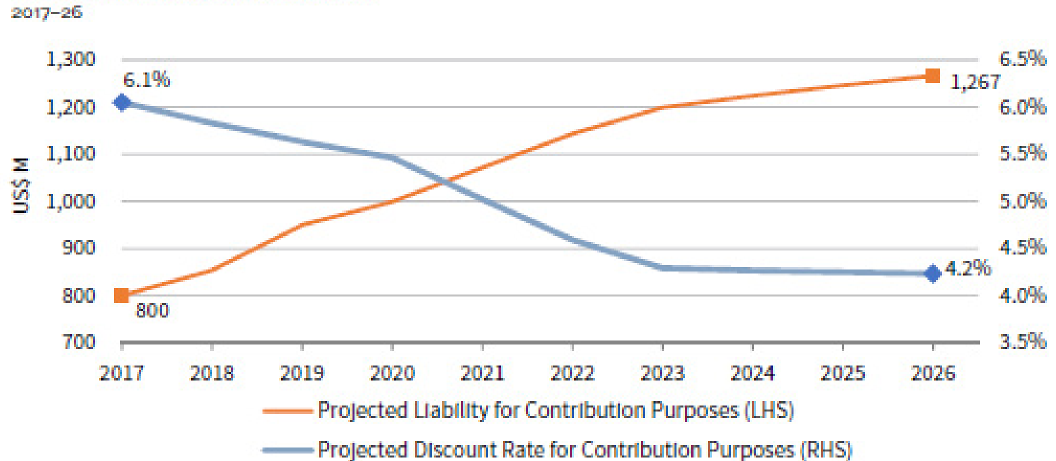
First, updated mortality tables, which have become effective for 2018 plan years, will cause the liabilities used in determining minimum required contributions to increase by approximately 4%–5% on average. It should be noted that plan sponsors have the ability to defer mortality updates until 2019 if either "administratively impracticable" and/or if the update would result in "an adverse business impact that is greater than de minimis." While it appears many plan sponsors will likely elect a deferral due to an "adverse business impact," the consequences of higher liabilities will still be felt by plan sponsors in the coming years.[1]

Second, the multiple iterations of funding relief that have occurred since the 2008 financial crisis are gradually dissipating as artificially high funding discount rates begin to converge with recent market yields. As shown in Figure 1, this results in a lower discount rate and a higher liability for contribution purposes and, consequently, likely higher required contributions going forward.

FIGURE 1 SAMPLE PLAN PROJECTED LIABILITY AND DISCOUNT RATE FOR CONTRIBUTION PURPOSES
2017–26



Source: Cambridge Associates LLC.
Notes: This illustration captures projected liability and discount rates for a sample plan with an $800 million starting PPA liability. It assumes updated mortality starting in 2019; annual normal cost of $36 million; and market rates remaining at June 2018 levels.

Furthermore, many plan sponsors have used credit balances to satisfy minimum required contributions in recent years. This mechanism, which relies on employing excess contribution money from prior years, may not be as helpful going forward, as these balances have gradually been depleted.

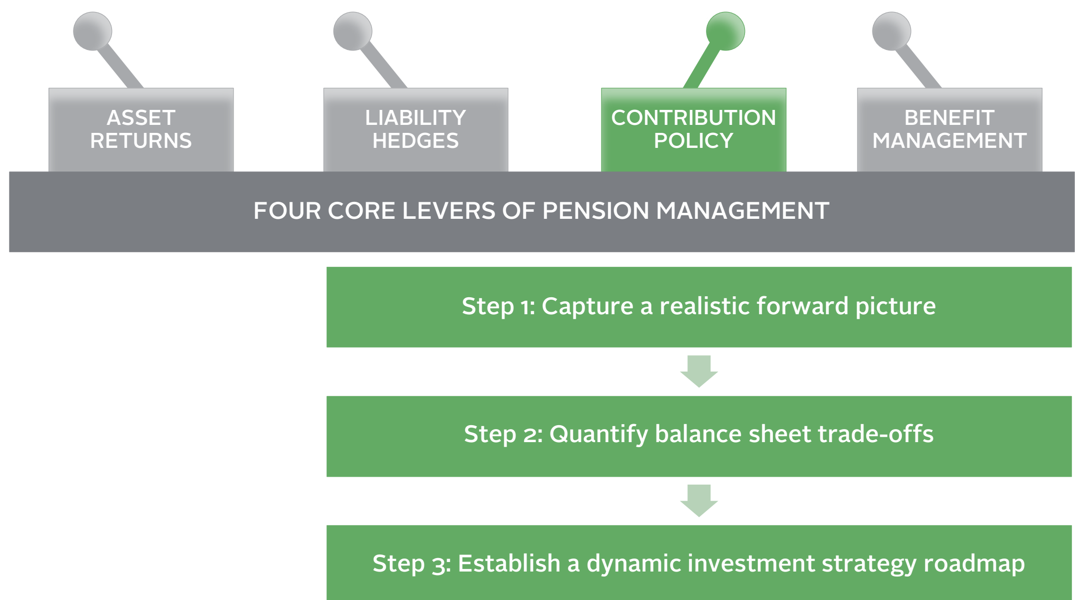
The dynamics that have resulted in muted contributions in recent years have been largely beneficial to plan sponsors by allowing cash to be allocated to other company uses. But these factors have also created a bit of complacency and an unrealistic estimate of expected future contributions. Challenging investment returns and extremely low discount rates—despite year-to-date increases—present further hurdles for sponsors as they contemplate options for infusing money into their plans. For many plan sponsors, the contribution vacation is slowly coming to an end.

1 Plan sponsors will also be familiar with several rounds of recent PBGC premium increases now made worse by the new mortality requirements (no deferral opportunity), effective in 2018.

EMPLOYING THE CONTRIBUTIONS LEVER

Some effective actions can be taken to address this potentially mounting financial burden. As we described in a recent paper, "A Balancing Act," plan sponsors have four levers to help manage their defined benefit plans—asset returns, liability hedging, benefit management, and contributions policy.[2] The use of each lever should be appropriately balanced and coordinated to each plan's optimal effect. With regard to contributions, plan sponsors should consider several actions (Figure 2), which we expand upon below.

FIGURE 2 EMPLOYING THE CONTRIBUTIONS LEVER



Source: Cambridge Associates LLC.

CAPTURE A REALISTIC FORWARD PICTURE

As a first step, each plan sponsor should ensure that its key stakeholders have a full understanding of their plan's projected minimum required contributions over the next five to ten years. This analysis should capture the updated mortality assumption, as well as the wear-away of the discount rate smoothing and credit balance depletion mentioned above. Also critical will be assessing the impact of various asset returns and discount rate changes, to get a full picture of the magnitude of required contributions under different market environments. This can be done via a combination of specific deterministic scenarios and supplemented by stochastic simulations of future economic environments.

Plan sponsors would benefit from viewing the minimum required contribution forecast as just that—the minimum. Although funding minimums are governed by regulations, a sponsor has leeway in the timing and amount of contributions that may be made into a plan above and beyond the minimum required. Contribution policy represents the most direct link between a company's balance sheet and its defined benefit pension plan, even if the intra-balance sheet flow is initially a zero-sum game. A thorough

2 Jeff Blazek, et al., "A Balancing Act: Strategies for Financial Executives in Managing Pension Risk," Cambridge Associates Research Report 2017.

analysis must be done to compare the return on investment of a pension contribution to either paying down existing company debt or reinvesting in the broader business. The decision on when to fund the pension and how much to contribute can substantially affect funded status in future years.

Therefore, a detailed analysis should be performed that focuses on the contributions needed to meet the plan's objectives. Is the objective to stay above 80% funded on a PPA basis to avoid certain restrictions? Is the objective to achieve fully funded status in three years? Is the objective to terminate the plan in five years? Minimum required contributions are unlikely to achieve these goals on their own and therefore should be treated as merely a lower boundary.

QUANTIFY BALANCE SHEET TRADE-OFFS

In many cases, the return on investment for contributions to the company pension plan may not be immediately clear. Certainly, pension contributions are a use of company capital that must compete directly with other uses of cash within the organization that may have a more direct link with company revenue and profitability. To properly assess the trade-off between pension contributions and other uses of capital, it is helpful to view the pension underfunding as analogous to standard balance sheet debt, with a potentially high interest cost. Oftentimes, when PBGC premium impacts are also included in this analysis, plan sponsors find that paying down the pension debt (i.e., underfunding) is a more efficient use of capital as compared to paying down other debt on the balance sheet. This has also been a significant driver of corporations taking out debt to fund pension plans.

ESTABLISH A DYNAMIC INVESTMENT STRATEGY ROADMAP

It is important to have a clearly defined investment strategy roadmap in place before contributions are made to achieve efficient implementation and preserve funded status gains. Once contributions are made to the plan—either through existing company cash, debt proceeds, or company stock—the key is to protect the improvement in funded status. Many plan sponsors would like to forget that S&P 500 companies have poured nearly $500 billion into their pension plans in the last eight years only to see a 3% increase in funded status.[3] To ensure pension contributions are most impactful to the plan's health, it is critical to reassess asset allocation and portfolio construction as contributions are made.

How best to allocate the new capital into the pension plan's investment portfolio will depend on several factors. For plans that have significantly reduced their underfunding, a material portion of the contributions should be invested in liability-hedging fixed income to reduce funded status volatility and help lock in the plan's funded status gains. Plans that are closed to new participants or completely frozen will also lean heavily toward de-risking assets, perhaps following a funded status glide path. On the other hand, plans that are either open to new participants or plans digging out of

3 Aggregate funded status and contributions have been estimated by Cambridge Associates based on a compilation of 10-K filings for companies in the S&P 500 Index as of year-end 2017 and year-end 2009, as provided by Bloomberg L.P. These calculations include total pension assets, liabilities and contributions for a given company, including those for non-US plans and, in some instances, for nonqualified plans sponsored by that company.

large underfunded gaps will need to be thoughtful about allocating the new money to return-seeking assets, especially given elevated equity valuations. For plans that have the resources and can take on some illiquidity, adding to low-beta diversifiers and/or private investments may be an effective way to avoid contribution regret.

A company's ability to contribute to its pension plan, unfortunately, does not remain constant. Periods in which markets perform poorly (creating a need for higher pension contributions) may coincide with periods during which the company itself faces financial adversity and has less free cash flow to set aside for pension infusions. Therefore, the risk profile of pension assets may be intertwined with the risk profile of the company's core operations. Another aspect to consider in terms of the "cyclicality" of contribution policy is that when times are good and a company has more cash to invest in its pension, market valuations may be elevated. Financial executives must monitor the competing forces of their ability to fund their pensions and the attractiveness of deploying cash into higher priced investments.

CONCLUSION

While the focus on making contributions prior to the mid-September tax deadline is important, it should be the first step in establishing a dynamic contribution roadmap. Especially given mounting contribution requirements ahead, plan sponsors should take this opportunity to view their contribution policy as one available lever—along with asset returns, liability hedges, and benefit management—in navigating the pension plan to a strong financial position. Adopting a comprehensive strategic plan for the pension that aligns with broader organizational objectives is also critical to success.

Contribution strategy should be actively managed in the same way that asset allocation, portfolio construction, and manager selection are reviewed regularly. To be effective, it requires ongoing oversight and should allow for adjustments as markets and company capital needs change over time. Ultimately, a well-executed contribution strategy can shift the focus away from underfunded pension plans and toward the core strategic initiatives that will help drive the company forward. ■

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