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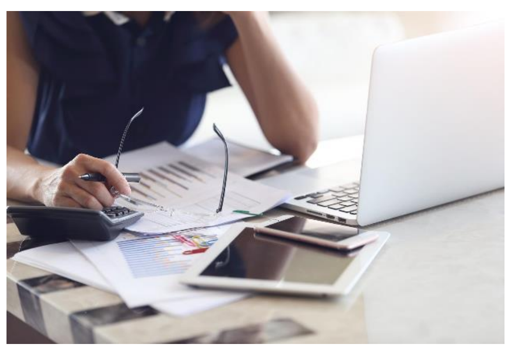
Corporate Pension Funding – Is Sooner Better than Later?

For the last five years, corporate pension plan sponsors have enjoyed the flexibility of lower defined benefit plan funding requirements made available by several iterations of funding relief passed by Congress. While some sponsors have chosen to contribute based on the requirements had the funding relief not been made available, others have not, which puts many sponsors at real risk of falling behind on prudent funding goals. Rising PBGC premiums combined with the possibility of tax reform relief that could reduce the value of deductions may make accelerating contributions beyond minimum requirements a smart move.

Background

Single-employer defined benefit plans have been subject to minimum funding requirements for over 40 years, dating back to the enactment of ERISA. The rules that determine the funding requirements have changed several times and were most recently overhauled by the Pension Protection Act of 2006 (PPA), though softened by interest rate stabilization provisions in the Moving Ahead for Progress in the 21st Century Act (MAP-21) and subsequent extensions. Many plan sponsors have taken advantage of this funding relief and have limited contributions, resulting in reduced funded levels when measured at current market rates.

Meanwhile, during this period of "relief," PBGC premium rates have seen significant increases, mortality has been improving, and many sponsors have taken meaningful steps to de-risk their plans through a combination of plan design, investment policy and risk transfer actions. The proposed tax reform is yet another significant development that may spur plan sponsors on to take another look at their overall pension strategy.



Phase Out of Funding "Relief"

With the enactment of PPA, the basic paradigm of pension funding was to value pension plans on a mark-to-market type basis, funding current costs annually and paying off unfunded amounts over a seven year period. With the stock market and interest rate turmoil that ensued shortly after implementation of PPA, Congress provided funding "relief" by effectively delaying the application of this new paradigm … and then extended that relief twice. Barring further congressional action, that relief will phase out rapidly during 2021-2024. Ironically, over the last decade since PPA was enacted with an aim of improving plan funding, some plans have actually drifted farther away from full funding of current obligations and find themselves facing substantial increases in required contributions over the next several years.

As a first step in evaluating whether to contribute "sooner vs. later," sponsors may wish to consider that the phase-out of funding relief means that "later" may actually be much sooner than they think.

Mortality Improvements

Plan participants are expected to enjoy longer life expectancies according to the latest mortality studies. Actuaries, accountants and regulators have been paying ever-increasing attention to ensure that the mortality rates used to develop plan costs reflect this reality and better anticipate improvements in longevity. PPA requires that mortality rates be reviewed no less frequently than every 10 years to reflect actual experience and projected trends. Based on their most recent review, the IRS has proposed a mortality update that would impact funding requirements for plan years starting in 2018. While the implementation of this update is currently held up by regulatory bureaucracy, its impact will be felt soon and will result in further increases to pension liabilities and plan funding requirements.

The looming increases to funding requirements resulting from these mortality changes are another factor in the contribute "sooner vs. later" decision.

PBGC Premiums

ERISA-mandated premium payments to the PBGC have skyrocketed in recent years, with several more increases on the horizon. While a portion of the premium increases is based solely on participant count, the largest component for underfunded plans is often the portion determined as a percentage of the unfunded liabilities of the plan. Independent from any other considerations, sponsors have already been actively evaluating the merits of contributing additional amounts to their plans just to defray PBGC premiums, which currently run at 3.4% of unfunded liabilities. With liabilities increasing because of the mortality improvements, these premiums, and the resulting advantage that comes from avoiding them, will rise commensurately.

The additional economic benefits from accelerated funding that come from PBGC premium savings add a third factor to the contribute "sooner vs. later" considerations.

De-risking Strategies

For the better part of the last decade, plan sponsors have paid increased attention to the merits of "de-risking" their plans through both liability driven investment strategies and risk transfer activities, including annuity purchases and lump sum payouts. The goal of these tactics is to reduce the volatility of their funded status. Liability driven investment strategies typically involve allocating a portion – often a significant portion – of plan assets in fixed income securities with a similar duration profile as the plan liabilities. This puts asset volatility more in sync with liability volatility, thus minimizing the likelihood of a significant change in funded status due to changes in interest rates. Annuity purchases and lump sum cashouts shrink the size of both the assets and liabilities, thus limiting the size (in absolute dollars) of asset and liability fluctuations. These two tactics can be applied individually or jointly.

So how does accelerating plan funding fit into a de-risking strategy?

First, consider what might happen if a sponsor increases pension funding without considering the risk management aspects of the transaction. If the sponsor contributes more to the plan without making any changes to asset allocation or considering risk transfer, there is a larger pool of assets, subject to larger swings in market value, which actually increases pension risk!

However, in most cases, a better funded plan gives the sponsor the opportunity to move to a lower volatility investment profile, allowing them to further reduce funded status risk and decrease the likelihood of significant losses. It also gives the sponsor the opportunity to explore risk transfer actions, because a well funded plan can better afford to transfer a portion of assets and liabilties out of the plan without adversely affecting the remaining plan. Finally, while a lower risk asset allocation will typically result in a lower expected return on plan assets for accounting purposes, this lower expected return is applied to a larger overall asset base, often times resulting in a relatively neutral impact on P&L expense.

Plan sponsors should be sure to consider how contributing “sooner vs. later” could allow them to explore pension risk management strategies more in line with their objectives than those they were previously able to pursue.

Possible Tax Reform

In the event that corporate tax reform moves forward as proposed, defined benefit plan sponsors have another reason to consider, or re-consider, their plan funding policy. Simply put, if corporate tax rates are reduced, tax-deductible pension plan contributions will produce a smaller tax offset and therefore become more expensive. This may present yet another incentive for funding prior to any changes in the tax code to lock in the value of deductions based on current tax rates.

In considering whether to contribute “sooner vs. later,” sponsors may consider that the value of deductions will decline if tax reform is enacted, thereby reducing the value of tax deductions for pension contributions.

In Closing

As the window of funding relief begins to close, plan sponsors who have made use of it may want to consider funding beyond required minimums now to get ahead of potentially large increases over the next several years. Meanwhile, in light of other developments surrounding defined benefit pension plans, even plan sponsors who have funded above the minimum required amounts have good reason to consider accelerating their funding. Finally, as tax reform now enters the picture, the possibility of reduced corporate tax rates gives defined benefit plan sponsors yet one more reason to consider whether increased plan funding should be a priority. And remember, the deadline to make final 2016 plan year contributions is just around the corner (September 15 for calendar year plans)!

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