HEALTH WEALTH CAREER

HOW MUCH TO PRE-FUND?

TAX REFORM AND THE 2018 DB OPPORTUNITY

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OVERVIEW

For pension plan sponsors, voluntary pre-funding now looks more compelling than ever before, thanks to the recent tax reform legislation, which cuts the headline corporate tax rate for 2018.

Right now, a window of opportunity is open to lock in current tax deductibility of 35% for any plan contributions attributable to the 2017 tax year. Once that window closes, future contributions will be deducted at the new 21% rate.

This new tax-related benefit to accelerating contributions is amplified by other advantages:

- Reduced PBGC Variable Rate Premiums, which are a significant tax on unfunded liabilities
- Improved pension earnings on income statements
- The availability of cash from improving business conditions, repatriation, and/or cheaper debt
- The ability and desire to accelerate de-risking activities
- The wear-away of funding relief: “pay now or much later” is changing to ”pay very soon” leading to a much shorter time horizon for investment risk to close the funding gap

After tax savings of up to 14% together with PBGC premium savings of 4% in many cases will encourage many to pre-fund their pensions this year. So while many will quickly get past the question of whether to pre-fund, the trickier question is how much?

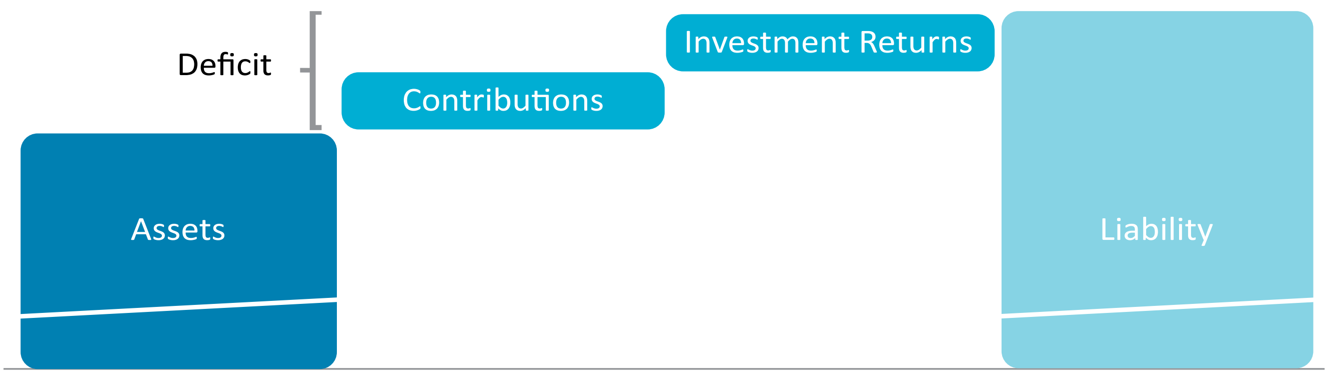
In our April 2017 paper, “DB Pensions and the Emergence of the Big Bang Strategy”, we addressed the plan sponsors who may take bold funding and de-risking actions, including full plan termination for fully frozen plans. At the other end of the spectrum, for a variety of good reasons, many sponsors will continue to pay minimum required contributions. This outline focuses on the sponsors that fall in between.

THE PRE-FUNDING DECISION IN CONTEXT

Many sponsors considering pre-funding face a delicate balance between pre-funding for tax benefits and potentially crowding out future investment returns. While sponsors should optimize their tax strategy, they also need to guard against paying more than needed to fully fund the plan. De-risking activity enabled by voluntary pre-funding will also reduce the investment opportunity forgone. Plan sponsors will fall on a spectrum in terms of seeking excess returns versus desire for de-risking which will, in turn, influence how much they decide to pre-fund.

The balance of contributions and investment returns illustrated below will be affected by the current and future asset allocation, de-risking actions planned, and outlook for markets and interest rates.

EXHIBIT 1
ANATOMY OF A PENSION DEFICIT



Note that the liability above includes carrying costs of maintaining the plan (e.g. PBGC premiums) or the cost of termination, depending on the sponsors' ultimate destination.

The triangulation of these factors can make the pre-funding decision a complex one, but the financial rewards are worth the analytical effort to extract them. We encourage plan sponsors to evaluate pre-funding decisions in a similar manner to other capital allocation decisions. Because pension funding has cascading investment and de-risking implications, this evaluation should be done over multiple years. Consistent with other capital allocation decisions, the question of how much to pre-fund should be measured in terms of Net Present Value (NPV) and/or as an Internal Rate of Return (IRR). These measures can quantify and combine federal tax and PBGC premium savings with future investment implications. In addition, stress testing such metrics under various funding and economic scenarios will also calibrate the impact of existing investment allocations and de-risking actions already planned or resulting from pre-funding actions. Finally, this review should be evaluated in terms of relative risk (pension risk relative to other corporate risks and avenues for capital). These synthesized measures can help cut through several complexities including the trade-off between tax and PBGC premium savings and investment opportunity costs.

Mercer estimates that pre-funding for most companies will result in an IRR materially in excess of the Company's Weighted Average Cost of Capital ("WACC") resulting in positive NPVs adding to shareholder value. A Company's WACC is often used as a hurdle rate for a project with similar risk levels to the overall firm. However, the choice of hurdle rate and the NPV or IRR of the project will vary based on a host of factors outlined below:

1. TAX AND PBGC PREMIUM STATUS

Pension sponsors that experience material corporate tax rate reductions as a result of tax reform will generally benefit the most from pre-funding. In addition, sponsors paying a variable rate PBGC premium will experience an additional benefit of approximately 4% per year due to PBGC premium tax savings – effectively reducing these deficit taxes. For plan sponsors at the PBGC variable rate per participant cap, contributions up to a certain point may not bring savings until the cap threshold is met.

2. ACCOUNTING FOR FUTURE INVESTMENT OPPORTUNITY AND POTENTIAL DE-RISKING ACTIONS

The value of pre-funding can decline as contributions increase due to the effect of crowding out investment returns. This will also depend on whether the plan is open, closed, or frozen and views on potential uses of any future surplus. In addition, to the extent funded status under or over performs in the future (from more positive investment or interest rate experience than expected), economics of pre-funding will change. While planning for the expectation is a good starting point, we also encourage some stress testing to fully understand the trade-off between tax savings and investment opportunity costs.

Protecting future investment opportunity does assume that the sponsor wishes to continue its strategy of funding its deficit with future returns and accepting the volatility that comes with that strategy. The pre-funding opportunity could also cause sponsors to rethink that strategy using contributions to accelerate de-risking steps, with some going all the way to full plan termination.

Balancing upside investment opportunity, most plan sponsors have, by now, put some form of de-risking gameplan in place either to de-risk investments through Liability Driven Investing or to de-risking liabilities through pension risk transfer activity.

Pre-funding actions should account for such actions and their impact on investment opportunity and may also accelerate these actions.

Ultimately, pre-funding decisions should be interlocked with targeted investment gains and de-risking activity actions planned.

3. HURDLE RATE UTILIZED BASED ON AVAILABILITY AND ALTERNATIVE USES OF CASH

Where a corporate hurdle rate is utilized to evaluate pension pre-funding, this should consider the inherent pension risk compared to the risks involved in other capital allocation opportunities. A Company's WACC is often used for this purpose as it is the return expected by the Company's investors and debt holders which imbeds the overall risk of the company. Also, the after tax cost of debt may be an appropriate hurdle rate for a business that could plausibly increase leverage without negatively impacting its borrowing capacity or cost.

In addition to alternative uses of cash, the hurdle rate decision can further be influenced by how the pre-funding contributions are invested. While many will invest in liability hedging assets so that the action does not increase pension risk, others will invest in risky/growth oriented assets, which in turn, would increase the hurdle rate to be applied.

4. ACCOUNTING IMPLICATIONS

In addition to the economic benefits of accelerated funding, pre-funding also typically results in a pension income benefit for GAAP purposes. Any pre-funding will add to the expected return on assets ("EROA") line item of pension expense (i.e. pre-funding will decrease pension expense or increase pension income).

COORDINATING WITH OTHER STRATEGIC POLICIES – WHAT COMES NEXT?

The necessity to coordinate pre-funding decisions with a broader pension financial strategy is more critical than ever considering the 2018 decision. For example:

- The pre-funding question is an ideal opportunity for sponsors to take a fresh look at their pension deficit and the question of how much to fund, earn, and the associated risk to take.
- Sponsors will need to determine how to invest any accelerated contributions – whether consistent with their existing asset allocation or weighed more towards liability hedging assets so that pension risk is not increased by this action. This should be coordinated with some review of the existing asset allocation and any glidepath in place to determine whether these need to be re-calibrated.
- Pre-funding will often enable sponsors to consider risk transfer actions that were prohibited due to lower funding levels. The tax reform catalyst may now enable a series of actions to help manage and reduce legacy pension obligations that were seen as cash prohibitive before.

For calendar year tax payers, the window of opportunity is fairly short (contribution deadline for most sponsors to apply old tax rates is September 15, 2018). Given the governance process involved in what could be sizeable contributions for many, we encourage pension sponsors to start this evaluation now if they haven't already. Now is a great time to connect the dots fully between tax, investment, and de-risking opportunities.

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