FIRST PRINCIPLES CAPITAL MANAGEMENT

"The Choice is Yours"

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Thoughts on the state of corporate pension plans - part II of II

At the risk of dating myself, I remember well a marketing slogan from an early '70s FRAM® Oil Filter TV commercial, where a trusted mechanic says the famous line "you can pay me now, or pay me later®."[1] He was suggesting that if you changed the car's oil and filter today that you would likely avoid a costly engine repair down the road. Sage advice, and a very memorable marketing campaign. Corporate pension funds are facing similar "maintenance" choices as they approach this year's contribution decision, particularly with regulatory fees for underfunded plans going up in earnest. If pension investment committee members could don grease-stained overalls, most would probably say something similar to their corporate plan-sponsor brethren.

As we saw in our last piece, "The Electric Glide," the amount of underfunding of many corporate pension plans (i.e., 81.5% funding level per Milliman 100 Pension Funding Index) has reached a point where many pension investment committees will freely admit that they can't solve their plan's deficit problem on their own, even with cooperative financial markets. They are frustrated that even after generating strong investment returns over the past five years, their longer-term immunizing goal remains elusive and that their funded ratios have barely budged. As we highlighted, periodic benefit payments are the funded-ratio silent killer for most under-funded plans, elevating the required hurdle rate for plan assets.

To truly solve the pension deficit, we concluded that investment committees need the help of their sponsors in the form of ample contributions to keep the pension engine running smoothly. We saw that any meaningful progress along the glide path (e.g., >10%), and any attendant reallocation towards long-term corporate bonds, will likely occur only with a sound contribution policy. Glide paths and strong investment performance are necessary but not sufficient in the quest towards de-risking and fully-funded status. Rules-based glide paths provide an important fiduciary assurance like a modern-day car's GPS; but they are most valuable when the pension vehicle is progressing forward, rather than stuck in neutral, as many plans are. Realistically, for most underfunded closed plans, contributions are a *fait accompli* - a function of when rather than if, except for the most credit-beleaguered plan sponsors. Perhaps it's time for a new maintenance slogan: "the choice is yours, you can contribute now or you can contribute even more later."

Since much of the funded-ratio burden is on the shoulders of sponsors, the questions now are when will they contribute and to what extent. As we discussed, the defined benefit pension marketplace tends to move as a monolith due to shared regulatory regimes and macro capital markets forces, as well as confronting similar demographic trends. However, pension plan individuality is best expressed through contribution policy, which is a bespoke decision based on unique circumstances of each parent company. This year's contribution dance between plan sponsors and fiduciaries should be particularly noteworthy, as a confluence of regulatory factors come into play, encouraging thoughtful contribution analysis. During the third quarter (typically the season when sponsors evaluate pensions) we may see significant contribution announcements from many companies along with significant long-term debt issuance to help funding. Besides growing weary of doing the Electric Glide, what makes this year more noteworthy for contributions? Several factors.

First, the possibility of corporate tax reform from the Trump Administration and Congress in the second-half of 2017 has the potential to lower tax rates from 35% to 20% or lower. Because pension contributions in an underfunded scenario are deductible for tax purposes, any major corporate tax reform will likely create incentives both on a GAAP (e.g., deferred tax asset) and tax bases to accelerate large-scale contributions and deductions in 2017 for many sponsors. Even if legislation gets delayed and is enacted sometime next year, it will still likely encourage higher contributions in 2017 from those sponsors forecasting the possibility of retroactivity to the beginning of 2018.

[1]FRAM® and its iconic slogan are registered trademarks of the UCI-FRAM Group.

Plan year beginning in	PBGC VRP (% of deficit)
2015	2.40%
2016	3.00%
2017	**3.40%**
2018e	3.87%
2019e	4.36%
2020e	4.44%
2021e	4.53%

Second, the Pension Benefit Guaranty Corporation (PBGC) belt is ever tightening around the waist of most underfunded pension plans, as the premium it charges to backstop pensions continues to increase. The PBGC assesses pension plans two types of premia, one per capita (i.e., number of beneficiaries) and one linked to an underfunded amount (i.e., Variable-Rate Premium or VRP). The VRP is going up based on an inflation-adjusted schedule (left) and will become meaningful relative to the cost of debt for many sponsors over the next few years. For example, a pension fund with a $100 million underfunded amount as determined by PBGC metrics on January 1, 2018 will be required to pay a premium of approximately $3.87 million in 2018 – not an insignificant implied annual cost of capital, especially for underfunded plans stuck doing the Electric Glide.

Importantly, the VRP isn't risk-adjusted based on the creditworthiness of the plan sponsor. This means that for a given deficit amount, the PBGC charges the same premium for a pension of a double-A rated parent as it would for a single-B parent, even though the PBGC's risks are very different. Thus, the non-risk adjusted VRP evokes different contribution behavior depending on a sponsor's credit rating and cost of capital. Lower rated companies with higher capital costs will be less motivated to contribute, because any premium savings will be less meaningful on a relative basis (Table I below).

In the pension marketplace where we've seen the importance of contributions, it's often the case that the rich get richer, and the poor stay poor. As such, it should come as no surprise that pension plans of often-bankrupted U.S. airlines are among the most underfunded large-scale plans, while those of money-center banks are among the most overfunded plans. Unfortunately, the VRP policy will only help to perpetuate this trend.

Table I: PBGC VRP fee savings relative to sponsor contribution based on credit rating

		Sponsor Issuer by credit rating				
		AA	A	BBB	BB	B
A. Issue by sponsor	Long-term cost of debt	4.00%	4.25%	4.50%	5.75%	7.00%
B. Invest in plan	Portfolio of long-term bonds	4.38%	4.38%	4.38%	4.38%	4.38%
C. Savings in plan	Avg. PBGC VRP 5-yr premium	4.10%	4.10%	4.10%	4.10%	4.10%
	Total economic value	8.48%	8.48%	8.48%	8.48%	8.48%
B+C-A	Net value to sponsor	4.48%	4.23%	3.98%	2.73%	1.48%

Does that mean that we should expect to see a wave of corporate bond issuance in Q3 2017 to fund contributions into pension plans later this year, as well as expect those same plans in turn to invest in long-term corporate bonds as per their glide paths? More supply of bonds with built-in demand, an investment banker's dream scenario! As with all things pension, it depends – largely because of built-in regulatory complexity surrounding pension trusts. In general, a nexus of issues will drive each decision, primarily linked to three key factors:

1. **Tax capacity** of the parent sponsor for a material 2017 deduction. Some companies may have capacity, which could help spur funding, while others might not (i.e., net operating loss carryforwards). The latter are likely good candidates for "or-you-can-contribute-even-more-later" scenario when they can better utilize contribution deductions down the road.

2. **Corporate finance wherewithal** of the plan sponsor. This is a confluence of several factors including having the debt capacity for a new issuance to fund any sizeable contribution. Adequate debt capacity entails having a suitable balance sheet (i.e., leverage ratio) and income statement tolerance (i.e., debt service coverage), as well as finding ratings-joy with the credit rating agencies. Relative size of the pension plan deficit versus the plan sponsor's balance sheet is an important consideration too. As an example, some of the largest highly-rated U.S. industrial companies have pension plans whose projected benefit obligations are larger than their balance sheets. This presents an ongoing challenge because the amount of a typical pension deficit (i.e., 15-20%) may dwarf shareholder equity, prohibiting major contributions. Another X-factor is whether a sponsor is undertaking a major share re-purchase program, which could preempt any pension move. Lastly, some lower rated sponsors (i.e., sub-investment grade) will be hard pressed in all cases to justify anything but a "maintenance" contribution.

3. **The extent of the underfunding.** Merely because a large plan has a sizeable underfunding on a GAAP basis doesn't necessarily mean that it will be subject to PBGC VRP. The PBGC uses different metrics (e.g., higher discount rate and more benign mortality assumptions) in calculating the PV of a plan's liability, which is often much lower than its GAAP value. As a rule of thumb, the VRP assessment will likely kick-in for plans whose funded ratio is below 90% on a GAAP basis.

Table II below outlines potential contribution scenarios based on the relationship between the credit worthiness of a sponsor versus its plan's funded ratio, as well as estimates the likely asset allocation deployment of the funding based on a typical glide path. In brief, herd mentality is not expected.

Table II: Which plan sponsors are likely to contribute, and where will they allocate proceeds in pension

	GAAP plan funded ratio				
Credit quality of Plan Sponsor	**60-70%**	**70-80%**	**80-90%**	**90-100%**	**100%+**
Strong investment grade issuer AA+ - A+	Likely to make large contribution, but not invest 100% in bonds	Likely to make large contribution, and invest majority in bonds	Likely to contribute and to invest 100% in bonds	Not likely to contribute, perhaps small amount	No contribution expected
Investment grade issuer A+ - BBB-	Likely to contribute, but not 100% in bonds	Likely to contribute, and invest majority in bonds	Likely to contribute, and invest 100% in bonds	No contribution expected	No contribution expected
Sub-investment grade issuer BB+ and lower	Not likely to contribute, perhaps small maintenance amount	Not likely to contribute, perhaps small maintenance amount	No contribution expected	No contribution expected	No contribution expected
	Underfunded based on PBGC metrics and likely subject to VRP ←			**→ Likely not subject to PBGC VRP**	

While the research of many investment banks would have us believe that there is a never-ending pension appetite for long-term corporate bonds, and that every little sell-off of the 30-year Treasury or major rally in global risk assets puts another bid on corporate spreads thanks to glide paths, the reality is found in the details of each company. Sure, pension glide paths are a shared roadmap to the retirement corporate bond terminal, but the journey will be extremely slow if left to the vagaries of the capital markets – with a reasonable likelihood of never reaching the de-risking destination. Yes, sponsor contributions will help plans move along the path with nitrous-like short-term boosts. But as we've seen, the pension funding decision is an individual one, where many may choose to change the oil and filter today, pay the VRP, and pray that they can avoid engine failure down the road.

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