Key Considerations for 2018

2017 proved to be another volatile year for pension plan sponsors. The market environment combined with several regulatory updates may provide plan sponsors with some potential opportunities for 2018. Here we focus on three key areas for plan sponsors thinking about enhancing their pension risk outcomes.

Contribution Strategy

Companies with pension plans have a short window of opportunity to minimize the after-tax cost of funding their plans in 2018. Tax reform passed in December 2017 included a reduction in the business tax rate from 35% to 21% starting with the 2018 tax year. While historically the after-tax cost of contributing dollars to the pension plan was 65 cents on the dollar, the cost will increase to 79 cents on the dollar for the 2018 tax year and beyond (for example, for a $50 million 2017 tax year contribution, this represents a savings of $7 million). In addition, there are other potential benefits to contributing money into a pension plan, including:

- lower Pension Benefit Guaranty Corporation (PBGC) premiums;
- increased pension earnings;
- an opportunity to de-risk investments;
- an opportunity to transfer risk; and
- improved overall plan risk profile.

Partially in anticipation of corporate tax reform, we saw increased contribution activity during 2017, with a number of large organizations making discretionary contributions. Companies generally have 8.5 months after the plan year ends to contribute for the prior tax year. This means that for calendar year plans, September 15, 2018, will be the last day to contribute for the 2017 tax year. For underfunded plans needing to fund their plans in future years, prefunding options should be reviewed before the window of opportunity closes.

Investment Strategy

Despite discount rates falling almost 50 basis points, favorable equity markets allowed plan funding positions to be ahead for the year. Though the outlook for pension funding positions is difficult to predict, one lesson learned from previous periods of volatility is that plan sponsors could enjoy a smoother path to full funding by locking in funded status gains as they occur. This can be achieved with a glidepath de-risking strategy that allocates more assets to liability hedging assets as the plan's funded status improves. Indeed, 2017 was a year of progress on glidepaths, with periods of gains during the year triggering de-risking action.

With low long-term interest rates helping to keep pension liabilities high and the prospect of higher discount rates uncertain, we expect organizations that were waiting on rates to rise could be more willing to adopt strategies aimed at reducing volatility of plan financials. Plan sponsors should work with an investment advisor to determine if the long-term strategy is appropriate and aligned with company objectives.

Risk Transfer Strategy

Risk transfer strategies such as lump sum windows and retiree annuity buyouts have been common in recent years. One of the major incentives has been to reduce PBGC premiums, which have been on the rise. Once an individual is removed from the plan either through lump sum or annuity purchase, the plan sponsor no longer needs to pay the per-participant PBGC premium for that participant, which has more than doubled in the last six years (from $35 in 2012 to $74 in 2018 per participant per year) and is projected to increase further. Variable rate premiums could also be reduced for certain plans.

Though the benefit of reduced PBGC premiums still exists, plan sponsors may be less hesitant to do bulk lump sums starting this year, especially since the Internal Revenue Service has updated mortality tables for lump sum determinations starting in 2018. This means that lump sum payments to terminated participants will be higher in 2018 than in previous years due to the longer life expectancies estimated from the updated mortality tables, all else equal. Plan sponsors that remain focused on reducing liabilities and other costs of maintaining their defined benefit plans may not view this cost increase as a deterrent, in our view.

For more information, contact Kimberlene Matthews, Defined Benefit Product Specialist, at 312-338-8138 or kimberlene.matthews@pnc.com