Under New Tax Law, Finance Leaders Show an Appetite for Pension De-Risking

The passage of the Tax Cuts and Jobs Act, aimed at accelerating economic growth, is driving senior finance executives to reduce the liability risks associated with their corporate defined benefit (DB) pension plans.

That revelation was one of the important findings of a new study focusing on how the new tax law, which went into effect this year, is influencing a range of pension fund-related decisions. The online survey, conducted by CFO Research in collaboration with Prudential Financial, drew 127 responses from finance executives whose companies have DB plans for current and/or former employees.
Among the top conclusions: Senior finance executives are using the new tax law’s benefits to ramp up their funding contributions. Under the rules, businesses have until mid-September of 2018 to deduct their pension plan contributions at the 2017 rate of 35%. After that, the new 21% rate kicks in. Not surprisingly, about three-quarters of survey respondents, 74%, say that their organization is “very likely to make a substantial DB plan contribution” in time to take advantage of the larger tax deduction.

Rohit Mathur, head of Global Product and Market Solutions in Prudential’s pension risk transfer business, says the survey’s results make sense. “We are seeing a number of companies accelerating pension contributions, driven in part by changes in the tax law,” he said. “We are also noticing an increasing interest in pension risk transfers among plan sponsors.”

Even after the September deadline, companies can take advantage of the significantly reduced corporate tax rate to use a portion of expected tax savings to fund their pensions at higher levels. In the survey, 64% of respondents say they are “very likely to use the tax savings from the new law to increase funding of our DB pension plan(s).”

The new law also includes a provision allowing U.S.-based multinational corporations to repatriate foreign earnings at lower tax rates than the 35% they would have paid in the past. Under the new law, companies can take advantage of a one-time repatriation of cash at the rate of 15.5% (cash holdings) and 8% (nonliquid assets). About a quarter (24%) of survey respondents say they plan to use repatriated capital to bolster their DB funding levels.
Among the companies that expect the Tax Cuts and Jobs Act to generate excess income, 29% expect to use those funds to minimize liability risk, through such efforts as boosting retiree healthcare funding. The study also found that plan sponsors are considering altering their investment strategies, as well as transferring pension obligations to an insurance firm, a transaction known as a pension risk transfer.

**Shifting DB Risk**

For senior finance executives, the decision to improve the funding levels of their companies' DB plans isn’t solely an outgrowth of the new tax policy. Plan sponsors, having long struggled to produce sufficient returns to offset increasing liabilities (i.e., due to persistently low interest rates and increasing longevity), are now contending with rapidly changing conditions.

Another DB-related cost, premiums levied by the Pension Benefit Guaranty Corporation (PBGC), is also on the upswing. The variable-rate component of the premium, which is calculated using a DB plan’s unfunded obligations, is increasing from $38 per $1,000 of unfunded vested benefits this year to $42 per $1,000 in 2019. The variable-rate increase has been an annual ritual since 2013, when the rate stood at $9 (where it had been since 2007). In addition, over the past six years, the per-participant component of the premium has increased by almost 115%.
The Pressure to Keep Growing
DB plan returns are also under pressure to keep growing, thanks to the fact that life expectancy is increasing, as reflected in IRS mortality tables. In the survey, 70% of respondents agree that “the recent changes in actuarial mortality assumptions, and the prospect of further changes, are creating ‘longevity risk’ for my organization that places additional pressure on our DB funding levels.”

Overall, the growing expense of maintaining DB plans along with the potential risks from underfunding are driving senior finance executives to consider an increasingly appealing option: transferring some or all of that risk to an insurance company. Companies with well-funded plans can “lift-out” and transfer some or all of their pension obligations to an insurance company as a way to reduce risks and administrative expenses—including PBGC premiums. In return, they purchase a group annuity contract for plan participants.

In the survey, 62% of respondents say they “agree” that once their “DB pension plan becomes well-funded” their organization is “very likely to execute a full or partial pension risk transfer to an insurance company.”

In sum, by skillfully taking advantage of The Tax Cuts and Jobs Act, plan sponsors can accelerate DB plan funding and, in the short-term, deduct contributions at a higher rate. By controlling their risks and costs, senior finance executives can stabilize and strengthen their companies’ DB pension plans—sheltering them from sources of volatility—and preparing them to be delivered into the hands of a third party that can reliably serve participants in the long run.

About the Respondents
This year marks the eighth annual survey that CFO Research has conducted in cooperation with Prudential Financial, Inc.

Survey respondents came from a variety of industries, led by financial services/real estate, health care, and auto/industrial/manufacturing. They consisted mostly of chief financial officers, directors of finance, and vice presidents of finance. A majority of respondents came from companies with $250 million to more than $5 billion in annual revenues.