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INSIGHTS

Tax Reform: A Guide for Pension Plan Sponsors

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EXECUTIVE SUMMARY

- The Trump administration continues to communicate its intention to push ahead with corporate tax reform.

- Potential reform may create an incentive for plan sponsors to direct funds into underfunded defined benefit plans now rather than later.
  * Low interest rates may allow plan sponsors to "borrow and fund" at an attractive level.

- We believe plan sponsors should consider making plan contributions in the near future to potentially avoid missing out on tax savings.

- The proposed tax reform also has the potential to impact the long corporate bond market. Positioning a portfolio solely on the basis of tax reform that for various reasons may not occur is not recommended. However, plan sponsors could consider the following strategies, which we believe will serve them well irrespective of tax reform materializing.
  * Maintain existing long corporate bond exposure
  * Take advantage of attractive entry points into the long corporate bond market
  * Consider long duration alternatives as part of the opportunity set

Introduction

A reduction in marginal tax rates as part of corporate tax reform may present opportunities for some defined benefit ("DB") pension plan sponsors. Lower tax rates, assuming they are made effective prospectively, would favor immediate contributions due to tax savings. More broadly, tax reform may impact demand and/or supply for long corporate bonds. This paper will discuss some key topics related to tax reform that are germane to DB plan sponsors.

Examining the Opportunity to Maximize Tax Savings from Pension Contributions

President Trump and Congressional Republicans have stated that corporate tax reform is a priority of this administration. The current marginal corporate tax rate for taxable income over $18.3 million is 35%. As recently as his April 26th tax plan release, President Trump has reiterated his plans for a 15% corporate tax rate. Assuming the tax reform is passed, made effective January 1, 2018, and is only prospective in nature, defined benefit ("DB") plan sponsors could save an additional $20 for every $100 of contributions made before the lower rates become effective. The opposite logic applies to capital expenditures. If equipment investment becomes expensible, as Republican tax proposals advocate, delaying capital investments until tax reform takes place would generate tax savings for firms. Importantly, corporations are not faced with a binary decision in terms of funding a pension plan or making capital investments; however, assuming tax reform does materialize, corporations are likely better off moving DB cash contributions forward in time while postponing capital expenditures, all else equal. Since details of these proposed measures are incomplete and potentially subject to negotiations, plan sponsors should consult with their tax advisers to ensure continued compliance with respect to tax deductions.

In the current low interest rate environment (see Figure 1), DB plan sponsors could consider issuing debt or another means of borrowing capital to fund a portion or the entirety of a plan's deficit. A few secondary positive effects of funding include:

- Lower PBGC variable-rate premiums
- Reduction in funded status risk assuming contributions are invested in liability-hedging assets

Figure 1:

A-Rated Corporate Bond Yields (Last 20 Years)

Source: Bloomberg Barclays Capital. Data through May 31, 2017.

PBGC variable-rate premiums are scheduled to increase from the 2017 rate of $34 per $1,000 of unfunded vested benefits to at least $37 and $41 for 2018 and 2019, respectively[1]. Additionally, flat rate premiums are due to increase from $69 per participant to $74 and $80 over the same period. An increase in funded status would reduce the variable rate premium for underfunded plans and would present more opportunities for liability/risk transfer activity, allowing plan sponsors to save on PBGC flat rate premiums and other expenses. Higher funded ratios also allow greater flexibility in risk management initiatives, including liability driven investing and interest-rate hedging programs.

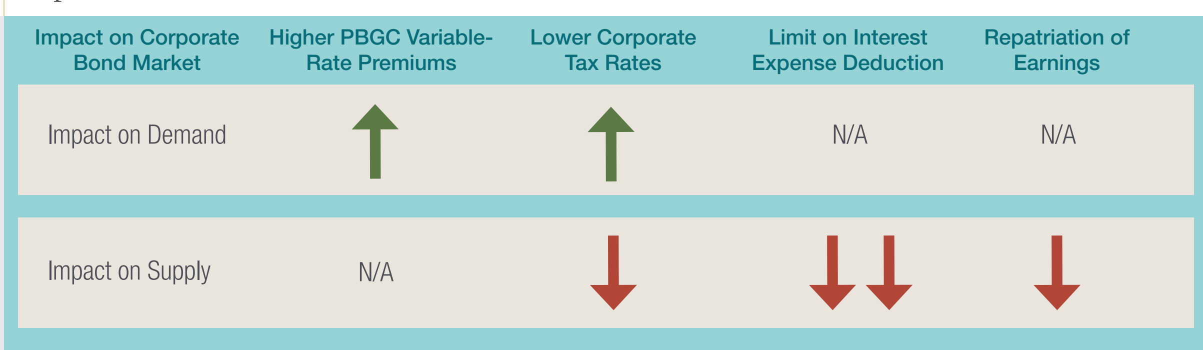
There are two primary reasons plans might hold off on pre-funding plan deficits: 1) the expectation that contributions at some level will not be required either due to portfolio performance or rises in interest rates, and/or 2) borrowing costs for lower rated corporates might make debt markets an unattractive source of funds. Understandably, plan sponsors may be worried about the regret of "overfunding" their plan. A detailed analysis of assets, liabilities and contributions can help identify the level of future contributions that will likely be required.

Implications for the Long Corporate Bond Market

In addition to increases in PBGC variable-rate premiums, a confluence of factors related to potential tax reform may have an impact on the supply/demand dynamic within the corporate bond market.

Figure 2:

Factors and the potential impact on the corporate bond market



For illustrative purposes only

[1] Variable-rate premium rates published by the official PBGC website (www.pbgc.gov) as of June 2017. These rates are subject to indexing.

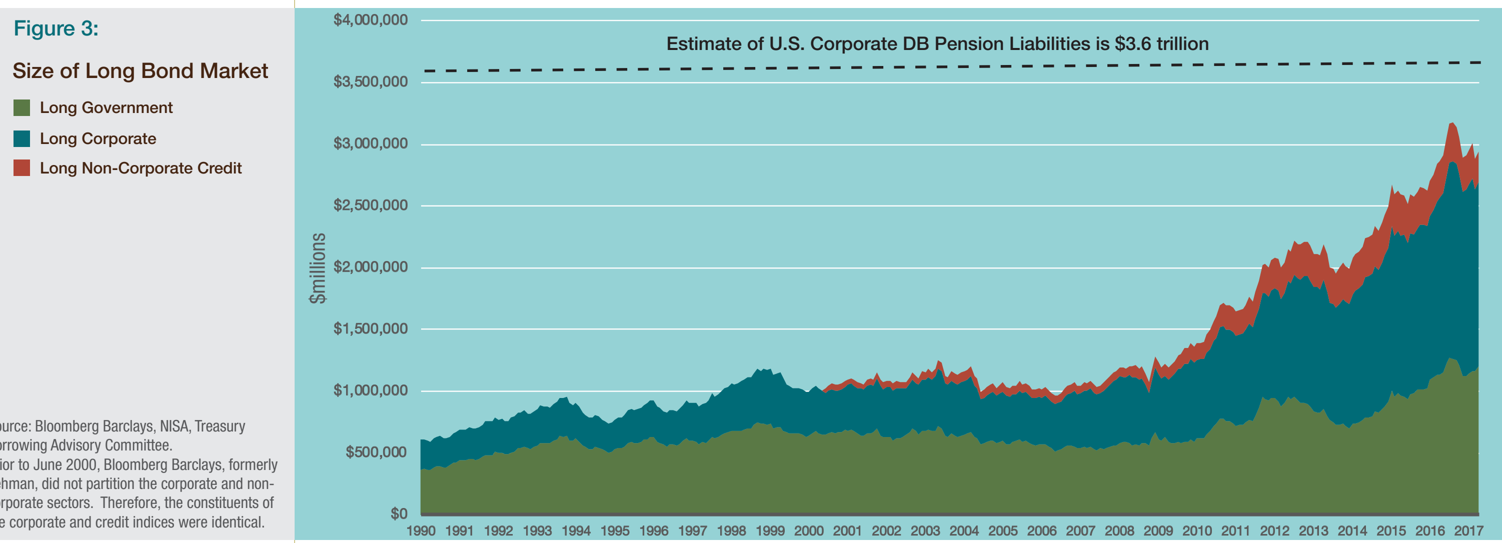
Implications for the Long Corporate Bond Market (con't)

1. Higher PBGC variable-rate premiums: If increases to PBGC variable-rate premiums prompt plans to expedite contributions this will likely increase the demand for corporate bonds and Treasury bonds.
2. Lower corporate tax rates: As previously mentioned, the potential for lower corporate tax rates could spur contributions, which, all else equal, would likely increase demand for long bonds (both corporate and Treasury) in the short-term. Further, lower corporate tax rates would reduce the value of interest-expense deductions. This would reduce the attractiveness of debt financing, which could impact the supply of corporate bonds.
3. Limit on the deductibility of corporate interest expense: This aspect of tax reform has been mentioned in various Republican tax proposals. In our view, it would reduce the incentive to issue debt.
4. Repatriation of earnings: A repatriation holiday would likely lead to less supply of corporate bonds as companies would be able to access their offshore liquidity as opposed to issuing debt.

By juxtaposing the $3.6 trillion in U.S. corporate pension liabilities to the current market value of long duration public benchmarks, Figure 3, provides a rough sense of the potential demand for long duration corporate and government bonds from the U.S. corporate defined benefit community. Further, corporate DB plans are certainly not the only natural buyers of long corporate bonds as U.S. insurance companies, foreign investors, and multi-sector bond strategies are all significant purchasers of long corporate bonds.

Figure 3:

Size of Long Bond Market



Source: Bloomberg Barclays, NISA, Treasury Borrowing Advisory Committee.
Prior to June 2000, Bloomberg Barclays, formerly Lehman, did not partition the corporate and non-corporate sectors. Therefore, the constituents of the corporate and credit indices were identical.

While we presented why there might be an increase in demand for corporate bonds, we do not want to overstate the impact of the potential incremental demand[2]. If U.S. corporate pension plans, on average, increased their allocation to long corporate bonds by 1% this would yield approximately $30 billion of incremental demand. Further, benefit payments due to beneficiaries in the next 10 years, as a percent of a plan's total liability, can be significant, particularly for mature/frozen plans. DB plans, particularly as they move along their respective glide paths, will likely be buying corporate bonds across the curve.

[2]The U.S. corporate pension market is approximately $3 trillion in market size.

Implications for the Long Corporate Bond Market (con't)

In other words, not all of the incremental dollars allocated to corporate bonds will be long-dated. To state the obvious, there is a wide range of factors that might impact supply/demand dynamics in the long corproate bond market. Nonetheless, if all, or even some of the factors mentioned earlier materialize, it could create a dynamic where demand exceeds supply at a time when plan sponsors are seeking to add long corporate bond exposure. With that set of conditions in mind, we believe that plan sponsors could consider the following strategies which should serve them well irrespective of tax reform materializing.

1. Maintain existing long corporate exposure. Corporate bonds serve as a hedge to liabilities and could be costly to repurchase.
2. Structure governance in such a way that allows the plan sponsor to take advantage of attractive entry points (e.g. February/March 2016) to add additional long corporate exposure.
3. Consider long duration alternatives[3], which can serve as a diversifier to corporate credit risk, are sensitive to interest rates, and can provide a total return similar to or in excess of the corporate bond market. Sectors to consider include:
    a. Corporate private placements
    b. Long duration mortgages (e.g. agency CMOs, CMBS, commercial whole loans)
    c. Taxable municipal bonds

Conclusion

Tax reform is a central focus of the Trump administration and Congressional Republicans. The prospect of tax reform may create an incentive for plan sponsors to direct funds into underfunded defined benefit plans now rather than later. We believe plan sponsors should consider making plan contributions in the near future to potentially avoid missing out on tax savings. Importantly, if tax reform does not materialize plan sponsors may still benefit from funding in the form of lower PBGC variable-rate premiums and risk reduction (assuming the contribution is invested in liability-hedging assets).

In addition, certain aspects of tax reform may have an impact on the supply/demand dynamic within the corporate bond market. We believe plan sponsors should consider 1) maintaining existing long corporate bond exposure 2) taking advantage of attractive entry points into the long corporate bond market and 3) including long duration alternatives as part of the opportunity set. These strategies will likely serve sponsors well even if tax reform were not to occur, or if it took a different form relative to recent proposals.

[3]See Rocaton Insights - Expanding the LDI Tool Kit: Alternatives to Long Corporate Bonds (link) for more detail.

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