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Insight for Corporate Defined Benefit Plan Sponsors

Borrowing money to reduce PBGC premiums

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This article has been updated to reflect increases in PBGC premiums contained in the Bipartisan Budget Act of 2015.

In recent years, Congress raised PBGC premiums sharply for single-employer defined benefit pension plans. In 2016, the increased premiums will act as an effective tax of 3.0% per year on unfunded pension liabilities, with additional increases scheduled through 2019. This article discusses plan sponsors borrowing money to fully fund their pension plans, thereby eliminating these PBGC premiums.

An overview of PBGC premiums

Pension Benefit Guaranty Corporation (PBGC) premiums consist of two components: a flat-rate per participant premium and a variable-rate premium. The variable-rate premium is effectively an annual "tax" on unfunded pension liabilities. So, for example, if a plan sponsor has $100 million in assets and $120 million in liabilities (as measured under PBGC rules), there is a $20 million unfunded liability. Based on 2016 premium rates, the PBGC "tax" would be 3.0% x $20 million, or $600,000 *per year*.

Following is a summary of the currently scheduled PBGC premium rates.

YEAR	FLAT-RATE PREMIUM	VARIABLE-RATE PREMIUM
2016	$64	3.0%
2017	$69	3.3%*
2018	$74	3.7%*
2019	$80	4.1%*

** The actual rates are indexed to wage inflation and could exceed the rates shown. Premium rates in 2020 and beyond are also indexed to wage inflation.*

In addition, the variable rate premium is capped on a per participant basis. The cap will be $500 per participant in 2016, and is indexed to wage inflation thereafter.

Ways to minimize the tax bill

The increases in PBGC premiums give plan sponsors a larger incentive to fully fund their plans. Sponsors with strong cash positions may simply contribute money to their pension trusts. But other sponsors may be strapped for cash. In that case, borrowing money and investing the proceeds in the pension trust may be an attractive alternative.

Here's a simple example: Let's say the plan sponsor can borrow at 6.0% interest for a 10-year period. The sponsor can then invest the debt proceeds in the pension plan at 4.0% per year. Doing this avoids the annual PBGC tax of 3.0%. A simple one-year return from the transaction is a positive cash flow of 1.0% per year (= 4.0% + 3.0% - 6.0%).[1] The sponsor saved money by borrowing and investing in the pension plan, and avoiding the PBGC premium.

Of course, there are many factors to consider in making this transaction. This article will cover some of the highlights, but a complete answer will vary by plan sponsor. Two of the most important considerations are how to structure the transaction and what to do with the money once it is in the pension plan.

How to structure the borrowing transaction

Factors to consider when borrowing funds include:

- Method of borrowing: Two primary options are a direct loan from a financial institution or issuing bonds. Plan sponsors should consider whether accounting treatment may vary depending upon the method of borrowing.
- Structure of repayment: Two common approaches are amortizing payments like a mortgage or issuing a bond with periodic interest payments and full principal repayment at maturity.
  - Amortizing the debt over seven years may allow plan sponsors to somewhat replace the IRS minimum required contributions prior to issuing debt, but this may not be a readily available payment structure.

1 Several factors can complicate this calculation, including multi-year borrowing, the impact of taxes, and the variable rate premium cap.

- Using a traditional bond structure with repayment occurring over 10, 20, or 30 years would give plan sponsors more cash-flow flexibility in the short term, but would not settle the outstanding liability until the debt is paid off at maturity.
- The longer the debt repayment period, the less attractive the transaction may become. If the plan sponsor intends to roll over the debt, that should be modeled at the outset.

- What is the interest rate on the debt? The lower the rate, the more attractive the transaction becomes.
- What is the plan sponsor's marginal tax rate? The higher the tax rate, the more attractive the transaction may become.

How to invest the debt proceeds

Once a sponsor borrows to fund the pension plan, the next issue is how to invest the debt proceeds. A simple solution is to invest them in corporate bonds with a similar interest rate sensitivity (or "duration") as the liabilities of the pension plan. In this way, the market value of the new assets and the liabilities they cover will rise and fall in tandem.

What about the investment holdings for the rest of the trust? Should they change, too? The answer to that question will differ based on the situation of the plan and its sponsor.

- For example, if a plan is frozen, once it is 100% funded on a PBGC basis, there is not much to gain–and plenty to put at risk–by investing in equities. However, a relatively small equity position may still make sense. Favorable equity returns can help defray administrative expenses and further improve funded position. Moreover, liabilities that extend beyond 30 years are difficult to hedge using fixed income alone. Finally, annuities purchased during a plan termination can cost significantly more than PBGC liabilities.
- By contrast, for a plan with ongoing accruals, retaining a significant equity exposure could potentially help offset the long-term expected costs of the plan.

These ideas are only a start, meant to provide a sense of what plan sponsors may want to consider. There are many different approaches a plan sponsor could take for investing the debt proceeds and restructuring previously existing assets. At a minimum, a plan sponsor should review the current target asset allocation and determine if changes are warranted based on its objectives, risk tolerance, and the plan's improved funded position.

We caution that this article is *not* recommending that plan sponsors borrow money to invest in additional equities–that would be investing on margin, and could significantly increase investment risk for the sponsor. The focus of this article is reducing PBGC premiums, not amplifying investment risk and expected return.

What about the financial statements?

Assuming the plan sponsor invests the debt proceeds in bonds, one outcome will likely be a lower expected rate of investment return for financial reporting purposes under U.S. GAAP. If no other changes are made to the trust's investments (i.e., the remainder of the portfolio is invested as it always was), then the reduction in expected rate of investment return will be offset by the increase in the assets from the debt proceeds. In many cases, pension expense might actually *decrease*; however, the sponsor will also face an interest cost associated with its borrowing.

By contrast, if the rest of the pension portfolio is invested more conservatively than it previously was, the net impact could be an *increase* in pension expense. Interestingly, for sponsors reporting under IFRS the expected investment return effectively uses the same discount rate as the liabilities, so no such "disincentive" exists to invest more conservatively.

It is also worth keeping an eye on the cash flows. The fees and interest on the borrowing can be compared against the projected PBGC premium savings plus the additional expected investment income from the reinvested debt proceeds. Since all financial accounting eventually unwinds to reflect cash, if a transaction is expected to have a positive net present value of cash flows, it may be misleading to focus solely on changes to short-term pension and interest expense.

Financial modeling can help answer several related questions. How should the plan sponsor invest the debt proceeds and the preexisting assets? What is the best term and structure for borrowing? What might be the tax impact? And how would volatility in financial markets or business environments affect different strategies?

Future funding considerations

Once the pension plan is fully funded on a PBGC basis, ongoing contributions to the trust will be significantly reduced or eliminated. Future contributions would arise generally from:

- Participants earning additional benefits
- Administrative expenses
- Asset losses relative to liabilities
- Unexpected increases in liabilities (e.g., people living longer than expected)

Plan sponsors who borrow to fund should consider appropriate funding and investment strategies to address each of these possibilities.

Other items to consider

In reviewing and modeling the idea of borrowing to fund, here are several items to keep in mind.

Capped out: Plans whose variable rate premiums are limited by the per participant cap may not realize as much benefit as plans that are below the cap.

Don't forget expenses: Calculate all borrowing costs gross of investment and professional expenses, and estimate the additional expected investment income net of all management fees.

Effect on credit: Additional borrowing should be reviewed against existing debt covenants, and whether the borrowing could lead to credit rating downgrades and higher borrowing costs. Explaining the proposed transaction to interested parties may help address their potential concerns.

Stressing out: A bit of stress testing–what happens if bond yields jump, or stock prices drop–can help plan sponsors understand how adverse market conditions may affect this strategy. For some sponsors, the information gained from more complicated modeling and scenario testing may be worth the investment.

PBGC elections: The PBGC offers a "smoothed" and a "market" option for calculating liabilities. If a plan invests heavily in liability-matching corporate bonds, using the market option may help the plan avoid future PBGC premiums, because the assets and liabilities would move together with the corporate bond market.

Fiduciary considerations: Making investment decisions on behalf of a pension plan means thinking about the interests of plan participants first. Improving a plan's funding by investing additional funds in high quality fixed income seems likely to meet fiduciary requirements. But don't hesitate to review the situation with legal counsel.

But the Feds pay for it: Companies whose underfunding is paid for in part by reimbursements under government contracts may want to consider whether those reimbursements are more valuable than the cost of PBGC premiums paid on unfunded liabilities.

Other sources of contributions: Could the sponsor instead contribute property (e.g., land or company stock) to the pension trust? Legal counsel should be consulted regarding how to navigate prohibited transactions rules, among other considerations.

So what's the plan?

Interested plan sponsors should consider borrowing to fund and modeling its impact on cash flows, financial statements, and tax returns. For many sponsors, eliminating the 2016 variable rate premium will require fully funding the plan no later than September 15, 2016.

Deciding whether and how to borrow and fund will vary significantly by plan sponsor. Each sponsor's or plan's situation has its own distinct characteristics. Going through the items in this article can provide an initial framework.

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