

To fund or not to fund: Incorporating pension deficits in capital and risk budgeting

RETIREMENT & BENEFIT PLAN SERVICES

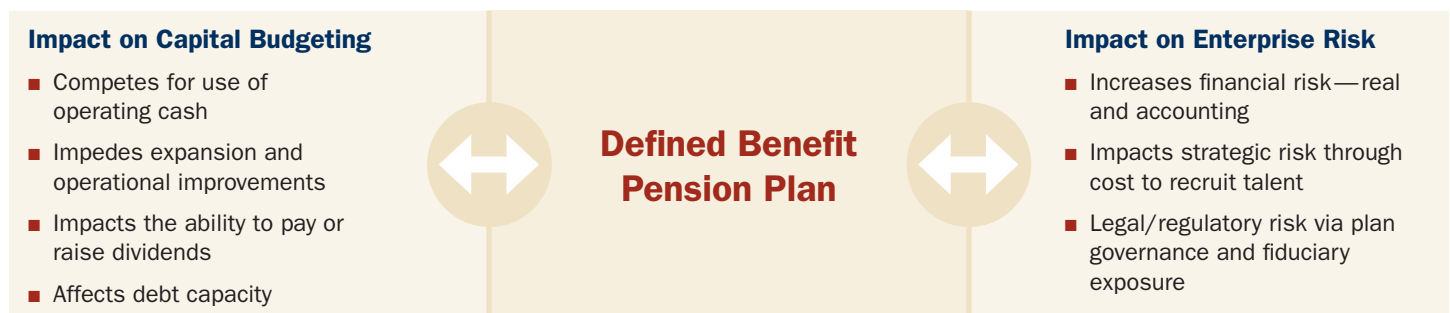
Executive Summary

For most companies, fully funding the defined benefit pension plan is seen as desirable for a host of financial, regulatory and qualitative reasons. Most notably, a significantly underfunded plan can require substantial cash contributions, impair the firm's credit rating, and send a negative message to employees. Yet the need to put more money into an underfunded plan is only one of many ongoing demands on capital, which can include updating plant and equipment, buying back debt or stock, expanding operations, and acquiring other businesses.

Similarly, a company must continuously assess its risks across multiple arenas — financial, strategic, operational and environmental — and prioritize how much of each risk to take. Decisions on how to invest pension fund assets should be made in the context of this overall set of risks.

This paper examines the value of investing capital beyond mandated minimums in an enterprise's pension plan from a capital budgeting perspective. It also discusses the evaluation of pension investments as an integral part of the company's overall risk profile. This holistic approach places pension decisions within the firm's overall capital- and risk-management processes.

An organization's pension plan directly affects its capital and risk management, as shown below:



Furthermore, in the absence of competing capital needs and scarce cash, there are definitive advantages to eliminating pension deficits as follows:

- Tax deductibility of contributions
- Tax-free buildup of investment returns
- Reduced insurance (Pension Benefit Guaranty Corporation) premiums
- Lower expected total cash outlay
- Recognition of earnings on future profit and loss statements (P&Ls)
- Greater opportunity to reduce volatility and protect funded status through investment strategies
- Improved employee perception and security
- Fewer restrictions and disclosures

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Pension plan funding and the capital budget

A company's capital budgeting process is the critical step for determining resource allocation decisions. The funding of the pension plan should be included in this exercise, as it often requires substantial cash allocations. However, plan funding should not be regarded only as a potential demand on capital; unfunded pension liabilities are in fact debt issued by the plan sponsor, with employees as holders of the debt. Thus the organization should regard the plan funding decision both as a potential use of capital, to be prioritized alongside other possible uses, and as a *source* of capital coming from employees. The relative attractiveness of obtaining capital from that source versus others should be continually assessed.

How much capital to allocate to the plan, and how best to obtain that capital, should not be a new concern for plan sponsors. However, these issues, along with plan risk management, have become more critical, due to the dramatic changes in the environment in which plans operate.

- *Plan funding deficits and their impact on the sponsor's reported financial performance have become highly visible to stakeholders.*

Pension accounting changes have resulted in a direct impact on balance sheets. As a result, stakeholders can directly assess the plan's impact on the sponsor's financial health. Investors, analysts and regulators now give greater weight to fluctuations in the plan's funded status in their evaluations of a firm. With greater disclosure and improved access to information, employees can scrutinize the level and security of their promised benefits more closely than ever.

- *Sharp drops in equity markets and interest rates have worsened funding shortfalls.*

The financial challenges and low interest rates that have plagued pension plans over the last several years have caused pension funding levels at many companies to move from surplus into deficit. Indeed, the financial crisis exposed the risks of investing plan

assets without a solid understanding of plan liabilities. Pension shortfalls have grown to the point that they now comprise a substantial percentage of market capitalization for many sponsors.

- *Rating agencies have become more consistent in evaluating pension shortfalls for what they are: a form of debt that affects the company's overall risk exposure.*

Standard & Poor's Ratings Services treats the tax-adjusted unfunded balance of these corporate defined benefit plans as debt-like obligations and includes pension funding as part of its rating analysis.¹ With increasing frequency, agencies are building the plan's funded status into their rating of the sponsor.

Inefficiency of pension debt

Organizations should continually review the firm's level of pension debt as one component of its overall capital structure. Pension obligations may be less attractive than other options available in external credit markets. When reviewing its options for debt financing, a company should be aware that pension debt, while convenient, is actually fairly inefficient.

What makes pension debt inefficient? First, the level of repayment is variable and unpredictable. It is based on an interest rate that resets annually and on factors that may be less favorable than prevailing fixed or variable rates available from lenders. Second, by carrying pension debt the organization is deferring the full tax deductibility of eliminating the debt and forgoing the tax-free buildup of the earnings on such a payment.

Finally, a company may be able to improve the terms under which it has borrowed to fund pension debt by swapping such obligations with other financing vehicles, either on its own credit or backed by a letter of credit. Doing so can both lower the effective interest rate and bolster plan security as perceived by employees. The need to pay higher premiums to the Pension Benefit Guaranty Corporation (PBGC) for insuring plan benefits further adds to the cost of pension deficits versus other forms of debt.

To illustrate these points, we present the following case study:

¹ Source: Standard & Poor's.

CASE STUDY PART 1*

A hospital system with solid credit rating considered eliminating a \$20 million pension deficit via a five-year fixed term loan at 3.0%.

Step 1: Quantify the benefits of prefunding.

We quantified the savings our hypothetical client could realize by prefunding the plan, using various measures such as cash flow and the impact on the P&L and balance sheet; we also examined associated risks. As seen in Exhibit 1, we reviewed the impact on the plan from four perspectives — cash flow, earnings, balance sheet, and transactional costs. As expected, prefunding the pension deficit is advantageous, as shown in the preponderance of green-shaded areas under the Prefund column in Exhibit 1. However, this analysis assumes the availability of “free cash.” To holistically assess the transaction, we need to review the costs of replacing this debt, as outlined in Step 2.

Exhibit 1: Impact of Prefunding (In Thousands)

	Pay minimum	Prefund
Cash flow		
Expected 10-year cash outlay	\$27,100	\$23,900
Earnings		
10-year accounting income (8% assumed)	\$18,900	\$22,000
Balance sheet		
10-year change in funded status		
10% return	\$52,700	\$59,400
8% return	\$33,000	\$36,000
6% return	\$16,500	\$18,700
-15% in years 1 and 2; 8% afterwards	\$19,000	\$18,500
Other transactional costs		
PBGC variable premium	\$9 per \$1,000 underfunding	\$0

Step 2: Analyze prefunding trade-offs on other corporate initiatives.

Based on the hospital’s internal cost of capital, and factoring in transaction costs, we assessed the full impact of the refinancing option from cash flow, earnings, and balance sheet perspectives.

Even when factoring in the 3% fixed cost financing, there were advantages to swapping the pension debt with conventional debt across all measures. As shown by the green-shaded areas of Exhibit 2, the transaction added value from across all cash flow, balance sheet and earnings measures. Also, since this was a non-tax-paying hospital, it did not include an analysis of the up-front savings on advanced tax deductions on the prefunding contribution. This could be an additional benefit to consider for tax-paying organizations.

Exhibit 2: Total Hospital Impact (In Thousands)

	Pay minimum	Prefund with 3% loan	Net savings
Cash flow			
10-year outlay	\$27,100	\$25,700	\$1,400
Earnings			
10-year income (assumed 8%)	\$18,900	\$20,700	\$1,800
Balance sheet			
10-year improvement	\$33,000	\$34,700	\$1,700

Step 3: Assess qualitative factors and implementation considerations.

We reviewed additional considerations beyond the strictly financial. An assessment and comparative weighing of trade-offs were essential to the client’s decision to move forward with the transaction. Confirmation from the hospital’s credit rating agency that the transaction would have a neutral to positive impact on its rating opinion, and thus not impair the hospital’s future ability to raise capital, was a key part of this process.

* Case Studies are for illustrative purposes only and are not reflective of an actual client or situation.

Exhibit 3: Impact of Prefunding on Rating Opinion

Consideration	Pay minimum	Prefund with 3% loan
Volatility of cash flow and balance sheet risk	●	●
Transparency/timeliness of funding information	●	●
Moves payment/planning outside of plan	●	●
Target early plan termination and eliminate shortfall	●	●
Once funded, money cannot come back out (but can be managed)	●	●
Eliminate PBGC variable premium (\$100k year 1)	●	●
Participant view/risk exposure	●	●

- Supports the consideration
- Neutral to the consideration
- Does not support the consideration

Conclusion: Following a detailed analysis of its existing pension debt and identification of sources of capital available to replace that debt, the hospital concluded that there were advantages to swapping its pension debt with debt from a 3% fixed five-year term loan. Furthermore, the risks and financing terms may be better understood and managed under the revised structure than under the existing plan debt.

Once the \$20 million in additional assets was invested in the plan and the funding position was restored, the hospital reevaluated its investment approach in order to limit its downside exposure to further funding erosion.

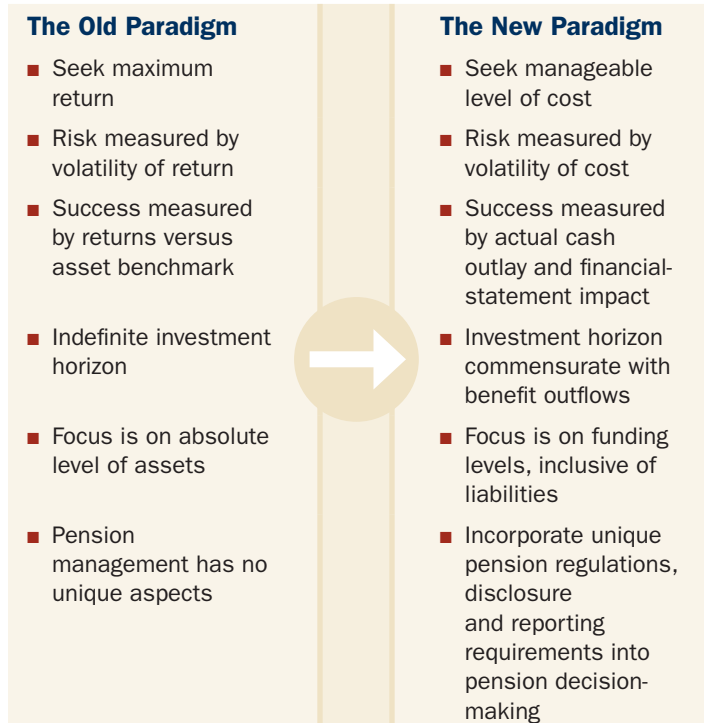
Pension plan funding and investment risk

The pension plan should also be an integral part of the sponsor’s strategic assessment of risk. After all, the plan’s impact on overall enterprise risk extends well beyond investment risk. For example, plan governance and fiduciary oversight expose the organization to legal risk.

Most obviously, however, plan investments and the valuation of plan liabilities based on interest rates expose the organization to significant financial risk. Understanding how these risks impact not only the pension investments but also the organization as a whole creates the best risk-adjusted value for company stakeholders.

Sponsors generally want both low plan costs and highly predictable plan expenses, yet these two goals are at odds with each other. The challenge is to strike the right balance between acceptable cost and acceptable risk, both within the plan and for the organization as a whole. Risk management techniques employed at the corporate level can be effective in determining an optimal risk profile and evaluating these trade-offs.

Specifically, a company should understand its risk budget and the implication on the organization to negative outcomes, determine which risks it is compensated for, and develop a plan to allocate efficiently across risks in ways that maximize return. When this approach is used within the framework of the pension, the focus shifts away from traditional asset-focused considerations toward holistic goals based on organizational objectives as outlined below.



CASE STUDY PART 2*

Plan investment management was revised to incorporate liability implications and limit downside risk exposure to funding levels.

Once the plan was made whole by the \$20 million contribution from the loan proceeds, the hospital wanted to limit future declines in its plan’s funded position resulting from market or interest rate movements. Once the commitment to eliminating the deficit through a loan was made, there was very little appetite to reintroduce risk into the pension plan investment strategy that might cause the full funding status to erode. Within this risk allocation, the client also wanted to improve its ability to forecast the size of future cash contributions.

Working with the client, we conducted a detailed review of the interrelations between assets and liabilities, focusing on strategies expected to be less correlated or negatively correlated to interest rate movements. Plan investments were then restructured to meet the client’s goals. Finally, the investment policy statement was modified to lay out a schedule for periodically reassessing the portfolio as the plan’s funded position improves and evolves over time.

A critical aspect of our review was adopting a holistic approach to evaluating the various options, measuring their total impact on future cash flows and financial statements rather than holding to a narrow total-return perspective.

As seen in Exhibit 4, restructuring the plan’s asset class allocations enhanced the plan’s 10-year funded status, under both best-case and worst-case scenarios. The trade-off in lowering the plan’s exposure to equities was to lessen potential appreciation during secular bull equity markets.

Exhibit 4: Impact of Revised Asset Allocation

	Current allocation	Revised allocation
Domestic equity	27.0%	16.5%
International equity	27.0%	5.0%
LDI bonds	0.0%	48.5%
Other fixed income	25.0%	11.5%
Alternatives	21.0%	18.5%
10-Year funded status		
Worst case	72%	85%
Expected	104%	107%
Best case	158%	135%
10-Year contributions (after initial \$20 million) (In thousands)		
Worst case	\$34,000	\$25,000
Expected	\$9,000	\$11,000
Best case	–	–

* The case study is hypothetical and not reflective of an actual client or situation.

Is your organization wrestling with plan funding issues?

Bank of America Merrill Lynch can assist you in making decisions on your plan's funding in today's more complex and transparent environment. Our consultants can work with your organization to craft funding strategies that meet plan liabilities and create enterprise value.

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