2017 Pension Plan Report Card – An Above Average Year

Strong markets coupled with favorable changes in corporate tax rates made 2017 a very good year for pension plan sponsors. The continuing run up in the equity markets meant that most plan sponsors saw funded status improvements in 2017 in spite of discount rate declines. Even the end of year dip in discount rates was followed up by a similar bump up in January 2018.

The major legislative event was tax reform. While the change in corporate rates was not aimed at pension plans, the implication for them may be significant. Plan sponsors should evaluate their ability to maximize contributions to their plans or borrow to fund their plans for the 2017 plan year to optimize tax deductions. Extra contributions will lead to improved funded status and the potential for a wave of plan terminations in the next few years.

Legislative/Regulatory: A- (tax reform)

With the passage of tax reform, companies will want to analyze the impact of making additional contributions to their plans and receiving higher deductions. Generally, contributions made by September 15, 2018 can be counted for the 2017 plan year and included on the sponsor's 2017 tax filing. With the highest corporate rate dropping from 35% to 21% the cost of each $100,000 of contribution increases $14,000 after the 2017 tax year.

In 2017 we finally received regulations from the IRS that reflect new mortality tables issued back in 2014 by the Society of Actuaries. The new tables now apply to minimum funding liability calculations, PBGC liabilities, and lump sum calculations. There is the option of delaying application of the new tables for minimum funding purposes until 2019.

Even with favorable market returns in 2017, we expect more plans to hit the PBGC variable rate premium cap in 2018 with the increase in liabilities and the rise in the applicable variable rate percentage applied to unfunded liabilities. Sponsors should look at five-year forecasts of minimum funding requirements and PBGC premiums to plan for what will most likely be increases across the board. This could prompt accelerating contributions to take advantage of higher tax deductions and to mitigate rising PBGC premiums.

Pension Risk Transfers: A (another record year for insurers)

The annuity purchase market was even hotter in 2017 than in 2016. Initial reports from insurers indicate that 2017 was on track to reach upwards of $20B in annuity purchases. This is up from the approximately $14B in 2016. Many plan sponsors are starting to look at a second or third tranche of annuity purchases primarily to reduce projected PBGC premiums and shrink the overall size of their plan.

As we have discussed over the past few years, purchasing annuities from an insurance company for small annual benefit retirees is a 'no brainer.' This is particularly true if the plan is subject to the PBGC premium cap.

Plan sponsors will want to evaluate whether or not an annuity buyout makes sense for them. (For more information on what this entails, see our article series on annuity purchases Part 3) Plan sponsors tend to find that the high administrative costs (PBGC premiums, recordkeeping, etc.) justify purchasing annuities now.

Mortality Assumptions: B (lower liabilities again)

Similar to 2015 and 2016, the SOA published an updated mortality improvement projection scale in the fall of 2017. The new projection scale was the result of incorporating additional demographic data into the SOA's mortality model along with some modifications to the model.
Plan sponsors can expect another reduction in accounting liabilities due to the 2017 update. For those sponsors using the RP-2014 mortality tables with the MP-2016 improvement scale, updating to the new projection scale should see a reduction in accounting liabilities around 1%.

**Interest Rates (Accounting): C+ (lower but stable)**

The high-quality corporate bond yields that are used for financial accounting declined through the first half of the year. The second half of the year leveled out and that's where rates have more or less stayed since August; however, at the tail-end of December rates took a quick dive down another 0.15% to 0.20%. The discount rates sponsors will select at year-end will most likely be about 0.50% lower than last year-end.

![Citi Pension Liability Index](image1.png)

**Interest Rates (Funding): C (continue to come down)**

The underlying yield curve used for determining the liabilities for minimum funding came down substantially from the beginning of 2017 to the end of 2017.

![Full Yield Curve](image2.png) ![HATFA Interest Rates](image3.png)

The 10% corridor around the 25-year historical average interest rates continues to be in effect for 2018. The 2018 rates, similar to the last few years, will be lower than the prior year's rates with decreases of approximately 0.25% in the first segment, 0.20% in the second segment, and 0.20% in the third segment (slightly more than in prior years). Similar to changes from 2016 to 2017, liabilities for contribution purposes in 2018 will be higher by about 2% - 4% due to discount rates.
Market Performance: A+

The year started off strong with risk assets rallying, fueled by hopes of tax reform, infrastructure spending, and deregulation coming from the White House. There were some jitters over possible political risk in Europe but those fears abated with the election of centrist Macron in France. The ECB and Japanese Central Banks generally kept monetary policy steady while the Fed began to tighten by increasing rates. Volatility stayed at all-time lows and markets had a generally smooth rally throughout 2017. The year ended with the passage of tax reform in the U.S and the continuation of a synchronized global recovery. Both were generally seen as a positive for market returns.

The year ended with the S&P 500 up approximately 22%. Developed international equities provided even more impressive returns with the MSCI EAFE Index up 25%. The Dollar depreciated by 10% vs. a broad basket of currencies which helped boost international equity returns in dollar terms. Emerging market equities were the best performers with a return over 37%.

The U.S. Treasury interest rate curve flattened during the year, with short term rates rising as the Fed increased the federal funds rate three times, in line with its advance announcements. The Fed also began to reduce its balance sheet towards the end of the year. The longest part of the curve fell with the 30-Year Treasury bond yield decreasing from 3.1% to approximately 2.7%. Bond markets generally saw small increases especially in more risky sectors such as high yield and emerging market debt as credit spreads narrowed and overshadowed rises in rates. Intermediate duration bonds returned 3.5% during 2017. High yield and emerging market debt increased significantly, up 7.5% and nearly 9.2%, respectively. Long duration corporate bonds increased 12.1% while long duration U.S. Treasuries increased 8.5%.

Plan sponsors with the traditional 60% equity/40% aggregate fixed income portfolios have in general seen their portfolios return approximately 14%, while those with 60% equity/40% liability matching bonds would have seen returns around 18%.

![2017 Cumulative Market Returns](image)

Thoughts Going Into 2018

Here are some things to watch for and consider as we move through 2018:

- **“Shrink the ball! – Retiree Carveouts”** – This will continue to be a trend in 2018 with many plan sponsors that have previously implemented an annuity purchase looking at doing another round this year. The annuity markets continue to be hot and several new insurers entered the annuity buyout space last year increasing competition.

- **Borrow to fund** – With tax reform, many plan sponsors are eyeing additional contributions above their minimum required contributions to take advantage of the higher 2017 deduction. For companies with good credit ratings borrowing capital to fund the pension plan can be economically advantageous.
- **Equity markets** – The current bull market is approaching its 9 year anniversary – the second longest since WWII. In 2018, many investors face an uncomfortable dilemma. Past gains can be locked in from a position of relative strength but strong economic conditions and the desire to outperform bonds mean many will also wish to stay invested. Equity valuations look historically expensive and we are seeing increasing evidence that we are relatively late in the economic cycle. However, we have yet to see the indicators of an economic slow-down that could provide a clearer message to sell equities and take the gains achieved to date. In fact, on a relative basis, we currently prefer to take risk in equities rather than government or corporate bonds while at the same time we acknowledge the very real risk of a market fall. There are options for plan sponsors to consider as we discussed in our recent article on Managing Equity Risk in 2018.

- **Cash considerations** – We have mentioned this in prior years but it is still relevant today: Plan sponsors need to continue to evaluate the long-term cash funding impacts of the legislative changes enacted over the last few years. Contribution requirements will remain suppressed again in 2018. But if, and when, the current interest rate corridor expands, sponsors will see large increases in cash calls. Larger contributions now will prevent shocks later and save PBGC premiums.

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