Bolton Insight

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Borrowing to Fund Pension Deficits – Is it Right for Your Plan?

Low interest rates have negatively affected plans by increasing required pension contributions, PBGC variable rate premiums, and financial obligations. However, plan sponsors can benefit from these low interest rates by borrowing money to fund pension obligations which could also reduce risk within the plan, reduce plan expenses, simplify plan administration, and provide increased benefit security for plan participants.

Borrowing to fund is effectively an interest rate swap; swapping a variable form of debt (unfunded pension liabilities) for a fixed form of debt (principal and interest on a loan). Pension liabilities are floating costs, varying with interest rates to measure liabilities, asset returns, and changes in covered population; whereas a loan of borrowed funds is a fixed cost unaffected by economic conditions or participant demographics. Also, borrowing to fund pension liabilities can significantly reduce PBGC premiums resulting in a much lower borrowing cost.

Key Variables to Consider

Each plan sponsor should evaluate if borrowing to fund pension deficits makes sense in their situation. Plan sponsors should consider:

- Effect of Corporate taxes – Pension contributions are a deductible expense in the year they are made while interest payments on a loan are deductible as accrued. In 2018 the marginal corporate tax rate was reduced to 21% which lowers the cost of borrowing to achieve a net cost savings. However, any tax savings are based on the marginal tax rate which may limit or eliminate tax savings for highly leveraged companies already carrying substantial debt.
- Cost of capital – Enough money must be borrowed to eliminate pension deficits or comparably be less than the amount owed from the minimum required contribution and PBCG variable premium costs. Plan sponsors may incur higher interest costs to borrow which could offset the benefit of eliminating any pension deficits.
- Available financing period – Plan sponsors may have the opportunity to borrow greater amounts for a period longer than 7 years, but with a comparable payment to the 7-year amortization funding requirement. This could rapidly reduce unfunded liabilities and variable premium costs.
- Form of financing – Borrowed funds may be in the form of a loan from a financial institution that would require interest and principal payments throughout the life of the loan. Plan sponsors could also consider borrowing in the form of a bond issuance that requires only periodic interest payments with principal repaid at maturity. The repayment structure will impact the cost of financing relative to paying minimum required contributions and PBGC premiums.
- Restrictive covenants – Plan sponsors must be mindful of how the proposed borrow-to-fund transaction may affect any agreements associated with existing debt. Although borrowing to fund essentially swaps one type of debt for another, covenants could treat one of these types of debt more favorably.
- Effect on credit rating – Credit rating agencies are typically aware of the level of pension deficits and take this into account when evaluating an entity's credit. Borrowing to fund pension deficits is usually a credit neutral or positive event from a rating perspective because of the increased certainty of the annual payment amounts.

- Investment advisory fees – There may be opportunities to reduce investment-related fees, either through a shift from active to passive management, or through use of different investment vehicles with lower expense ratios. Fees may decrease as a percentage of assets if additional funds cross into a different tier.
- Administrative costs – Fees may be reduced or the need for certain administrative and regulatory filings for more severely underfunded plans, such as IRC Section 436 benefit restrictions, PBGC 4010 reporting, and certain PBGC reportable event filings eliminated.

Plan sponsors could also consider modifying the plan's asset allocation to put the contributed funds in duration matched investments which will move parallel with the portion of the plan's underfunding. A similar shift in asset allocation for the remaining plan assets may be practical to avoid generating losses on the original underfunding that must be contributed to the plan simultaneously.

Mortality and other demographic risks must continue to be managed. Newly invested plan assets could concurrently be used for a pension risk transfer transaction, such as a voluntary lump sum window or annuity contract purchase from an insurance company. Both options transfer risk away from the plan sponsor to the plan participants in a lump sum window or an insurer in the case of an annuity contract purchase.

Borrowing to fund may not be the right decision for every plan. Plan sponsors should work with their actuary and other plan advisors to develop a customized strategy while evaluating all risks and protecting their investment. For more information please see our latest article and contact Jim Ritchie at (443) 573-3924 or jritchie@boltonusa.com.