February 5, 2024

PUBLIC FIXED INCOME

Overfunded U.S. Pensions:

Uses and Benefits of Surplus Pension Assets

Executive Summary

- Corporate pension plans are sponsored by more than 500 of the Russell 3000 companies.[1]
- During the last few years, many of these pensions have become fully funded for the first time since 2008 and, because of widespread adoption of liability driven investing (LDI), bonds now represent a majority of pension assets.
- With more in hedging assets and less equity risk, pension surplus is likely to persist.
- This paper will discuss six possible uses of excess pension assets and the benefits of maintaining, i.e., not spending, a surplus.

MetLife Investment Management

Introduction

The Pension Protection Act (PPA) passed in 2006 and first became effective in 2008. In the time between passage and the effective date, pension funded status dropped. At the end of 2007 the average funded ratio was 106% and by the end of 2008 it had fallen to 79% due to stock market losses during the financial crisis. It is likely PPA would have been very different had funded levels been in 2006 what they were at the end of 2008. In fact, subsequent legislation has delayed PPA's most stringent funding requirements. Pension funding relief allowed plan sponsors to wait on favorable markets to rebuild pension surpluses.

After three consecutive years of double-digit stock market returns, year-end 2021 average pension funded status once again achieved a surplus.[2] The thirteen-year period from 2008 until 2021 saw many plan sponsors implement LDI with derisking glidepaths, which, over time, drove an increased allocation to bonds and a decreased allocation to stocks.

Many sponsors also implemented programs to reduce the size of their pensions including closing plans to new entrants, freezing future benefit accruals, offering lump sums to separated participants and transferring liabilities to insurers through the purchase of annuities, commonly called pension risk transfers (PRTs).

In summary, the pension landscape has changed dramatically since pensions were last overfunded. We believe it is appropriate to reconsider the topic. In this paper we discuss six possible uses for as well as some benefits of keeping a surplus.

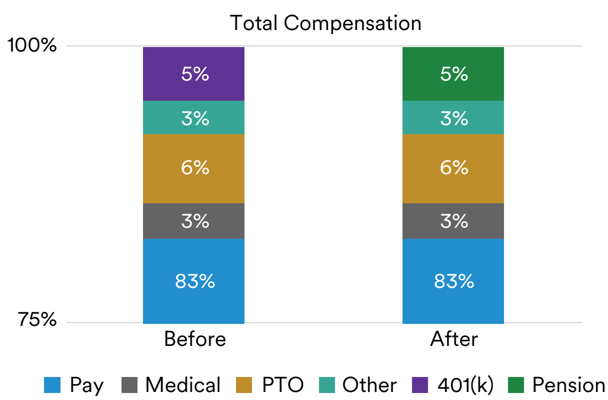
Pension Benefit Increases

Many corporate pensions have been closed to new entrants and had future benefit accruals frozen. One efficient option for using surplus pension assets is to restart benefit accruals or reopen the plan. This can be done in the context of reducing other elements of total compensation to achieve savings.

For example, IBM recently announced unfreezing of their pension, adding a 5% cash balance pension benefit and eliminating a 5% contribution to the 401(k) plan. The new pension benefit will use the surplus and save the 5% that would have otherwise been contributed to the 401(k) plan.

In these restart situations, the new pension benefit can be structured differently than the legacy benefit. For example, a plan with a frozen final average pay benefit could be reopened with a new cash balance benefit. In particular, PPA added safe harbor cash balance plan designs as a low-risk pension option for plan sponsors. Subsequently, cash balance has become the predominant new type of pension benefit.

Chart 1 | Hypothetical Illustration



Source: MIM Analysis; 12/31/23. For illustrative purposes.

Total Compensation Remains Unchanged: The Overfunded Pension Provides a Replacement Retirement Benefit for the Eliminated Employer Contribution to the 401(K) Plan.

Paying Retiree Medical Benefit Costs

Many corporations have legacy unfunded retiree medical plans. The on-going benefit costs of these plans are typically paid from corporate cash. One potential way to efficiently use pension surplus is to pay retiree medical benefits. This can be done through a combination of a Section 420 asset transfer and a Section 401(h) subaccount.[3] The rules surrounding this were recently updated in the Secure 2.0 Act of 2022.

Corporate Synergies

Surplus plan assets can be used in a corporate acquisition that includes an underfunded plan. When pensions are included in an acquisition, the purchase price typically includes a pension adjustment to reflect the funded position of the acquired plan. A purchaser with an overfunded plan can monetize their surplus by acquiring a business with an underfunded plan.

In the example in table 1, the acquisition purchase price is adjusted down $20 million to reflect the underfunded pension. Post acquisition these plans may be merged or left stand-alone.

Table 1 | Illustration of Pension Surplus Monetized in Corporate Acquisition

Pensions			
($M)	Buyer	Acquisition	Post Acquisition
Assets	1,200	80	1,280
Liabilities	1,000	100	1,100
Surplus	200	(20)	180
Ratio	120%	80%	116%

Source: MIM Analysis, 12/31/31, for illustrative purposes.

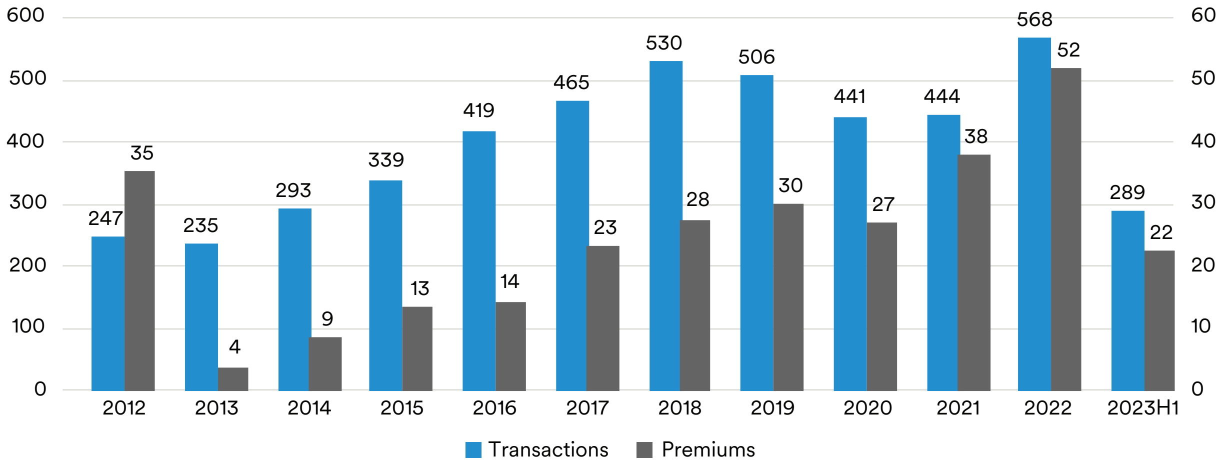
Pension Risk Transfer

PRTs have been an increasingly popular way to reduce or eliminate pension financial risk for the plan sponsor. Higher interest rates and funded status levels have driven PRT premiums to record levels in 2022 and 2023.

The PRT market is comprised primarily of two types of strategies: plan terminations and lift-outs or partial buy-outs, most often of retirees. Retiree lift-outs cover participants who have retired and who are already in payment status Partial buy-outs typically drive premiums, but transaction counts are mainly for plan terminations, especially small plans.

As transactions and premium volume have grown, so has the PRT provider market. This growth includes evolution, and concerns have been raised about some of the newer market participants. The SECURE 2.0 Act passed in 2022 charged the Department of Labor with reviewing guidelines governing PRTs and reporting findings to Congress in 2023. Although work has been done and hearings held, DOL findings will not be delivered until sometime in 2024. Despite the uncertainty associated with this unfinished review, market demand, high interest rates and improved funded status continue to drive PRT transactions.

Chart 2 | PRT Transactions and Premiums by Year



Source: Aon, U.S. Pension Risk Transfer, Market Insights, March 2023 and 2023 Mid-Year Update. 12/26/23.

Paying Plan Administrative Costs Including Fees and Staff Expenses

Pension assets can be and typically are used to pay plan expenses like PBGC premiums, actuarial fees, and investment management fees. With a plan surplus, there may be motivation to consider paying a greater proportion of plan administrative expenses from plan assets. For example, it may be permissible to pay the expenses of staff who support the plan, including associated employee pay and benefits costs.[4]

For plan expenses to be paid from plan assets the plan document must permit payment, the expenses must be reasonable, and costs incurred must be for the exclusive benefit of plan participants.

Furthermore, the Department of Labor has taken the position that there is a class of activities which relates to the creation, rather than the management, of plans. These activities, generally referred to as settlor functions, include decisions about the formation, design, and termination of plans. The DOL position is that settlor functions are not payable from plan assets, however administrative costs are.

Table 2: Settlor vs. Administrative Pension Support Tasks

Settlor Functions	Administrative Functions
Plan design work	Plan administration and benefit calculation expenses
Work associated with corporate transactions, like mergers, acquisitions, or plan spinoffs	Communicating plan benefits to participants and beneficiaries
Accounting calculations for pensions, e.g., ASC 715	PPA required funding calculations
Plan amendments not required to keep the plan qualified and not required to implement the plan, e.g. an amendment to change plan benefits	Plan amendments required to maintain tax-qualified status, e.g., as required for a change in pension law
Expenses related to union negotiations	Expenses related to implementing plan changes from union negotiations

Sources: Department of Labor Guidance on Settlor v. Plan Expenses; American Society of Pension Professionals and Actuaries: What Expenses Can Be Paid from Plan Assets?; 12/26/23.

Surplus Assets Recaptured Through Plan Termination

Surplus assets can revert to the employer when a pension is terminated. These asset reversions are taxed, including through excise taxes, so other options may be more efficient uses of plan assets. However, a plan termination with an asset reversion is one option for accessing plan surplus.

If at least 25% of the surplus is used in a qualified replacement plan, QRP, the remaining surplus assets are taxed at 20%. If a QRP is not used, then asset reversions have a 50% excise tax. Asset reversions are also includable as taxable income to the sponsor.

Some sponsors have split their pension into two plans, one for active participants and the other for inactives, then terminated the plan for inactives to capture surplus assets through an asset reversion. This two-step process is called a plan spin-off/termination. The IRS has stopped issuing advance approvals of spin-off/terminations indicating a more negative and potentially aggressive view by the Service.

Qualified Replacement Plans Summary

Qualified Replacement Plans

- Can be a new or existing plan; can comprise multiple plans.
- Can be a defined benefit (pension) or a defined contribution (savings) plan but cannot fund matching contributions.
- Must include at least 25% of excess assets and can include as much as 100%.
- Must allocate excess assets to participants at least as fast as evenly over seven years.
- Must cover at least 95% of the active employees in the terminating plan who remain employees after plan termination; other employees can be included.
- Can include payment of expenses from plan assets for administration of the QRP.
- IRS Private Letter Rulings have been issued; these are voluntary and not currently available for plan spin-off/termination transactions.

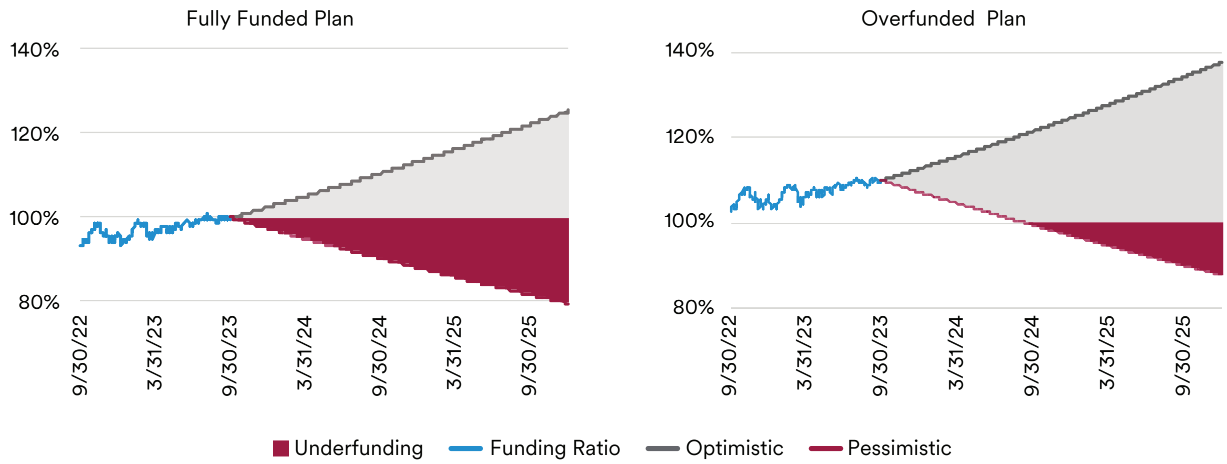
QRPs Reduce the excise tax on reverting assets from 50% to 20%

Source: Internal Revenue Code, Section 4980; Rev Proc. 2022-28. 12/26/23

Benefits of Plan Surplus

Some plan sponsors may prefer to keep and grow a pension surplus rather than finding a near term use for it. Simply knowing there are potential uses for surpluses may be enough motivation to support this approach. There are benefits to having an overfunded position in a pension. First, overfunded plans do not have required contributions or PBGC variable rate premiums. Second, the larger the plan surplus, the less likely plans will ever have contribution requirements or VRPs. Third, accounting treatment for overfunded plans results in income on the sponsor's P&L.

Chart 3 | Funding Projection Comparing Fully and Overfunded Plans



Source: MetLife Investment Management calculations. Illustrations of plan funded ratio history and a range of possible future outcomes using certain capital market assumptions. The left chart shows a fully funded plan (100% funded ratio) and the right chart shows an overfunded plan (110% funded ratio). The overfunded plan is more likely than the fully funded plan to be overfunded in the future.

Conclusion

The pension environment has changed significantly since pensions were last overfunded and these changes present opportunities to those plan sponsors with overfunded plans. There are several potential uses of surplus plan assets and benefits to keeping and growing the surplus.

Endnotes

1 As of 12/31/23 there were 585 companies in the Russell 3000 who reported in their most recent SEC Form 10-K having pension obligations that were more than $50M and 60% funded or better. As of 9/30/23 there were 588 and at 6/30/23 this figure was 569. Changes in the composition of the Russell 3000 are the greatest source of change in this figure.

2 MetLife Investment Management, Quarterly Pension Funded Status press release, 12/31/2023.

3 Section 420 of the Internal Revenue Code describes the conditions of a qualified asset transfer from excess pension assets into a health benefits account. Qualified asset transfers preserve the tax-qualified status of the pension, avoid asset reversion taxes and ensure the transfer is not an ERISA prohibited transaction. Section 401(h) of the Internal Revenue Code defines the conditions for a health benefit subaccount to exist within a tax-qualified pension trust. This is not intended as tax advice. Please consult with your professional tax advisors before taking action.

4 Paying costs from plan assets should be done in consultation with ERISA counsel. MIM does not practice law or provide legal advice.

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