$20 BILLION CLUB: POLICY STRATEGIES

3-PART CONSOLIDATED SERIES: INVESTMENT, BENEFITS, AND FUNDING

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$20 billion club: Policy strategies

3-part consolidated series: Investment, benefits, and funding

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Introduction

The $20 billion club is a group of pension plans with more than $20 billion in global pension liability. We have been reporting on this group since 2011, pointing out how and why its funded status has changed, and we have been reporting on how these sponsors' strategies for managing risk have evolved over time.

In the past, we have used the $20 billion club strategy updates to assess how these mega-plans adapted over the previous year. This paper addresses the major levers that plan sponsors can pull to impact the trajectory of their large defined benefit (DB) plans. These three broad levers are often closely intertwined and pulling one lever can lead to adjusting another. The three key levers are:

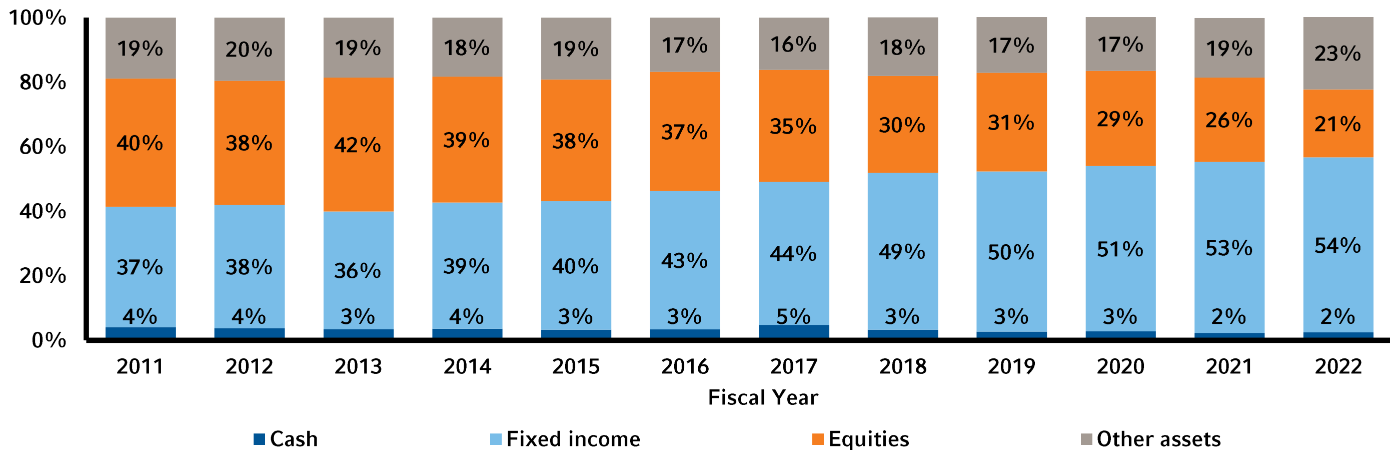
1. **Investment policy:** This lays out how those contributions go to work for the sponsor
2. **Benefits policy:** This directly impacts plan participants' benefit accruals
3. **Funding policy:** This determines the contributions made by the sponsor to pay for those benefits

Part I: Investment policy

This section delves into the plan investment policy within the $20 billion club and what has transpired in recent history. The investment policy is used to instruct how the plan sponsor wants its plan assets allocated and what objectives and constraints guide this decision. During the past decade, there has been an overall industry shift in asset allocation, from investing assets with a traditional asset-only focus to an asset-liability focus. This holds several important advantages to sponsors, such as decreased volatility in plan surplus (difference between assets and liabilities) year to year. We have discussed in the past how this trend has reared its head in the $20 billion club and, unsurprisingly, this has continued over the past few years.

Over the full strategy series, we'll get into some of the details on why plans might have started and continue to march down the de-risking path, but let's start with showing what we're talking about. **Exhibit 1** illustrates the broad average asset allocation of the club for the period 2011 to 2022.

Exhibit 1: Average actual asset allocation 2011-2022



Source: 10-k filings. Annual averages are based on the $20 billion club membership in the given year.

Over the past decade, the average amount of fixed income assets has slowly been on the rise and equities have been on the decline. For many plans, this type of asset allocation move is typically the result of an increase in funded status and pre-planned through a glidepath. Due to how DB plan liabilities are measured, they behave in a very similar manner to fixed income assets. By increasing the amount of fixed income held by the plan, the assets will begin to behave more like liabilities. The more the assets behave like the liabilities, the less the surplus will fluctuate. Since 2011, the average amount of fixed income assets has increased by 17%. Moving from an asset allocation of 60/40 to 45/55 is not an insignificant move and illustrates a deliberate move toward assets that behave more like the liabilities.

In 2022, the de-risking trend continued, with target asset allocations decreasing equity allocations by about 3% on average, fixed income increasing by about 2% and other assets by about 1%. It is important to distinguish the difference in these targets from the actual allocations shown in **Exhibit 1**. Actual allocations are subject to market movement and these jumbo plans can fall victim to their size in how quickly actual allocations move toward targets. The target allocations give a good idea of the intended strategic asset allocation and tend to be stickier than actual allocations. A few notable moves in 2022 can be seen in **Exhibit 2**:

> *The more the assets behave like the liabilities, the less the surplus will fluctuate.*

Exhibit 2: Notable target asset allocation activity in 2022

ORGANIZATION	NOTABLE ACTIVITY
3M	Fixed income allocation increased by 10%
AT&T	Fixed income allocation increased by 5%
Dow	Fixed income allocation increased by 6%
General Electric	Fixed income allocation increased by 4%
Johnson and Johnson	Fixed income allocation increased by 3%
Merck	Equity allocation decreased by 13%
Northrop Grumman	Fixed income allocation increased by 11%
Raytheon	Fixed income allocation increased by 10%

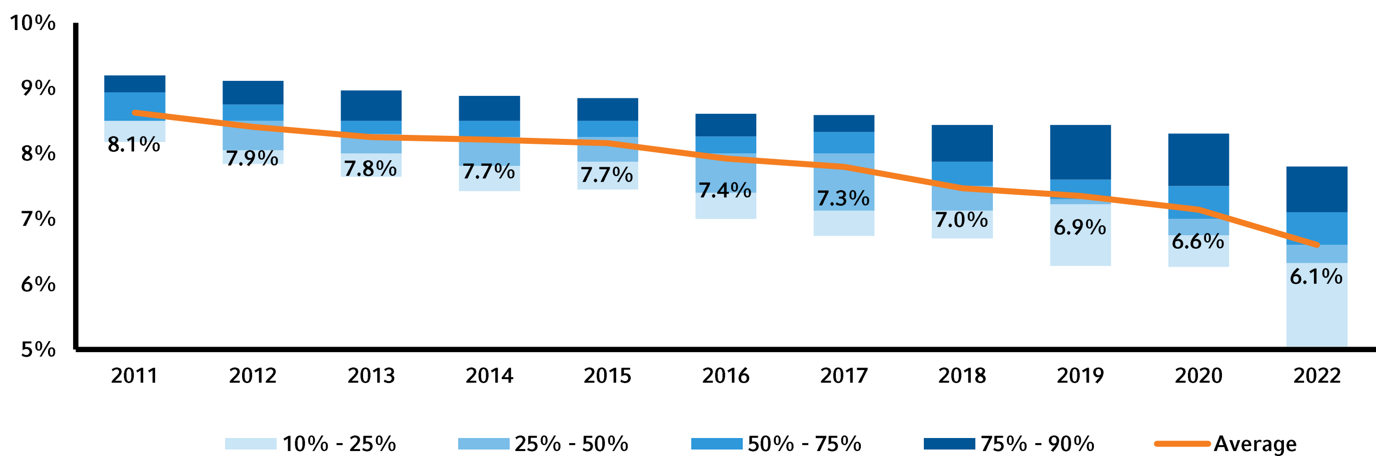
Source: 10-k filings.

A key metric that is tied to the asset allocation and the investment policy is the expected long-term return on assets (ELTRA). In broad terms, the ELTRA assumption is useful only in the calculation of pension expense, which may be more or less important for a given company. Every $20 billion member has reduced its ELTRA assumption over the past decade, but some have done so more dramatically. Many companies have commented over the years on the decrease in ELTRA being associated with de-risking moves and increased fixed income allocations. **Exhibit 3** illustrates this downward trend on the assumption over time.

In 2022, 11 companies lowered their ELTRA assumptions. While many of these decreased assumptions were smaller 20-30 basis-point declines, a few notable exceptions had larger declines. These included 3M and PG&E, which both decreased by 50bps, and UPS and Exxon, which decreased by 60bps and 70bps, respectively.

Every $20 billion member has reduced its ELTRA assumption over the past decade…

Exhibit 3: ELTRA assumptions since 2011



Source: 10-k filings. Based on the $20 billion club membership in the given year.

What does this all mean for your DB plan?

As mentioned, the different levers available to plan sponsors are often intertwined and we'll get into the other levers over this paper, but for the investment policy, the trend is clearly one toward de-risking plan assets, even when this will reduce the expected returns for the plan. This is in the face of funding regulations like the American Rescue Plan Act[1] and Infrastructure Investment and Jobs Act that have provided plan sponsors the ability to take contributions holidays and potentially incentivize increasing risky assets in the plan.

At Russell Investments, for closed or frozen plans, we have a strong belief in a similar approach that the members of the $20 billion club have taken. This is one of the reasons we advocate for implementing a glidepath in the investment policy statement. As a plan approaches full funding, we view it as a good idea to lock in your wins by moving from growth-oriented to liability-hedging assets, which will ultimately reduce the plan's surplus volatility. When starting this transition, it can be even more impactful to use longer duration fixed income assets[2] like treasury STRIPs, or even synthetic rate exposure through Treasury futures.

This is one of the reasons we advocate for implementing a glidepath in the investment policy statement.

Part II: Benefits policy

This section reviews the benefits policy of the $20 billion club and what we might glean from the recent history of these mega-plans. The benefit policy is one of the key levers a plan sponsor can pull to impact the plan outlook. This can range from very minor tweaks to the plan's benefit formula, to major adjustments that close the plan to new hires or freeze the plan's accrual for existing participants.

During the past decade or so, there has been a broad trend in the industry toward closing and freezing DB plans. The reasoning behind this approach is myriad, complex, and non-linear. Regulations, funding hurdles, and workers' preference toward benefits can be cited, but there is no single item that is the root cause. When the Pension Protection Act of 2006 (PPA) was passed, the DB landscape changed dramatically. While the resulting changes significantly increased protections for participants, the same changes increased the cost, governance, and burden on pension plan sponsors.

Since then, large DB plans have been on the decline, both in plan count and participant count. Total participant count is down more than 33% from 2006 to 2021, according to the Pension Benefit Guaranty Corporation (PBGC) data tables. This takes place through closing, freezing, and the subsequent natural attrition as participants leave the plan through cash out or pass away but this can be accelerated by executing pension risk transfers[3]. This is no different for the $20 billion club plans that have altered plan design by closing plans to new entrants and, in many cases, freezing benefit accruals altogether, followed by small to large pension risk transfers.

Like many of the trends we are bringing to light in this series, this has come up in the $20 billion club before and it is no surprise that it has continued in the past few years. Closing and/or freezing a DB plan will inherently reduce the risk that the plan poses the plan sponsor due to the reduction in future uncertainty associated with benefit accruals for active participants. This, in turn, has an impact on the investment policy, which we detailed in the previous section. **Exhibit 4** details some notable activity in this space over the past few years.

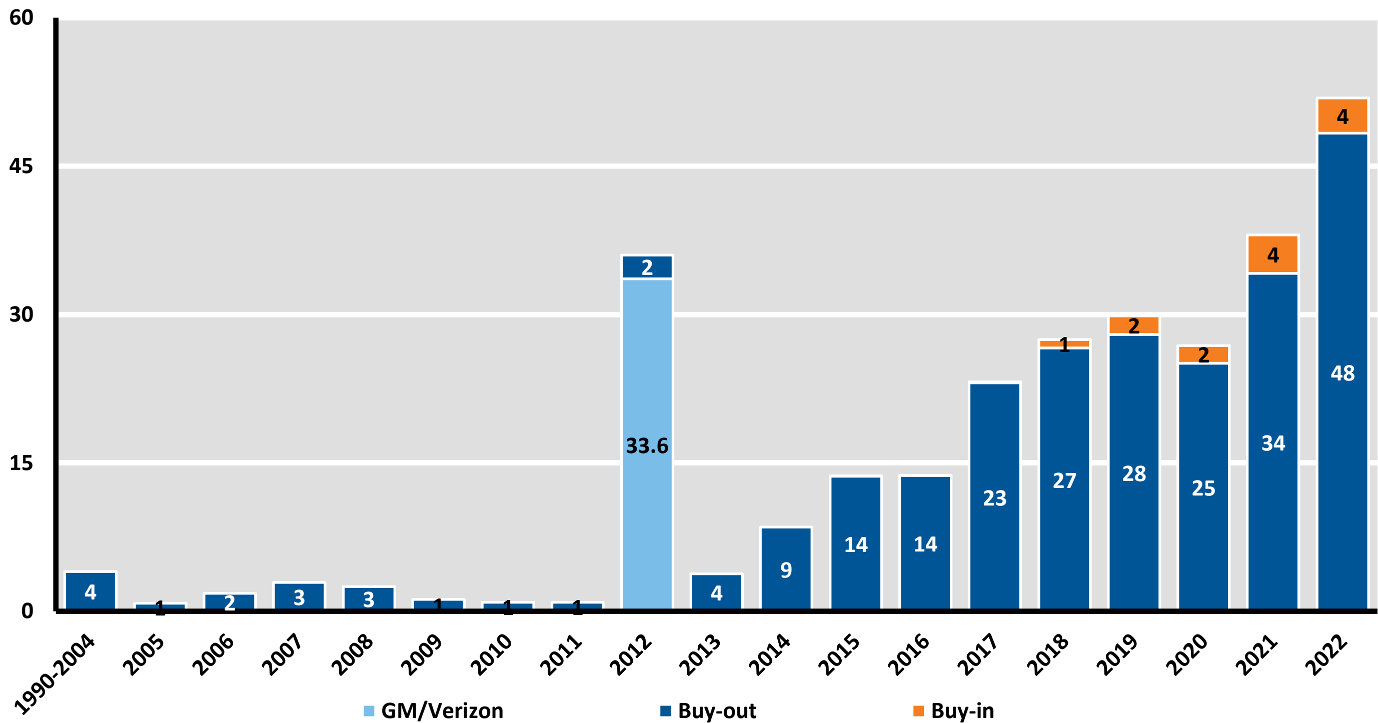
> *While the resulting changes significantly increased protections for participants, the same changes increased the cost, governance, and burden on pension plan sponsors.*

Exhibit 4: Notable activity 2021-2023

ORGANIZATION	NOTABLE ACTIVITY
UPS	Full freeze of 70,000 non-union participants became effective in 2023, as announced in 2017
AT&T	2023 $8.1B group annuity contract purchase
IBM	2022 $16B group annuity contract purchase
Lockheed Martin	2021 $4.9B and 2022 $4.3B group annuity contract purchases
Pfizer	2022 $0.5B group annuity contract purchase

The IBM risk transfer was an especially noteworthy move by the company, being the second largest annuity purchase to date at $16 billion. Second only was the unprecedented 2012 General Motors annuity purchase of a momentous $25 billion, which arguably kicked off the high pace of annuity purchase risk transfer we see in the industry today.

Exhibit 5: Annuity purchase history



Source: LIMRA Secure Retirement Institute.

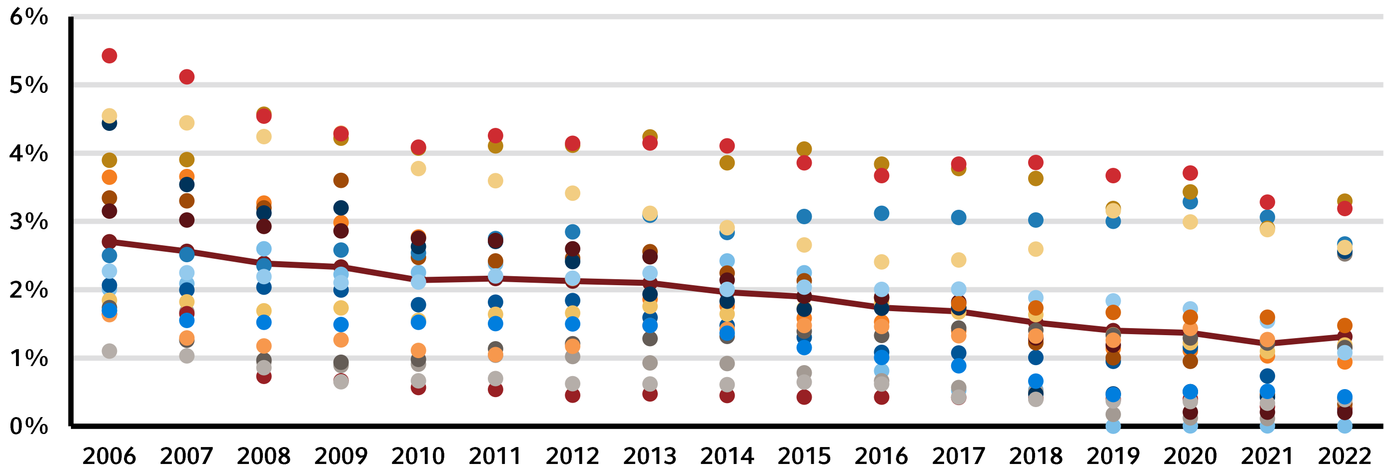
While the UPS freeze was announced several years ago, it's worth noting that of the $20 billion club members, UPS had the highest service cost relative to PBO in 2022, a key metric when considering open and closed plans. UPS was one of only two plans where this ratio was above 3% in 2022 with Johnson and Johnson being the other. This freeze to their non-union participants will decrease this ratio going forward. With UPS in mind, let's look more broadly at this key metric.

As a way of further illustrating the trend of pension plans closing and freezing, we can look at the size of service cost relative to PBO across the $20 billion club. The service cost for a pension plan represents the annual cost associated with new benefit accruals for active participants. For an established and open plan, the service cost relative to the PBO will be consistent as active participants accrue benefits and inactive participants exit the plan through mortality (or otherwise). This ratio of service cost to PBO is generally between 3% and 5% for an open plan.

However, there has been a broad trend of plans closing to new entrants (soft-freeze) and freezing benefit accruals altogether (hard-freeze) for several years. For a soft-frozen plan, this ratio will decrease over time and will be 0% for a hard-frozen plan. **Exhibit 6** illustrates the move of closing and freezing plans since PPA was passed in 2006 through the decline of service cost to PBO. In 2006, the service cost ratio among these companies ranged between 1.1% and 5.4%. In 2018, the range had dropped to between 0% and 3.3%, with an average decrease of about 1.6% since 2006.

__Exhibit 6__ illustrates the move of closing and freezing plans since PPA was passed in 2006 through the decline of service cost to PBO.

Exhibit 6: Service cost relative to PBO since 2006



Source: SEC Form 10-K filings.

With the uptick in pension risk transfers, which focus on non-accruing participants (i.e., they have no service cost), it would be reasonable to expect that the service cost relative to PBO would increase as the PBO shrinks. However, even as plans have executed lump sum offers and annuity purchases, the ratio of service cost to PBO has continued to drop over the past few years, further emphasizing the impact of closing and freezing.

It would be fair to point out that this ratio on average did not decrease in 2022 for the first time since we began tracking this metric more than a decade ago. This is partially due to the restructuring of the $20 billion club membership, which we comment on below. However, looking at **Exhibit 6**, we have started seeing diverging paths even within the $20 billion club members. The plans with higher service cost relative to PBO have been relatively flatter, or at least have a slower decline, than those plans now at the bottom of this exhibit that continue their steady trend toward zero. Similar to UPS previously mentioned, many of these freezes were implemented years ago and are continuing to come to fruition or have over the past few years. This is something we will continue to track.

> *We're here to help with those complications and work through those details whether it be picking the right return-seeking and liability-hedging mix, selecting the equity mix, or helping implement a completion mandate to reduce interest rate risk.*

What does this all mean for your DB plan?

As we've mentioned, the different levers available to plan sponsors are often intertwined but the industry trend on benefits policy has been one that has leaned into closing and freezing plans and executing risk transfers[4]. This reduces the overall risk of the plan through a shorter in-plan duration and the ability to lock things in[5] when fully funded through hibernation[6] as well as other concepts; however, there are considerations on how and when to do this. Choosing the right populations to annuitize with an insurer is already an important decision, but are you considering what that will mean for the asset allocation after the fact? Off-loading certain participant cohorts can look appealing at first blush, but the leftover plan can sometimes unintuitively lead to higher average contribution requirements.

At Russell Investments, we are agnostic on whether your plan is open, closed, or frozen; however, each of these plan states has drastically different needs, objectives, and goals. Open plans will inherently have a higher return hurdle rate to keep up with the service cost for actively accruing participants. Frozen plans have a definite timeline as participants leave service through termination, retirement, and ultimately mortality; this means that plan sponsors may want to consider end-game planning and how to approach those specific concerns. Closed but unfrozen plans land somewhere in the middle with unique considerations and timelines. Add a layer of funded status to the mix and things can get complicated fast. We're here to help with those complications and work through those details whether it be picking the right return-seeking and liability-hedging mix, selecting the equity mix, or helping implement a completion mandate to reduce interest rate risk.

Part III: Funding policy

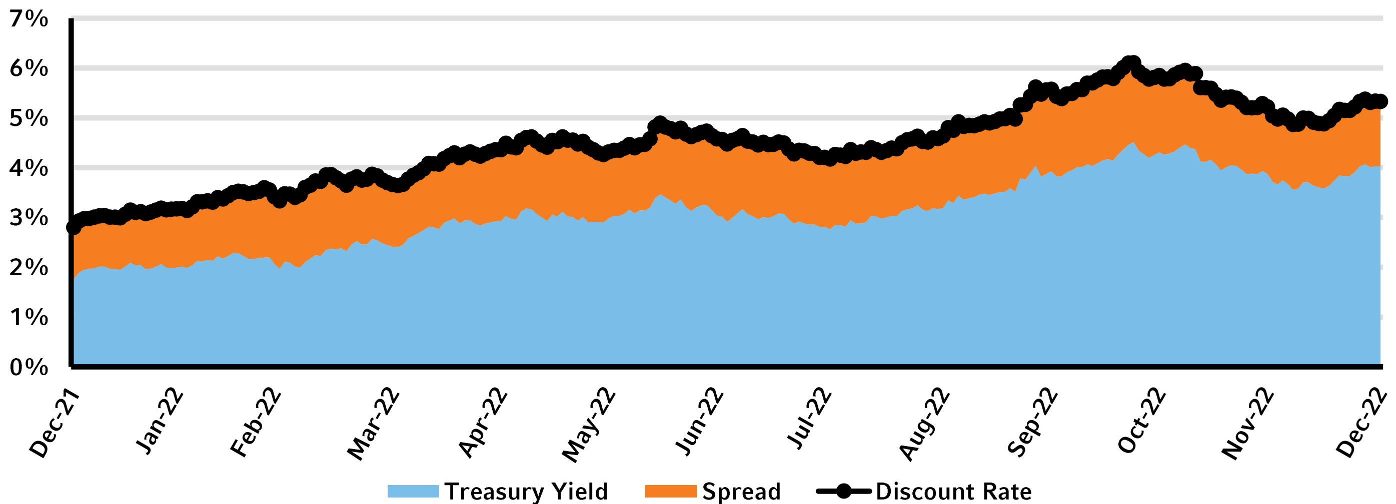
In this final section, we'll be reviewing the funding policy of the $20 billion club and what we might gather from the recent history of these mega-plans. Many plan sponsors have official policies to "contribute at least the amount required under the law" but under the hood, there is often much more going on than meets the eye with respect to this policy.

Similar to the other policies we've discussed over the course of this series, the funded policy is intertwined with the other policies but, perhaps even more so than the others, the funding policy is a function of the funded status of the plan. Of course, there are regulatory contribution requirements under the Pension Protection Act (PPA) based primarily on funded status, but it goes further than that. Depending on the goals of the plan sponsor, funding can continue up to and beyond the plan being fully funded. Before we dive into some more contribution specifics, let's take a step back and review the funding status of the plans in the $20 billion club.

In what has felt like a string of extraordinary years, 2022 was exceptional within the pension space. Broadly speaking, interest rates have been on the decline for the past 40 years and this creates an additional headwind for pension plans as falling discount rates mean rising liabilities. Over the course of 2022, we saw discount rates rise 250 basis point (bps) for plans with a duration of 12 years (with a peak of +330 bps in the middle of October), as illustrated in **Exhibit 7**. As detailed in our $20 billion club 2023 update[7], this created an actuarial gain larger than any we've seen in the history of the $20 billion club. However, this was largely offset by the largest investment loss we've seen—even larger than the investment losses seen in 2008 as part of the Global Financial Crisis.

> *This puts the $20 billion club at its highest aggregate funded level since 2007, a threshold that could mean interesting things for the future and something we'll be keeping a keen eye on.*

Exhibit 7: Discount rates during 2022 for a 12-year duration liability; discount rate based on Merrill Lynch A-AAA yield curve.

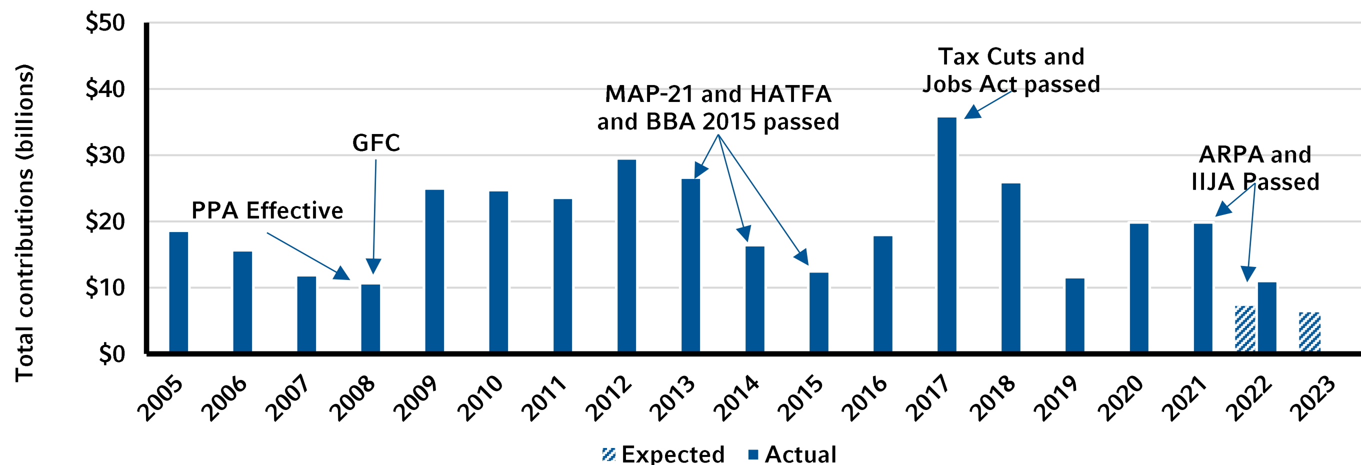


Source: Russell Investments. Discount rate based on Merrill Lynch A-AAA yield curve.

However, pension plans don't live in absolute returns space like much of the investment industry, and the interest rate rise had a larger impact on the liabilities than losses seen on the asset side. This lead to an increase in funded status for the $20 billion club members in aggregate. This puts the $20 billion club at its highest aggregate funded level since 2007, a threshold that could mean interesting things for the future and something we'll be keeping a keen eye on.

As mentioned, for better or worse, many plan sponsors' funding policies are linked to minimum required contributions under PPA. While PPA does provide a path to full funding in large part due to the shortfall amortization, regulations over the past decade have enabled plan sponsors to reduce or fully put off contributing to their plans, as seen in **Exhibit 8**. With the exception of the Tax Cuts and Jobs Act (TCJA), each noted piece of legislation with pension funding relief-related measures has led to a reduction in contributions in the following years. The Tax Cuts and Jobs Act led to a large increase in contributions in 2017 and 2018 due to the tax benefits of contributing to pension plans. While funding relief sometimes provides much needed cash flow flexibility for plan sponsors, plan funded status has not always benefitted from it.

Exhibit 8: $20 billion club members contribution history in the context of legislation



We also see in **Exhibit 8** that contributions for the $20 billion club members were at their lowest point since PPA became effective and would have been the lowest if not for ExxonMobil contributions of $4.2 billion ($3.2 billion more than the expected 2022 contributions). If the expected contributions in 2023 hold, they will be the lowest we've seen while monitoring the $20 billion club.

What does this all mean for your DB plan?

As previously mentioned, while the different levers available to plan sponsors are often intertwined, the industry trend on funding policy has geared itself to taking advantage of the funding relief and opportunities offered up by regulatory changes over the past decade as well as their increased funded status.

Since the introduction of MAP-21 (Moving Ahead for Progress in the 21st Century Act)[8] legislation and subsequent pension funding relief legislation, discount rates for contributions have been disconnected from discount rates for accounting disclosures. For the first time since MAP-21 was passed, because of the large increase in rates in 2022 that were mentioned, the market interest rates are near or above the interest rates used to determine regulatory contributions. This can lead to interesting decisions, which we discussed earlier in 2023[9], that have direct impact on the regulatory contributions and therefore many plan sponsors' funding policy.

Leading up to the plan being fully funded, we would generally advocate for greater funding for the plan if the sponsor has the capacity to do so. In our 2022 prudent pension funding report,[10] we discussed what it might look like to fund a plan in the context of cash flow from operations. Once the plan is fully funded, managing the plan can then be simplified through hibernation,[11] and costs of the plan decrease in a meaningful way. In most cases, this will lead to no longer needing to make annual contributions and largely reduce the risk of large downside contribution events.

For the first time since MAP-21 was passed…the market interest rates are near or above the interest rates used to determine regulatory contributions.

Conclusion

One of the main goals of the $20 billion club has always been to help plan sponsors understand how industry trends have been developing. Not all plans are created equal, and we focus on these largest plans because they have access to the most sophisticated service providers and the latest innovative strategies. They also tend to have experienced experts on staff who can focus a large portion of their time on their DB plans. By gathering and examining what these jumbo-sized plans have been implementing and adjusting, both reactively and proactively, we not only observe the current trends, but also gain unique insight into where the industry may be heading.

As we've highlighted over the course of this paper, the Investment, Benefits, and Funding policies for the $20 billion club members are always on the move. Like all plan sponsors, they are looking on how to best handle the assets and liabilities under their purview and there is a lot of insight to be gleaned from them. We've touched on some important topics here, how these jumbo plan sponsors have approached them and how they may impact your plan, but every plan is unique and how and what gets implemented is something Russell Investments is well situated to help with.

A note on $20 billon club membership

Over the past several years, inclusion in this group of mega-plans could have increased a few times due to falling interest rates, which caused liabilities to soar. However, we have kept this group stable in the past to maintain a certain level of consistency. 2022 was an exceptional year in many ways, but that has shone through in the DB plan space perhaps more keenly than many other areas. We have used this as an opportunity to refresh the membership of our $20 billion club. The 2023 list of 20 companies—many of which have long been members of the club—can be found in our 2023 update[12].

[1] Field. A. (2021, March 11). "How the American Rescue Plan impacts funding relief for pension plans". Russell Investments Blog. Available here: https://russellinvestments.com/us/blog/american-rescue-plan-and-funding-relief
[2] Owens. J. (2022, November 16.) "Is now the time to elevate your hedge ratio?". *Russell Investments Blog*. Available here: https://russellinvestments.com/us/blog/elevate-hedge-ratio
[3] Owens. J. (2022). "Risk transfer potholes: How to avoid them or brace for impact". *Russell Investments Research*. Available here: https://russellinvestments.com/us/blog/risk-transfer-considerations
[4] Owens, J. (2023). "Pension risk transfer options and considerations". *Russell Investments Research*. Available at: https://russellinvestments.com/-/media/files/us/insights/institutions/defined-benefit/pension-risk-transfer-options-and-considerations.pdf
[5] Owens, J. (2023). "A guide to pension plan hibernation". *Russell Investments Research*. Available at: https://russellinvestments.com/-/media/files/us/insights/institutions/defined-benefit/a-guide-to-pension-plan-hibernation.pdf
[6] Owens. J. (2021, February 23). "DB plan hibernation: Does it really work?". *Russell Investments Blog*. Available here: https://russellinvestments.com/us/blog/db-plan-hibernation
[7] Owens. J. (2023). "$20 billion club: It's been a minute since we've seen numbers like this…". *Russell Investments Research*. Available here: https://russellinvestments.com/us/blog/2023/03/2023-20bn-club-update
[8] "Moving Ahead for Progress in the 21st Century." *MAP-21 | Federal Highway Administration*, www.fhwa.dot.gov/map21/. Accessed: September 12, 2023.
[9] Frick. B. (2023, March 14). "PPA yield curve elections: A potential for change". *Russell Investments Blog*. Available here: https://russellinvestments.com/us/blog/ppa-yield-curve-elections
[10] Hall, M., Owens, J., and Frick, B. (2022). "2022 Prudent Pension Funding Report". *Russell Investments Research*. Available here: https://russellinvestments.com/us/blog/2022/11/2022-prudent-pension-funding-report
[11] See endnote 5.
[12] See endnote 7.

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