$20 billion club strategy

2018 update

Defined benefit (DB) plan sponsors utilize several key pension plan policies to determine the successful cost and risk management of their plan. Their benefits policy impacts plan participant benefit accruals; their funding policy drives the contributed amounts to cover these benefits; and the investment policy can alleviate the burden on sponsors to furnish cash in support of plan benefits. Furthermore, a sponsor's accounting policy can influence any of these decisions based on their financial impact. The levers of pension management are intertwined, which complicates the sponsor's decisions in choosing the levers' the appropriate setting. This leaves many plan sponsors looking to their peers as well as to larger plan sponsors to guide the way.

The largest corporate DB sponsors in the United States don't follow industry trends – they set them. Gathering and understanding the policy and strategy trends among these 20 jumbo-sized sponsors helps us not only observe current trends, but also provides us with a glimpse into where the industry may be headed.[1]

Based on our analysis of the FYE 2017 annual filings, these corporations continued to make changes to their pension plan policies to take more control of the costs and better manage their risks. This note will review what changes were made, and the trends they may be influencing.

In the current low interest rate and return environment, sponsors are continuing to focus on areas they can control, which are found in their plan design, funding and investment policies. Improving plan funded positions and taking steps to minimize portfolio risks will help promote stability, reduce surprises and place the sponsors in control of their DB plans' endgame.

Benefits policy

The most impactful way for a plan sponsor to control the costs of a pension plan is through its benefits policy, which encompasses decisions from plan design (i.e., the size and the style of promised benefits) to participant eligibility for future benefit accruals (i.e., closing participation to new hires and ultimately freezing benefit accruals). Although the primary goal of modifying the benefit policy is usually to reduce the cost to the sponsor (i.e., to reduce or limit the benefits to be paid in the future), there are also some participant-valued enhancements to certain plan design changes such as benefit portability, transparency and comprehension.

Leading the charge in managing pension costs through benefits policy, the $20 billion club has collectively made numerous plan changes through the years. Many members of the $20 billion club have made plan design changes like introducing a "hybrid" plan design (e.g., cash balance or pension equity) ,[2] while only about 40% of defined benefit plans are hybrid in nature.[3] Moreover, almost all of the plans in the $20 billion club are closed to new entrants, with some completely frozen to new benefit accruals.[4]

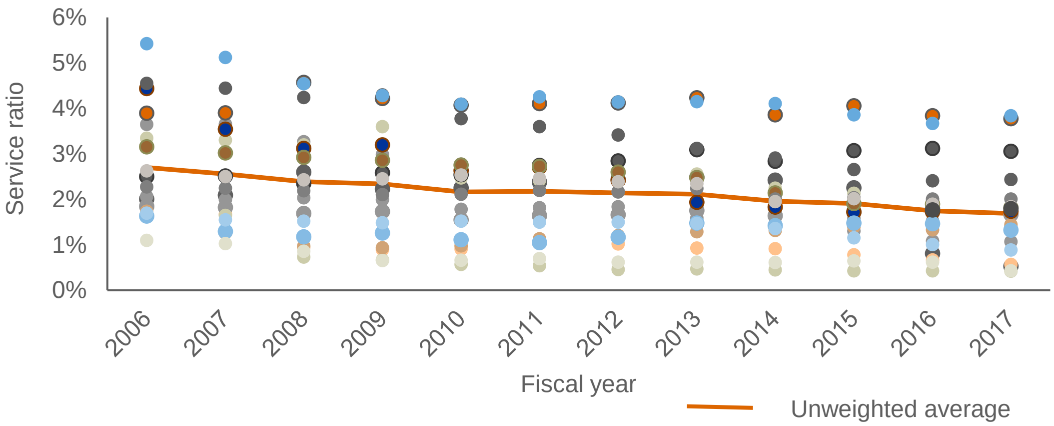
Notable activity in 2017[5]

UPS	Announced it will freeze its non-union plans in 2023
Pfizer	Full freeze of U.S. DB plans became effective
Ford	Implementing 35-year service cap on all salaried benefits, effective 12/31/2019

Key statistic: Falling service cost

A pension plan's service cost represents the cost of the annual benefit accrual for plan participants. Since the passage of the Pension Protection Act of 2006 (PPA), plan sponsors have been implementing plan changes to reduce the rising costs of future benefits. In 2017, frozen plans represented nearly 30% of all DB plans, up from roughly 15% of plans in 2006, which was the year PPA was signed into law. To illustrate the overall trend toward plans closing and freezing, Exhibit 1 looks at how service cost has declined relative to total plan liabilities over time. In 2006, the service cost ratio among these companies ranged between 1.1% and 5.4%. In 2017, the range dropped to between 0.4% and 3.8%, with an average decrease of about 1%.[6]

Exhibit 1: Service cost relative to PBO since 2006



Source: 10-k filings

The industry trend on plan design

Many sponsors continue to adjust, reduce or eliminate DB benefits by adopting hybrid plan designs (often cash balance plans), closing plans to new entrants or freezing benefit accruals to manage and reduce pension costs.

Funding policy

The funding policy guides the plan sponsor in determining the size and timing of contributions. Although all DB plan sponsors pay at least the minimum required contributions annually, which are affected by both financial market conditions and pension legislation, some DB plan sponsors are opting to contribute even more to their plans. Beginning with the implementation of PPA in 2008, which coincided with the Global Financial Crisis (GFC), plan sponsors faced rising contribution requirements that only began to dissipate under multiple rounds of federal transportation aid linked pension funding relief. Recently, though, the rising burden of underfunding a plan – resulting in drastically increasing Pension Benefit Guaranty Corporation (PBGC) variable rate premiums[7] – combined with the looming prospect of changes to mortality assumptions,[8] has led some plan sponsors to make additional discretionary contributions above their minimum required amounts.

In 2016, half of the $20 billion club's members publicly disclosed that they had no significant U.S. contribution requirements, despite most paying more than that. Then, in 2017, the $20 billion club posted a record setting $37.5 billion in contributions, mostly to take advantage of current federal tax deductions that will be reduced because of the Tax Cuts and Jobs Act of 2017, and to lower future required contributions.

Notable activity in 2017[9]:

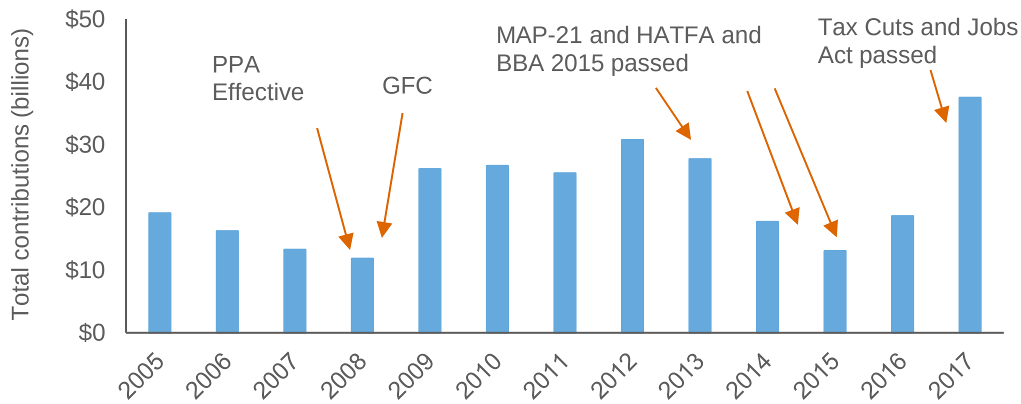
COMPANY	2017 CONTRIBUTION	DISCLOSED MOTIVATION(S)
United Parcel Service	$7.4 billion	Tax savings
Verizon	$4.1 billion	Reduce future contribution requirements
Boeing	$4.0 billion	Reduce future contribution requirements, tax savings
DuPont	$3.1 billion	Improve funded status, tax savings
United Technologies	$2.2 billion	Improve funded status, plan split, de-risking, tax savings
Ford	$1.8 billion	Mandatory contributions, tax savings
Raytheon	$1.6 billion	Mandatory contributions, tax savings
3M	$1.0 billion	Tax savings
Northrop Grumman	$0.6 billion	Tax savings

Additionally, $20 billion club sponsors FedEx, GE, Pfizer and Lockheed Martin all plan significant contributions during 2018 to improve funded status and take advantage of the higher federal tax deductions before the new corporate tax cuts.

Key statistic: Trend in contributions relative to major pension legislation and economic environment

While the PPA and the GFC led the $20 billion club to more than double its collective contributions, funding relief under Moving Ahead for Progress in the 21st Century (MAP-21), the Highway and Transportation Funding Act (HATFA) and the Bi-Partisan Budget Act of 2015 (BBA) nearly, or entirely, eliminated contribution requirements, which allowed these plan sponsors to reduce their levels of contributions to pre-GFC levels. One of the side effects of these legislative acts, however, was to ultimately encourage greater discretionary contributions to offset the higher variable rate of PBGC premiums. The Tax Cuts and Jobs Act of 2017 only gave these plan sponsors the incentive to accelerate this funding for tax savings purposes. Exhibit 2 illustrates the pattern of contributions from the $20 billion club in relation to the numerous recent pension related regulations.

Exhibit 2: Annual global pension contributions for $20 billion club members since 2005



Source: 10-k filings

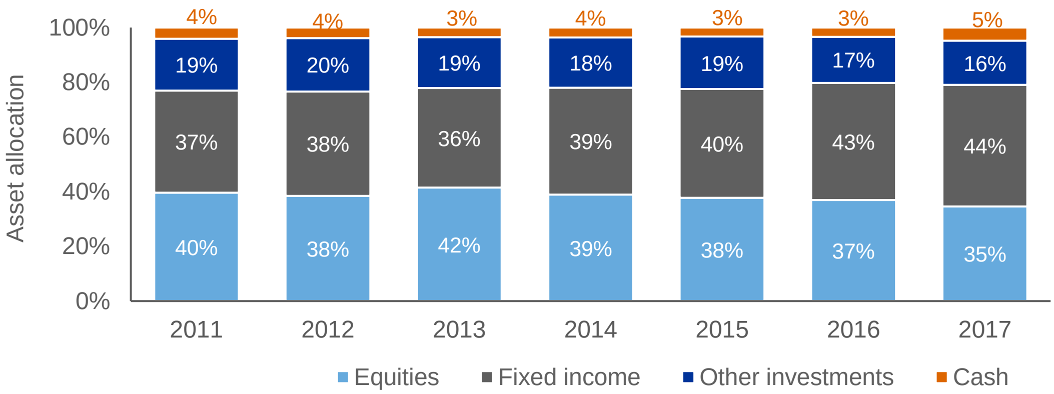
The industry trend on funding policy

While many DB sponsors continue to take advantage of funding relief, pressures from rising PBGC premiums, mortality used for contribution requirements and the eventual phase-out of funding relief have begun to reverse this trend. The federal corporate tax rate will decrease in 2018, and that will encourage plan sponsors to accelerate funding prior to the 2017 plan year contribution deadline (September 15, 2018 for plan years ending 12/31, or 8 ½ months after the end of the 2017 plan year).

Investment policy

Plan sponsors utilize their investment policy to codify how they want their plans' assets allocated and what objectives and constraints guide these decisions. Each plan sponsor has its own unique situation influencing its investment decisions, but the $20 billion club has led a strategic shift from an asset-only focus to an asset-liability focus[10]. Over the last few years, these plan sponsors have made significant shifts in their portfolios to fixed income from return-seeking assets. While funded statuses have stagnated recently, leaving the 2017 average asset allocation relatively unchanged from 2016, large discretionary contributions in 2017 and 2018 will likely lead to continued de-risking. Exhibit 3 shows the average asset allocation of the $20 billion club over the last seven years.

Exhibit 3: Average asset allocation (2011-2017)



Source: 10-k filings

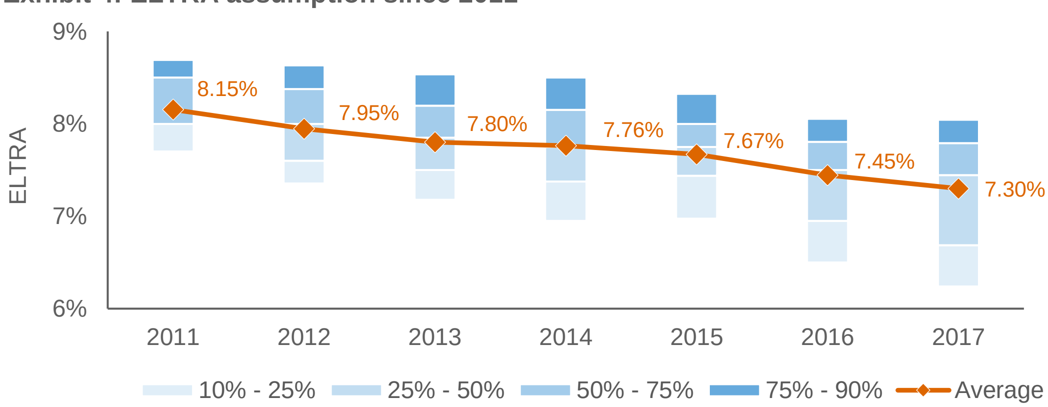
Notable activity in 2017[11]

Exxon	Allocated additional 10% to fixed income assets
United Technologies	Allocated additional 10% to fixed income assets
General Motors	Allocated additional 6% to fixed income assets
IBM	Increased fixed income allocation target from 70% to 80%
UPS, DuPont, and Verizon	Increased cash from contributions, have not changed allocation targets
Lockheed Martin	Reintroduced return-seeking assets by 10%

Key statistic: Expected long-term return on assets (ELTRA)

In 2011, every member of the $20 billion club maintained an ELTRA assumption between 7.5% and 8.75%.[12] By 2017, seven companies had decreased the ELTRA assumption to below 7%.[13] In the last six years, the overall average decrease in ELTRA was 0.85% (see Exhibit 4). While Verizon increased its ELTRA from 7.0% to 7.7%[14] in 2017, five plan sponsors meaningfully reduced their ELTRA assumptions including Dupont, by 1.5%, and IBM, by 1.25%.

Exhibit 4: ELTRA assumption since 2011



Source: 10-k filings

The industry trend on investment policy

DB sponsors continue to shift toward a more liability-driven investing (LDI) strategy. Due to a combination of increased fixed income and lower market return expectations, ELTRA assumptions are shifting lower. For 2018, multiple $20 billion club members will be lowering their ELTRA – AT&T from 7.75% to 7.00%, GE from 7.50% to 6.75%, IBM from 5.75% to 5.25% and United Technologies from 7.30% to 7.00% – while citing changing investment strategies to increase fixed income and updated capital market assumptions.[15]

Accounting policy

A sponsor's accounting policy generally does not impact the financing of pension benefits, though it can potentially influence the sponsoring organization's decisions. While pension accounting under Accounting Standard Codification (ASC) 715 has remained relatively unchanged since 2007,[16] beginning in 2016, the SEC began to allow plan sponsors to use an alternative method for calculating service cost and interest cost. This change allowed sponsors to apply individual spot rates from the yield curve to separate expected cash flow components of the service cost and interest cost, which reduced the service and interest cost components of pension expense.

Notable activity since 2017[17]:

Half of the $20 billion club has adopted the "spot rate method" for determining interest cost and service cost. The reasoning being that this methodology provides a more precise measure and improves the correlation between projecting the plan's cash flows and corresponding spot rates.

The industry trend on risk transfer

DB sponsors have not widely adopted the spot rate method for pension expense,[18] but lowering the service and interest costs in pension expense will make the impact of lowering ELTRA assumptions more palatable.

Final thoughts

Many corporate sponsors have taken steps to reduce the cost and risk of their DB plans. These trends continued in 2017 with new plans closing or freezing, and a higher overall shift to liability-hedging fixed income. Moreover, 2017 brought record setting contribution levels as robust capital markets combined to help improve funded status. In the current low interest rate and return environment, sponsors are continuing to focus on areas they can control, which are found in their plan design, funding and investment policies. Improving plan funded positions and taking steps to minimize portfolio risks will help promote stability, reduce surprises and place the sponsors in control of their DB plans' endgame.[19]

[1] See also Owens, "$20 billion club posts record contributions in 2017 as funded status jumps," Russell Investments Research, 2018.

[2] According to 5500 filings. For information on cash balance plans and their investment strategies, see Owens, Sylvanus, Jaugietis, "LDI for Cash Balance Plans," Russell Investments, 2014.

[3] PBGC 2015 data book

[4] In a plan closure, new hires will not receive DB benefits (often in favor of enhanced defined contribution benefits), but existing employees continue to accrue. With a plan freeze, all future benefit accruals are curtailed for new *and* existing employees.

[5] Based on 10-k filings

[6] Based on 10-k filings

[7] Source: PBGC. See also Collie, "PBGC premiums in their historical context: ouch!," Russell Investments Fiduciary Matters blog, January 30, 2017; and Owens, "Extended funding relief + higher PBGC premiums = a lethal combination," Russell Investments Fiduciary Matters blog, December 9, 2015.

[8] See Barbash, "Improved mortality assumptions to affect pension funding calculations from 2018," Russell Investments Fiduciary Matters blog, October, 9, 2017.

[9] Based on 10-k filings

[10] See Collie, "The Pension Plan Herd Has Broken Up," Fiduciary Matters blog, March 24, 2016.

[11] Based on 10-k filings

[12] Based on FYE 2011 10-k filings

[13] Based on FYE 2017 10-k filings

[14] Based on FYE 2017 10-k filing. Interestingly, Verizon's actual allocation includes a 7% increase in cash, with the only comment on long-term target investment return being based on current market interest rates and valuation levels, consensus earnings expectations and historical long-term risk premiums.

[15] Based on FYE 2017 10-k filings

[16] In 2007, Financial Accounting Standard (FAS) 87 was revised into FAS 158 which most significantly required plan sponsors to recognize funded status on the company's balance sheet and shift certain gains and losses from pension expense to other comprehensive income.

[17] Based on FYE 2017 10-k filing

[18] Source: Farrell, Glickstein, McFarland, and Scott, "Fortune 1000 pension sponsors' use of the 'spot rate approach' to measure service and interest cost," Willis Towers Watson, 2016

[19] While 2017 saw significant increase in annuity buyout activity, the $20B club was surprisingly quiet in the pension risk transfer space outside of FedEx's $1.3B lump sum window. But this group set the tone for pension risk transfer activity going back to GM and Verizon completing $33.5B in risk transfers in 2012.

AUTHOR: Joshua Barbash

ABOUT RUSSELL INVESTMENTS

Russell Investments is a global asset manager and one of only a few firms that offers actively managed multi-asset portfolios and services, which include advice, investments and implementation. Russell Investments stands with institutional investors, financial advisors and individuals working with their advisors—using our core capabilities that extend across capital market insights, manager research, asset allocation, portfolio implementation and factor exposures to help investors achieve their desired investment outcomes.

FOR MORE INFORMATION:

Call Russell Investments at **800-426-8506** or visit **russellinvestments.com/institutional**

First used: April 2018 AI-26498-04-21