Conning's Corporate Pension Review – 2020:

The Pandemic Impact

November 2021

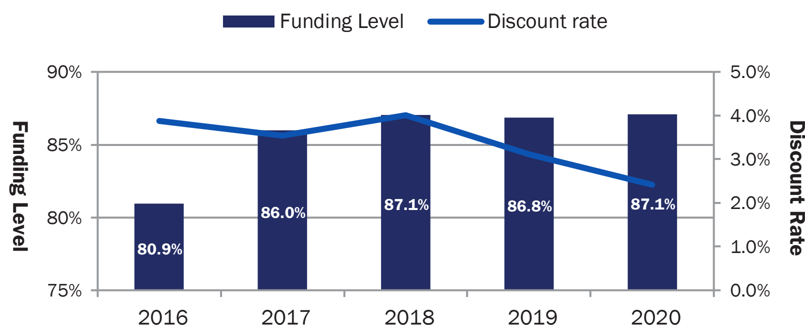
CONNING®

ASSET MANAGEMENT | WHITE PAPER

Conning's Corporate Pension Review 2020 examines the financial health of the U.S. corporate defined benefit (DB) industry through the analysis of 563 U.S. corporate DB plans that provided data from the end of 2016 through the end of 2020. In addition, it examines key issues impacting DB pension plans.

EXECUTIVE SUMMARY

Exhibit 1: Funding Status 2016 – 2020



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- As of September 30, 2021 the average corporate DB pension plan's funded status was 95.5%, an increase from 87.1% at year-end 2020.
- In 2020, DB plan financials were impacted by the Covid-19 pandemic's broader effects on equity markets and interest rates. As the economy stabilized (largely due to coordinated government stimulus globally), those effects have lessened, contributing to the improvement in funding status.
- The improvement in economic conditions and plan funding statuses has contributed to the resumption of pension risk transfer (PRT) business in 2021.

The onset of the Covid-19 global pandemic brought heightened recessionary fears and rattled equity and bond markets across the globe. While the initial spike in both equity and bond market volatility ultimately subsided, volatility remained elevated relative to pre-pandemic historic lows.

In addition to the pandemic's impact on company financials, the response by central banks to reduce interest rates contributed to a decrease in the discount rate used to calculate pension liabilities. The discount rate reduction was the key driver of the increase in pension liabilities. Market conditions were another factor in the reduction of the expected return on assets to their lowest level over the observation period.

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About LDI at Conning

The cornerstone of Conning's LDI philosophy is disciplined pension risk management. We believe that a robust LDI strategy should have a clear understanding of a plan's risk appetite in order to develop a risk budget that reflects the considerations of the plan's stakeholders, anticipated contribution amounts and where the plan may be in its de-risking glidepath. As a result, we believe each plan requires a customized solution that addresses its unique needs.

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Executive Summary (cont'd)

Looking beyond Covid-19's impact, continued increases in Pension Benefit Guaranty Corporation (PBGC) premiums[1] remain a concern for plan sponsors. Similarly, 2020 reminded plan sponsors of the close relationship between equity market volatility and the amount of their unfunded plan liabilities (UFPL). Those issues drive de-risking efforts such as the implementation of liability-driven investing (LDI) strategies, lump-sum payments to qualified members in order to extinguish liability obligations, and potential PRT transactions.

Having slowed during the first half of 2020, PRT transactions have rebounded. Through September 2021, the number of transactions and the dollar amount of liabilities transferred exceeded 2020's total.

Conning's analysis of the financial results for U.S. corporate DB pension plans in our database found that in 2020 their average funded status increased slightly from the prior year. That said, 2020 continued to represent significant progress from 2016's funded status. The progress was due to certain plan sponsors' continued efforts to trade performance for stability, continue plan contributions, and effectively implement LDI-based glidepaths/journey plans.

COVID DISRUPTION

The onset of the Covid-19 global pandemic brought heightened recessionary fears and rattled equity and credit markets across the globe. While the initial spike in volatility in these markets ultimately subsided, volatility remained elevated relative to the historic lows of the pre-pandemic period. It is generally accepted that the full extent of this global crisis is likely to be felt for years. While layoffs and restructuring in corporate America continue to take place even more than a year after the initial outbreak, corporations apparently are stepping up cost-control efforts and reevaluating the workplace going forward.

Pension investors continued to reap the benefits of a strong equity market recovery in the years after the Global Financial Crisis. However, plans that had not de-risked were still impacted by interest rates continuing a downward trend. On the flip side, sponsors that had adopted a strategic glidepath, a phased-in approach to de-risking based on funding level improvements, likely earned increased protection from surplus downside risk. A glidepath typically involves a reduction in the growth portfolio allocation coupled with improving the hedge against a plan's liabilities with the extra dollars allocated to hedging from a growth portfolio, thereby making the funding level less susceptible to interest rate and credit spread volatility. While equity markets have regained strength since the onset of the global pandemic, a perfect storm of falling equities and yields could have easily wiped out any gains enjoyed over the past several years.

Plans that have lost ground in terms of their funding level will expect to receive an increased charge from the PBGC demanding higher (variable rate) premiums. This is in addition to the added pressure of temporary phased-in changes passed by Congress over the last decade to increase and stabilize the funding basis interest rate. Furthermore, plans whose funding levels haven't materially improved and had "kicked the can down the road" by taking advantage of the Coronavirus Aid, Relief, and Economic Security (CARES) Act that allowed 2020 contributions to be deferred to 2021,[2] will likely be looking at a heftier contribution in 2021 to fulfill prior shortfalls. Simultaneously, it is not surprising that certain industries, such as airlines and tourism, will be hit harder with losses pertaining to their corporate operations and little free cash flow to fund any growing pension deficits. With rates lower over the course of 2020, some plan sponsors started evaluating avenues for borrowing to fund their pension deficits and potentially bringing increased stability to the corporation's balance sheet.

In 2021 and beyond, pension plan sponsors will need to navigate these tumultuous times with caution, as they confront recessionary risks, a global economic slowdown, low returns and the potential risk of even lower interest rates/yields. Future actions by corporations to reduce their workforces will likely have a direct impact on projected liabilities and planned contributions. In addition, PBGC premiums could very well be the catalyst for increased PRT activity, driving more plans to undertake lump sum offerings or go to a full termination. Industry data suggests the cost of a buyout has been gradually on the decline, which indicates an increase in competitive buyout pricing via increases in the number of insurers competing for new business and the market's risk appetite for such transactions.

As the economy continues to stabilize and efforts to de-risk come into focus, plan sponsors are likely to increase allocations to fixed income and reduce the size of their growth portfolios. Plan sponsors may in tandem look to the derivatives markets for synthetic exposure to either growth or hedging assets to help free up capital for more efficient use in other parts of their plans' portfolios. Such actions by plan sponsors would lower funding level volatility and downside risks associated with their pension plans but will also have some balance-sheet implications as a consequence of a lower expected return on assets due to lower yields prevalent in fixed income relative to expected growth asset returns. With the pressure on corporations to revive the sustainability of their businesses, it comes as no surprise that pension investors will need to look to derivatives and other cost-effective and creative ways to weather the uncharted waters that lie ahead.

[1] Source: Pension Benefit Guaranty Corporation (PBGC), Premium Rates, last updated Oct. 14, 2021, https://www.pbgc.gov/prac/prem/premium-rates
[2] Source: U.S. Department of the Treasury, Internal Revenue Service, "Coronavirus Relief for Retirement Plans and IRAs," "Information for Plan Sponsors," https://www.irs.gov/newsroom/coronavirus-relief-for-retirement-plans-and-iras#:~:text=The%20CARES%20Act%20provides%20that,accrue%20on%20any%20unpaid%20contribution

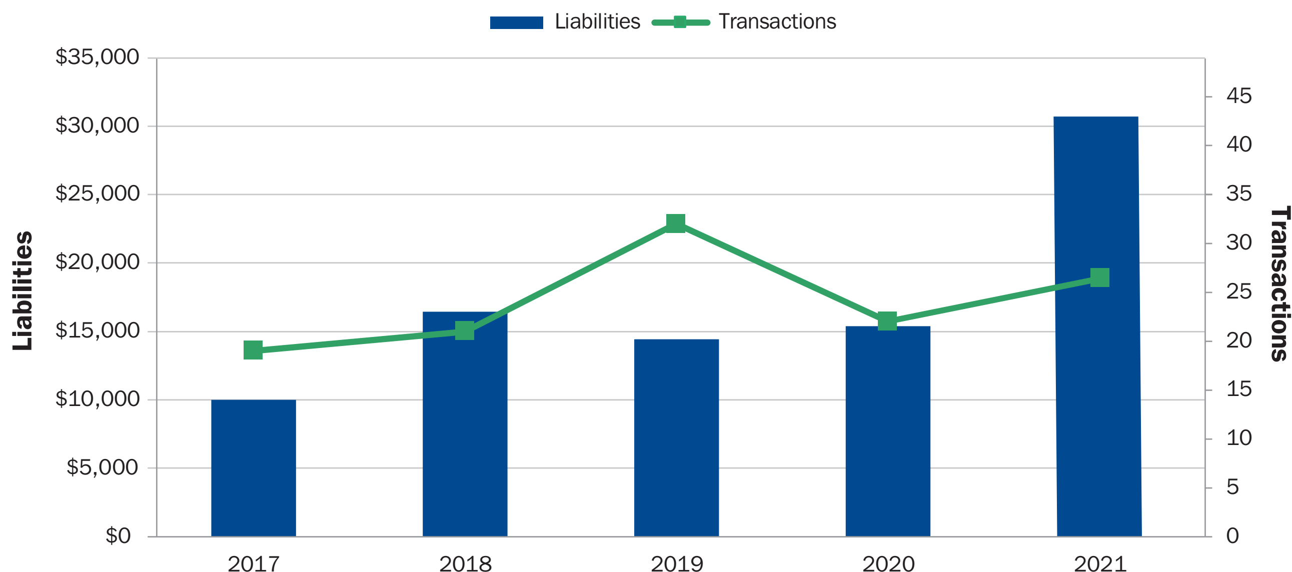
U.S. PRT MARKET RECOVERS MOMENTUM

During 2020, PRTs slowed as insurers became cautious in executing any de-risking moves during the height of the pandemic. As the year progressed and rolled into 2021, the number of PRTs increased. Even with the slowdown, insurers continued to enter the PRT market. Looking at the remainder of 2021 and beyond, plan sponsor interest in de-risking is likely to increase particularly if funding level improvements are maintained or augmented. The future growth of the PRT market appears bright.

Through September 2021, there had been $30.7 billion of U.S. pension liabilities transferred in 27 separate transactions. Both liabilities and transactions through the first nine months of 2021 have exceeded the full-year amounts for 2020. **(See Exhibit 2.)**

Exhibit 2: U.S. PRT Liability Volumes and Transactions

$ in millions, as of September 30, 2021



Prepared by Conning, Inc. Sources: Company press releases

Three factors in driving PRT activity in 2021 are the funding status of DB plans, competitive pricing by insurers of PRTs, and plan sponsors' assumptions about interest rates. In terms of funding status, the strong growth of equity markets in 2020 benefited those plans with significant allocations to equities. Overall, our analysis of the 2020 funding status of 563 U.S. DB plans with five consecutive years of reported plan assets showed that their funding status of 87.1% was slightly higher than 2019's 86.8%.

The other key factor will be the assumptions plan sponsors make on where interest rates are likely headed. The Federal Reserve's continued low interest rate policies have forced downward pressure on yield curves. Those low rates impact DB pension discount rates used to calculate the present value of the liabilities. Plan sponsors will need to assess the future for capital market risks, returns, and asset allocation strategies as they attempt to manage pension plan risks holistically as they relate to their entire enterprise. If they assume that interest rates may remain low, or even decline, then interest in LDI, followed by or in tandem with a lump summing and PRT transaction to remove the liabilities off the corporate balance sheet, may increase.

U.S. CORPORATE DB PLAN FINANCIAL ANALYSIS: 2020

In 2020, the U.S. corporate DB plans in Conning's database saw their funded statuses increase (slightly) from the prior year. That said, 2020 continued to represent significant progress from 2016's funded status levels. This progress was due to plan sponsors' continued efforts to bank good performance for stability, continue plan contributions, and shift assets from equities to fixed income.

Key Findings

- Total funded status increased slightly from 86.8% at the end of 2019 to 87.1% by the end of 2020.
- The average pension discount rate decreased from 3.11% p.a. at end-2019 to 2.42% per annum (p.a.) by end-2020, contributing to a growth in pension liabilities in 2020.
- The 2020 average expected return on assets was 5.08%, a 33-basis-point decrease from 2019 and was the lowest expected return over the analysis period.
- Unfunded pension liabilities (UFPL), which are (positive) differences between liabilities and assets, were a higher percentage of company free cash flow at the end of 2020 compared to year-end 2019 (45.9% compared to 44.3%, respectively) due to the pandemic's impact on company financial results.
- UFPL was a slightly higher percentage of total company equity at the end of 2020 compared to year-end 2019 (4.9% compared to 4.5%, respectively).
- Total UFPL was 5.7% of the total long-term debt inclusive of the pension liabilities at end-2020, compared to 5.5% the previous year.
- At end-2020, fixed income assets were 50.8% of total plan assets, an increase from 49.3% for end-2019. Equities were the second-largest end-2020 allocation at 31.2%, compared to 30.5% at end-2019. The combination of alternative investments, real estate, and cash was third at 18.8% as of end-2020, a decrease from 20.2% as of end-2019.
- Amongst all sectors at the end of 2020, the best-funded pension plans were in the Financial sector (95.8% funded) whereas the Energy sector held the title of worst-funded (79.8%).

Plans' Funded Status Weakens as Liability Growth Outpaces Asset Growth

Plan sponsors are concerned about the impact of UFPL and its variability on company financials. In 2020, plans saw their funded statuses increase (slightly) from the prior year. That said, end-2020 represents significant progress from end-2016 in terms of funded status.

Asset Returns Lower, Plan Contributions Increase

Aggregate plan assets increased 11% in 2020, due to continued contributions by plan sponsors and investment gains. At the end of 2020, pension assets were $1.6 trillion, compared to $1.4 trillion at the end of the prior year. Plan sponsors reported an aggregate $182 billion actual return on assets in 2020, compared to $206 billion in 2019.

While plans of all sizes reported lower actual returns on assets during 2020 versus 2019, the smallest plans with assets of $500 million or less had the biggest year-over-year decrease of 29%. Plans with $10 billion or more in assets reported the lowest year-over-year decrease of 7%.

Plan sponsors increased their plan contributions by 13% in 2020. In 2020, aggregate plan contributions were $36 billion compared to $31 billion the prior year.

Liabilities Increase as Discount Rates Decrease

Aggregate plan liabilities increased 11% in 2020, from $1.6 trillion at the end of 2019 to $1.8 trillion at the end of 2020. That increase was larger among bigger plans over the same period. For example, plans with $10 billion or more in plan assets reported an aggregate 12% increase in pension liabilities, while plans with less than $1 billion but more than $500 million in plan assets reported a 1% increase in pension liabilities over the same period.

This growth in plan liabilities was driven in part by a 69-basis-point decrease in the discount rate used to calculate plan liabilities in 2020. Plans with less than $1 billion but more than $500 million in plan assets had the largest decrease of 81 basis points in the discount rate. While this larger discount rate drop should reflect a proportionate increase in the pension liabilities, it must be noted that the categorization of a plan's asset level category (e.g., $500 million -$1 billion) is determined at the end of 2016 and kept constant for the remaining years thereafter (i.e., for years 2017-2021). Since 2016, the aggregate discount rate of all plans has decreased from 3.87% p.a. to 2.42% p.a.

Funding Status Levels Off, Unfunded Pension Liabilities Decrease

At a cumulative level, in 2020 the plan funded status increased slightly to 87.1%, compared to 86.8% at the end of 2019. Over the period, funded status was at 80.9% at the end of 2016 and increased through end-2020. In dollar terms, UFPL was $293 billion at the end of 2016 and ended 2020 at $233 billion.

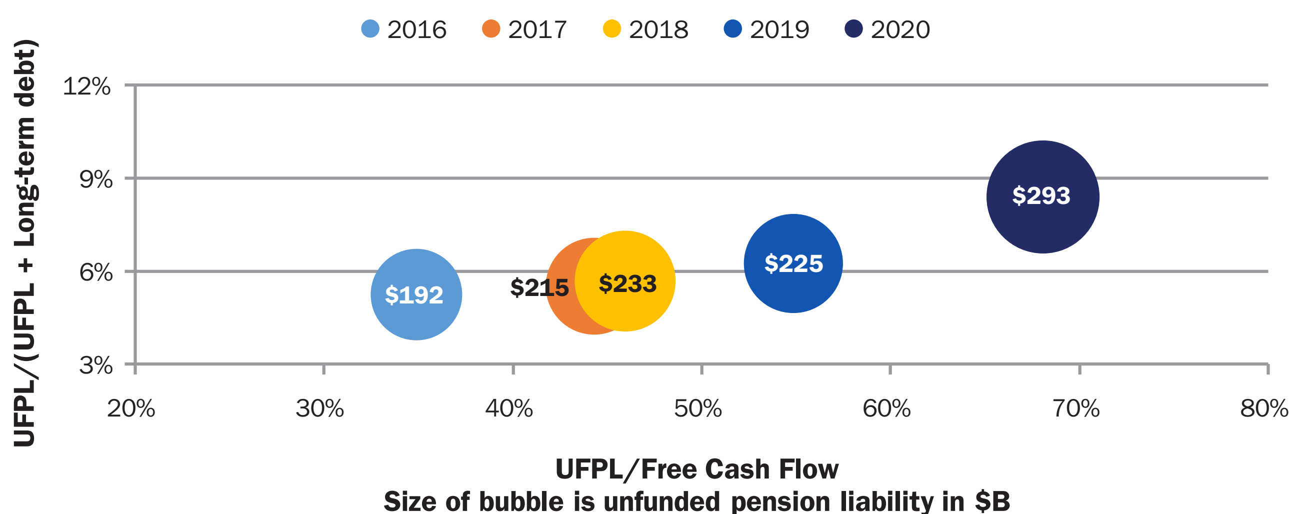
Unfunded Plan Liabilities Remain Significant Percentage of Free Cash Flow and Equity

UFPL is viewed as unsecured senior debt by lenders and rating agencies. A significantly large UFPL figure can lead to credit downgrades and a higher cost of capital. At the same time, the requirement to close the UFPL gap can consume some amount of free cash flow.

Both are reasons for plan sponsors to consider approaches such as LDI strategies that are aimed at reducing UFPL variability. Additional strategies to reduce the amount and variability of UFPL are to improve investment returns, increase plan contributions, or, in coordination with an LDI approach, a combination of all three.

To evaluate the UFPL impact, Conning measures UFPL as a percentage of free cash flow and as a percentage of the sum of UFPL and long-term debt, i.e., total implied long-term financial obligations **(see Exhibit 3)**. At the end of 2020, the $233 billion in UFPL equaled 45.9% of the combined free cash flow. This was higher than the previous year and reflects an increase in free cash flow in 2020 for all plan sponsors except those sponsoring plans with $10 billion or more in plan assets.

Exhibit 3: Unfunded Pension Liability Impact



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As a percentage of combined UFPL and long-term debt, UFPL increased to 6.0% by the end of 2020 from 5.8% at the end of 2019. UFPL increased 8% in 2020 compared to a 5% increase in long-term debt.

Plan Size Impacts Performance

There was a noticeable difference in the funding level changes among different sized plans. Conning categorized the plans in our database into four groups based on plan asset size:

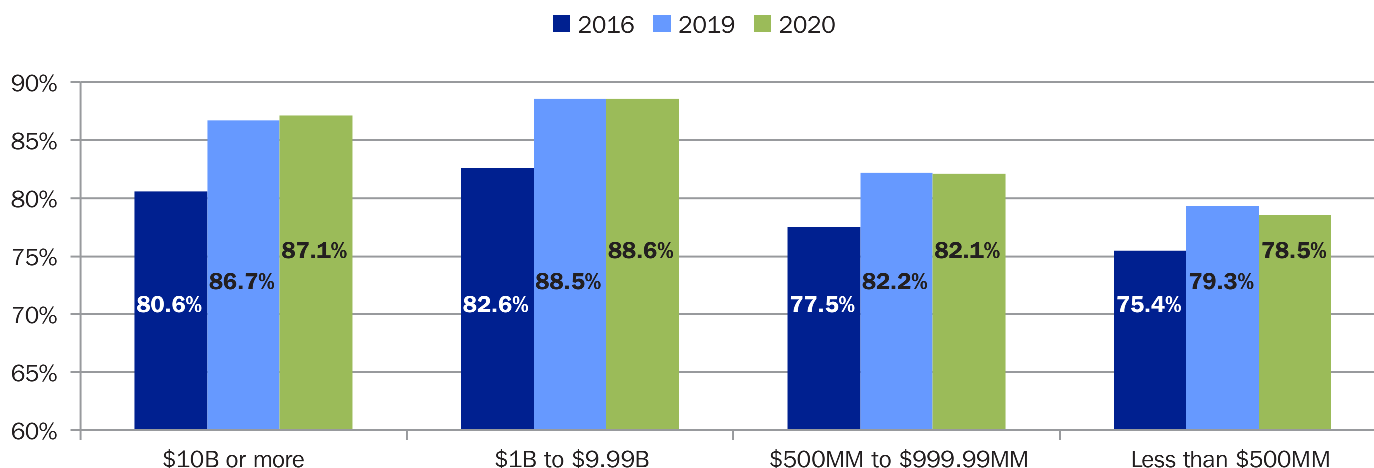
1) $10B or more:	34 plans	3) $500MM – $999.99MM:	84 plans
2) $1B - $9.99B:	164 plans	4) Under $500MM:	279 plans

Funding Status Varies Across All Plan Sizes

As **Exhibit 4** illustrates, two of the four size categories reported slightly lower funded status in 2020 compared to 2019. All categories were above 2016's funding status levels. This change reflects plan sponsor efforts to improve funding status.

Plans with $10 billion or more in assets had an aggregate funding status of 87.1% at the end of 2020, an increase from 86.7% at the end of 2019. Plans with $1 billion to $9.99 billion in assets saw a slight increase to 88.6% over the same period. Plans with $500 million to $999 million in assets experienced a slight decrease in aggregate funded status to 82.1% in 2020. The smallest plans, those with less than $500 million in assets, saw their aggregate funding status decrease to 78.5% over the same period.

Exhibit 4: Funding Status by Plan Asset Size



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Plans with $10 billion or more in assets reported an 11.9% increase in plan liabilities in 2020. Plans with $1 billion to $9.99 billion in assets had an increase of 9.5% over 2019. Plans with $500 million to $999.9 million and those with less than $500 million in assets had increases of 7.3% and 1.1%, respectively **(see Exhibit 5)** over the same period.

Exhibit 5: Plan Liabilities: YOY change 2018 – 2020

	2018	2019	2020
$10B or more	-7.5%	11.4%	11.9%
$1B to $9.99B	-8.4%	9.3%	9.5%
$500MM to $999.99MM	-8.0%	8.0%	7.3%
Less than $500MM	-7.8%	7.1%	1.1%

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One factor contributing to the increase in plan liabilities was the decrease in discount rates used to calculate pension liabilities, as seen in **Exhibit 6**. Over 2020, plans with $10 billion or more in assets reported a 64-basis-point decrease in the average effective liability discount rate. Plans with $1 billion to $9.99 billion reported a 74-basis-point decrease over the same period. Plans with $500 million to $999.99 million in assets had an 81-basis-point decrease, and the smallest plans had a 67-basis-point decrease in their effective liability discount rate over the same period.

Exhibit 6: Average Discount rate (p.a.)

	2018	2019	2020
$10B or more	3.95%	3.00%	2.36%
$1B to $9.99B	4.33%	3.41%	2.67%
$500MM to $999.99MM	4.03%	3.18%	2.37%
Less than $500MM	3.86%	2.98%	2.31%

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The increase in plan liabilities was offset by the increase in plan assets, as shown in **Exhibit 7**. Plans with $10 billion or more in assets reported a 12.1% increase in assets for 2020. Plans with $1 billion to $9.99 billion in assets had an increase of 10.2% over 2020. Plans with $500 million to $999.9 million in assets had a 7.1% increase over the same period. However, those plans with less than $500 million in assets had a 0.6% decrease in plan assets over 2020.

Exhibit 7: Plan Assets: Y-O-Y Change 2018 – 2020

	2018	2019	2020
$10B or more	-6.1%	11.3%	12.1%
$1B to $9.99B	-7.6%	8.7%	10.2%
$500MM to $999.99MM	-8.1%	9.5%	7.1%
Less than $500MM	-6.4%	4.4%	-0.6%

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Regardless of changes to plan assets or liabilities, plan sponsors generally increased plan contributions in 2020 relative to years prior **(see Exhibit 8)**. Plans with $10 billion or more in assets increased plan contributions by 10.8% versus 2019. Plans with $1 billion to $9.99 billion in assets increased their 2020 contributions by 21.5% over 2019. Plans with $500 million to $1 billion decreased their contributions by 9.1%, for the same period and plans with less than $500 million in assets increased their contributions by 15.6% over 2019 levels.

Exhibit 8: Plan Contributions Y-O-Y Change 2018 – 2020

	2018	2019	2020
$10B or more	-2.6%	-43.8%	10.8%
$1B to $9.99B	-14.8%	-37.9%	21.5%
$500MM to $999.99MM	-9.2%	-17.1%	-9.1%
Less than $500MM	5.8%	-41.3%	15.6%

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Given the turmoil caused by Covid-19's impact on financial markets, the challenge for plan sponsors with negatively affected plans will be identifying opportunities to rebuild funding levels and reduce exposure to equity market declines and volatility as the economy stabilizes.

UFPL Impact Mixed on Total Debt and Free Cash Flows

In 2020, the financial impact from the Covid-19 pandemic was most strongly felt among the largest companies that sponsored the largest plans. As seen in **Exhibit 9**, plan sponsors with plans that have $1 billion to $9.99 billion in assets experienced a 5% increase in free cash flow in 2020, compared to 2019. Plan sponsors with plans that have $500 million to $999.99 million in assets had a 73% increase in free cash flows over the same period, which was primarily driven by five companies in our database.

Exhibit 9: Free Cash Flow Y-O-Y Change 2018 – 2020

	2018	2019	2020
$10B or more	28.9%	-2.9%	-13.5%
$1B to $9.99B	-3.3%	20.1%	5.4%
$500MM to $999.99MM	6.0%	-1.9%	72.6%
Less than $500MM	33.8%	-11.7%	23.1%

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Sponsors of the largest plans also took advantage of the prolonged low interest rate environment to increase their long-term corporate debt (issuance) outstanding. **Exhibit 10** shows that sponsors of plans with $10 billion or more in assets increased their long-term corporate debt outstanding by 5% in 2020. Sponsors of plans with $1 billion to $9.99 billion in assets had a 4% increase in long-term corporate debt outstanding over 2020. Sponsors of plans with $500 million to $999.9 million in assets increased their long-term corporate debt outstanding by 14% during 2020. Sponsors of the smallest sized plans increased their long-term corporate debt outstanding in 2020 by 4%.

Exhibit 10: Long-term Corporate Debt Y-O-Y Change 2018 – 2020

	2018	2019	2020
$10B or more	-0.9%	2.4%	4.9%
$1B to $9.99B	6.3%	11.3%	4.4%
$500MM to $999.99MM	5.3%	2.8%	14.5%
Less than $500MM	3.0%	7.1%	3.7%

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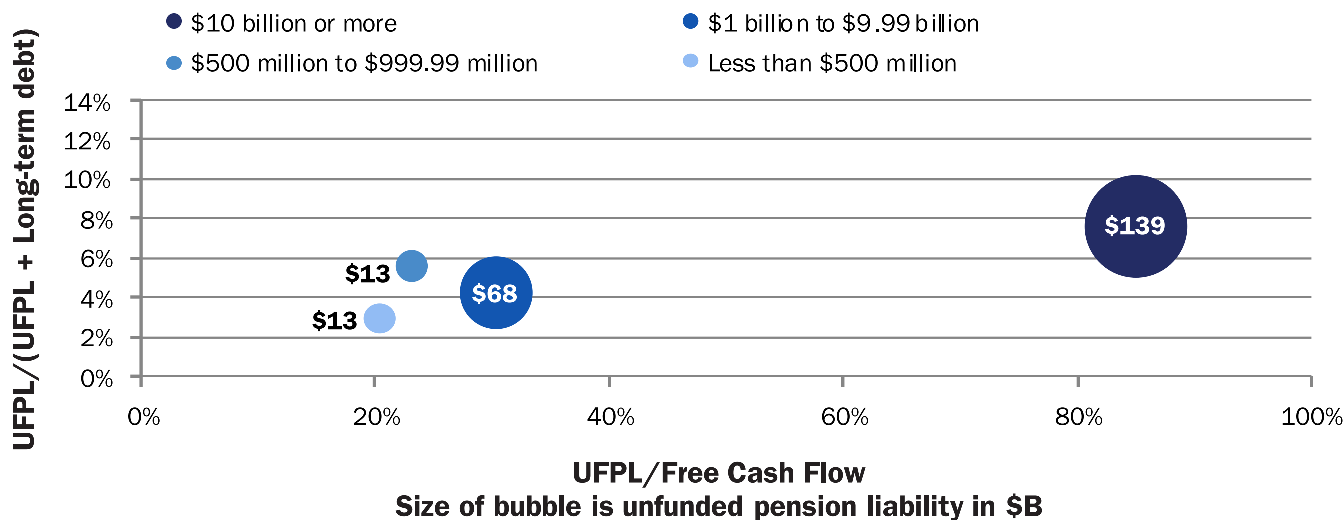
As seen in **Exhibit 11**, the largest plans saw UFPL increase to 85% of free cash flow at the end of 2020. Plans with $1 billion to $9.99 billion in assets saw their UFPL increase to 30% of free cash flow at the end of 2020. The ratio of UFPL to free cash flow for plans with $500 million to $999.99 million in assets increased to 23% at the end of 2020. UFPL was 20% of free cash flows for plans with less than $500 million in assets at the end of 2020.

Exhibit 11: Unfunded Pension Liability Impact by Plan Size – 2020



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For corporations with DB pension plans, these results provide some indication of the volatile impact created by UFPL on key corporate metrics. Reducing that impact is one reason plan sponsors are likely to continue reducing pension plan risk.

Sector Analysis Highlights Variation

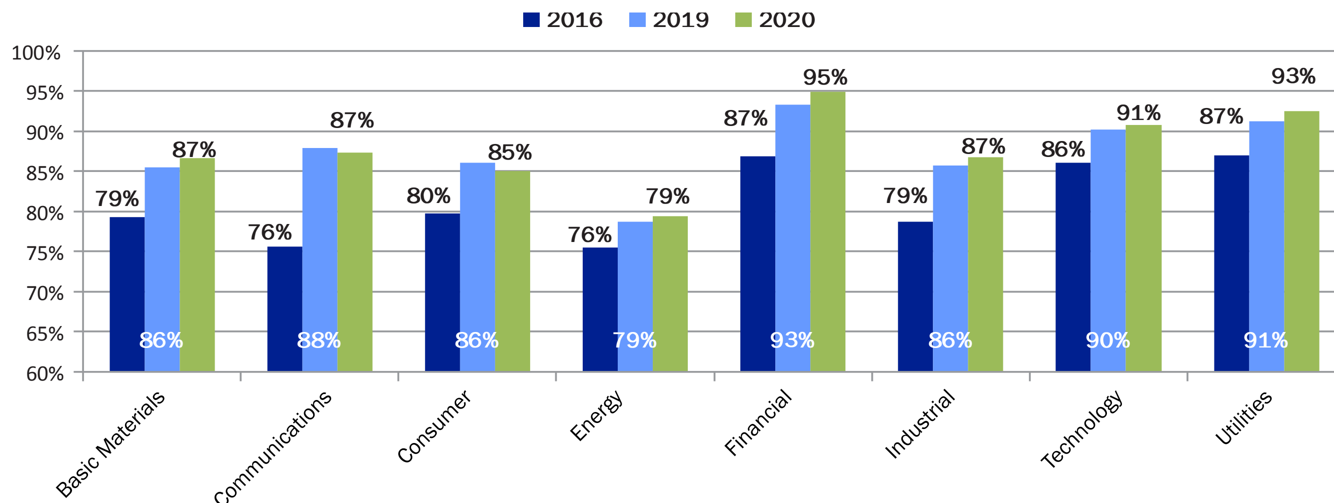
Categorizing plans according to their sponsors' industry sector reveals significant variations in funded status and discount rates. There are eight industry sectors represented among the plans in Conning's database. The number of companies within each sector varies, from 18 in the technology sector to 164 in the consumer sector.

Amongst these sectors, the Industrial and Consumer sectors had the largest share of DB pension assets (28% and 15%, respectively) at the end of 2020. Their dominance likely reflects the presence of large, long-established companies such as GE and Procter & Gamble. Combined, those two sectors represent approximately $773 billion in plan liabilities.

Broad Cross-Sector Improvement in Funding Status

The majority of sectors improved their funding status **(see Exhibit 12)** in 2020. The basic material sector increased its funding status from 86% in 2019 to 87% in 2020. The energy sector increased its funding status to over 79% in 2020. The financial sector increased its funding status to 95% in 2020. The industrial sector increased its funding status from 86% in 2019 to 87% in 2020. The technology sector's funding status increased slightly from 90% in 2019 to 91% in 2020. Utilities increased from 91% in 2019 to 93% in 2020.

Exhibit 12: Funding Level by Sector



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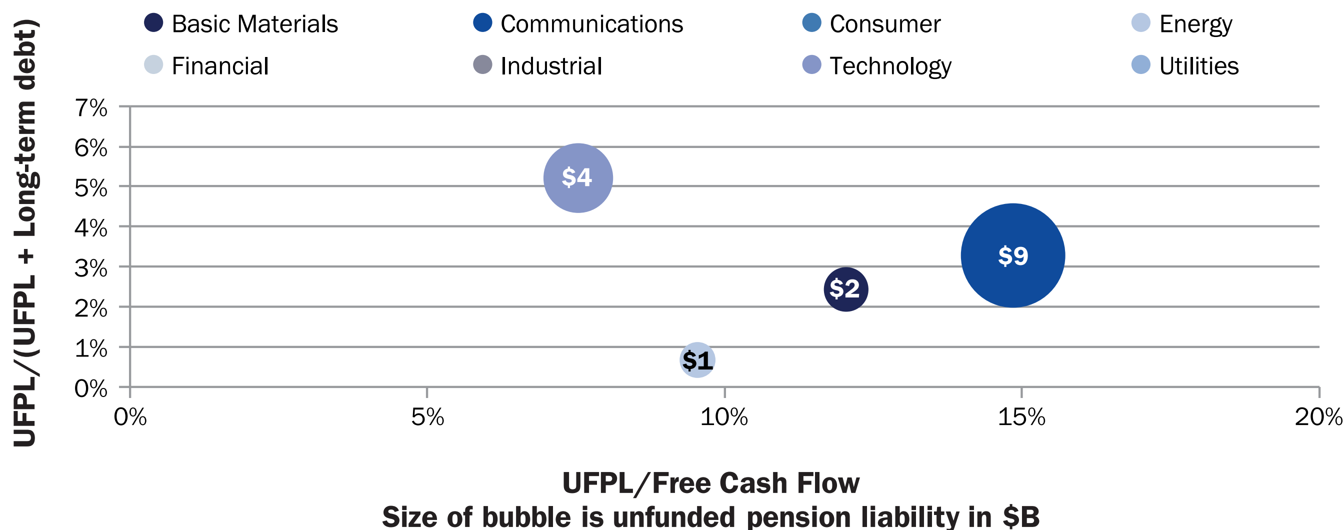
Over a longer period, all industry sectors are well above their 2016 funding status levels.

Average discount rates for the eight sectors decreased in 2020. The average discount rates in 2020 ranged from 2.38% p.a. for plans of sponsors in the technology sector to 2.65% p.a. for the communications sector. Among all the sectors, the financial sector had the largest decrease in discount rates: 57 basis points from the end of 2019 to the end of 2020.

UFPL Impact on Total Debt and Free Cash Flows by Sector

The impact of UFPL on free cash flows by industry sector is illustrated in Exhibit 13. The number of companies within an industry sector amplifies the impact of companies with net losses producing some cases where the UFPL exceeded the sector's free cash flow. As a result, for the sector analysis given, we removed any company reporting negative free cash flow for a given year. This had a significant impact on the Utilities sector, which, prior to the removal of negative-cash-flow companies, on average, reported negative free cash flows in 2020.

Exhibit 13: Unfunded Pension Liability Impact by Plan Sector Adjusted for Negative Free Cash Flows



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Data and Methodology

The data in this annual review was reported in the 10-Ks of 563 publicly traded companies with DB plans. These companies were selected from a broader universe of the Russell 3000 index constituents because they had consistently filed pension data every year for the period of 2016 through 2020. Changes in the year-to-year composition of the companies in our annual review reflect M&A activity as well as incomplete filings for this five-year period.

We categorized these companies based on their plan assets and their business/industry sector. Because companies can change size categories as plan assets increase, our historical plan size analysis is based on the companies' size categories at the end of 2020.

It is also important to note that asset definitions are not uniform. Conning's analysis of companies' financial statements has found that some firms only report individual stocks as equities, while other firms include stock mutual funds. A similar mixing of types occurs in fixed income. In addition, some companies report their assets as "Other" rather than cash, debt, equities, alternatives, or real estate. In this analysis, Conning has adjusted assets reported as Other by the companies on a weighted percentage basis to debt, equities, alternatives, and real estate.

About This Report

Conning's Corporate Pension Review 2020 is a report examining the impact of pension plan funded status on companies' earnings and capital. We further analyze these metrics by plan size and corporate sectors to understand the potential impact of business size and focus.

Our reports study a five-year period of company pension plan data, and our 2020 report database is comprised of 563 company pension plans from the universe of Russell 3000 index constituents that had financial data for 2016 through 2020. Any reference to pension liability values (unless otherwise stated) is assumed to be the U.S. GAAP-based pension valuation.

About Conning

Conning (www.conning.com) is a leading investment management firm with more than $209 billion in global assets under management as of September 30, 2021.* With a long history of serving the insurance industry, Conning supports institutional investors, including insurers and pension plans, with investment solutions, risk modeling software, and industry research. Founded in 1912, Conning has investment centers in Asia, Europe and North America.

*As of September 30, 2021, represents the combined global assets under management for the affiliated firms under Conning Holdings Limited and Cathay Securities Investment Trust Co., Ltd. ("SITE"). SITE reports internally into Conning Asia Pacific Limited, but is a separate legal entity under Cathay Financial Holding Co., Ltd. which is the ultimate controlling parent of all Conning Holdings Limited controlled entities.

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