The Pension Funding Stabilization amendment in the highway bill (Moving Ahead for Progress in the 21st Century (MAP-21) bill (S. 1813)) which was recently passed by Congress will reduce how much cash US corporations are required to contribute to their defined benefit plans in the next few years. According to the actuarial firm Milliman, for purposes of funding rules under the Pension Protections Act (PPA), liabilities will continue to be measured based on a 24-month-average, high-quality corporate bond discount rate but the rate will be adjusted so that it does not fall outside a “corridor” around the average discount rate over the preceding 25 years. The corridor is +/-10% beginning in 2012 then widens to +/-30% by 2016. Because the funding stabilization provision of the bill adjusts the interest rate used to determine pension obligations, it marks a notable change from one of the critical aspects of PPA - that calculated pension obligations closely correlate to current financial market conditions.

The topic of pension fund stabilization has been a key concern of sponsors defined benefit plans and has served as an impetus for pension funding relief since last year when Federal Reserve monetary policy placed downward pressure on long-term interest rates. Heading into 2012, low funding levels were pressuring some plan sponsors from a balance sheet, income statement and cash flow perspective. The decline in funded levels due to historically low interest rates has ramifications for plan sponsors including the recognition of a larger gross pension liability and potential impact to the company financials. The recent legislation by Congress marks the third time in a little over a decade that Congress has acted to amend pension discount rates to provide much needed funding relief. According to Goldman Sachs, these actions could represent a continued trend of providing relief for plan sponsors during times of funding stress, while also raising vital tax revenues by reducing mandatory cash contributions.

The recent bill does provide relief for corporate sponsors who faced significant increases in cash contributions, especially for sponsors with liquidity issues stemming from tighter credit markets. Stable and predictable contribution requirements enable finance officers of defined benefit plans to more efficiently budget cash outlays for their pension plans. The provisions as set forth in the amendment would effectively reduce contribution requirements initially and ultimately increasing them each year until they would exceed the level of contribution requirements call for under current law. According to Milliman, since the interest rates
would be confined for several years, increases and decreases in the market level of interest rates would have little effect on reported funded status and contribution requirements during those years. In addition, plans that would otherwise fall below key funding thresholds will now have more time to improve the funding levels and avoid restrictions on the ability to pay benefits, such as lump sums. Plan sponsors will need to recognize that the relief is only temporary. The corridor will widen each year, ultimately maxing out at 30% of the 25-year average. In addition, as time moves on, the high interest rates of the early part of the 25-year period would fall off and be replaced by the lower interest rates in today’s credit markets. As a result, the rates smoothed over 24 months will like move closer to or within the 25-year corridor over the next few years. By 2016, when the corridor has fully widened to 30%, discount rates used for funding purposes would likely again be akin to interest rates smoothed over 24 months.

The pension funding relief bill does come with some caveats. The legislation only affects ERISA funding requirements not financial reporting. Determination of the discount rate for calculating GAAP funded status that is reported on the balance sheet of a plan sponsor, as well as the amount of pension expense that is to be recognized through the income statement, will be unchanged. GAAP rate is still based upon market interest rates for high-quality, long-term fixed income securities. While Congress passes legislation determining the discount rate for funding purposes, financial reporting discount rates are dictated by regulations set forth by the Financial Accounting Standard Board (FASB). Plan sponsors need to understand that the funding relief could actually hurt reported financial results for those companies that chose to contribute less to its plan as the pension liability recognized on the balance sheet (GAAP purposes) will not decline as much as it would if a higher contribution had been made.

Also serving as a headwind to plan sponsors, the Pension Benefit Guarantee Corporation (PBGC) premiums rise substantially for all plans and underfunded plans, in particular, will incur higher variable-rate premiums. The PBGC flat-rate premiums will increase from $35 to $42 per participant in 2013 and $49 in 2014, and then will be indexed for inflation. Additionally, the PBGC variable-rate premium that is assessed on each $1,000 of unfunded vested benefits will more than double by 2015. From a cost perspective, plan sponsors still have a strong incentive to keep their plans well-funded, which means companies with strong cash flows are likely to contribute more than the minimum required contribution under the bill.

From a risk management perspective, plan sponsors have been motivated to pursue liability-driven investing (LDI) as part of a pension portfolio de-risking initiative. In a risk management framework, LDI attempts to better align plan assets with liabilities so as to minimize funding volatility that is associated with changes in market interest rates. In the near term, the legislation will shift the calculations for funding requirements further away from a market-to-market framework. Despite this implication, from our experience pension accounting tends to influences decisions on actual contribution and asset allocation decisions than the minimum contribution rules. As we noted earlier, under GAAP accounting, pension plan sponsors are still exposed to market interest rate volatility for accounting purposes. In this vein, if the goal of the plan sponsor is to minimize balance sheet and pension expense volatility this will continue to provide an incentive for plan sponsors to maintain and not abandon their LDI objectives regardless of capital market volatility. To avoid higher PBGC premiums associated
with the new relief, we would suggest that plan sponsors confer with their actuary and consider cashing out terminated vested participants to avoid the increase in PBGC premiums and lower administrative costs.

In summation, while the recent legislation provides funding relief for corporate defined benefit plan sponsors facing daunting cash contributions, the relief is not a panacea. While plans that would otherwise fall below key funding thresholds absent funding relief will now have more time to improve funding levels, and avoid restrictions on their ability to pay some accelerated benefit forms. However, the bill does not change the plan sponsor’s underlying obligations and does not eliminate other variable forms of pension expenses. Offsetting lower projected minimum contributions will be the significant increases in PBGC costs. At the end of the day, reduced contributions translate to larger accounting funding deficiencies. Finally, it also remains understood that pension obligations will eventually need to be funded. Today’s funding requirements are reduced they will most likely resurface as higher cash contributions in the foreseeable future.

Sources: Milliman; Goldman Sachs Asset Management; Society of Actuaries; Prudential Retirement and J.P. Morgan

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