

Pension Series

MAPping the Future of Pension Funding

On August 8, President Obama signed the Highway and Transportation Funding Act of 2014 (HATFA-14) into law, thereby temporarily maintaining the solvency of the Highway Trust Fund. Approximately two-thirds of the financing for the law came not from transportation-related sources, but rather from an extension of the relief granted in 2012 to single-employer pension funds under the Moving Ahead for Progress in the 21st Century Act (MAP-21). Overall, while this extended relief can benefit most pension plan sponsors by giving them flexibility around the timing and amount of contributions for the next several years, it may not decrease the total amount of contributions required over the long term. We are quick to remind sponsors that the higher discount rates allowed under this law have a very limited scope and do not change the health of the plan from an economic, accounting, or plan termination perspective.

What Has Changed

As brief background, the Pension Protection Act (PPA) of 2006 established discount rates for valuing a plan's liability based on the 24-month average of segment discount rates or the full yield curve.¹ The 2012 MAP-21 legislation effectively put a floor on the segment discount rates allowed to be used to value a plan's liability for the purposes of determining minimum required contributions. If the 24-month average segment rates under the PPA fall below this floor, the sponsor can use the higher MAP-21 rates. Beginning in plan year 2012, the floor was set at 90% of the 25-year average segment rates, decreasing in annual 5% increments to 70% from 2016 onward. Because higher discount

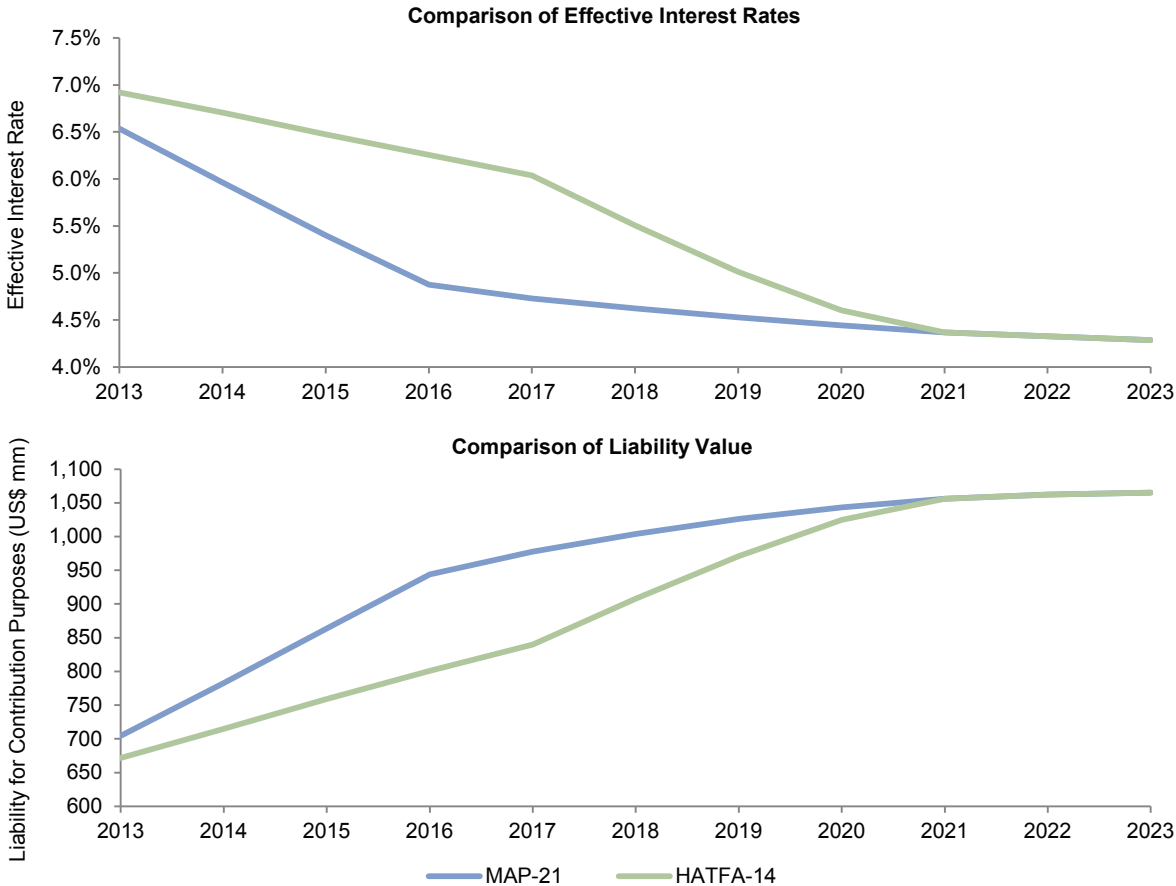
¹ Plan sponsors that maintained the use of the full yield curve were not impacted by MAP-21 rates.

rates result in lower liability values, a plan’s funded status deficit (and therefore its annual minimum required contribution) under the MAP-21 rates was reduced.

HATFA-14 resets the floor at the original 90% of the 25-year average rates for plan years 2013 through 2017, with a decline of 5% per year to a floor of 70% in 2021. The top chart below shows a comparison of the effective interest rate for a hypothetical pension plan² under MAP-21 and the new law, assuming that current segment rates stay flat for the period shown. Based on this assumption, the relief would wear away by 2021. The bottom chart below shows the impact on the liability for contribution purposes for a hypothetical pension plan. The impact of HATFA-14 on the value of the liability relative to MAP-21 is dramatic, with decreases of approximately 5% in 2013 and 10% in 2014, and decreases of up to 15% in 2015, 2016, and 2017.

² Our hypothetical pension plan has a liability duration of 13 years, a normal cost of \$10 million, approximate assets of \$700 million, and approximate market-based liabilities of \$900 million.

Hypothetical Pension Plan Under MAP-21 and HATFA-14: Effective Interest Rates and Liability Value 2013–23





The Path Forward: Considerations

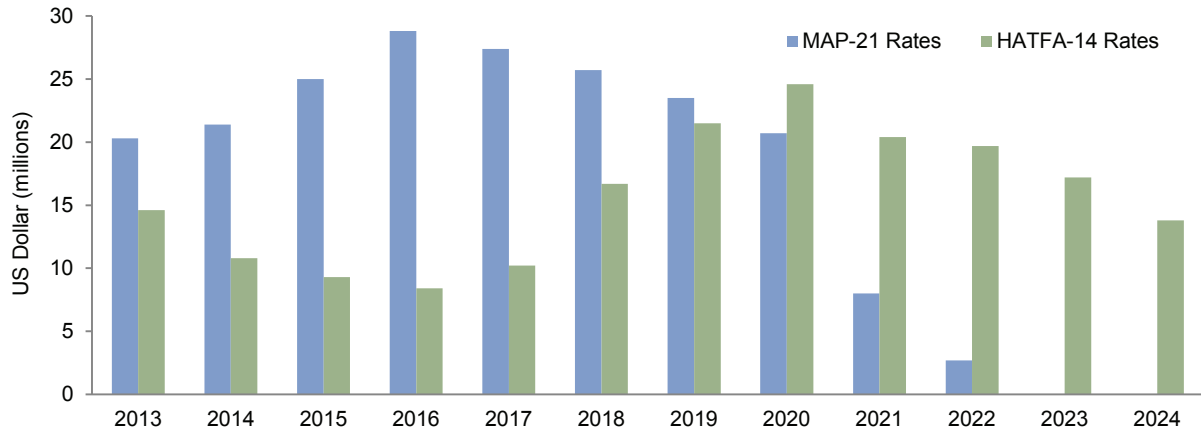
The answer to the question of how, or whether, to change either funding policy or investment strategy in light of the new regulation depends on many factors that are plan-specific. Certain plan sponsors may see an opportunity to assume more risk in the portfolio because the new law creates less chance of experiencing large increases in minimum required contributions. The increase in risk could be assumed via a reduction in fixed income assets or a reduction in the duration of the fixed income assets. While it is impossible to recommend a uniform course of action for all sponsors, we offer **four points of caution** for those considering this strategy.

First, as with MAP-21, the higher segment rates allowable under HATFA-14 apply to the calculation of the liability only for the purposes of determining minimum required contributions for a given plan year. The rates do not apply for accounting purposes or for the valuation of the plan considering a risk transfer or plan termination. Furthermore, the rates do not apply to the payment of lump sums offered to participants as part of ongoing plan provisions, a particular issue for underfunded plans. Therefore, sponsors sensitive to the financial statement impacts of being underfunded or that are seeking to terminate their plan must weigh the near-term consequences of lower contributions.

Second, an underfunded plan must eventually close the shortfall via some combination of contributions or asset returns. Absent a sustained increase in asset returns (and potentially higher surplus risk), lower contributions today generally mean higher contributions in the future. The chart on page 4 shows projected minimum required contributions for a sample plan under MAP-21 and HATFA-14. Assuming annual asset returns of 7.0%, the contribution relief experienced in the early years eventually wears away as the short-term contribution savings are simply deferred to later years, resulting in higher minimum required contributions and delaying the time to get to fully funded. Perhaps surprisingly, under these assumptions, the cumulative amount of contributions under HATFA-14 is only marginally less than those under MAP-21—the primary difference is a shift in the timing of those contributions.

Third, the annual cost of being underfunded has increased dramatically since 2012. MAP-21 included a substantial increase in both fixed-rate (per participant) and variable-rate (per \$1,000 of unfunded vested benefits) Pension Benefit Guaranty Corporation premiums, and these rates were hiked again in December by the Bipartisan Budget Act of 2013. Although HATFA-14 does not include an additional increase, the net result of earlier legislation is a near doubling of fixed rate and a more than tripling of variable-rate premiums by plan year 2017 relative to their pre-MAP-21 values. The higher discount rates allowed under HATFA-14 do not apply when calculating the plan's funded status for the purposes of determining variable-rate premiums. As these costs must be

Hypothetical Pension Plan Under MAP-21 and HATFA-14: Minimum Required Contributions
2013–24



Scenario	2013–24 (US\$ millions)	
	Cumulative Contributions	Present Value of Contributions at 5%
MAP-21	\$204	\$162
HATFA-14	\$187	\$134

paid either through existing assets or from additional contributions, the relief granted from lower required contributions to correct underfunding is partially offset by the higher cost of being underfunded. Plans with a large number of participants and a relatively low funded status may be most sensitive to this effect.

Fourth, how long the relief will last depends on the future path of interest rates, a variable that is notoriously difficult to forecast. If interest rates rise rapidly, the higher HATFA-14 rates could be replaced by the more marked-to-market 24-month PPA rates sooner than expected. For example, if we assume interest rates rise by merely 5 bps each month from June 2014 levels, the funding relief would wear away approximately two years earlier than our assumption in the charts on page 2.

Despite these considerations, most sponsors benefit from the optionality granted on the exact timing and amount of contributions. For example, a plan sponsor with many attractive investment opportunities in a given year might consider a small and temporary reduction in its anticipated plan contributions. On the other hand, some sponsors with hard frozen plans with strong funded status and a goal of terminating the plan may continue to contribute as much as they did even before MAP-21 was passed. A few plan-specific factors that must be taken into account in determining a response to the legislation include the following: the status of the plan (open/soft frozen/hard frozen); the size, age, and funded status of the plan; the sponsor’s sensitivity to contribution levels relative to accounting/economic metrics; and the tolerance for contribution volatility.



The Bottom Line

A plan sponsor's response to the extended funding relief under HATFA-14 depends on many plan-specific factors. Generally, sponsors that are primarily concerned with the level of near-term contributions may benefit from the additional flexibility in contribution timing that the law offers. However, because the new law does not in any way impact financial statements or plan termination considerations, we don't think that it calls for a major change in investment strategy. All sponsors should consider the impact of lower near-term contributions on the long-term ability of their organizations to reach a fully funded plan status and determine how the length of the relief granted fits within the current funding and investment strategy. ■




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Exhibit Notes

All exhibits in this paper examine the impact of MAP-21 and HATFA-14 on a hypothetical pension plan with the following characteristics: a liability duration of 13 years, a normal cost of \$10 million, approximate assets of \$700 million, and approximate market-based liabilities of \$900 million.

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