For your information

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2012 Pension Plan Funding Stabilization Finally a Reality

Pension interest rate stabilization and PBGC premium hikes have been enacted with the 2012 student loan and transportation legislation titled *Moving Ahead for Progress in the 21st Century (MAP-21)* signed today by President Obama. The interest stabilization changes apply to ERISA single-employer plans that base liability calculations on PPA segment rates and are predicted to trim 2012 contribution requirements by 15% to 25% or more for typical plans.

Background

Section 412 of the Internal Revenue Code (Code) and Section 302 of the Employee Retirement Income Security Act (ERISA) set minimum funding standards that single-employer defined benefit plans subject to ERISA must satisfy. These standards were radically changed by the Pension Protection Act of 2006 (PPA). Key changes included a shortened period for amortizing funding shortfalls and specified interest rates based on corporate bond yields for valuing liabilities. The economic recession that developed shortly after PPA went into effect pushed interest rates and asset returns down and the resulting plan liabilities—and contribution requirements—up. Employers sought relief from Congress to address the expectation that the economy would improve and interest rates would soon rise to a more normal level.

Congress responded with the Pension Relief Act of 2010 (PRA). Under PRA, employers could choose between two amortization-extension options for reducing current cash contribution commitments to their plans. Details on the relief provided in 2010 are explained in our June 28, 2010 For Your Information. The opportunity to select one of the relief options in PRA expired at the end of the 2011 plan year.

Because interest rates remain historically low at least in part due to government efforts to stimulate the economy, employers returned to the Hill to ask for additional measures to stabilize their contribution requirements and allow corporate funds to instead be used to expand operations and reduce unemployment.

Congress Delivers 2012 Pension Relief Act

In MAP-21, Congress responded to employers with new funding relief in the form of interest rate stabilization, but also dished out Pension Benefit Guaranty Corporation (PBGC) premium hikes. Because reduced employer contributions to pension plans reduce the tax deduction claimed by employers, funding relief is scored for U.S. budget purposes as a “revenue raiser.” The revenue from

funding relief will help pay for a temporary extension of the Stafford student loan interest rate reduction as well as the cost of the MAP-21 transportation changes.

What Funding Changes Are in the New Law for Single-Employer Plans?

Currently, minimum funding liabilities are calculated using one of two approaches to determine the present value of future pension plan payments. The first approach is to discount future expected payments using a “yield curve” of corporate investment-grade bond data published by the U.S. Treasury for the preceding month; the second approach is to use three “segment rates” that are determined using averages from the most recent 24 monthly yield curves. Thus, either method uses interest rates drawn solely from the recent interest rate environment.

Segment rates. MAP-21 takes aim at liability calculations that use segment rates. Instead of using the two-year average of corporate bond rates to determine pension liabilities, the law stabilizes the segment rates by adding a cap and a floor for the current year’s rate. For 2012 plan years, the cap is set at 110% and the floor at 90% of the 25-year average of each segment rate calculated as of September 30, 2011. These percentages change over subsequent years as follows.

For plan years beginning in this calendar year	Use the 25-year average for the period ending	Use this minimum percentage	Use this maximum percentage
2012	September 30, 2011	90%	110%
2013	September 30, 2012	85%	115%
2014	September 30, 2013	80%	120%
2015	September 30, 2014	75%	125%
After 2015	September 30 of prior year	70%	130%

Under PPA plan sponsors may have elected to “look back” up to four months prior to the beginning of the plan year for the segment rates to be used. That election remains in place; however, all plan years that begin in a given calendar year use the same minimum and maximum segment rates, without regard to the day of the year that the plan year begins or to the lookback election.

Stabilization effect on liabilities. The adjustments described above are expected to increase the 2012 effective interest rate for most plans by 140 to 170 basis points. Higher interest rates translate to lower present values of future benefit obligations; in minimum funding terms this means a lower Funding Target and Target Normal Cost. The decrease in liabilities for a particular plan will depend on that plan’s projected cash flow, with the greatest reduction produced for plans with shorter- rather than longer-term benefit payment obligations. A typical plan might see a 15% reduction in target funding liability and a 15% to 25% or greater reduction in contributions required for the 2012 plan year, depending on the plan’s funding level and benefit design.

For ensuing years, because interest rates have been falling more or less continuously for the last 30 years, the 25-year average of segment rates will trend downward. This will be exacerbated by the

widening spread between the minimum and maximum percentages in the table above. For example, consider a current 24-month average of 2% and a 25-year average of 4% for 2012 for the first segment rate. MAP-21 sets a minimum of 3.6% (90% of 4%) so that 2012 liabilities for this segment are determined using 3.6% interest instead of 2%. For 2013, the 25-year average is expected to be somewhat smaller and the minimum will be determined by a factor of 85%. If the 25-year average were to drop from 4% to 3.8%, for example, the stabilized interest rate would be 3.23% (85% of 3.8%).

Stabilization effect on shortfall amortization. In addition to their role in determining plan liabilities for minimum funding purposes, the segment rates, and now the stabilized segment rates, are used to determine the amortization charge that pays off unfunded liabilities. Much like a home mortgage, a higher interest rate translates to higher amortization charges, so the new law suppresses liabilities but increases the rate of the payoff of any unfunded pension obligation. Nevertheless, for most plans the net effect will be a significant reduction in contributions for plan years beginning in 2012 and for two or three years beyond.

Will the Stabilized Rates Be Used for Other Purposes?

The segment rate change applies for determining the minimum required contribution and the Adjusted Funding Target Attainment Percentage (AFTAP) certification that controls the application of benefit restrictions under Code Section 436. MAP-21 specifies that the change does not apply for these purposes:

- Code Section 417 (minimum benefits such as lump sum cash-outs and relative value illustrations)
- Maximum benefits under Code Section 415 (because of their reference to the Section 417 rate)
- Deductible contributions under Code Section 404
- Excess pension assets described in Code Section 420
- PBGC variable-rate premiums
- ERISA 4010 reporting to the PBGC

It appears the stabilized rates will also apply for various rules that cross-reference segment rates, such as the hybrid plan interest-crediting rate third-segment rate safe harbor, but confirmation and details about these referenced purposes will require IRS guidance.

How Soon Can the Stabilized Rates Be Used?

Plan sponsors can choose to use the stabilized segment rates starting with plan years beginning on or after January 1, 2012 or January 1, 2013. Plan sponsors can also choose to start using the stabilized segment rates for funding purposes for 2012 plan years but delay using them until 2013 plan years for purposes of the benefit restrictions in Code Section 436. MAP-21 does not offer the option to use the stabilized rates for 2012 benefit restrictions but delay using them for funding purposes to 2013.

Notwithstanding the MAP-21 option of implementing the stabilized rates for 2012, keep in mind that the initial 25-year period used to set the minimum and maximum for 2012 includes segment rates for the period from October 1, 1986. Because data on pre-October 2003 corporate bond spot rates is not currently available, the effect of the new law on segment rates will not be entirely clear until Treasury announces how it will construct data for this purpose.

For plans that opt to value liabilities using the full yield curve, there is no adjustment to their interest rates. Only the segment rates are modified by MAP-21. Plan sponsors considering a switch to segment rates to take advantage of the lower minimum funding requirements that the new law would produce will be happy to hear that MAP-21 includes permission to change from using the full yield curve to the stabilized segment rates without the need for IRS approval.

When Should the Stabilized Rates Be Used for Benefit Restrictions?

Lower interest rates have meant that more plans have dropped below either the 80% or 60% thresholds that are meaningful under the Code Section 436 benefit restrictions. But while plan sponsors may be eager to improve the funding picture for this purpose so that plan participants can have access to the benefits and distribution options that are intended to be provided under their plans, they need to carefully consider how a change implemented for their 2012 plan year could affect benefits that were already communicated or distributed.

For example. Consider a calendar year plan whose AFTAP for 2011 was 83%. Under the presumption rules, this is reduced to 73% as of April 1, 2012. The actual old-law AFTAP was certified as 79% and there were no credit balances to waive to get this figure to 80%. Participants were told the usual lump sum distribution option would be limited as of April 1. Under MAP-21, the 2012 AFTAP is 84%. If the plan sponsor “elects” to implement MAP-21 for benefit restriction purposes for 2012, it appears that all benefits processed from April forward have to be revisited, as opposed to just implementing the change for the future.

MAP-21 does not explicitly say that the new AFTAP certification can be limited to prospective application in 2012. Plan sponsors would need authorization from the IRS to base distributions early in the year on the original certification, with distributions after a revised certification is done determined on the basis of that new certification. It remains to be seen if, and how quickly, the IRS will provide guidance on how this would work.

MAP-21 does offer the option of delaying the use of the stabilized rates for benefit restriction purposes until the plan year beginning in 2013, as noted above. This should allow plan administration to continue as planned for the 2012 plan year based on pre-law-change AFTAP certifications. One downside to be considered, however, is that the delay will not only affect 2012 administration, but also affect the presumptions that will apply in 2013 up until an AFTAP certification can be made for 2013 based on the stabilized rates. However, it is possible that future guidance from IRS may permit the use of a 2012 AFTAP based on stabilized rates for 2013 presumption purposes even though it is not used for 2012 restrictions.

The choice is described in MAP-21 as an "election," but it is not clear whether the election is made in the form of an amendment, when that amendment would need to be adopted, or whether that amendment is exempt from the Code Section 436(c) requirement, that is, the requirement to determine that the cost of the amendment will not inappropriately reduce the AFTAP or meet employer contribution requirements to fund the amendment before it can go into effect.

New Disclosure Requirements for Some Employers

Additional disclosures about the effect of the stabilized rates on minimum funding requirements and on plan funding percentages will be required in the Annual Funding Notice provided to participants in some plans for plan years beginning in 2012, 2013, and 2014. A plan administrator must provide additional information if:

- The plan covered 50 or more participants on any day of the preceding plan year.
- The stabilized Funding Target is less than 95% of the regular Funding Target.
- The funding shortfall without stabilization is $500,000 or more.

If all three conditions are met, the Annual Funding Notice must include a statement that the law modified the determination of present values by adding 25-year averaging of interest rates in addition to two-year averaging and that the change may result in smaller employer contributions when interest rates are at historic lows. The notice also must include a table showing the old- and the new-law funding target attainment percentage, funding shortfall, and minimum contribution side by side for the year and each of the two preceding years. New-law values for years prior to 2012 are not required.

The new law requires the Department of Labor to update the model Annual Funding Notice to include this additional information in a prominent manner, such as on a separate first page before the remainder of the notice.

PBGC Premiums and New Governance Rules

The good news on funding relief is counterbalanced somewhat by disappointing news about PBGC premiums. The new law boosts the current single-employer $35 per participant cost to $42 for 2013 and $49 beginning in 2014, with indexing thereafter. In addition, variable rate premiums will be indexed to reflect inflation and will escalate to at least $13 per $1,000 of underfunding for 2014, and then to at least $18 for 2015. The exact figures will depend on the intervening inflation adjustments. However, a new cap will limit the per participant variable rate premium to $400 starting in 2013; this figure will be adjusted for inflation after 2013.

Flat-rate premiums for multiemployer plans will increase from $9 per participant to $12 for 2013, and will be adjusted for inflation in subsequent years.

Governance. PBGC had been lobbying for legislation that would give it control over premium rates without the need for Congressional action. MAP-21 does *not* include that change. However, it does

include a number of changes to PBGC's governance. MAP-21 clarifies various requirements for board of directors meetings and personnel, sets a five-year limit on the term of the PBGC's director, and requires a study to develop recommendations for the board and board policies.

MAP-21 also establishes a new Participant and Plan Sponsor Advocate to act as a liaison between the PBGC and participants in terminated pension plans to ensure that participants receive everything to which they are entitled under the law. The Advocate will also help plan sponsors resolve disputes with the PBGC.

Finally, MAP-21 requires that the PBGC contract with an outside agency to conduct an annual review of its pension insurance modeling systems, and that the PBGC develop internal quality review procedures.

An Extension and a New Option for Excess-Assets Transfers

Plans with assets in excess of 125% of the sum of the plan's funding target and target normal cost for the plan year can use those excess assets to fund current year retiree medical benefits under the qualified transfer rules in Code Section 420. In some cases, transfers to cover future-year costs and benefits provided under a collective bargaining agreement are also permitted. These options were set to expire after 2013.

MAP-21 extends the availability of these options through December 31, 2021 and adds the option of using transfers to fund retiree group-term life insurance. The assets transferred for the purchase of group-term life insurance must be maintained in a separate account within the plan, apart from both the assets in the retiree medical account and the other assets in the defined benefit plan. Various limits on transfer frequency and maintenance-of-effort requirements are applied separately to the retiree medical and the retiree group-term life benefits. Generally, only group-term life insurance not in excess of $50,000 may be purchased with the transferred assets.

As noted previously, the modifications to stabilize segment rates are not applicable in determining whether the 125% excess asset threshold is reached.

In Closing

MAP-21 is good news for employers eager to divert corporate dollars to expand operations and create jobs. Employers should keep in mind, however, that the ultimate cost of a plan is the amount of the benefits it pays. If future investment results do not generate sufficient dollars to pay for benefits, there will be greater demands for further employer contributions to the plan. Some employers may want to consider a middle ground of currently contributing above the new minimum set by MAP-21.

Reference: Excerpts from the Conference Committee Explanation

Buck Can Help

- Determine whether stabilized rates should be implemented initially for 2012 or 2013 for funding purposes—which calls for considering the cost of modifying previously completed valuation work and the effect on quarterly contribution choices
- Determine whether stabilized rates should be implemented initially for 2012 or 2013 for benefit restriction purposes—which calls for an examination of how 2012 administration and presumptions for 2013 will be changed
- For well-funded plans, determine whether transfers to fund retiree medical or term life insurance benefits are an attractive use of excess pension assets

This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.
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