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Reality check — mortality improvements and volatile investment returns

Whether considering the cost of pensions and other retirement benefits or the income that a defined contribution plan can deliver from an accumulated account balance, mortality rates and investment returns are two key components for assessing results. Pressures from competing interests are afoot for both; actual changes to the values used for varying purposes will come piecemeal, or not at all.

Background

Consider these recent developments:

- A multi-year study by the Society of Actuaries (SOA) has culminated in the production of an exposure draft offering updated mortality tables to reflect recent improvements in longevity.
- Last week, the Senate passed up an opportunity to extend unemployment benefits paid for by an extension of the 90 to 110% MAP-21 interest rate corridor, but action in the near future on MAP-21 is likely. (See our February 7, 2014 *Legislate*.)
- Late last month, FASB decided not to add new pension accounting projects to its workload despite a congressional request to consider changing accounting measurements to use a long-term average discount rate similar to what was provided in MAP-21. (See our January 30, 2014 *For your information*.)
- Bright investment returns for 2013, albeit suppressed a bit by early 2014 results, have improved defined contribution and defined benefit plan funding status. Defined contribution plans can deliver better individual retirement results and defined benefit plans are closer to their "end game."

Updated mortality tables that reflect longer life expectancies will translate into increased retirement plan contribution obligations for employers, larger liability values for accounting statements, and larger lump sum payments. In the case of defined contribution plans, longer life expectancies will translate into smaller monthly checks from annuity products or draw-downs aimed at stretching out payments for a longer retirement period. Don't blame the tables — they merely help to create a more accurate picture of reality. In the end, it is the actual amount of benefits paid out that determines the cost of any retirement plan.

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Similarly, actual investment returns, along with actual benefits paid, determine the contribution obligation of a defined benefit plan sponsor. Segment rates, stabilized segment rates, or selected discount rates merely assign the overall plan cost to specific time periods. Plan option rates (including minimum distribution segment rates) set actual plan benefits; these stated rates do have an actual effect on benefits.

Draft SOA mortality table changes

On February 4, the Society of Actuaries RPEC (Retirement Plans Experience Committee) released an exposure draft revealing the results of their multi-year mortality study of participants in uninsured pension plans in the United States. There was also a companion exposure draft of mortality improvement (e.g., how fast these rates are changing). The tables produced by this study are expected to become the basis for mortality assumptions used in future pension funding valuations, accounting measurements, and defined benefit plan lump sums.

Did Buck Consultants have a hand in developing these tables?

Indeed, Buck actuary, Andrew Eisner is a member of the RPEC committee responsible for this project.

The cost impact of these proposed tables will be significant. The tables show that people are living longer, especially at older ages. The improved longevity applies for both males and females, but female longevity is increasing more than males. It is estimated that many plans will see liabilities increase 6 to 8%, or 8 to 10% if not currently using generational mortality. The increase may also be larger still for plans that have a COLA feature or for retiree medical plans where benefits increase by health care trend. The actual impact on a particular plan will depend on the plan's demographics and features.

Lump sums will increase similarly once this new mortality becomes required for cashout calculations. And with continually improving mortality (independently determined by insurers using their own experience studies) annuities will cost more, thus increasing the cost to close out a plan and reducing the monthly benefit purchased with a defined contribution account.

The proposed RP-2014 table is recommended to replace RP-2000 and earlier tables; the proposed MP-2014 projection scale is recommended to replace Scales AA, BB, and BB-2D. There is also a new table for disabled life mortality, and separate mortality tables for white collar and blue collar participants. Finally, the study even published mortality rates for participants in the top and bottom quartiles by pay (pre-retirement) and by benefit amount (post-retirement) to allow users to see the variability of the rates by income.

When will these tables apply?

We anticipate changes to be effective for accounting purposes starting as soon as year-end 2014. We do not expect IRS or PBGC to implement the changes for minimum funding, AFTAP certifications, deductions, variable rate premiums, plan termination calculations, or plan document purposes any sooner than 2016. RP-2014 may not be appropriate for valuing public plans, which have markedly different mortality experience than private plans. Large public plans are likely to continue to use mortality assumptions based on their own experience.

Why did the SOA do this study?

The study was performed because pension actuaries need to have a variety of up-to-date mortality tables available to accurately measure pension and other postretirement benefit obligations. In addition, an important motivation was the requirement under the Pension Protection Act minimum funding rules that the Secretary of the Treasury review at least every 10 years "applicable mortality rates" for various qualified plan funding requirements.

Do we expect changes in response to comments?

We think it is unlikely the tables themselves will change at all. It's possible that the top-and-bottom quartile tables will be removed, to prevent possible misunderstanding that they are suitable for actual plan valuation, and replaced by general descriptions of the mortality impact of being in the top or bottom income quartile.

Extended interest rate relief

In addition to the increase in liabilities from longevity improvements, the continued depressed interest rate environment — reflected in the mandated yield curve/segment rate interest assumptions used by ERISA single employer plans — is pushing costs higher than more normal interest rate scenarios would call for. In MAP-21 (see our July 6, 2012 *For your information*), Congress addressed this situation with 25-year averaging of the segment rates that employers use for determining plan liabilities for minimum funding purposes. In addition, the 25-year average segment rates are constrained within a 90 to 110% corridor. The result for 2012 was that plans used 90% of the 25-year average because the resulting interest rates were higher than the regular segment rates. For later years, the 90% decreases by 5% per year, until 2016 when it reaches and remains at 70%. This gradual reduction in the amount of the 25-year averages generally limits the beneficial impact of the averaging and corridor to the 2012, 2013, and 2014 plan years.

Some plan sponsors have asked Congress to apply the 90 to 110% corridor beyond just 2012. Because such an extension would raise federal revenue (by depressing corporate deductions), it is widely believed that Congress will indeed extend the corridor to pay for some other promise. Most recently it was considered in connection with a failed bid to extend unemployment benefits; next it could be to pay for restoring military pension COLAs, or any number of other wish list items.

Will these higher interest rates offset the longevity improvements?

For many plan sponsors, the proposed MAP-21 extension would largely offset the mortality change for funding in 2016. But artificial restraints won't apply for all valuation purposes. As noted above, FASB rebuffed a Congressional request to consider changing accounting measurements to use a long-term average discount rate similar to what was provided in MAP-21. For accounting purposes, auditors will continue to look to current bond yields to set discount rates used for valuing plan liabilities.

Real returns — real costs

But those great 2013 market returns count for something, right? Yes, indeed they do! Just as the cost of a plan is based on the actual benefits provided, the employer's contribution obligation is reduced by real gains produced by the plan's investments. Great returns in 2013 help narrow the gap between plan assets and liabilities, producing a real reduction in unfunded liabilities. For employers seeking to exit the defined benefit plan market, narrowing the gap brings them closer to the point where assets are sufficient to close out the plan with lump sum payments and annuity purchases. However, once the new SOA mortality tables are in place, that gap will widen again.

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In closing

Without a doubt, your plan population is living longer and the cost of defined benefits will increase over time accordingly. With SOA's exposure of updated mortality tables likely to increase ERISA minimum funding costs for 2016, and sooner for financial statements, plan sponsors may wish to evaluate methods of smoothing costs with their actuaries. With significant asset gains from 2013 blunting the cost of longevity gains, 2014 might be a good year to increase your funding commitment to smooth the transition with near-term increases to avoid a cliff later on.

Defined contribution plan populations are living just as long and plan sponsors and fiduciaries may wish to emphasize this in plan communication materials and modeling so participants are aware of the need to save more than ever and carefully consider their spend-down options.

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