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For Your Information®

Volume 38 | Issue 170 | December 24, 2015

Increase in Fed Interest Rates Affects Defined Contribution Plans

On December 16, the Federal Open Market Committee increased the target range for the federal funds rate from 0.00%-0.25% to 0.25%-0.50%. Federal Reserve officials also announced plans, subject to the performance of the economy, to gradually increase rates further. Plan sponsors should be aware of the impact of the rate change on defined contribution plans.

Background

Since the financial crisis of 2008, the Federal Open Market Committee — a panel of Federal Reserve Board officials responsible for determining monetary policy — has suppressed the federal funds rate to near zero. (The federal funds rate is the interest rate at which banks make overnight loans to other banks and influences the interest rate charged for various types of loans.) This has lowered the yields earned on all manner of “fixed” investment options.

This month, the committee increased the target range for the federal funds rate for the first time since 2008. Our December 17, 2015 *For Your Information* discussed the impact of the committee’s decision on defined benefit and OPEB plan accounting determinations.

Effect on Interest Rates for New Participant Loans

The most direct impact of the committee’s actions for defined contribution (DC) plans is on the interest rates that plans must charge for participant loans.

For DC plans subject to ERISA, loans to plan participants are generally considered a prohibited transaction unless certain DOL exemption requirements are met. One of the requirements of the participant loan exemption is that plans must charge a “commercially reasonable” rate of interest. However, the DOL has neither defined a specific benchmark on which to base the loan interest rate nor has it prescribed how often the plan’s loan interest rates must be reset. It is the obligation of the plan administrator (or other person delegated the task) to ensure that the loan interest rates being charged are commensurate with the interest rates charged by those in the business of lending money for loans that would be made under similar circumstances.

Many DC plans tie the interest rate on loans to the U.S. prime interest rate as published in the *Wall Street Journal* as of a specific date within the most recent calendar month or quarter. The prime interest rate is the rate that banks charge their most credit worthy customers, and changes in the prime interest rate are largely determined by changes in the federal funds rate. And so, with the committee's announcement, major money center banks, such as JP Morgan Chase, Citibank and Bank of America, have increased their prime interest rate from 3.25% to 3.50%.

Given the committee's actions, all plan sponsors should ensure that the interest rate charged on new plan loans is updated in accordance with the rules stated in their plan documents and/or loan rules — just as they adjusted the rates downward when the rates were trending lower.

Effect on Plan Investment Funds

The impact of rising short-term interest rates on the financial markets is less certain.

One benefit for plan participants is that the average annual returns of Money Market Funds — now close to 0.00% in many cases — are predicted to rise in sync with the committee's rate increase. However, in some cases, Money Market funds have been waiving expenses to avoid negative returns for investors, so that the interest rate increase may be swallowed up (at least in part) by investment management fees that were previously waived.

Whether the historically low returns now offered by other capital preservation options used in DC Plans (e.g., Stable Value Funds, Fixed Accounts, or Guaranteed Investment Contracts) will rise as well is not yet clear because rates paid by these funds are more likely to be tied to intermediate-term bond yields. Intermediate-term bond yields are only indirectly affected by the federal funds rate. So far, no clear pattern has emerged on whether intermediate-term bond yields will float up in reaction to the committee's actions.

DC plan sponsors may want to verify that their plan administrators have fully implemented any "competing investment" restrictions on transfers from their plan's stable value option. These restrictions (also known as "equity wash restrictions") limit the ability of participants to directly or indirectly transfer balances from stable value funds to other money market/fixed income funds within the plan's investment lineup. These types of limitations are imposed by stable value fund providers who guarantee payment of all fund withdrawals at book value. Since rates paid by stable value options have consistently exceeded money market rates in recent years, there has been little reason for participants to undertake such a trade. However, at some point in the future, short-term rate increases could cause Money Market Funds yields to overtake those of Stable Value Funds, so there will be more focus on plan sponsors to enforce these provisions.

The committee's actions may indicate some turmoil ahead in the financial markets after years of relative stability since the 2008 financial crisis. This may be another good opportunity to remind participants to maintain a long-term perspective rather than reacting to short-term market volatility.

In Closing

We'll be watching how the markets react and will update you about any significant developments.

Volume 38 | Issue 170 | December 24, 2015

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