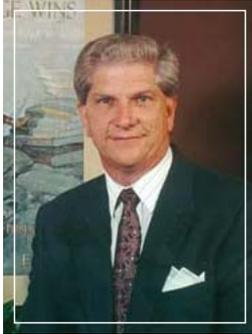




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# New Pension Relief Act

## ... Friend or Foe?

On July 6, 2012 President Obama signed the “Moving Ahead for Progress in the 21<sup>st</sup> Century” Act (MAP-21 as it is called). This was a highway construction Bill with several amendments as is customary for Congress to attach amendments to favorable legislation so the odds of passing these amendments are high. Pension topics were several of these amendments included under:

***Part I – PENSION FUNDING STABILIZATION***

***Part II – PBGC PREMIUMS***

***Part III-IMPROVEMENTS OF PBGC***

***Part IV-TRANSFERS OF EXCESS PENSION ASSETS***

Such legislation has been promoted as *pension relief* from higher contribution costs. On closer inspection this legislation may very well add costs and impair the solvency of the pension plan. When the Pension Protection Act (PPA) became effective in 2008, it governed the calculation of contribution costs. A key provision was the discount rate methodology. Beginning with the 2008 pension plan year the discount rate methodology was changed from long Treasury rates to high quality corporate bond rates. The PPA provided plans with two discount rate options: a spot rate yield curve of current yields or a 24-month average of a smoothed 3-segment yield curve (0-5 years, 5-20 years and 20 years plus). All rates were based on high quality corporate bonds (AAA, AA and A). Under the new MAP-21 Act, the 3-segment rates have been relaxed to allow corporations more ability to manage or manipulate the discount rates in order to reduce contribution costs.

### **Part I - Pension Funding Stabilization**

You have to admire how politicians can name laws in such a way as to give you solace and comfort on what they have passed. MAP-21 does not provide funding stabilization. It provides lower contribution costs which actually reduces the economic Funded Ratio (vs. making a contribution which increases the Funding Ratio). Under MAP-21 the 3-segment discount rates used will be the 25-year average of each segment rate (not a 24-month average) suggesting a less volatile but much higher discount rate yield curve than the last 24-month moving average. It is expected that 2012 25-year average discount rates for MAP-21 will be 140 to 170 basis points higher than the 24-month average. This would reduce the present value of liabilities by 14% to

26% initially and artificially enhance the Funded Ratio for contribution calculations. MAP-21 also provides a corridor which allows corporations to choose discount rates between the parameters of the corridor based on whichever is the **closest** to the 3-segment rates. This corridor starts at 90% to 110% in 2012 and widens by 5% per year for five years and then freezes at that level. To understand the reduction in contribution costs is to understand how the corridor reduces the present value (PV) of liabilities. Based on a **constant** 5% 3-segment discount rate and a **constant** 6.50% 25-year discount rate here is a sample of how the PV of liabilities would be reduced using both a 10-year and 15-year modified duration liability schedule:

<b>MAP-21 Discount Rate Corridor</b>						
<b>Year</b>	<b>----- Corridor -----</b>		<b>Discount Rates</b>		<b>PV of Liabilities Reduction:</b>	
	<b><u>Minimum</u></b>	<b><u>Maximum</u></b>	<b><u>Min.</u></b>	<b><u>Max.</u></b>	<b><u>10-year</u></b>	<b><u>15-year</u></b>
<b>2012</b>	<b>90%</b>	<b>110%</b>	<b>5.85%</b>	<b>7.15%</b>	<b>-8.50%</b>	<b>-12.75%</b>
<b>2013</b>	<b>85%</b>	<b>115%</b>	<b>5.53%</b>	<b>7.48%</b>	<b>-5.30%</b>	<b>-7.95%</b>
<b>2014</b>	<b>80%</b>	<b>120%</b>	<b>5.20%</b>	<b>7.80%</b>	<b>-2.00%</b>	<b>-3.00%</b>
<b>2015</b>	<b>75%</b>	<b>125%</b>	<b>4.88%</b>	<b>8.13%</b>	<b>NA</b>	<b>NA</b>
<b>After 2015</b>	<b>70%</b>	<b>130%</b>	<b>4.55%</b>	<b>8.45%</b>	<b>NA</b>	<b>NA</b>

As you can see the minimum corridor is the closest rate to the 3-segment rate and will be selected except after 2014 when the rate is lower than the 3-segment rate and would not be selected. If we saw a spiking of interest rates as a trend, the maximum corridor might be the closest to the current 3-segment rate and be selected. The minimum corridor reduces the PV of liabilities by 8.5% to 12.75% in 2012 and a lesser amount in 2013 and 2014. Such a hypothetical liability reduction also enhances the Funded Ratio and thereby reduces contribution costs. Combining the higher 25-year discount rates with a corridor adjustment could lower contribution costs significantly. The actuarial firm Mercer has estimated that such reduced contribution costs could total more than \$100 billion through just 2014. Mercer has also estimated that the aggregate deficit for S&P 500 companies with a DB pension plan (about 350 companies) is about -\$543 billion as of June 30, 2012 (@74% funded ratio).

The government is fully aware that pension contributions are a tax deduction. As a result, reducing contribution costs should in turn raise net income which will be taxed. Given that our corporate tax rate is now the highest in the world at 35% (averages at 39.2% including state income tax), then every \$100 billion in contribution cost savings could equate to \$35 billion in extra federal taxes. The federal government estimates that MAP-21 legislation will bring in **\$9.394 billion in new tax revenues over 10 years**. As such, tax payments leave the company entirely whereas contributions would become a pension asset thereby enhancing the Funded Ratio and perhaps the credit rating. There is another item to be noted here. Plan sponsors need to elect which discount rate option to use. Those who selected the *spot rate curve* option now have up to one year after the date of MAP-21 enactment to switch to the new 3-segment option. The 3-segment option seems to be an unfortunate reduction in proper pension funding which may have pension solvency implications if long term... *Caveat Emptor!*

## **Part II – PBGC Premiums**

Under Part II, PBGC premiums will be increased significantly. Single-employer premiums are raised from \$35 per participant currently to \$42 in 2013 (20% increase), \$49 in 2014 (additional 16.7% increase) and then indexed to inflation thereafter. Variable rate

premiums for unfunded plans will rise from \$9 per \$1,000 on underfunding to \$13 in 2014, \$18 in 2015 and indexed to inflation thereafter. Flat-rate premiums for multiemployers increase from \$9 to \$12 per participant in 2013 and indexed to inflation thereafter. The federal government estimates this will bring in **\$10.575 billion in new revenues over 10 years**.

### **Part III – Improvements of PBGC**

PBGC had been lobbying for legislation that would give it greater control over its premium rates without any need for Congressional permission. MAP-21 did not include such authority. However, it does enhance PBGC's governance. MAP-21 clarifies various requirements for board of directors meetings and personnel by setting 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 Plan Sponsor Advocate to act as a liaison between the PBGC and participants in terminated pension plans to ensure that such participants receive what they are entitled to under the law. The Advocate will also help to resolve any disputes between the plan sponsor and the PBGC. Part III also requires that the PBGC contract with an outside agency to conduct an annual review of its pension insurance modeling system with internal quality review procedures.

### **Part IV-Transfers of Excess Pension Assets**

Any plan that exceeds 125% Funded Ratio may transfer these excess assets over to retiree medical benefits (OPEB) under the qualified transfer rules in Internal Revenue Code Section 420 through December 31, 2021. To ascertain the Funded Ratio here, the MAP-21 corridors are not applicable. This option was set to expire after 2013. These transferred assets must be maintained in a separate account within the plan. Basically, only group-term life insurance not in excess of \$50,000 may be purchased with the transferred assets. Since OPEB (medical) assets are not tax-exempt, this transfer of assets is a taxable event. The federal government estimates this will bring in **\$354 million in new tax revenues over 10 years**.

### **Summary**

The new MAP-21 legislation which has been labeled as "pension relief" will create **\$20.323 billion in estimated federal revenues over the next 10 years as new costs for corporations**. No wonder this funding relief is scored for U.S. budget purposes as a "revenue raiser." Moreover, it reduces pension contributions which would help shore up pension Funded Ratios. It also penalizes unfunded pension plans with higher PBGC premiums on the unfunded amounts. Corporations should weigh the pros and cons of this legislation before deciding on what discount rate methodology it chooses. Reduced contributions today should be weighed vs. higher taxes, lower Funded Ratio, higher PBGC premiums for unfunded liabilities, potential pension solvency issues and the loss of new pension assets. As the old adage says: pay me now or pay me later... but you will pay the pension benefit someday!

***"An error is not a mistake until we refuse to correct it"***

**John F. Kennedy**