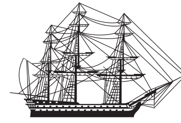

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Regulatory Brief: Pension provisions in MAP-21

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Executive summary

On July 6, 2012, President Obama signed into law a transportation bill, Moving Ahead for Progress in the 21st Century Act, known as MAP-21. The law includes several provisions related to defined benefit (DB) pension plans. These provisions were incorporated, in part, to raise revenue to pay for transportation improvements. Two provisions, interest-rate stabilization affecting pension liability calculations and a significant increase in premiums paid to the Pension Benefit Guaranty Corporation (PBGC), will impact almost all single-employer DB plans.

Interest-rate/DB funding stabilization

The Pension Protection Act (PPA) of 2006 drastically restructured DB funding rules, which accelerated funding requirements and specified new interest rates to be used to value these pension liabilities. These interest rates are based on investment-grade corporate bond yields and, as part of PPA, became effective in 2008.

Shortly after the accelerated funding provisions of PPA went into effect, severe economic conditions generated a decline in interest rates as investors looked for safety in bond investments. As a result, plan liabilities increased, in some cases dramatically.[1] To try to stimulate the economy, the Federal Reserve pushed interest rates down further. The Fed's action led to even higher liabilities, higher required contributions, and lower funding ratios. This prompted calls for relief through "stabilization" of what many perceive to be artificially low interest rates. MAP-21 is Congress's response to these calls for relief.

MAP-21 revises the three-segment rates under the single-employer funding rules. The segment rates will be adjusted if they are outside a specified range of the average of segment rates for the preceding 25-year period. To determine the applicable interest rate, a corridor is established around a 25-year average of corporate bond rates. If the 24-month average segment rate (the current PPA rule) is outside the corridor, then the limit of the corridor is used. In effect, a floor and a cap are created for the current year's rate. The 25-year average and corresponding corridor is created separately for each of the three segment rates (i.e., 0–5 years, 6–20 years, 20+ years) under PPA.

1 Corporate pension plan liabilities are tied to interest rates in an inverse manner. Higher interest rates, used for discounting future expected benefit payments, mean lower plan liabilities. Conversely, lower interest rates result in higher plan liabilities.

This grid shows the percentages used to determine the corridors:

	Percentage of 25-year average for lower bound on corridor	Percentage of 25-year average for upper bound on corridor
2012	90%	110%
2013	85%	115%
2014	80%	120%
2015	75%	125%
2016+	70%	130%

The corridor widens after 2012, which reduces the impact. **For most plans, there will be a significant reduction in the required minimum contribution for 2012, but the impact of the bill will decrease significantly by 2016.**

The segment rate change is applicable when calculating the:

- Funding target for minimum funding purposes.
- Target normal cost for minimum funding purposes.
- Effective rate of interest for determining the shortfall amortization charge.
- Adjusted funding target for funding-based limitations on benefits and benefit accrual.

The law is very clear that the stabilized interest rates are not applicable when calculating the:

- Minimum lump sums and cash-outs.
- Maximum lump-sum distributions.
- Maximum deductible amounts.
- Excess pension assets for purposes of funding retiree medical costs.
- PBCG variable rate premiums.
- ERISA 4010 information for the PBGC.

Plan sponsors can choose to use the stabilized segment rates starting with the plan years beginning in 2012 or 2013. Furthermore, plan sponsors can begin using the stabilized interest rates in 2012 for minimum funding purposes but delay using these rates until 2013 for adjusted funding target attainment percentage (AFTAP) purposes (i.e., benefit restriction determination). For example, a plan could continue to rely on an AFTAP that created a lump-sum benefit restriction (i.e., AFTAP less than 80%) valued using prestabilization rates even though an AFTAP calculated using stabilized segment rates might generate an AFTAP greater than 80%.

Client planning note: Most DB plans will have a lower minimum required contribution when MAP-21 changes are applied. Lower contributions made today will likely result in larger required contributions in the future. Sponsors should work with their actuaries to decide whether to "pay now or pay later." See the Considerations section below.

The interest-rate stabilization provisions of MAP-21 affect the calculation of segment rates. MAP-21 does not affect those plans using the full "yield curve" method. However, those plans using the full "yield curve" are permitted under MAP-21 to change to the stabilized segment rates without IRS approval.

On August 16, 2012, the IRS issued Notice 2012-55, which provided the adjusted MAP-21 segment rates for use in plan years beginning in 2012. The table below compares the 2012 25-year average rates adjusted for the 10% corridor, as published by the IRS, with the 24-month average three-segment rates at the end of 2011.

Segment rate	24-month average three-segment rates as of December 2011	Rate to be used after applying 10% corridor for 2012
1st segment	1.99%	5.54%
2nd segment	5.12%	6.85%
3rd segment	6.24%	7.52%

Based on this comparison, most plan sponsors can expect an increase in the 2012 effective interest rate of 130–180 basis points.[2]

The IRS notice also said that future guidance will be provided on other issues relating to applying the MAP-21 amendments, including benefit restrictions and transition concerns.

Increased PBGC premiums

Beginning in 2013, the PBGC single-employer per-participant flat rate, the single-employer variable rate, and the multiemployer per-participant flat rate premiums will increase significantly.

For single-employer plans, the per-participant flat rate premium will increase from the current $35 as shown here:

Year	PBGC per-participant flat-rate premium
2012	$35
2013	$42
2014	$49
Thereafter	$49 amount will be adjusted for inflation

Client planning note: DB plan sponsors will be paying significantly higher PBGC premiums. Sponsors should keep this in mind when deciding whether to reduce contributions based on MAP-21 measurements. Maintaining a higher level of contribution will reduce the unfunded vested liability and hence reduce the level of the PBGC variable rate premium. See the "Considerations" section below.

The variable-rate premium for single-employer plans, currently $9 per $1,000 of unfunded vested benefits will be increased under MAP-21 as shown here:

Year	PBGC variable-rate premium
2012	$9 per $1,000 of unfunded vested benefits
2013	$9 per $1,000 of unfunded vested benefits adjusted for inflation
2014	$13 per $1,000 of unfunded vested benefits plus the indexing for inflation
2015	$18 per $1,000 of unfunded vested benefits plus the indexing for inflation
Thereafter	Above dollar amount will be adjusted for inflation

Beginning in 2013, the impact of the increased variable-rate premium will be mitigated by a per-participant limit of $400, which will be adjusted for inflation thereafter.

The multiemployer per-participant flat-rate premium amount will increase to $12 in 2013 from its current $9 level. This premium amount will also be adjusted for inflation thereafter.

2 The impact on effective rate is dependent on liability duration, look-back month for the 24-month average three-segment rates, whether the plan pays lump sums, and other actuarial assumptions. Sponsors should consult with their actuary to determine the impact on their effective rate and funding target liability.

Considerations

Understand your liability

The MAP-21 legislation introduces another layer of complexity for plan sponsors in understanding their pension plan's liability. The 25-year average rate corridor will decrease many plan sponsors' funding target liability by 15% to 20%,[3] which will improve their funded status significantly. However, this "improvement" does not reflect the true funded status of the plan.

To understand the economic impact of their plan, sponsors should focus on a market liability.[4] Low interest rates increase the cost of any kind of future financial commitment such as retirement income and this should not be ignored in financial planning. Financial analysts will continue to view pension obligations, and funded status, on a market basis.

A market liability will be a better way for plan sponsors to measure the potential impact of transactions such as lump sum windows, annuity purchases, or plan terminations as these transactions generally occur at or near market interest rates. Regular monitoring of a market liability measurement is a key to good pension risk management.

Contributions

While this new legislation will have a major impact on contribution requirements, plan sponsors should carefully consider their level of contribution. The impact of contributing less to the pension plan may include:

- Higher future contributions: The MAP-21 measurements do not change the ultimate cost of the plan.
- Delayed derisking: Lower risk investments, lump-sum programs, or plan terminations may all depend on a certain level of funding.
- Increased PBGC premiums: The MAP-21 PBGC premium increases add additional weight to this concern.

Investment strategy

MAP-21 is unlikely to significantly impact plan sponsors' asset allocation strategy and it should not be a consideration. Progression along investment derisking glide paths will be delayed if plan sponsors reduce contributions based on MAP-21 measurements, but it is important that investment derisking glide path strategies be based on market assessments of the plan liability.

Conclusion

MAP-21 adds additional complexity for plan sponsors trying to understand their DB plan's financial implications. Sponsors will not want to lose track of a market measurement of their pension obligation. They will want to work closely with their actuaries to understand how the new law affects their plan and to decide what, if any, changes will be made in the plan's funding strategy.

If you should have any questions or comments about the MAP-21 legislation, please contact your Vanguard representative.

3 For a sponsor with a pension liability duration of 12, a 150-basis-point increase in the effective interest will result in an 18.5% reduction in the funding target liability.

4 The most common market liability for a pension plan is the liability calculated by discounting the expected benefit payments using a yield curve of high-quality corporate bond rates, such as the PPA full yield curve or the Citigroup Pension Discount Curve.

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