An Opportune Time for Funding

By David Geloran, CEBS, MBA

Summary

Many pension plan sponsors have been experiencing relief in their minimum required funding as a result of highway legislation called "Moving Ahead for Progress in the 21st Century" ("MAP-21"). With interest rates having remained at historically low levels for over a decade, this relief will soon wane. Plans may soon see an increase in required contributions, even if interest rates start to rise. Plan sponsors have a limited opportunity to amplify cost savings by prefunding to take advantage of 2017 tax rates.

Background

The Pension Protection Act of 2006 ("PPA") defined the interest rate for minimum funding purposes to be a 24-month average of high quality corporate bonds. Interest rates languished at historically low levels for the past decade, contributing to the pension "perfect storm" – the combination of the full enactment of PPA, the accounting codification under ASC-715, the credit crisis, and the great recession. As plan assets evaporated, the short-term average of a very long period of low interest rates drove liability valuations higher.

MAP-21 provided relief to plan sponsors rocked by increasing minimum required contributions and lower AFTAPs (percent funded). Introducing a second funding rate (called the "stabilized rate", equal to 90% of the 25-year average of high quality corporate bonds), the longer averaging period provided a higher and more stable average from year-to-year. The higher of these two rates (the 24 month average under PPA or the 25-year average under Map-21) are then used to determine the plan liabilities for minimum funding purpose.

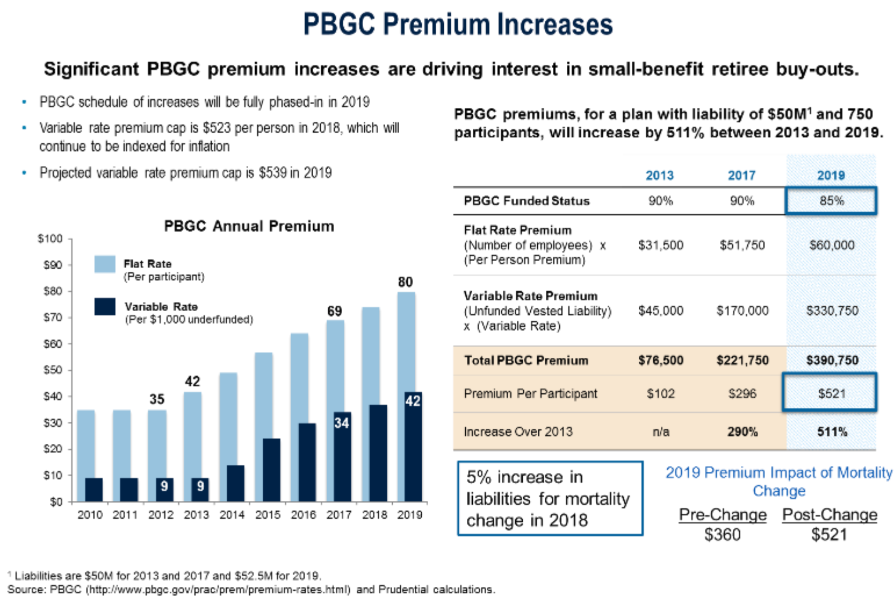
However, as more years of low interest rates from today enter the average period, and replace the higher interest rates from the early 1990's, this stabilization rate is starting to provide less relief. The initial expectation was that bond rates would rebound quickly, and the greater-of comparison of the PPA and MAP-21 rate would quickly revert to the PPA rate. Instead, the 25-year average is steadily dropping annually.

As well, the 90% multiplier is also scheduled to drop (85% in 2021, and 5% each year thereafter until it reaches 70% in 2024). With the promise of interest rates starting to rise, it will only be a matter of time until the 24-month PPA rate becomes higher than the stabilized rate. Yet, absent a spike in interest rates, whichever rate wins out, it will most likely be lower than today's rates (the typical 2017 MAP-21 stabilized rate hovers around 6%, compared to a PPA rate in the low 4's). This means that funding ratios may continue to drop and sponsors may soon see larger increases in their required contributions.

The drop in funded status renews concerns for plan sponsors looking to de-risk their plan. Lump sums and retiree carve outs require the plan be funded at least 80%, and dropping lower than this threshold may remove effective money saving tools from the sponsor's options. Credit balances may become depleted or forfeited, potentially increasing minimum required cash contributions. Quarterly contributions man become required, and the Annual Funding Notice starts to raise eyebrows. All while PBGC premiums continue to increase – with a 2018 rate of $74 per participant fixed and $523 cap on variable, poorly funded plans are paying almost $600 annually per participant and getting nothing in return.

Make the most of plan contributions

Additional Savings through Plan sponsors have a limited opportunity to amplify the savings potential of funding up their pension plans. Before the plan can be terminated, contributions must be made to fund the benefit obligation – but by making these contributions sooner, sponsors can reduce the carrying costs associated with maintaining the plan. Contributions deductible for 2017 would be more favorable for C corporations facing lower tax rates in 2018 – as much as 14 percentage points (the Tax Cuts and Jobs Act reduced corporate tax rates from 35% in 2017 to 21% in 2018). Maintaining an AFTAP above 80% allows sponsors to keep de-risking activities as viable options for reducing carrying costs. Plan administration is easier without restricted optional forms, and participants become less uneasy about the plan's funded status.



Consider a plan underfunded by $10 M. By making these deductions (which will eventually need to be made) by September 15 and deducting the contribution in 2017, the sponsor saves almost $1.5 M between PBGC premiums and higher tax deductions.

Deduction Year	2017	2018
Plan Contributions	$10,000,000	$10,000,000
Contributions After-Tax	$6,500,000	$7,900,000
PBGC Variable Premiums	0	$380,000
Premiums After-Tax	0	$247,000
Total After-Tax Costs	$6,500,000	$8,147,000

Money is currently relatively inexpensive to borrow, and the ROI on a low interest loan may be favorable compared to the anticipated carrying cost for the plan. These contributions prefund the benefit obligations and must be made to the plan prior to terminating the plan. In other words, sponsors ***must*** make these contributions before they can terminate, but in making them sooner they reduce the carrying costs associated with maintaining the plan. These savings reduce the erosion of hard-earned asset returns, reducing the call on cash needed to terminate the plan. The value of the higher tax deduction and the elimination of PBGC variable premiums alone make increased contributions a compelling argument for sponsors with access to cash or loans.