Contribution Relief with a Catch

At first blush, MAP-21 would appear to make pension plan contributions less likely in the near term. However, it also makes pension deficits more expensive by hiking the PBGC’s underfunding charge (the variable rate premium). The rise to nearly 2% on each dollar of deficit may encourage sponsors to voluntarily fund their plan even if not required to do so under MAP-21’s higher discount rates. By comparison, the rise in the per-head charge (the fixed rate premium) is of less concern.

Underfunding Gets More Costly

The Moving Ahead for Progress in the 21st Century Act (“MAP-21”) signed into law on July 6, 2012, temporarily reduced required contributions for underfunded pension plans. However, before plan sponsors close the corporate checkbook, they will likely take a closer look at the legislation’s change to the PBGC penalties on pension deficits. MAP-21 includes a timeline for a quick ramp-up in the PBGC’s variable rate premium, the charge assessed annually on every dollar underfunded versus the liability.

Variable Rate Premium

By 2015, the current premium of 0.9% on the pension deficit is scheduled to double to 1.8% plus an ongoing inflation adjustment. Furthermore, plans cannot rely on MAP-21’s higher discount rates to portray a more positive picture of funded status. The funding deficit and resulting premium owed must be calculated using the plan’s prior discount rate election.

Incentives for contributions are obviously heightened by the rising cost of underfunding. However, plan sponsors may be stepping back to consider a more subtle point. Pension underfunding is a form of borrowing that has costs, like the corporation’s borrowing in capital markets. Many sponsors will notice that the 2015 premium base of 1.8% may equal or exceed the credit spread they currently pay to issue debt. Indeed, this would be the case for about two-thirds of the issuers of investment-grade corporate debt based on their current spread level. While cost of capital questions related to the corporation and its DB plan are always complex, this premium increase could lead to higher plan contributions.

1 See our previous paper Funding Relief and Implications for Pension Investing for a discussion of MAP-21 and pension risk management, available on our website.

2 Source: Internal Revenue Service, September 27, 2012

3 Based on the option-adjusted spread (OAS) of the issuers (aggregated by ticker) included in the Barclays Intermediate Corporate Index as of 01/31/13.
contribution inflows as sponsors compare the relative costs of market borrowing to pension underfunding.  

The plan sponsor bears the ultimate economic impact of the higher premiums, but the premiums are paid from the pension plan and represent an additional plan liability. From the fiduciary’s perspective, will the 0.9% premium increase be viewed as significant? Some simple comparisons suggest this change will justify their attention. For example, any amounts the sponsor contributes could be viewed as having an annual “performance boost” above and beyond the return of the underlying assets of 0.9% in 2013, 1.3% in 2014 and 1.8% in 2015 and thereafter.

The fiduciary may prefer to view the variable rate premium as a percentage of total plan assets to get a sense of the “asset drag” created by the underfunding charge. Even in the case of a relatively well-funded plan in which a smaller penalty is spread over a larger asset base, the impact may be noteworthy. A plan that is 90% funded will see its annual underfunding charge rise from 0.1% to 0.2% in asset terms - not insignificant when compared to some plan management costs, for example. Naturally, as funded status declines, the effect is exacerbated because the premium in dollars rises and is spread across a smaller asset base. A plan that is 70% funded will see this premium rise from 0.4% to 0.8% in asset terms. In other words, the first 0.8% of asset return can effectively be viewed as paying the PBGC premium. The chart below illustrates this effect in more detail.

Having drawn several comparisons from the fiduciary’s perspective, the natural question may be what impact, if any, these changing costs have on their asset allocation decision-making. One approach to tackling this question may be to consider the increased PBGC premium as implying a different funded status level, potentially suggesting a new risk preference. Another angle may be to interpret the premium as a change to the risk profile of assets, amplifying the effects of the underlying return by applying additional costs to investment losses and avoiding those costs with investment gains (so long as the plan is underfunded). In any case, the apparent complexity of the question argues for a more detailed exploration, which we leave for a separate discussion.

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4 A direct comparison of corporate debt spread levels to pension underfunding would incorporate a variety of additional factors such as the tax treatments on corporate interest, pension plan contributions, pension plan earnings, as well as changes to the corporation’s capital structure.
Flat Rate Premiums

MAP-21 also increased the flat rate premium or “per-head charge” that a single-employer plan pays from $35 per participant to $42 in 2013 and $49 in 2014, plus an ongoing inflation adjustment. While this increase of 40% might be expected to cause some heartburn, a closer look reveals the impact may be of less concern.

The chart above is based on the top 500 corporate DB plans and shows that the median flat rate premium they paid in 2012 was about 0.05% as a percentage of their liability. This amount is slated to increase to 0.07% by 2014. The premiums paid are similar whether measured as a simple or weighted average of the top 500 plans.

The breakdown by participant type reveals that the contribution to total cost is similar when comparing active participants, retirees, and term vested participants (inactive participants with deferred benefits). However, when viewed relative to their respective liabilities, we see some notable variation between the participant types:

The relative cost for term vested participants is noticeably higher than for actives or retirees. This makes sense since these participants typically have a smaller balance of

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5 Top 500 corporate plan data as of 2011 from the US Department of Labor.
which the fixed PBGC premium will be a larger percent. This extra cost may partially explain the increase in recent lump sum termination offerings focused on the term vested population. However, even if these plans were to entirely eliminate their term vested participants via lump sum offerings, their total flat rate premium costs would drop by only 0.01%-0.02% relative to the entire liability. Returning to the earlier comparisons against asset returns, a savings of this size seems likely to be viewed as immaterial.

Importantly, this analysis on fixed rate premiums is based on the respective median values of the 500 largest corporate defined benefit plans, figures that may vary considerably for any individual plan. Plans with lower average participant balances (e.g., those with higher employee turnover rates or lower benefit accruals) will see the largest increases in the flat rate premium relative to their total liability. For example, while the median increase from 2012 to 2014 is 0.02%, about one in twenty plans will see an increase of at least 0.06% given their circumstances.

**Conclusion**

While the headline of a 40% increase in the PBGC’s per-head premium is potentially intimidating, for most plans this will amount to an additional cost of only a few hundredths of a percent. Short of techniques designed to trim head count (e.g., lump sum offerings), there isn’t much sponsors can do to limit this increase.

In contrast, for an underfunded plan, the change in the variable rate premium is material and should not be dismissed. The good news is that this cost can be managed, and fully eliminated if so desired. There have always been incentives for plan sponsors to fully fund pension plans (e.g., tax-exempt earnings, accounting statement treatment, etc.) but the increase in the variable rate premium makes increased funding even more attractive. While MAP-21 may have provided significant contribution flexibility for plan sponsors over the next few years, it also provides significant economic motivation for voluntary contributions in the years thereafter.
Appendix

Data sources:

- Barclays index data from Barclays POINT. With respect to Barclays’ information stated in this presentation – Source Barclays POINT/Global Family of Indices. ©2013 Barclays Bank PLC. Used with permission. Barclays and POINT are registered trademarks of Barclays Bank PLC.

- Variable rate premium and fixed rate premium data from the US Internal Revenue Service.
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- Defining the Pension De-Risking Spectrum (January 2013)
- The Credit Rating Impact of Pension De-Risking (January 2013)
- Efficient Tax Management in Taxable VEBA Portfolios (November 2012)
- Funding Relief and Implications for Pension Investing (October 2012)
- PSRX Overview and PSRX Guide (September 2012)
- Corporate Bond Scarcity? The Case for Separating Interest Rate and Spread Risks (August 2012)
- Prospective Funded Status Volatility (October 2011)
- Break-even Yield Curve (August 2011)
- Dynamic Liability Driven Investing (July 2011)
- Interest Rate Hedges (May 2009)
- Considerations Surrounding Corporate Bonds in Pensions (December 2008)

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