2012 year in review

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2012 was a historic year for defined benefit pension plans in the US. Interest rates continued to decline in 2012 much as they did for the past three years. The lower interest rates generally resulted in escalating liabilities and deteriorations in pension plan funded status. Assets during 2012 generally performed above expectations, at least up to the time of this publication (post-Thanksgiving but prior to the Fiscal Cliff resolution), but still could not keep pace with rapidly rising liabilities. Providing some relief from the IRS funding rules (but not SEC/FAS accounting rules) for single employer pension plans was the Moving Ahead for Progress in the 21st Century Act (MAP-21).

MAP-21 was signed into law on July 7, 2012 and had an immediate impact on most pension plans by providing interest rate relief. Although optional for 2012, it allowed plan sponsors to change the plan's actuarial method for determining pension funding liabilities from either a valuation date spot interest rate or a two-year smoothed average interest rate basis to interest rates falling within a 10% corridor of a 25-year smoothed average interest rate. Using interest rates dating back as far as 1984, (when double-digit rates were common) the average MAP-21 interest rate used to compute funding liabilities increased between 150 and 200 basis points. However, the 10% interest rate corridor around the 25-year averaged rate will be expanded in five percentage point increments each year until 2016 when it will reach 30%. Therefore, for each successive plan year after 2012, plan sponsors can expect the interest relief effect of MAP-21 to lessen.

Besides interest rate stabilization, MAP-21 required that, starting in 2013, the future premiums due to the Pension Benefit Guarantee Corporation (the PBGC) will increase. In 2012, employers paid the PBGC a flat dollar premium amount of $35 per plan participant and a variable rate premium of $9 per every $1,000 of unfunded vested benefit liability. The flat dollar per participant premium will increase to $49 by 2014 and variable rate basis will double from $9 to $18 by 2015. The impact of future inflation can increase these even more.

A key provision of MAP-21 required the PBGC unfunded vested benefit liability to be calculated on a pre-MAP-21 basis, that is, as if the higher MAP-21 rates did not exist. PBGC did, however, limit the total per participant premium paid by plan sponsors to $400 (which is indexed with CPI after 2013.) The premium cap does little in preventing potentially huge future increases in premiums for plan sponsors compared to their 2012 levels.

MAP-21 brought immediate relief to plan sponsors by lowering cash contributions in 2012. However, given the fact that the 25-year averaged interest rates under MAP-21 will decrease in future years (since the much higher rates from the 1980's fall out of the average each year and are replaced with the much lower recent interest rates and the widening of the corridor from 10% to 30%), we in fact know that pension liabilities and thus contribution requirements will likely spike up again several years from now. That coupled with the sharply higher PBGC premiums that need to be paid makes MAP-21 a temporary pension anodyne rather than a panacea. Many plan sponsors may consider contributing amounts in excess of MAP-21 minimum funding requirements in order to well position the plan for the contribution storms that may arise two to three years from now and to help reduce future PBGC variable premiums. Ironically, this behavioral action may have been underestimated as a potential impact of MAP-21, given that one of the major driving forces behind its enactment in Washington was to have it serve as a revenue raiser to offset costs for student loan federal subsidies.

The anticipated future effects of MAP-21 renewed talks toward de-risking pension plans during the second half of 2012. Many plan sponsors considered design changes such as moving from traditional final average pay formulas to less costly pension hybrid arrangements involving career average pay formulas. Offering optional lump sum distributions to plan participants also rose up in popularity given that this could help rid plans of potentially large liabilities for terminated vested and, in some cases, retired participants, thereby reducing plan size and risk. Lump sum distributions also helped some plan sponsors to recognize financial statement gains as higher liabilities were released from their balance sheets than the corresponding assets used to pay for them (an accounting windfall that results from using stale interest rates to compute lump sums payouts in a falling interest rate environment).

De-risking initiatives also had plan sponsors frequently strategizing with the plan's investment committees. De-risking investment strategies may include extending the duration of an investment portfolio to better match some of the longer duration liability components of a pension plan. Taking the matching concept further led some plan sponsors to consider making a higher shift to fixed income from equities in the hopes of immunizing a certain portion of their pension investment portfolio, a common practice known as liability driven investing (LDI). Some plan sponsors put into place dynamic LDI investment policies where the plan's investment portfolio would gradually de-risk with duration matched bond investments as the plan's funded percentage improved. Moreover, another strategy considered by plan sponsors given the low interest rate environment was to borrow money to fund up their plans to better facilitate de-risking actions and avoid PBGC variable premiums (essentially close to a 2% tax on unfunded vested liabilities).

Alternatively, there were other plan sponsors who shunned LDI strategies in 2012 as they felt the current interest rate environment marked the worst time to lock-in an interest rate wager. These plan sponsors were prepared to take on the risks in the equity market as they await interest rates to rise. One would expect the plan sponsors who have maintained their equity positions to have also considered prudent de-risking strategies such as equity tail-risk hedging strategies.

Even though there was much pension frenzy over the interest rate relief being provided on the cash funding side and the heightened focus on de-risking in 2012, financial statement accounting concerns remained key for many plan sponsors and CFOs. MAP-21 relief did not apply to financial statement accounting liabilities. Thus, there was no cushion against low interest rates and their impact on pension plan balance sheets and income statements, each of which worsened during 2012.

As 2012 draws to a close, there are still many concerns in the pension world and most of them expect to spill over into 2013. We can expect rises in plan sponsor contribution requirements given the declining interest rates of 2012. We can also expect an increase in pension expense for fiscal years ending in 2013. The November 2013 Milliman 100 Pension Funding Index reported that funded status losses during 2012 could translate into a 2013 pension expense increase of over $17 billion for the top 100 private section pension plans in aggregate.

MAP-21 requires additional information to be disclosed on annual funding notices that must be distributed to participants in 2013 under the Pension Protection Act. This revised funding notice will include funded status disclosures before and after the reflection of the MAP-21 funding relief. If you felt as though last year's notice was a tough read, you probably haven't seen anything yet!

Lastly, some plan sponsors and retirement professionals are still awaiting technical guidance related to multiemployer plans and eligible charity plans. With Washington being a hall of mirrors with legislators constantly pointing fingers, it is not clear what kind of new guidance and regulations will result. Hopefully, a happy medium will be reached between the attempts to raise revenue and the attempts to strengthen retirement adequacy.

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