January 28, 2021

Single Employer Pension Funding Relief Introduced in the House of Representatives

House Ways and Means Committee Chairman Richard Neal has introduced HR 409, the Emergency Pension Plan Relief Act of 2021 (EPPRA). Part of that bill would make significant changes to minimum funding requirements for sponsors of single employer defined benefit plans for plan years after December 31, 2019.

At least some of the changes proposed have been seen in prior legislative proposals but removed prior to enactment. In the case of the EPPRA, the two significant changes are modification of the segment rates used to determine funding requirements (but not PBGC premiums), and a change in amortization of funding shortfalls from 7 years to 15 years.

Changes in the Interest Rate Collars and Addition of a 5% Minimum Segment Rate

The following changes would be implemented for determining the segment rates used for determining minimum contributions:

- The 25-year averages used to determine the collars for funding segment rates would be the greater of the actual amount or 5% for each of the three segment rates. (The 25-year average segment rates have decreased for nine consecutive years and are currently 3.90%, 5.64% and 6.43% for plan years beginning in 2021.)
- The collar applied using the 25-year average would be revised to 95% and 105% for 2020 through 2025, easing 5% annually beginning in 2026 until reaching 70% and 130% in 2030. (This collar is currently 85% and 115% for 2021 easing to 70% and 130% by 2026.)

This combination would drastically increase the effective rate (flooring at no less than 4.75%) used to determine minimum contributions in the next five years, and thus decrease the minimum funding contribution requirements otherwise payable for most sponsors. For many reasonably well-funded sponsors, the expiration of prior funding relief efforts (e.g., easing of collars beginning in 2021) combined with low corporate bond rates is creating all or nearly all of the steep projected contribution increases in the next 5 to 7 years. These increases will occur despite strong asset returns for the last decade.

Shortfall Amortizations Changed to 15 Years

Under the Pension Protection Act, funding shortfalls (assets less than funding target liability) are generally amortized over a 7-year period. Prior to PPA, funding rules amortized new shortfalls over a much longer period. The shorter period under PPA was introduced to expedite resolving funding shortfalls, but also introduced significant volatility in regard to changes in assumptions used when calculating liabilities. The combination of steadily declining bond rates, changes in relief measures and the short 7-year amortization period subjects sponsors to the potential for steep short-term increases in contributions. The EPPRA would eliminate all prior funding shortfall bases for plan years after December 31, 2019. The shortfall would remain, but restart under a 15-year amortization, and any future shortfalls that occur based experience or changes in assumptions would also be amortized over a 15-year period.

Why Does This Legislation Make Sense? How Did We Get Here?

When discussing why simple legislation like this makes sense, we need to examine three things:

1. What is the goal of funding a pension plan?
2. What is the market environment and how has it changed?
3. What is the pressure, or lack of, generated by current legislation?

Ongoing funding of a pension plan is a simple process if risk is temporarily set aside. In a single employer defined benefit plan, the employer bears the risk. Benefits are earned and paid to participants and, in some cases, the plan pays expenses

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incurred in the process of doing the above. To be able to pay benefits and expenses, contributions are made by the plan sponsor (few allow employee contributions) and held in a qualified trust. Assets in the trust earn a return based on actual investment
experience.

In general, the goal of funding a pension plan is to pay benefits when due and remain solvent indefinitely. For many employers, maintaining solvency with some additional cushion is preferable. For plans with a longer-term outlook, PPA rules generally add some cushion above expected asset returns, and excess assets can be used to settle portions of future plan obligations if preferable. The objective of a sponsor seeking to terminate a plan in the next several years is drastically different, and investment philosophy in that case will generally forgo returns in favor of minimizing volatility. Unless a plan termination is in process, PPA funding rules almost entirely disregard these differences.

The original intent of pension funding proposals prior to PPA was to closely match funding, terminal liability (especially lump sum values), and liabilities for the purposes of PBGC premiums. The basic premise was marking assets and liabilities to the market, no matter how volatile, and funding deficits over a period no longer than 5 years. Opposite that were previous funding rules that were laden with very long amortization periods, individually selected assumptions, and crediting of various notional balances to be used in lieu of making cash contributions. That combination sometimes lead to underfunding and contribution holidays, when such holidays were counter to a Plan's long-term objectives. What we received with PPA was somewhat compromised from the original proposals, with averaging mechanisms added as well as a slightly longer amortization of funding deficits. Follow-on legislation since then has sought to ease the impact of one-time adverse events or the effect of the declining bond markets, usually combined with increased PBGC premiums.

In the case of the market environment, asset returns have been strong for most plans in the last decade, due to both strong equity returns and appreciation of long-term bond portfolios during a period of declining fixed asset yields. However, those declining yields have substantially increased PPA funding obligations when the effect of subsequent relief measures are disregarded. For example, the effective rate of the current one-month segment rates is approximately 250-300 basis points lower than the same rate a decade ago. As previous relief-legislation corridors are relaxed, rates will trend closer to the underlying bond rates over a relatively short period of time, and the funding target for sponsors may increase by 25%-40% solely due to the change in the bond rates. For sponsors looking to settle or eliminate their plans, this is the current outlook as settlement is done at market or near-market rates. The current rules grade toward requiring all sponsors to fund at near settlement levels, but do they really solve more problems than they create for sponsors of ongoing plans?

As the spread between expected returns and the underlying liability rates becomes larger and larger, the rules make less sense for sponsors of ongoing plans. Or have we given up on the idea of participants being covered by ongoing defined benefit plans? There are a lot of stakeholders involved in this process, including shareholders, owners, employees, participants, lenders, customers, and the PBGC. The provisions in the EPPRA will set a floor for the effective funding rate at 4.75% and lengthen the horizon over which sponsors must fund plans. This helps to recognize that a defined benefit plan is a long-term arrangement at least for some sponsors, and that funding toward the most onerous terminal level for a plan that has no intention of terminating is not a reasonable target, especially when compounded by unintended legislative consequences. It may even accelerate the pace that underfunded pension plans are turned over to the PBGC.

On balance, practitioners reviewing the EPPRA provisions in the context of long-term plans beset by short term fluctuations are likely to say, "It's about time. What took so long?"

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