The Bipartisan Budget Act of 2015

Strategic Implications for Pension Plan Sponsors

December 2015

Executive Summary

Highlights

On November 2, 2015, The Bipartisan Budget Act of 2015 (referred to here as BBA 2015) was signed into law. BBA 2015 includes significant increases in the flat-rate and variable-rate premiums charged by the Pension Benefit Guaranty Corporation (PBGC) for single-employer defined benefit plans, going well beyond the increases enacted in prior law. The BBA 2015 increases are effective for plan years beginning in 2017.

The additional PBGC premium costs will be most severe for pension funds that run large deficits but are not so underfunded that they are subject to the per-participant cap on the variable-rate premium. These plan sponsors will have a strong incentive to fund their plans and reduce the risk of subsequent drops in funded status.

BBA 2015 also extends the interest rate stabilization under the Moving Ahead for Progress in the 21st Century Act (MAP-21) and the Highway and Transportation Funding Act of 2014 (HATFA) for an additional three years beyond prior law. This means that plan sponsors generally will have more flexibility in how much they contribute over the next several years. However, this contribution flexibility will need to be weighed against the PBGC premium cost increases.

Finally, BBA 2015 includes a provision that may allow the development of longevity assumptions for pension funding purposes that better reflect actual plan experience.

BBA 2015 will prompt many pension plan sponsors to reconsider several aspects of their plan management strategies:

- **Funding strategy.** Plan sponsors may want to consider discretionary contributions to improve funded status. In 2019 and beyond, a carrying cost of at least 4.1% on unfunded liabilities (and likely more) can be saved through the avoidance of PBGC variable-rate premiums.[1] The value of this savings is compounded over time, since these costs are avoided each year the plan otherwise would have remained underfunded. By simultaneously allowing for lower required funding while increasing the penalties for underfunding, BBA 2015 provides an incentive to make contributions in excess of the minimum required amount.
- **Investment strategy.** Dynamic investment policies that reduce investment risk as plan funded status improves will become more attractive due to an increased penalty for plan underfunding. The added cost of risky investment strategies in downside scenarios will make the risk-reward trade-off favor less risky investments for well-funded plans. At the same time, decreased interest rate sensitivity in plan funding requirements may have the opposite effect (i.e., lower allocations to liability-hedging investments). We expect that the net effect for the typical plan's investment policy will be a steepening of its preferred glide path.
- **Settlement strategy.** Settling plan liabilities through lump-sum offerings and annuity purchases becomes more desirable as the increase in the flat-rate premium raises the fixed costs of maintaining a qualified pension plan.

[1] In addition to the increases in the fixed and variable PBGC premium rates legislated under BBA 2015, the premium rates are indexed to increases in national average wages. Assuming 3% annual increases in future national average wages, the variable premium rate is projected to be 4.4% of unfunded liabilities in 2019, and an even higher percentage in later years.

This paper provides an overview of BBA 2015's key pension-related provisions, an analysis of how they will impact plan sponsors, and strategic implications for pension plan funding, investment, and settlement strategies.

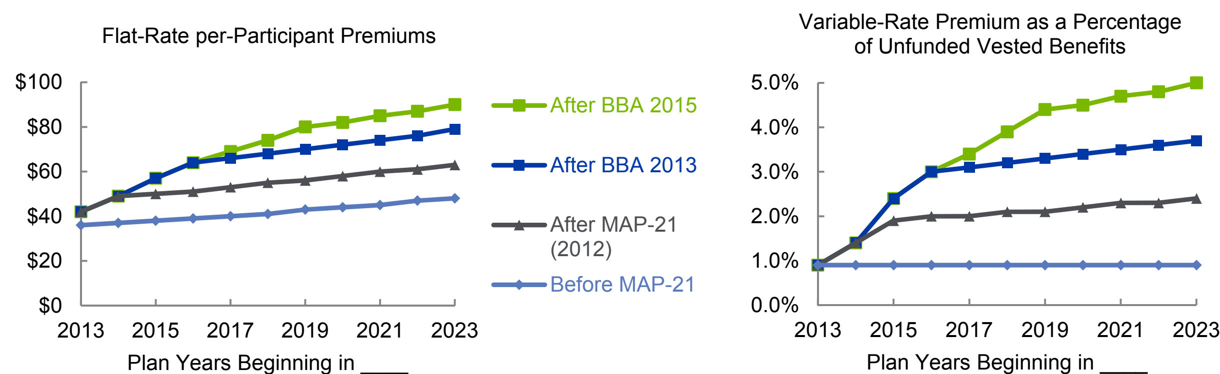
PBGC Premium Provisions

The PBGC is a U.S. government corporation created by the Employee Retirement Income Security Act of 1974 (ERISA) to ensure the continued payment of pension benefits to defined benefit pension plan participants in the event of plan sponsor bankruptcy or other PBGC takeover of the plan. The PBGC is not funded with general tax revenue, but instead is funded with the assets of plans it has taken over and premiums assessed on the pension plans it covers. PBGC premiums include two components: a flat-rate premium based on the number of participants covered by a plan, and a variable-rate premium based on the level of the plan's unfunded vested benefits (UVB).[2]

BBA 2015's PBGC premium provisions significantly increase the flat and variable premium rates for single-employer defined benefit plans. These increases go above and beyond the previous increases enacted in MAP-21 and the Bipartisan Budget Act of 2013 (BBA 2013). These changes were made to raise federal revenue—with a projected increase of $4.1 billion over the next 10 years, according to the Congressional Budget Office (CBO).[3]

The charts below illustrate the increase in PBGC premium rates outlined in BBA 2015 versus BBA 2013 over the next five years.

Exhibit 1: Illustrative Projection of Future PBGC Premium Rates by Plan Year



Note: These projections assume 3% annual increases in future national average wages.

BBA 2015 did not change the per-participant cap on the variable-rate premium from prior law. As a result, the premium increases will have the biggest impact on plans that are underfunded, but not so underfunded that they are subject to the cap.

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[2] In determining a plan's UVB, the present value of the plan's vested benefits is determined using the yields available on high-quality corporate bonds.

[3] The premium increases will reduce both the PBGC's deficit and the federal budget deficit, even though the PBGC is not funded by general tax revenue. Premium receipts are deposited in a "revolving fund" at the PBGC that appears on the federal government's balance sheet and provides the PBGC with permanent spending authority. This fund pays both benefits and other PBGC administrative expenses. Any increase in this fund has a direct impact on the federal deficit.

In addition to the PBGC premium rate increases, the due date for PBGC premiums for the 2025 premium payment year has been accelerated by one month, thus requiring payment on September 15 rather than October 15 for a calendar-year plan. Based on a literal reading of the statutory language, this acceleration of the premium due date will last for only one year before reverting back to the prior due date—though it is unclear whether the new law will actually be implemented in this way. While the acceleration would not raise federal revenue in real terms, the CBO projects that it will bring additional PBGC premiums of $2.6 billion within the Congressional 10-year budget window by moving the 2025 premium payments into the federal government's earlier fiscal year.

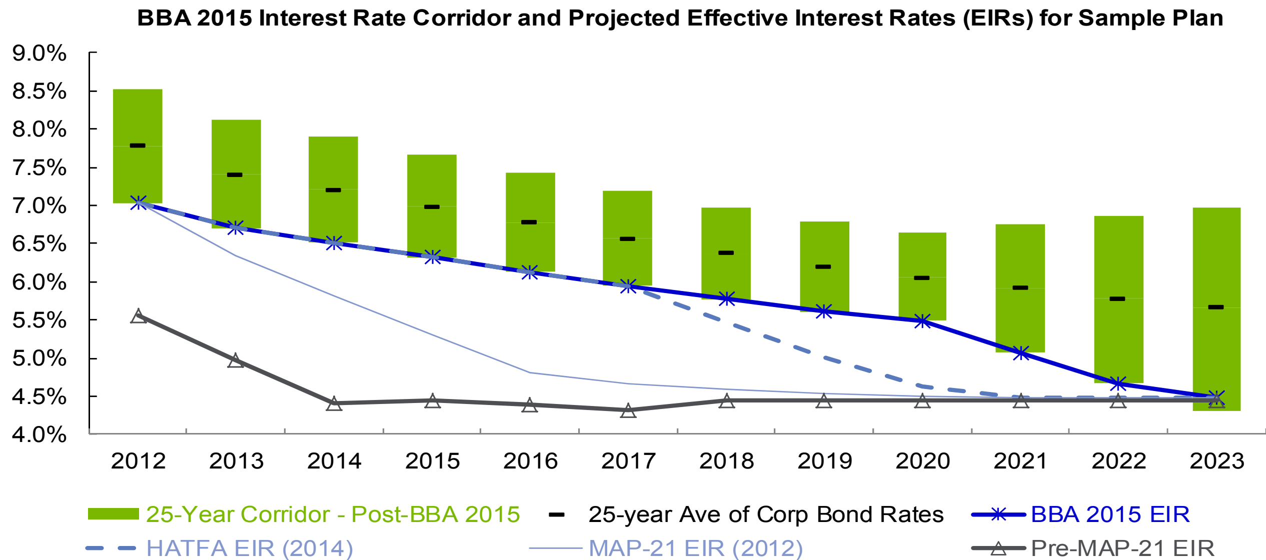
Interest Rate Stabilization Extension Provisions

Beginning in 2012, MAP-21 and HATFA established a "corridor" for the 24-month average segment interest rates that are used for pension funding purposes. This corridor is determined based on specified percentages of a 25-year average of the segment rates, and each of the segment rates is adjusted as needed so it falls within the corridor.

BBA 2015 extends the interest rate stabilization under MAP-21 and HATFA for an additional three years beyond prior law, so the corridor remains at 90%–110% of the 25-year average of the segment rates through 2020 (previously 2017 under HATFA). Then, in 2024 and beyond, the corridor widens by 5% per year to 70%–130% of the 25-year average of the segment rates.

The corridor applies for determining minimum required contributions and most benefit restrictions, but not for purposes of determining PBGC variable-rate premiums, lump-sum distributions, ERISA Section 4010 reporting, maximum deductible contributions, or Internal Revenue Code (Code) Section 420 transfers of excess pension assets to retiree health and life accounts.

The Aon Hewitt analysis shown in the chart below illustrates the impact of BBA 2015 on the effective interest rate (EIR) for a sample plan assuming that interest rates remain at September 2015 levels.



A case study illustrating the impact of the extended interest rate stabilization on plan contribution requirements is included in the “Impact on Plan Sponsors” section below.

Mortality Provisions

BBA 2015 includes a provision that may allow for the development of longevity assumptions for pension funding purposes that better reflect actual plan experience. Under prior pension funding rules, a specific minimum amount of experience data was needed in order to reflect actual plan longevity experience in pension funding valuations. If this threshold was not met, plans were required to use standard mortality tables prescribed by the IRS. In situations where only partially credible mortality experience is available, BBA 2015 allows for the development of plan-specific mortality tables based on a credibility weighting of that experience.

Although further IRS guidance is needed on how to implement this provision, plan sponsors may want to consider analyzing their own mortality experience to determine how reflecting this experience could impact their funding requirements and/or PBGC premiums.

Impact on Plan Sponsors

Impact on PBGC Premiums

The magnitude of the BBA 2015 PBGC premium increases will vary based on a plan's size, funded status, funding strategy, and other factors. In virtually all cases, however, the impact can be reduced—although not eliminated—by funding more than the minimum required amount over the next few years. Plans that are subject to the per-participant cap on variable-rate premiums will not see reduced premium levels until these plans are funded to such a level that the per-participant cap is no longer applicable.

Illustrative Example

To illustrate the change in PBGC premiums resulting from BBA 2015, consider a sample plan with the following characteristics:

- 80% funded[4] as of January 1, 2016 prior to any interest rate stabilization, with approximately $100 million in liabilities (without regard to interest rate stabilization) and $80 million in assets (as smoothed for funding purposes)
- Approximately 1,600 participants
- Plan asset returns are assumed to be 7% per year before reflecting plan administrative expenses

This illustration shows that the PBGC premiums prior to BBA 2015 over the 10-year period of 2016–2025 are projected to be $5,673,000, compared to $7,513,000 under BBA 2015. This 32% increase over pre-BBA 2015 PBGC premiums represents approximately 1.84% of plan liabilities. For underfunded plans, the value of different funding strategies can produce a material incremental return on accelerated contributions through the avoidance of PBGC variable-rate premiums, as shown in Aon Hewitt's analysis in the table below. Depending on the size and timing of excess contributions, the implied return could exceed 15%.

Exhibit 2: BBA 2015 Impact on Projected 2016–2025 PBGC Premiums for Sample Plan

Scenario	Projected 2016–2025 PBGC Premiums	Change from Scenario 1	Implied Return on Accelerated Contributions
Prior to BBA 2015	$5,673,000	–	–
BBA 2015 Scenario 1: No accelerated funding	$7,513,000	–	–
BBA 2015 Scenario 2: Accelerate $1 million funding in 2016	$7,382,000	($131,000)	13.1%
BBA 2015 Scenario 3: Accelerate $2 million funding in 2016	$7,221,000	($292,000)	14.6%
BBA 2015 Scenario 4: Accelerate $2 million funding in 2016 and 2017	$6,816,000	($697,000)	17.4%

As shown, the PBGC premium savings—expressed as a percentage of accelerated contributions—can

[4] Many plans have targeted an 80% funded status without regard to interest rate stabilization to avoid ERISA Section 4010 reporting requirements.

be significant. An added benefit of acceleration is that the plan's accounting expense under Accounting Standards Codification Topic 715-30 would decrease due to the lower level of administrative expenses and the increased value of plan assets. The net effect is an increase in the expected return on assets component of the annual expense.

Impact on Cash Contributions

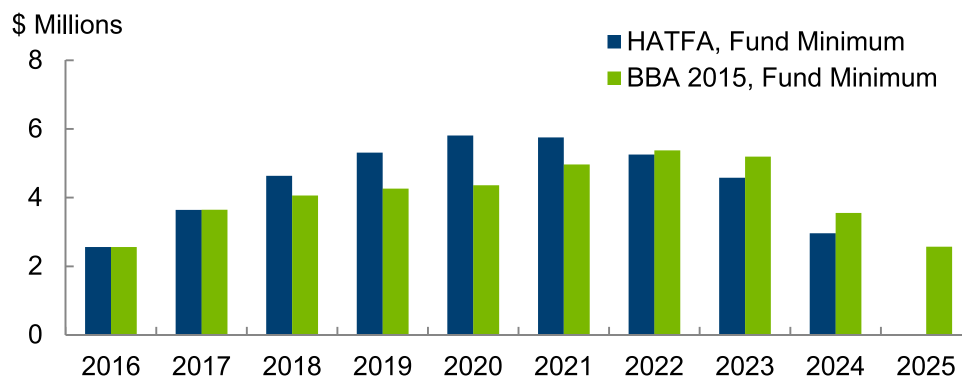
By extending the interest rate stabilization corridor for an additional three years, BBA 2015 results in lower required contributions beginning in 2018. Subsequently, reducing near-term contributions results in higher PBGC premiums as a plan's funded status—without interest rate stabilization—continues to deteriorate relative to prior law while the PBGC variable premium rate is increasing significantly.

Illustrative Example

Continuing with the example plan above, which has $100 million in liability and $80 million in assets, Aon Hewitt's analysis (shown in the illustrations below) demonstrates the impact of BBA 2015 on funding requirements over the next 10 years. Compared to HATFA's provisions, and assuming that interest rates remain at current levels and asset returns are within a typical expected range, cash contribution requirements are expected to decrease through 2021. In 2022 and beyond, cash contribution requirements are expected to increase compared to prior law. This illustration assumes that PBGC premiums are paid from plan assets. As a result, the increase in PBGC premiums due to BBA 2015 will also result in an increase in required contributions.

For plan sponsors that take advantage of the opportunity for reduced near-term contributions provided by BBA 2015, total contributions over the next 10 years are projected to be slightly higher than under HATFA. As discussed in additional detail below, careful consideration will be needed regarding whether to take advantage of the reduced near-term contributions or adopt a funding strategy to reduce or eliminate PBGC variable-rate premiums.

Exhibit 3: BBA 2015 Impact on Projected 2016–2025 Cash Contributions for Sample Plan



Scenario	PBGC Premiums	Employee Benefits	Total
	Total of 2016–2025 Contributions for:		
Pre-BBA 2015; fund minimum	$5.7	$35.1	$40.8
BBA 2015; fund minimum	$7.5	$33.3	$40.8

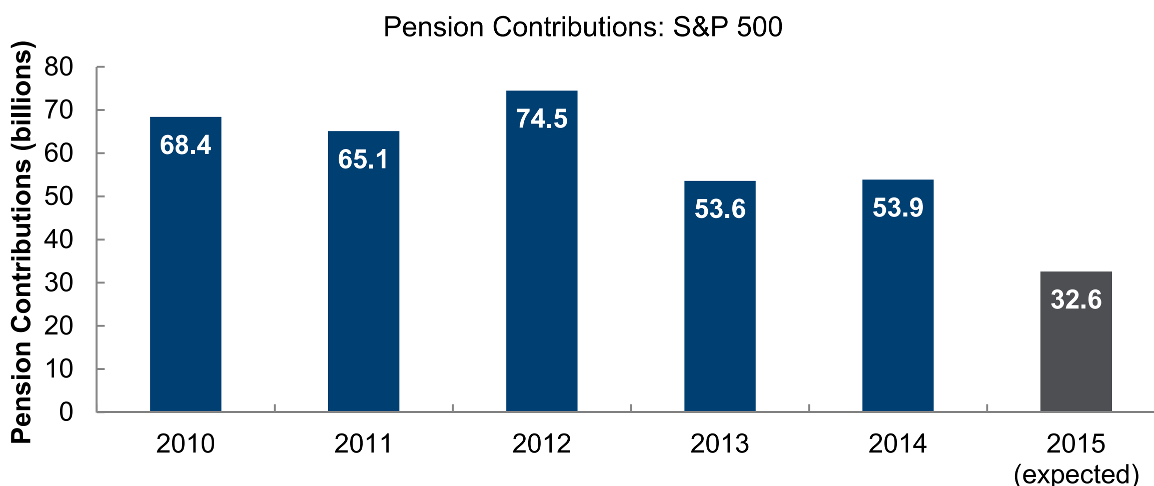
Strategic Implications for Plan Sponsors

Now is a good time for plan sponsors to consider the potential timing of pension contributions as well as alternatives for financing. In addition to its effect on funding strategies, BBA 2015 has implications for investment strategies and the attractiveness of plan settlements.

Funding Strategy

BBA 2015 makes it easier for corporations to defer contributions while simultaneously making it more expensive to do so. Which path will sponsors take? One clue is the experience so far with MAP-21 (2012), BBA 2013, and HATFA (2014). Like BBA 2015, these prior rounds of legislation offered funding relief while also increasing PBGC premiums. So far, as Exhibit 4 suggests, the response of many sponsors has been to fund less and pay the extra premiums. As the increases to the variable premium rate are now fully phased in, and are being further increased by BBA 2015, it is unclear whether this trend of lower funding levels will continue or sponsors will begin funding more heavily in order to avoid these higher premiums.

Exhibit 4: Historical Cash Contributions Among Plan Sponsors in S&P 500



Source: Compiled by S&P Dow Jones Indices from data provided by S&P Capital IQ.

We believe the value proposition for pre-funding, including borrowing to fund, is about to become much more compelling. Here's why:

- The financial benefits of pre-funding are now greater because of BBA 2015. Consider a scenario where borrowing cash would be needed to fund a pension plan in the amount necessary to eliminate PBGC variable-rate premiums. Assume that any borrowing will be done on a line of credit, and the amount will be paid back in level amounts over a period of 10 years. Further assume a 0% tax rate and a 5% discount rate.
- Prior to 2014, the savings in PBGC variable-rate premiums would have been 0.9% per dollar of unfunded obligation. The break-even borrowing cost is 5.9%. If the cash could be borrowed below 5.9%, it would make financial sense to borrow to fund the pension plan and eliminate variable-

rate premiums. Successive rounds of PBGC premium increases culminating with BBA 2015 will drive the break-even borrowing cost up to at least 9.1% by 2017.

- Assuming a 35% corporate tax rate, borrowing to fund becomes even more compelling since the interest on the debt is tax-deductible. The break-even pre-tax borrowing cost was 8.6% prior to MAP-21, but is now 11.7% under the BBA 2015 premium rates. The new rates make the borrow-to-fund trade-off even more attractive for companies with at or near-investment grade credit. Borrowing at sub-6% pre-tax rates could see substantial benefits regardless of the marginal tax rate.

		Break-Even Borrowing Cost	
	Year	**0% Tax Rate**	**35% Tax Rate**
Prior to MAP-21	2013	5.9%	8.6%
MAP-21 (2012)	2014	6.9%	9.5%
BBA 2013	2015	8.0%	10.6%
BBA 2015	2017	9.1%	11.7%

Source: Aon Hewitt Analysis

- Some may take the view that borrowing to fund a pension deficit merely swaps one form of debt (i.e., the pension deficit) for “hard” debt. In this view, the net borrowing cost associated with the pension deficit/hard debt swap may be zero, because the interest payments on hard debt replace interest growth in the pension deficit. Furthermore, interest payments on hard debt are tax-deductible, while interest growth on a pension deficit is not. In this view, the net financial impact of borrowing to fund can be reduced to two key items:

  (a) Tax deductions on interest payments on debt

  (b) Savings in PBGC premiums, net of tax

  Higher PBGC variable-rate premium rates have no impact on (a), but significantly increase the savings from (b).

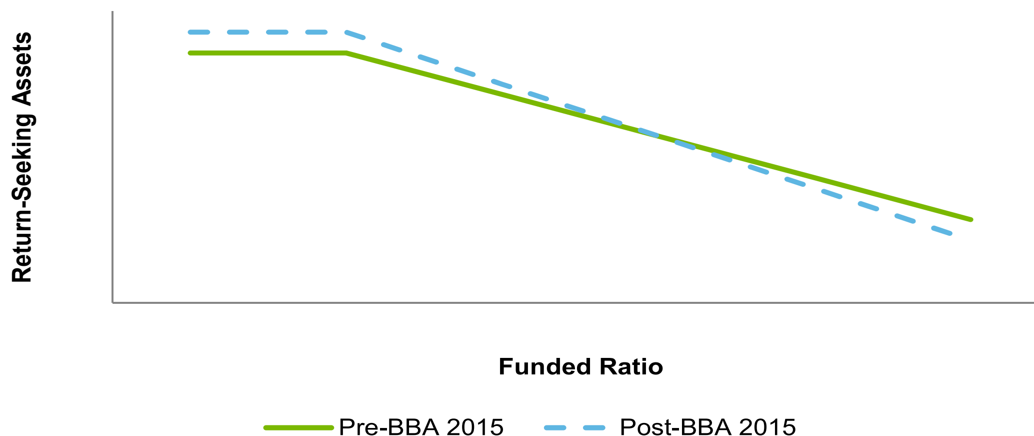
For companies that cannot raise cash at attractive rates, alternative funding approaches such as in-kind contributions may be worth another look. These can be structured to meet the “statutory exemption,” thereby avoiding the need to obtain a prohibited transaction exemption from the Department of Labor. But even if such an exemption is required, the potential savings in PBGC premiums may make the effort worthwhile.

Investment Strategy

Because BBA 2015 affects plan funding strategy, it also has a direct impact on investment risk, especially for plan sponsors with de-risking glide paths that connect the asset allocation to the funded ratio. Lower minimum required contributions may slow progress along de-risking glide paths.

Further, the new law has several provisions that may affect not just the plan’s position on its glide path, but the slope and level of the glide path itself. While the impact may vary by plan based on the plan’s circumstances and the sponsor’s priorities, we believe that for the typical situation, the new law encourages taking slightly more investment risk when a plan is underfunded but slightly less risk when overfunded. This is illustrated in the following exhibit, with the rationale described afterward.

Exhibit 5: Illustrative Glide Path Impact of BBA 2015



- Compared to prior law, fully funded plans under BBA 2015 typically will have slightly less risky asset allocations. This is because the increase in PBGC variable premium rates creates a greater penalty for being underfunded, which exacerbates the asymmetric consequences for fully funded plans taking investment risk. However, the higher PBGC variable-rate premiums also strengthen the case for fully funded plans, which might lead to a desire to take on more investment risk when underfunded.
- The extension of interest rate stabilization provides an incentive for more investment risk because the required cash contributions are less sensitive to the level of interest rates. That allows greater capacity for a plan's investments to be in anything other than long duration fixed income. For some, this means a slightly greater allocation to return-seeking assets like equities and alternatives. Others may choose to use the opportunity to adjust the duration of any fixed income via a hedge path, if they want to position the portfolio in expectation of rising rates.[5] Either way, the desire to take more investment risk tends to diminish as funded status increases, as the emphasis transitions from managing cash contribution volatility to managing the long-term economic funded ratio. Sponsors are more likely to elect unsmoothed funding interest rates when their allocation to fixed income increases beyond about 70%–75%.
- The ability to customize mortality tables may also influence investment programs. As a simple example, a plan with a blue collar population may end its glide path when plan assets are at 105% of the unsmoothed funding liability, as a proxy for the plan termination liability. However, if the plan changes its mortality assumption to assume lower longevity, then it might need to shift the glide path to end at 110% of the new funding liability to continue as a proxy for the plan termination liability, since lump-sum and annuity purchase calculations performed at plan termination may not fully reflect the blue collar nature of the population.

Overall, the impacts of BBA 2015 on a plan sponsor's preferred investment policy are typically incremental, but noticeable. In situations where the investment approach has been recently revised, we

[5] A "hedge path," is a rules-based approach to varying the duration of the fixed income portfolio based on the level of interest rates and the plan's funded ratio. It is often used in combination with a glide path, and has become more popular since interest rates have been near historical lows and many plan sponsors are reluctant to allocate to long duration bonds. Hedge paths are a transition strategy to long duration, and work as a return enhancer only if interest rates rise more than the market expects.

do not expect massive changes as a result of the new law. However, many de-risking glide paths and hedge paths were created several years ago, and have not been fully revisited since MAP-21, BBA 2013, or HATFA. If a comprehensive review of a plan's investment policy has not been performed since these multiple legislative changes became effective, then BBA 2015 could be used as an opportunity to engage in a broader review of the investment approach.

Settlement Strategy

BBA 2015's higher variable-rate and flat-rate premiums could also lead to the reconsideration of settlement strategies. In fact, BBA 2015's higher variable-rate premiums mean more sponsors will likely see highly leveraged benefits from settling obligations via lump-sum windows and insured buyouts. This is because reducing the participant headcount directly reduces the maximum variable-rate premiums, which are capped at $500 per participant in 2016 (indexed to national average wages). In some cases, based on Aon Hewitt's analysis, sponsors with unfunded vested benefits of about $16,000 or more per participant could expect to realize a savings in PBGC premiums of over $500 per participant settled per year (as Exhibit 6 shows). For smaller benefit amounts, the savings in PBGC variable-rate and flat-rate premiums will exceed, on a present-value basis, the entire amount of the lump sum paid.

Exhibit 6: PBGC Premium Savings Illustration

	Variable-Rate Premium (VRP)						
	A	B	C = A x B	D	E = lesser of (C, D)	F	E (if cap applies) + F
Year	**Deficit per Participant**	**VRP Rate**	**VRP Before Cap**	**Cap**	**VRP With Cap**	**Flat-Rate Premium**	**Savings per Lump Sum Paid**
2016	16,000	3.0%	$ 480	$ 500	$ 480	$ 64	$ 64
2017	16,000	3.4%	544	515	515	69	584
2018	16,000	3.9%	624	530	530	74	604
2019	16,000	4.4%	704	546	546	80	626

The higher variable and flat premium rates under BBA 2015 make settlements of all kinds more attractive, including:

- Lump-sum windows
- Small amount cash-out "sweeps"
- Adding a lump-sum optional form of payment, with or without an amount limit
- Annuity buyouts

We expect 2016 to be a big year for pension settlement activity. BBA 2015 may make it an even bigger year.

Timing and Suggested Next Steps for Plan Sponsors

The higher PBGC premium rates under BBA 2015 will take effect beginning in 2017, and the extended interest rate stabilization will take effect beginning in 2018. During the coming year, plan sponsors should evaluate whether and how to respond to these changes. Aon Hewitt recommends the following actions:

1. **Analyze.** Perform a projection of expected PBGC premiums and cash contributions using current funding and investment policies as a starting point. Reevaluate assumptions used in actuarial valuations as well as any impact on PBGC premiums and cash contributions. In light of the ability to use partially credible mortality experience, consider performing a mortality experience study.

   Analyze the impact of revised funding, investment, and settlement strategies on projected PBGC premiums and cash contributions.

2. **Determine strategy.** Consider changes to strategies in each of these three areas:

Strategy	Considerations
Funding	When not impacted by PBGC variable-rate premium per-participant maximum, accelerated funding will result in a direct decrease in PBGC premiums. If accelerated funding is not feasible from cash reserves, consider alternative funding sources such as borrowing to fund and in-kind contributions (e.g., company stock, real estate, preferred equity).
Investment	Reevaluate investment glide path given the more asymmetric risk-reward trade-off introduced by the higher variable-rate premiums. This is especially important if the investment policy has not been reviewed since the enactment of MAP-21, BBA 2013, or HATFA.
Settlement	Review settlement strategies such as lump-sum windows, small amount cash-outs, lump-sum optional forms of payment, and annuity buyouts to reduce participant headcounts—particularly for plans that are impacted by the per-participant maximum. Ideally, any settlement strategies would be reviewed as part of the investment policy review described above.

3. **Execute.** Move forward with the optimal pension plan management strategies, and monitor the plan's funded status for future trigger points such as de-risking events or plan settlements.

For additional information on BBA 2015 or to discuss its potential impact on your organization's pension plans, please contact your local Aon Hewitt consultant or one of the authors listed on the following page.

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