Rocaton

INSIGHTS

PBGC Variable Rate Premium Methodology Determination

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Executive Summary

- Many corporate plan sponsors are currently faced with a decision (deadline of October 15, 2014 for calendar-year plans) regarding the liability discount rate methodology they will use to determine the Variable Rate Premium (VRP) payable to the PBGC for the 2014 plan year.
- Most such plan sponsors have the opportunity to change the liability discount rate methodology from a 24-month average rate (Alternative Method) to a one-month spot rate (Standard Method[1]). Once the switch is made, the methodology cannot be changed again for five years.
- For plans paying a VRP, a change to the Standard Method will result in savings for payments due in mid-October, but introduces the likelihood of more volatile VRPs in future years.
- Given the current interest rate environment and increasing VRP rates, plan sponsors should understand the specific known 2014, and potential 2015 and later dollar impact on their plan(s) when considering whether to change their VRP methodology.
- The 2015 impact on plans depends primarily on how rates move for the rest of 2014. If "mark-to-market" PBGC rates[2] are estimated to be near or above the applicable 24-month average (approximately 4.4% for a typical plan[3]) at the filing deadline, there may be a compelling reason to switch to the Standard Method before the filing.
- If the methodology is not changed this year, there is the option to revisit it in future years, and at some point, a change in methodology may be advisable despite the increased volatility.

Introduction

Each year, by October 15th, most defined benefit plans[4] covered by the PBGC are required to pay VRPs. The VRP is calculated by a plan's actuary and is based on the product of the PBGC-defined multiplier and the plan's PBGC unfunded vested benefits (UVBs). There are a number of strategies and tactics plan sponsors can consider to better manage PBGC premiums which extend beyond the scope of this paper. We will focus on one strategy which may be most relevant for the 2014 PBGC filing. For this year's October 15th filing for calendar year plan years, plan sponsors are confronted with the decision to consider a change in the methodology they elect to calculate their UVBs.

There is a good reason why this decision to change VRP methodology doesn't come up often; once plan sponsors elect to change their methodology, they are locked in for **five** years. Most plan sponsors currently use the Alternative Method and have been doing so for the past five years. Therefore, most plans now have the option to change methodology to the Standard Method. The change is potentially appealing now because plan sponsors could reduce their 2014 VRPs by a meaningful amount by moving to the Standard Method. Before making this decision, it is important that plan sponsors also consider the likely 2015 impact as well as the potential impact throughout the five-year period in which the new methodology would be in effect. This paper seeks to help plan sponsors make an informed, forward-looking decision for the 2014 filing[5].

Why Consider a Change Now?

The reason to review a potential change for the 2014 filing is two-fold. First, as mentioned earlier, most plan sponsors have the option to make a change. Second, the interest rates used in the 2014 filing are based on 2013 rates. Rates ended 2013[6] approximately 50 basis points above the average for the two years ending in August 2013[7]. This leads to a reduction in 2014 plan year VRPs if the Standard Method is adopted. On the surface, it would

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[1] The spot rate is the monthly average rate during the month prior to the beginning of the calendar year (i.e. for the 2014 filing spot rates are December 2013 average rates)

[2] i.e., estimated mark-to-market spot rates calculated based on A-or-better rated corporate bond yields consistent with the methodology used to develop the PBGC Standard discount rates, not averaged over any period of time.

[3] Throughout this paper, we illustrate this issue with a "typical" plan with a liability duration of about 13-14 years (at a 4.4% discount rate). The actual effective rates that would be calculated for specific plans, under both the Standard and Alternative methods, would depend on the liability profile of those plans.

[4] Assumes calendar-year, mid or large sized plans where the Normal Premium Due Date is applicable.

[5] As with any decision regarding actuarial methodology used for determining pension funding, PBGC calculations or expense we would advise clients to also consult with the plan's actuary on this decision.

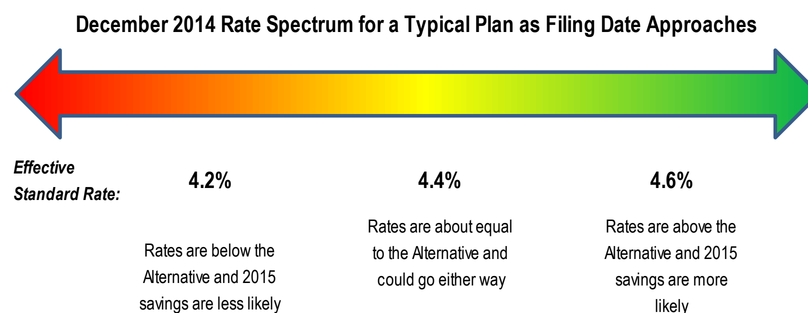
[6] The Standard Method rates are based on the December 2013 spot rates.

[7] Rates are based off of a typical plan with a four-month look-back. The alternative rates are based on the 24-month average of the September 2011 to August 2013 rates.

seem that plan sponsors should change methodologies and save on 2014 premiums. However, making the change for the 2014 filing will impact the plan sponsor for four additional years.

The Next Four Years

Predicting rates for the next four years is an extremely difficult task; however, plan sponsors might choose to forego the initial savings in 2014 because of the implied impact of the methodology change on the 2015 filing. Consider that for the 2015 PBGC filing, the Alternative Method rate which for a typical plan is based on the 24-month average through August 2014 is already known. The December 2014 one-month average will determine the Standard Method rate which exposes sponsors who elect that method to the risk of rate changes for the next three months. If plan sponsors choose to make a methodology change to the Standard Method in 2014, there is the potential to lose the VRP savings from 2014 in 2015. To compound the issue, the PBGC premium multipliers are scheduled to increase significantly (from 1.4% to at least 2.4% of the UVBs) between the 2014 and 2015 plan years. The potential two-year cumulative impact of switching to the Standard Method in the 2014 plan year will depend largely on interest rate moves from now until year-end[8]. Unfortunately, this decision must be made before the December 2014 Standard rates are known, which will determine the Standard Method calculation for the 2015 plan year.



Let's first consider if "mark-to-market" PBGC rates are near or above the 24-month average just before the PBGC filing date (October 15, 2014 for most plans). The cumulative impact on VRPs for the 2014 and 2015 plan years will likely favor making the switch as the 2014 savings in VRPs will not be **expected**[9] to be offset by additional VRP costs in 2015. If these rates should land significantly above the 24-month average at this time, plan sponsors will likely be even more compelled to make the switch to the Standard Method in order to reduce VRPs for the 2014 plan year and **expect**[9] reduced VRPs in 2015. On the other hand, if rates fall below the 24-month average just before the filing date it might be more compelling to continue to use the Alternative Method because it would become more likely that the 2014 savings would more than offset by additional VRPs in 2015 and the switch would have the disadvantage of more volatile VRPs in the future and lock this decision in for five years.

Beyond 2015, Rocaton's capital market forecasts build in the expectation that rates will rise back towards equilibrium levels. The charts below illustrate projected ranges of outcomes for the difference between the effective discount rates that would be calculated for the Standard Method versus the Alternative Method over the five plan years ending with 2018 given three sample scenarios for what might happen for the rest of 2014. If rates rise as we expect, plan sponsors should expect to derive savings in VRPs from the switch to the Standard Method, but with greater potential downside premiums relative to the Alternative Method, especially in light of the fact that the multiplier is scheduled to increase significantly in future years[10]. Recall that if the Standard Method is not adopted for 2014, there is still the ability to change in future years.

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[8] There are a number of other variables which can influence the net cost or savings from changing VRP methodologies between the 2014 and 2015 premiums, or over longer periods of times. Contributions, lump sum windows, investment returns, and so on should all be considered in evaluating a change in VRP methodology.

[9] It is entirely possible that rates could decline after filing and prior to year-end, meaning further savings for 2015 would not be guaranteed.

[10] 1.4% of the UVBs in 2014, at least 2.4% in 2015, at least 2.9% in 2016, and indexed after 2016

%ile	2014	2015	2016	2017	2018
99th	0.5%	0.0%	1.8%	2.2%	2.1%
95th	0.5%	0.0%	1.4%	1.6%	1.6%
75th	0.5%	0.0%	0.8%	0.9%	0.8%
50th	0.5%	0.0%	0.4%	0.5%	0.3%
25th	0.5%	0.0%	0.0%	0.0%	-0.1%
5th	0.5%	0.0%	-0.6%	-0.6%	-0.8%
1st	0.5%	0.0%	-1.0%	-0.9%	-1.3%

%ile	2014	2015	2016	2017	2018
99th	0.5%	-0.5%	2.0%	2.7%	2.7%
95th	0.5%	-0.5%	1.5%	2.1%	2.0%
75th	0.5%	-0.5%	0.8%	1.2%	1.0%
50th	0.5%	-0.5%	0.2%	0.6%	0.4%
25th	0.5%	-0.5%	-0.3%	0.0%	-0.2%
5th	0.5%	-0.5%	-1.0%	-0.7%	-1.1%
1st	0.5%	-0.5%	-1.5%	-1.2%	-1.7%

%ile	2014	2015	2016	2017	2018
99th	0.5%	0.5%	1.5%	1.6%	1.6%
95th	0.5%	0.5%	1.2%	1.2%	1.2%
75th	0.5%	0.5%	0.8%	0.7%	0.6%
50th	0.5%	0.5%	0.5%	0.4%	0.3%
25th	0.5%	0.5%	0.2%	0.1%	-0.1%
5th	0.5%	0.5%	-0.2%	-0.4%	-0.6%
1st	0.5%	0.5%	-0.5%	-0.7%	-1.0%

Conclusion

For many plans it remains unclear whether a switch to the Standard Method for calculating VRPs will be beneficial over the next five years. If rates are near or above the 24-month average when it is time to file in 2014 it is likely the switch to the Standard Method makes sense; however, if rates are below the 24-month average at the filing deadline, it might be more compelling to continue to use the Alternative Method and preserve the option to switch later. Plan sponsors should closely monitor rates levels as we approach the filing deadline and understand the rate level at which it makes sense for them to make the switch in methods, given their specific plan and ability to tolerate risk.

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