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RETIREMENT & PERSONAL WEALTH SOLUTIONS

Investment strategies for the current pension regulatory environment

Funding relief gives plan sponsors the option to defer contributions to their plans, but doing so incurs high PBGC premiums.

5.59%

January 2024
Third segment rate **with** relief

4.95%

January 2024
Third segment rate **without** relief

The variable-rate premium has increased fivefold in the last decade (from 0.9% in 2013), effectively making the VRP headcount-based for many plans.

5.2%

PBGC variable-rate premium on unfunded liabilities

$787

PBGC premium per participant for plans at VRP cap

The U.S. pension regulatory environment, characterized by funding relief and high Pension Benefit Guaranty Corporation (PBGC) premiums, influences the optimal investment strategies for pension plans. The American Rescue Plan Act (ARPA) funding relief significantly reduced funding requirements. Concurrently, dramatic increases to the PBGC variable-rate premium impose a meaningful headwind for many plan sponsors seeking funded status improvement.

Prior to 2022, funding relief allowed plan sponsors to use interest rates far above market levels to value liabilities for funding purposes. This eliminated cash contribution requirements for many plans. With market interest rates now at much higher levels, the relief is less helpful. In fact, many sponsors of well-funded plans have contribution requirements for the first time in several years — as asset losses from 2022 are incorporated into their funding valuations with almost no corresponding gain on the liability side. This is even true for many plans investing in liability-driven approaches through 2022, with funded ratios holding steady during the year on a market basis. Sponsors for these plans are now acutely aware that funding liabilities cannot be hedged.

The regulatory framework for pension plans must be considered as investment strategies are being developed. The most important ways in which the structures of funding relief and PBGC premiums affect optimal investment strategies for pension plans are outlined throughout the following sections.

Key takeaways

	Funding relief	PBGC premiums
Basics	• Incorporates an interest rate corridor, which allows higher interest rates to be used when rates are low to determine funding requirements. • Lengthens the amortization period for funding shortfalls. • Lowers funding requirements for the next 10+ years and makes those requirements more predictable.	• All plans pay a flat-rate premium of $101 per participant. • Underfunded plans pay a variable-rate premium of 5.2% of shortfall, capped at $686 per participant. • The "per participant" rates above are effective for 2024 and will be indexed for inflation in the future.
Insights	• Lengthens time horizon for many plans, enabling more risk-on investing, even in some less liquid asset classes. • Could enable tactical under-hedging, since funding liabilities are not closely tied to market interest rates.	• PBGC premium structure is generally supportive of glide paths because it creates asymmetric risk profiles. • For plans at the VRP cap, settlement strategies that reduce headcount can be an effective way to mitigate premiums, but there are trade-offs.

Funding relief background

Pension funding relief has been a major factor in the pension landscape practically since the application of the Pension Protection Act (PPA) in 2008. The PPA was designed to push plan sponsors into funding their plans more aggressively than before. The great financial crisis arrived later that year, however, and the combination of falling equity markets and interest rates presented a perfect storm for plan sponsors. The PPA exacerbated those issues by forcing many plan sponsors to make large cash contributions at a very challenging time, so Congress was forced to act. The first iteration of funding relief appeared in 2012 with the Moving Ahead for Progress in the 21st Century Act (MAP-21). Since then, funding relief has been modified and extended several times, most recently in 2021 with the ARPA and the Infrastructure Investment and Jobs Act (IIJA).

Every variation of funding relief has centered on allowing plan sponsors to use higher interest rates for minimum required contribution calculations. Relief is implemented through complex mechanisms looking back at interest rates over 25 years and applying corridors — rather than simply reflecting current market interest rates. With higher discount rates used, liabilities are lower, funded statuses are higher, and contribution requirements are either reduced or eliminated. There has always been a phase-out mechanism included for the relief to wear away at some point in the future. Historically, as this phase-out approaches having a significant effect, a new extension of relief has been passed.

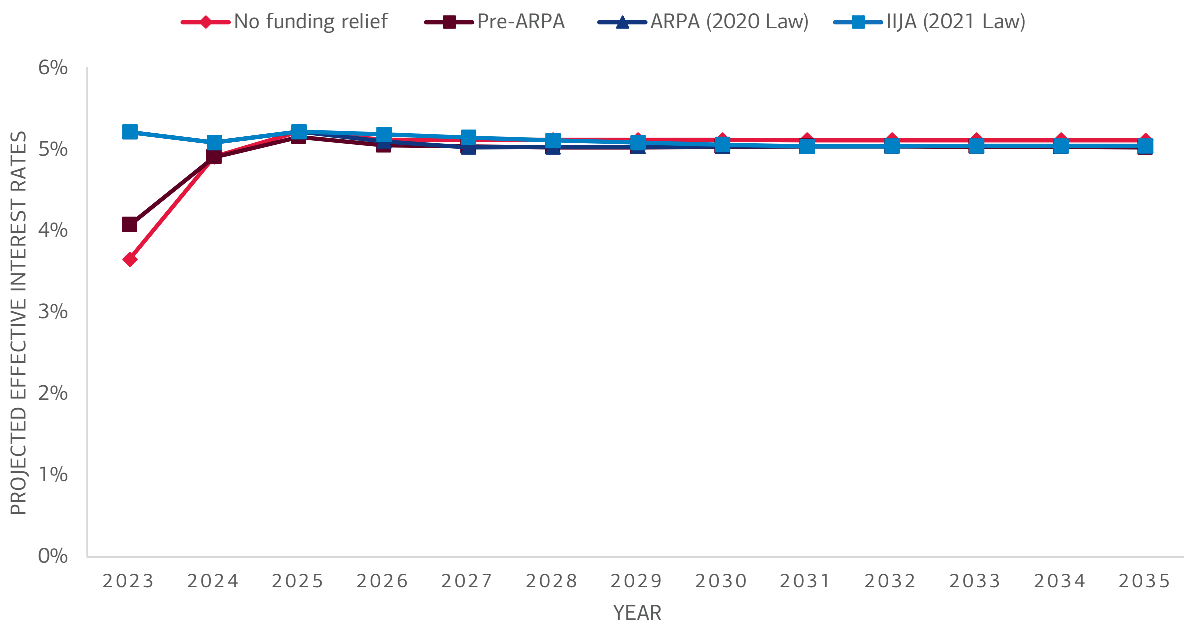
The goal here is to explain the impact that funding relief has on plan sponsors without focusing on the specific mechanisms determining funding requirements for pension plans. Particularly, this explanation will focus on how funding relief may change investment-related considerations and provide support for specific types of investment strategies.

There are two primary mechanisms by which funding relief reduces funding requirements for U.S. pension plans:

1) The relief imposes a floor on the interest rates used in funding valuations, which has resulted in lower funding liabilities and thus lower minimum required contributions over the last decade. However, the impact of the interest rate floor is not as significant anymore. Following the significant increases to market interest rates in 2022, rates are currently at similar levels to the floor imposed by funding relief.

2) The relief also prescribes a longer amortization period (15 rather than 7 years) for amortizing funded status shortfalls. The extended amortization period mostly reduces funding requirements and limits their short-term volatility.

Funding relief extended again (and again)



Effective interest rates are calculated for a hypothetical plan with a duration of about 12 years at a 5% discount rate. Projections assume market interest rates remain at levels observed during December 2023, based on the published applicable interest rates under IRC 417(e) for that month (5.01% for 5 years, 5.13% for next 15 years, and 5.15% beyond 20 years).

For illustrative purposes only.

Impact of funding relief on future funding requirements

The impact of the relief varies widely from plan to plan. Plans with larger funding deficits can experience dramatically reduced funding requirements. The risk associated with contribution requirements increasing in the near term is also reduced by funding relief. Well-funded plans (that would have minimal funding requirements absent relief) are largely unaffected.

Investment implications

For plan sponsors that benefit significantly from the relief, the main implications for investment strategy are:

1) The expected time horizon for the plan is lengthened as the relief delays funding requirements significantly, making a near-term plan termination considerably less likely.

2) The impact that asset losses have on near-term funding requirements has been significantly dampened, which may allow some plan sponsors to tolerate more risk.

3) Funding interest rates are now similar to market interest rates. Thus, funding relief currently isn't having much of an impact on liabilities. However, if interest rates were to experience a sharp decline, then the interest rate corridor would again provide significant relief — providing downside interest rate protection. This may hinder the rationale for using a liability-driven investing (LDI) approach.

For plan sponsors who were concerned that poor investment results might lead to large near-term contribution requirements, funding relief may help and allow for more aggressive asset allocations.

Investment ideas

Longer time horizons and a greater risk tolerance could enable some modifications to a plan's investment strategy:

1) Both could allow for a more aggressive asset allocation and/or glide path generally — targeting higher returns with a greater reliance on return-seeking assets.

    a) Absent funding relief, one or two bad years in the markets could result in a sharp increase in required cash contributions. The extended amortization period significantly dampens the impact of a poor performance year.

    b) Over the long run, equities are generally expected to outperform bonds. For plan sponsors that can accept the short-term volatility, staying invested in a well-diversified growth asset allocation should pay off.

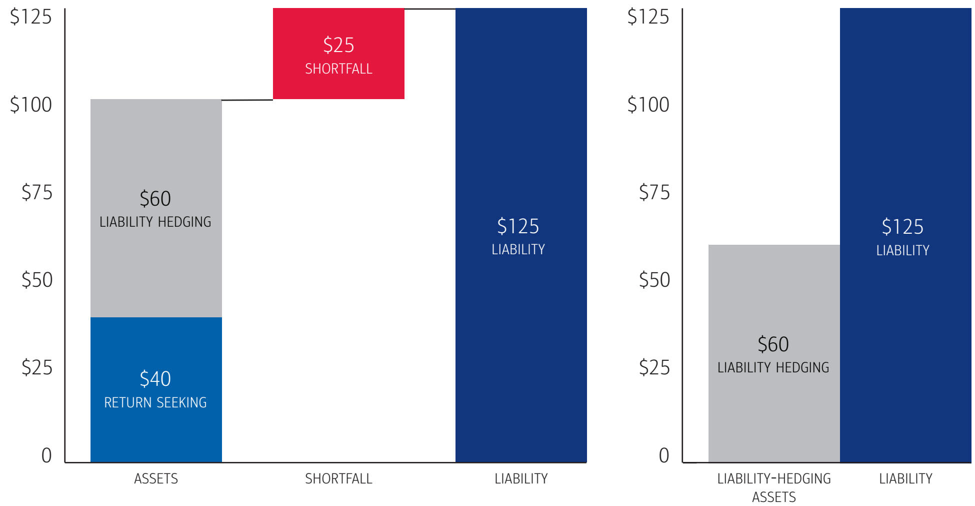
2) A longer time horizon could also allow for a greater use of illiquid private assets such as private equity, private debt, real estate and infrastructure.

    a) Adding alternatives to the return-seeking asset mix may be particularly important if the overall allocation to return-seeking assets is increased. Alternatives may mitigate some of the additional risk through greater diversification.

    b) For more on alternative investment strategies, please refer to Merrill's *Tap into greater opportunity with Alternative Investments* brochure.

3) Liability hedging strategies could be reevaluated to allow for more tactical under-hedging of interest rate risk in the immediate term. On the next page, we'll explore the trade-offs associated with such an approach.

Hedge ratio illustration



The **hedge ratio** is the portion of the liability's interest rate risk that is hedged.

Assuming fixed income assets are invested to match liability duration, the hedge ratio is the funded ratio times the liability allocation.

For example, for a plan that is 80% funded with a 60% allocation to LDI, the hedge ratio is 48% = 80% x 60%.

Liability-hedging assets could be invested at durations that are longer (or shorter) than the duration of the liability itself to target a higher (or lower) hedge ratio.

For illustrative purposes only.

Funding relief and interest rate risk

Funding relief could support the under-hedging of liabilities for plan sponsors with the necessary risk tolerance.

- Absent funding relief, a plan sponsor may be concerned with declining interest rate risk potentially leading to high cash contribution requirements.
- With funding relief, interest rates can't fall below a specified floor. This provides downside relief if interest rates were to fall sharply.
- The 5% floor on interest rates makes it so that each segment rate can't go below 4.75% through 2030 and below 3.5% once relief is fully phased out in 2035.
- Plan sponsors with higher risk tolerances could use some of that risk budget to take more interest rate risk.
- Adopting a policy with a larger return-seeking asset allocation, and therefore a smaller liability-hedging allocation, will result in a lower interest rate hedge ratio.

However, there are reasons many plan sponsors will decide to maintain a robust LDI strategy.

- Reducing funded status volatility may be important to stabilize financial accounting results, satisfy debt covenants or enable settlement strategies.
- Following meaningful interest rate increases in 2022, bond yields provide attractive returns. Future interest rates are inherently difficult to predict, but this at least provides an opportunity for LDI strategies to produce strong absolute returns going forward — especially if interest rates trend lower again.
- Long-duration government bonds usually benefit from a "flight to quality" that coincides with a sharp sell-off in equity markets. Having some exposure to long Treasurys usually reduces equity risk.
- Tactically under-hedging will also only be attractive for plan sponsors with conviction that long-term interest rates are more likely to rise than to fall.

Elevated PBGC premiums and the application of the VRP cap

PBGC premiums have increased significantly in the last decade and have thus become a central consideration in strategy setting for pension plans. There are two components of PBGC premiums: flat rate and variable rate. The flat-rate premium is a simple headcount-based premium. At $101 per participant for 2024, it is more than double the rate from 10 years ago. The variable-rate premium is more complex and determined as a percentage of the unfunded liability, but cannot exceed a per-participant cap.

PBGC premiums should be considered in the development of prudent investment policies for pension plans. The structure of the PBGC VRP creates asymmetric risk profiles, where the upside and downside associated with taking risk may be unbalanced. In general, this risk profile supports the use of de-risking glide paths. Targeted settlements can be effective for reducing PBGC premiums for plans at the cap, though not without trade-offs.

Increases to PBGC premium rates

	2014	2024	Increase
Per-participant flat-rate premium	$49	$101	2x
VRP rate on PBGC shortfall	1.4%	5.2%	4x
VRP per-participant cap	$412	$686	1.6x

More on the PBGC VRP

The basic VRP works like a tax on shortfall of plan liabilities less plan assets. At 5.2% for 2024, the rate has increased more than fivefold in the last decade. The VRP represents the largest portion of premiums paid by most plan sponsors, though well-funded plans can avoid it entirely.

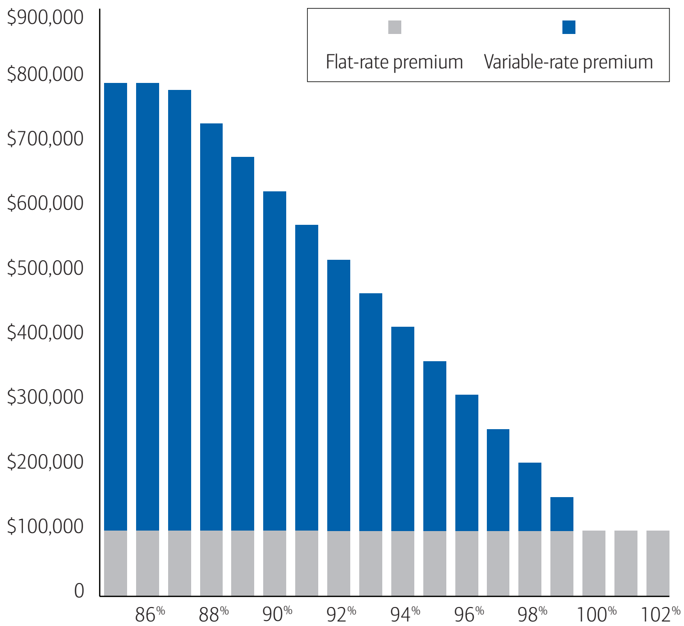
1) The VRP cannot exceed the variable-rate premium cap ("the cap"), which is $686 per participant for 2024.

2) Since 2014, the VRP rate has increased nearly 300%, whereas the cap has increased about 60%. Due to this disconnect, many plans are currently benefiting from the cap and were not several years ago.

3) The PBGC liability is calculated using one of two interest rate measures available. The standard method is based on corporate bond rates at the beginning of the plan year, while the alternative method involves smoothing over 24 months and a small look-back. Whichever method is used, the applicable interest rates are much lower than funding interest rates and are generally more closely related to market interest rates.

4) The assets are calculated using the market value of assets with no smoothing. Contributions made during the first 8½ months of the plan year can also be included in the assets.

PBGC premiums by funded ratio example



The plan shown in this illustration has a PBGC liability of $100 million and 1,000 participants (so the average participant's benefit is worth $100,000).

For illustrative purposes only.

Observations:

- The flat-rate premium is unavoidable and independent of the funded ratio.
- The variable-rate premium is eliminated at a 100% funded ratio.
- The cap applies here at a funded ratio of 86%.
- The funded ratio at which the cap applies is a function of the average liability per participant:
  - For plans with higher average liabilities, the cap will apply at higher funded ratios.
  - For plans with lower average liabilities, the cap will apply at lower funded ratios.
  - Thus, underfunded plans with lower per-participant liabilities (higher headcounts) will be subject to the highest PBGC premiums as a percentage of assets.
- Plans subject to the cap stand to benefit from funded status volatility, while plans that are fully funded can only see premiums increase if their funded ratio changes.

Implications for pension investment strategies

The influence of PBGC premiums on a plan's investment strategy depends on that plan's funded status and is best addressed through an asset-liability study based on a stochastic projection of a plan's financials (including funding requirements and PBGC premiums).

The asymmetric risk profiles created by the structure of the VRP are evident when considering two hypothetical plans:

A plan that is very well funded (100% on a PBGC basis) has no VRP. If the plan's funded status worsens, any new shortfall will be penalized at over 5% in PBGC premiums annually. There is no corresponding benefit from further improvement to the plan's funded status. This plan has asymmetric downside risk, meaning improvements receive no benefit, but declines are significantly punished.

A plan that is poorly funded on a PBGC basis and subject to the cap would not see its PBGC premiums increase even if its funded status worsens because of the effect of the cap. However, achieving funded status improvement could reduce PBGC premiums significantly. This plan has asymmetric upside risk, meaning improvements are rewarded but declines are not consequential.

As those hypotheticals illustrate, poorly funded plans are rewarded for taking risk whereas well-funded plans are penalized. The structure of the PBGC premiums is supportive of de-risking glide path strategies whereby risk is reduced as a plan's funded status improves. We believe a glide path should be designed for a pension plan only after modeling the plan's PBGC premiums under various economic scenarios, since they represent the largest annual expense for many plans.

PBGC premiums and settlements

Settlement strategies, including lump sum windows and annuity purchases, can be used to reduce PBGC premiums. Settlements are particularly effective at reducing PBGC premiums for plans at or near the VRP cap, where the annual PBGC premium savings are nearly $800 per removed participant. It is important that settlements be considered as part of a broader pension risk management strategy, where the plan's investment strategy is the centerpiece.

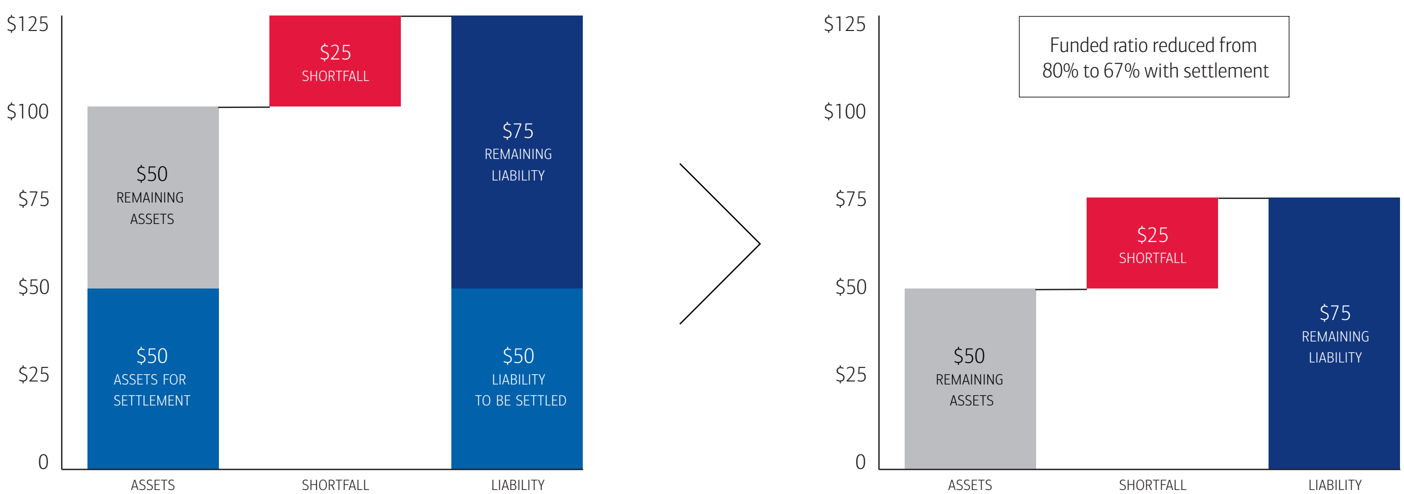
1) There are important trade-offs associated with settling liabilities, especially in a low-interest-rate environment where settlement costs are high.

2) Settling liabilities in an underfunded plan will further worsen the plan's funded status, even if liabilities are settled at book value. This could make it challenging for assets to keep pace with liabilities post-settlement.

3) Settling liabilities at a discount rate well below the expected return of the portfolio is financially equivalent to investing in an asset that perfectly hedges those liabilities, but with a lower return locked in. This means plan sponsors could be "settling" for 4% or 5% when they'd expect long-term returns of 7% or 8% by continuing to invest those same assets.

Bank of America can help you evaluate settlement opportunities within the broader context of your long-term pension risk management strategy.

Settlement illustration



For illustrative purposes only.

Observations:

- Assuming liabilities can be settled at cost, a settlement will reduce the funded ratio of an underfunded plan, though the shortfall in dollar terms will be unaffected.
- A lower funded ratio could trigger cash contribution requirements, though funding relief could mitigate this effect.
- A lower funded ratio may make it harder for a plan to achieve investment-related goals, with fewer assets remaining to match or exceed the growth on the liability.

Conclusion

We've addressed two defining aspects of the current regulatory environment for U.S. pension plans: funding relief and PBGC premiums. As described, funding relief reduces funding requirements, while dramatic increases to the PBGC VRP impose a meaningful headwind for many plan sponsors looking for funded status improvement.

These recent changes to the regulatory environment have had a particularly meaningful impact on relatively poorly funded plans. These plans benefit from funding relief the most, but they also pay the highest PBGC premiums. The investment-related implications of these regulatory changes are somewhat similar for these plans as well. For most poorly funded plans, the relief extends time horizons and increases the tolerance for short-term negative results. The structure of PBGC premiums creates an asymmetric risk profile whereby taking more risk may be rewarded with potentially reduced PBGC premiums.

To combat this challenging environment, we believe these plan sponsors should be reassessing their pension risk budgets and exploring ways to increase expected returns going forward. There is an opportunity for plan sponsors to drive funded status improvement in the coming years without needing to fund their deficits through contributions. We believe these plan sponsors are most likely to succeed when delegating investment decisions to a sophisticated investment advisor with a proven chief investment office.

For more information, please contact your Bank of America representative or visit go.bofa.com/retirementplans.