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Pension Financial Impact of Record Low Treasury Bond Rates

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How will defined benefit pension plans fare as a result of the 30-year U.S. Treasury bond rates falling below 2.00% for the first time in U.S. history? This 100 basis point drop from the beginning of the year and the fact that U.S. Treasury bond rates of all durations are down significantly from the beginning of the year, have pension plan sponsors, CFOs, and actuaries alike, taking an in-depth look at the financial impact.

How Will Record Low Treasury Bond Rates Impact Your Company's Defined Benefit Plan?

Due to the long-term benefit structure of pension plans, their liabilities produce high duration values that are particularly sensitive to movement in long-term interest rates. For instance, a standard frozen pension plan may have a duration of 12 which indicates that a decrease in the discount rate of 100 basis points would produce a 12% increase in liabilities.

Under U.S. GAAP and International Accounting Standards, pension liabilities are typically valued using a yield curve of corporate bond rates (which have high correlation to treasury bond rates) to discount projected benefit payments. Current analysis shows that the average discount rate has decreased over 100 basis points from the beginning of the year using this methodology. Assuming all other plan assumptions are realized, the larger liability value caused by the decrease in discount rates will drive up the pension expense and cause a significant increase in the company's other comprehensive income, reflecting negatively on the company's financial statements.

What If We Want to Terminate our Pension Plan in the Near Future?

For companies that are contemplating defined benefit pension plan termination, there will also be a significant increase in the cost of annuity purchases. The actual cost difference depends on plan-specific information; however, an increase of 10-20% from the beginning of the year would not be out of line with the current market. This can be particularly problematic for companies who have already started the plan termination process. Due to the current regulatory structure of defined benefit pension plan terminations, companies must begin the process months before the annuity contract is purchased. Their decision to terminate is based on estimated annuity prices which could be significantly different than those in effect at the time of purchase.

Consider Growth in Lump Sum Payment Value and PBGC Liabilities

Additional consequences of record low treasury bond rates include growth in the value of lump sum payments and PBGC liabilities. Minimum lump sum amounts must be computed using interest rates prescribed by the IRS in IRC 417(e)(3) which are based on current corporate bond yields. PBGC liabilities are also determined using these rates (standard method) or a 24-month average of those rates (alternative method). If current interest rates hold, lump sums paid out during 2020 will likely be 10-15% higher than those paid out in 2019 for similarly situated participants. In addition, there would be a corresponding increase in the liability used to compute the plan's PBGC premium. In 2020, there will be an estimated 4.5% fee for each dollar the plan is underfunded on a PBGC basis. Depending on the size and funding level of the plan, the spike in PBGC liability may correspond to a significant increase in the PBGC premium amount.

Actions You Can Take to Mitigate the 2020 Financial Impact

There is potential to help mitigate the financial impact for 2020 by taking action now. Since lump sum payments are projected to increase significantly in 2020, offering a lump sum window to terminated vested or retired participants during 2019 could be a cost effective way to reduce the overall liability of the plan.

Contributions to the plan in excess of the mandatory required amount will help offset rising PBGC premiums since the premium is based on the underfunded amount, not the total liability. Additional contributions would also help offset the increase in pension expense.

The best advice we can offer at this time is to discuss these implications internally and with your service providers. Begin a dialogue with your investment advisors about the potential need to re-evaluate the current strategy due to market conditions. Contact your plan's actuary to get estimated financial impacts so you can plan and budget accordingly. If your plan has recently begun the plan termination process, you may need to reconvene with decision-makers to make sure this strategy is still economically viable.

Questions? For more information, you can utilize *Findley's Pension Indicator* to track the funded status of a variety of plan types each month. To learn more about how falling interest rates may impact your plan specifically contact your Findley consultant or Adam Russo at *adam.russo@findley.com* or 216-875-1949.