PBGC bids a not-so-fond farewell to old lump sum rates

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In this article

Just under a year after proposing to update its lump sum actuarial basis, PBGC has released a final rule indicating that the agency will stop the monthly publication of lump sum interest rates at the end of this year. The final rule adopts the Internal Revenue Code (IRC) Section 417(e) basis for lump sums payable by PBGC. For private-sector defined benefit (DB) plans using the old tiered rates for lump sums and other purposes, the rule provides an alternative table that should closely align with the former methodology. The new rule is effective for valuation dates on or after Jan. 1, 2021.

PBGC legacy lump sum rates

The new rule is primarily intended to update the "increasingly obsolete" tiered (immediate and deferred) interest rates PBGC uses for determining de minimis lump sums for terminated DB plans under the agency's trusteeship. PBGC has been attempting to change this old basis since 1998, but received strong pushback on behalf of the "relatively small number" of private-sector DB plans that use the legacy tiered rates. Nonetheless, in anticipation of future changes in the lump sum basis, PBGC began publishing two separate tables of interest rates in 2000: One for lump sums payable by PBGC (Appendix B rates) and an identical table of rates for private-sector pension plans (Appendix C rates). At that time, PBGC recommended that plan sponsors clarify their plan documents to specify which set of rates the plan uses.

PBGC's 2019 proposal called for the agency to adopt the Section 417(e)(3) methodology for lump sums paid by the PBGC. In addition, for plans using the private-sector/Appendix C rates, PBGC proposed a final, fixed set of tiered rates equal to a 10-year average of the published rates over the period ending in July 2019. The proposal to use the Section 417(e) basis for PBGC-paid lump sums did not raise significant

objections. But commenters, including Mercer, expressed concern about permanently locking in the Appendix C rates at the proposed levels, which included an immediate rate of 1.5%, considerably higher than the then-current (and still current) rate of 0.0%. The proposed rates would have produced lower lump sums than the current legacy rates, but would have produced larger lump sums if interest rates ever recovered to historically more normal levels. Commenters requested that PBGC adopt an alternative basis adaptive to changes in the interest rate environment.

New table for legacy rates

PBGC was persuaded by commenters' arguments against using a fixed rate for Appendix C, but was unwilling to adopt an entirely new variable basis solely for private-sector plan use. Nor did PBGC want to maintain its "outdated" historical basis, which relied on certain Moody's indices only available for a fee. As a compromise, the final rule provides a table of interest rates that closely replicates PBGC's actual published rates. According to PBGC's calculations, the substitute basis would have produced rates within 25 basis points of the actual published rate 99% of the time over the past 10 years. This means that lump sums using the new basis should be about the same as they would have been under the old basis.

The rates for a given determination date are based on the 12-year rate for the *second* preceding month from the IRS-published corporate bond yield curve. Using the second previous month ensures plans can determine the appropriate rates about two weeks before those rates go into effect — roughly the same time frame as the current publication schedule for the legacy rates.

The table provides the immediate and deferred rates that correspond to 12-year corporate rates from 3.18% to 10.02% (with a minimum immediate rate of 0% for corporate rates below 3.18% and a maximum immediate rate of 7.50% for corporate rates above 10.02%). For instance, based on the July 2020 12-year rate of 2.38%, the immediate rate is 0% (and all deferred rates are 4%). But if the corporate bond rate returns to the December 2010 level of 5.32%, the immediate rate would be 2.50%.

Plan amendments and anti-cutback issues

Some plans that still use PBGC rates specifically reference the private-sector/Appendix C rates, while others reference the Appendix B rates or simply the PBGC lump sum rates. Until now, the two sets of rates have been identical, so the distinction has never been critical. However, the distinction matters now because the plan's language will dictate how the sponsor implements its new PBGC basis. Because implementing this change may require a plan amendment and could raise anti-cutback concerns under IRC Section 411(d)(6), most sponsors will want to consult with legal counsel before proceeding.

Plans that reference the Appendix C rates and will continue to do so might not need any amending, since only the rate underlying the interest basis will be changing. These plans shouldn't have any anti-cutback concerns. According to the rule's preamble, IRS has indicated to PBGC that the anti-cutback rules aren't violated just because PBGC changes the underlying interest rates used to determine lump sums.

(However, since PBGC's description of its discussion with IRS isn't formal guidance, sponsors may still wish to consult with legal counsel for reassurance.)

Plans that explicitly refer to Appendix B will likely need an amendment because the final regulation removes and reserves Appendix B altogether. These plans may be able to switch to PBGC's 417(e) rates without anti-cutback concerns, since those rates are replacing Appendix B. However, sponsors might have difficulty implementing this change for the reasons discussed below in Challenges with the nonlegacy rates, and may face pushback from participants who want to protect the old basis. If the sponsor wants to switch to the Appendix C rates, it might have to protect the PBGC 417(e) rate on benefits accrued through the date of the change, although this may be a minor concern because the plan must already use the 417(e) basis to provide the legal minimum benefit.

If the plan document doesn't specifically refer to either appendix, the situation becomes murkier. The plan document might suggest an interpretation that the plan has been using Appendix B or C, depending on the language used. For example, a reference to "PBGC's lump sum interest rate" might be viewed as a reference to the Appendix C rates because PBGC established that appendix for private-sector plans. Alternatively, a reference to "the interest rates used by PBGC" could be viewed as a reference to Appendix B. A nonspecific reference could create uncertainty about whether the plan's basis is changing, regardless of which basis the sponsor wants to use going forward. This in turn creates uncertainty about the potential anti-cutback issues.

Some sponsors might consider adopting a clarifying amendment specifying the current basis. However, it may be too late to do so without raising anti-cutback concerns. In the preamble to the 2000 regulations that created Appendices B and C, PBGC explained that IRS indicated that an amendment to explicitly use the Appendix C rates would not violate the anti-cutback rules if the amendment were adopted before PBGC amended its regulations to de-link the two appendices' rates. But now that the final rule has been published (even though it isn't yet effective), whether such an amendment could still be made without triggering the anti-cutback rules is unclear.

Challenges with the nonlegacy rates

Plans that will continue to align with PBGC by moving to the Section 417(e) interest rates may find the new basis problematic to implement, as the old and new rate structures don't correspond well. For instance, the final rule defines the new interest rate assumption with reference to the month containing the plan's termination date, but ongoing plans have no termination date to use as a reference point. Also, while the PBGC interest rates for a particular month were historically published in the prior month (e.g., the January rates were published in December), the Section 417(e) segment rates are not published until the middle of the month, which could lead to a delay in lump sum payments. (Many plans use a lookback period of up to four months in their 417(e) basis to avoid this delay, so final benefits can be determined in advance of the benefit commencement date.)

Some plan sponsors may seek to resolve these difficulties by treating the new PBGC (non-Appendix C) rates as a Section 417(e) basis. Under this approach, the plan's PBGC basis must be conformed to the plan's already existing Section 417(e) basis (including any lookback period), because a plan may only have a single Section 417(e) set of rates. An alternative approach would be to treat the PBGC rates as its own basis that only happens to be based on Section 417(e), but that would require an ongoing comparison with the plan's existing 417(e) basis. Although this latter approach is arguably more conservative, it would not solve the above problems.

Other plans may have entirely different implementation challenges. For instance, some plans that will use the PBGC 417(e) basis going forward refer specifically to the PBGC immediate interest rate (e.g., for cash balance interest crediting purposes), but an immediate rate won't exist under the new structure. Plan sponsors facing these or any other implementation issues should consult with legal counsel to determine what remedies may be available.

Related resources

Non-Mercer resources

- Final rule (Federal Register, Sept. 9, 2020)
- Proposed rule (Federal Register, Sept. 30, 2019)

Mercer Law & Policy resources

- Mercer urges PBGC to consider alternatives to old lump sum rates (Dec. 9, 2019)
- PBGC proposal would end publication of old lump sum rates (Sept. 30, 2019)

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