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Publications

Treasury Issues Final Regulation on Constructing Yield Curve

ATTORNEYS & PROFESSIONALS

Mark Carolan
mcarolan@groom.com
202-861-5424

Joshua Shapiro
jshapiro@groom.com
202-861-2613

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The Treasury has published final regulations on the methodology for constructing the yield curve that underlies how present values are calculated for defined benefit plans. The final regulations are nearly identical to the proposed regulations (we covered here), with the only difference being a clarification of the methodology. The final regulations also closely follow the existing methodology in Notice 2007-81, though they make two key changes.

The yield curve is an important input for how a defined benefit pension plan determines (a) its funded level, (b) any applicable minimum required and maximum deductible funding amounts for a year, and (c) the minimum present value of lump sum distributions to participants. Generally, the interest rates used to determine the plan's funded status and contribution amounts reflect an average of the yield curve for the prior 24 months. The minimum present value yield curve, on the other hand, reflects the average over just the prior one month.

The IRS outlined its method for determining the yield curve for these purposes in Notice 2007-81. Very generally, Notice 2007-81 provided that the yield curve would be calculated by gathering market data on bonds that meet certain criteria, and applying adjustments based upon a bond's credit rating (among other factors). The calculations result in a single yield curve that is designed to mirror current market pricing.

Following the proposed regulations, the final regulations provide for two changes to the existing approach. Callable bonds would now be included in the yield curve data, but only if the call feature is exercisable in the last year before maturity. Call features of this type have become more widely used in the bond market, and the Treasury concluded that including them would better reflect the market. Second, the proposed regulations would apply a new adjustment variable. This "hump adjustment variable" is intended to produce a yield curve that better reflects a rate hump that often occurs around 20-year maturity bonds.

The final regulations explicitly describe a step that was implied in the proposed regulations. In determining the spot discount rates, it was implicit that a par yield curve would need to be determined as well (a par yield curve provides the rate at a specific maturity that is equal to the yield for a bond with the same maturity for which the price is the same as a principal amount). The final regulations clarify the methodology in the proposed regulations, and are not intended to make a substantive change from the proposed regulations.

The final regulations apply for months that begin on or after February 1, 2024.