

Moving Forward in a Tough Economy: Understanding and Addressing the Market's Impact on Defined Benefit Plans

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QUICK LOOK

- ➔ Lower asset values can put more pressure on the bottom line, significantly increase funding requirements and create possible benefit restrictions for employees.
- ➔ Since the circumstances of each plan need to be analyzed separately, employers should work with their actuaries.
- ➔ The different courses of action need to be considered in the context of plan and business implications.

As Americans are painfully aware, the U.S. economy is facing enormous challenges related to credit concerns and the liquidity crisis in the financial sector. In 2008, several pillars of the investment banking community collapsed, Fannie Mae and Freddie Mac were placed in conservatorship and several major corporate icons faced possible bankruptcy. These and other tumultuous events wreaked havoc on capital markets and investment values. In response, Congress passed and President George W. Bush signed into law an unprecedented \$700-billion bailout package, the Federal Reserve pumped substantial amounts of money into the credit markets and, as this article went to press, every day brought news about further extraordinary measures.

In these times of extreme market volatility, information is critical, particularly when dealing with defined benefit (DB) plans.



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What Are the Implications?

Noting that the dates in this article assume calendar plan years and fiscal years, lower asset values as of Dec. 31, 2008, will generally create the following problems for corporate DB plans in 2009:

- **More pressure on the bottom line.** Although decreased market value of assets in pension funds will put pressure on the pension expense that plan sponsors must book, the impact might be mitigated by a lower value of liabilities because the corporate bond rates on which they are valued have gone up. This might be further mitigated for plans that use a market-related value of assets in determining pension expense because the market-related value is likely to be higher than market value. Nevertheless, the 2009 expense may be significantly higher than anticipated. In addition, the Dec. 31, 2008, net balance sheet pension liability is likely to be higher.
- **Significantly increased funding requirements.** Generally, any additional underfunding due to

investment losses will be amortized over seven years. Although these asset losses are offset somewhat by liability gains (that is, decreases in liabilities) as a result of higher year-end interest rates, the liability gains are not expected to be as beneficial as under the accounting rules because of 24-month smoothing techniques on interest rates employed in the determination of liabilities for funding purposes that do not exist in the determination of liabilities for accounting purposes. Furthermore, companies may wish to contribute more than the minimum required amount in order to avoid certain benefit restrictions imposed by the funding rules.

Also noteworthy is that employers who had used the transition rule for funding, thereby exempting themselves from a Pension Protection Act (PPA) of 2006 amortization payment for 2008 because their plans were 92 percent funded as of the start of the year, could face an abrupt cost increase. If their plans are less than

94 percent funded as of Jan. 1, 2009 (including contributions receivable), they will lose the ability to transition gradually to the PPA requirements. In addition, reaching that 94-percent funded level might not be feasible, considering the drop-off in asset values. Thus, employers will have to fund for an amortization charge for 2009 (and later years) that reflects the full underfunding.

- **Possible benefit restrictions for employees.** If the funding level (using assets reduced by the carryover balance) falls below 60 percent or 80 percent, benefit restrictions may apply. For example, if the level drops below 60 percent, the plan cannot pay lump sums or similar accelerated benefit forms, must freeze benefit accruals and cannot pay plant shut-down benefits. If the funding level falls below 80 percent, the plan generally can only pay 50 percent of benefits in the form of a lump sum or similar payment form, and benefit increases generally cannot take effect. Benefit restrictions can be avoided if the funding level without subtracting the carryover balance from the assets exceeds 100 percent (94 percent for 2009, if a transitional rule applies). In addition, a Pension Benefit Guaranty Corp. (PBGC) variable rate premium applies when the plan's vested liability is less than 100-percent funded. To the extent that the plan has an unfunded vested liability, the plan must pay a PBGC variable rate premium equal to 0.9 percent of the underfunding. Unlike additional required funding, these payments are paid to the PBGC rather than the plan, and thus do not reduce the plan's underfunding.

What Are the Possible Options?

The above discussion of the possible funding implications is based on the

current law as this article was written. However, Congress has been asked to relax the minimum funding and benefit restriction rules to reduce the stress on employers as the country faces a recession. (For details on the legislative relief being discussed, see “The Prospect of Additional Relief from Washington.”)

In the meantime, since the circumstances of each plan are different and need to be analyzed separately, employers should work with their actuaries to understand the range of possible outcomes to avoid surprises and to scope out viable courses of action. Furthermore, rather than looking at the DB plan in isolation, all of this should be considered within the general business context. For example, an early retirement incentive program to soften the impact of expected layoffs cannot responsibly be evaluated without looking at the impact on the crucial funding ratios, and any consideration of additional plan contributions should take into account the possibility that contracting economic conditions could place other urgent demands on the employer’s available cash.

The Prospect of Additional Relief From Washington

The U.S. House and Senate have passed separate bills that would include technical corrections that allow for more favorable asset-smoothing approaches, but the differences between the two bills had not been worked out at press time.

In addition, anticipating further Congressional action to deal with the country’s continuing economic crisis, industry groups have proposed additional legislative relief, such as:

- Expanding the 90 percent to 110 percent corridor around the market value of assets that applies to the computation of the average value of assets
- Revising the transitional funding rule that phases in the amortization without imposing a threshold test (i.e., the plan would only amortize the unfunded liability from 94 percent and not 100 percent, even if the plan’s funding level is below 94 percent on Jan. 1, 2009)
- Allowing a change in liability and asset valuation methodologies as of Jan. 1, 2009, without individual approval from the Internal Revenue Service
- Extending the period for amortization of 2008 plan losses, or other special relief, for 2009.

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Some courses of action for employers to assess are:

- To improve the fiscal year-end balance sheet, employers that can afford to do so could make an additional contribution to their pension plans before fiscal year-end.
- To keep their plans above the various thresholds that could exacerbate the funding requirements or trigger benefit restrictions, employers should consider the following:
 - Paying additional contributions for the 2008 plan year. Employers whose plans' funding levels were less than 10 percentage points higher than a threshold for 2008 may need to act before April 1, 2009. At that time, the 2008 funding level is assumed to decrease by 10 percent, and without further action, restrictions could apply. If the plan was more than 10 percentage points above a 2008 threshold, the employer has until Sept. 15, 2009, to make additional contributions for the 2008 plan year.
 - Using existing carryover balances. Jan. 1, 2008, carryover balances that are not used for 2008 are credited with the actual 2008 return, which is likely to be negative. Thus, it may be advantageous to use the carryover balance for 2008 contributions.

- Changing asset and/or liability valuation methodologies retroactively to Jan. 1, 2008. This possibility should generally avoid creating a material change to the 2008 certification required for benefit restrictions. One example of such a modification might be to elect to use the spot yield curve to discount liabilities instead of the alternative 24-month average yield curve, as the spot yield curve currently results in lower liabilities.

Another possibility that might alleviate the funding requirements — but would not address possible benefit restrictions — is requesting a waiver of the minimum funding requirement.

The above list is an illustration of possible paths each employer can explore. The different courses of action need to be considered in the context of plan and business implications. For example, whereas a waiver of minimum funding requirements may mitigate the need to make a large, unexpected plan contribution, it may create difficulties with regard to existing loan covenants. By understanding the various implications, employers should be able to address the impact of the current market conditions on defined benefit plans and move forward in a challenging economy. 

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