

## Implications of the Current Market Conditions for DB Plans and Possible Options for Dealing with the Challenges they Present

As all Americans are painfully aware, our economy is facing enormous challenges related to the credit concerns and the liquidity crisis in the financial sector. Over the last few months, several pillars of the investment banking community collapsed and Fannie Mae and Freddie Mac were placed in conservatorship. These and other tumultuous events have wreaked havoc on the capital markets and investment values. In response, Congress passed and President Bush signed into law an unprecedented \$700 billion bailout package, the Federal Reserve has pumped substantial amounts into the credit markets and every day brings news about further extraordinary measures that are under consideration.

In these times of extreme market volatility, information is critical. This *Spotlight* summarizes the 2009 accounting and funding implications for corporate defined benefit (DB) plans and presents an overview of possible ways to deal with the challenges they present.

### WHAT ARE THE IMPLICATIONS?

Lower asset values as of December 31, 2008<sup>1</sup> will generally create the following problems for corporate DB plans in 2009:

- **Higher Expense under FAS 87** The impact of a decline in assets might be mitigated by a decrease in the 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, 2009 expense may be significantly higher than anticipated. In addition, the December 31, 2008 net balance sheet pension liability is likely to be higher.
- **Increase in the Minimum Required Contribution** Generally, any additional underfunding due to investment losses will be amortized over seven years. Under the new funding rules, the yield curve used to discount liabilities has commonly been determined based on a 24-month average to reduce volatility, so the value of liabilities for funding purposes may not decrease as much as FAS liabilities. In addition, unlike for FAS 87, asset averaging is limited, and thus, many employers are using a market value of assets to determine plan funding contributions.

Employers that had used the transition rule for funding, which exempted them from a PPA'06 amortization payment for 2008 because their plans were 92 percent funded as of the start of the year, could face yet another abrupt cost increase. If their plans are less than 94 percent funded as of January 1, 2009 (including contributions receivable), they will lose the ability to transition gradually to the PPA'06 requirements. With the drop-off in asset values, the large contribution that may be required to reach the 94 percent funded level by the start of 2009 might not be feasible. Thus, they will have to fund for an amortization charge for 2009 (and later years) that reflects the full underfunding.

<sup>1</sup> The dates in this *Spotlight* assume calendar plan years and fiscal years.

- > **Possible Benefit Restrictions** If the funding level (using assets reduced by the carryover balance) falls below 60 or 80 percent, benefit restrictions may apply.<sup>2</sup> 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 Corporation (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. Congress has been asked to relax the minimum funding and benefit restriction rules, to reduce the stress on employers as the country heads into recession. (See the [text box on the last page](#) for details on the legislative relief being discussed.)

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 year-end surprises and to scope out viable courses of action. Further, rather than looking at the DB plan in isolation, all of this should be considered within the context of the business generally. 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.

Some courses of action for employers to assess are:

- > To improve the December 31, 2008 balance sheet, employers that can afford to do so could make an additional contribution to their pension plans before 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 September 15, 2009 to make additional contributions for the 2008 plan year.
  - **Using Existing Carryover Balances** January 1, 2008 carryover balances that are not used for 2008 are credited with the actual 2008 return that 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 January 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.

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<sup>2</sup> If the funding level falls below 60 percent: (1) the plan cannot pay lump sums or similar accelerated benefit forms; (2) the plan must freeze benefit accruals; and (3) the plan cannot pay plant shutdown benefits. If the funding level falls below 80 percent, the plan generally can only pay 50 percent of a benefit in the form of a lump sum or similar payment form, and benefit increases generally cannot take effect.

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 to be explored by each employer. The different courses of action need to be considered in the context of both 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.)



*Sibson Consulting understands that these are challenging times for you as employers and we will be vigilant in keeping you informed about how developments in the financial markets and reactions in Washington affect your DB plans. In the meantime, if you have any questions or if you would like to discuss this further, please do not hesitate to contact your Sibson consultant or the nearest Sibson office.*

## THE PROSPECT OF ADDITIONAL RELIEF FROM WASHINGTON

Separate bills have been introduced and passed by the House and Senate that would include technical corrections that allow for more favorable asset smoothing approaches, but the differences between the two bills have not yet been worked out.\*

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 to 110 percent corridor around market value that applies to average asset methods,
- 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 January 1, 2009),
- Allowing a change in methodologies (*e.g.*, the asset method) as of January 1, 2009 without individual approval from the Internal Revenue Service, and
- Extending the period for amortization of 2008 plan losses, or other special relief, for 2009.

(To return to the discussion of the implications and possible options, click [here](#).)

\* The Senate bill (S. 1974) is available on the following Web page: [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110\\_cong\\_bills&docid=f:s1974es.txt.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_bills&docid=f:s1974es.txt.pdf) The House bill (H.R. 3361) is available on the following Web page: [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110\\_cong\\_bills&docid=f:h3361eh.txt.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_bills&docid=f:h3361eh.txt.pdf)

Atlanta	678.306.3100
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Calgary	403.692.2264
Chicago	312.984.8500
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Raleigh	919.233.1220
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