

Going Beyond Compliance with Pension Reform: Preparing to Mitigate Increased Volatility

Following recent Congressional action, it is now expected that the most significant change in the funding rules for pension plans since ERISA will become effective on January 1, 2008. (The [News in Brief](#) box at the bottom of the next page provides background information.) These changes will affect all private pension plans, whether ongoing, closed or “frozen.” Initially, all sponsors of private plans will want to understand the nature of the changes and the effect they will have on near-term funding requirements. This *Spotlight* discusses what actions sponsors might take to understand and respond to the increased volatility that pension reform is likely to trigger.¹

WHAT ARE THE IMPLICATIONS?

The minimum funding requirements under the new law will result in increased volatility for many plan sponsors for several reasons:

- **Reduced “Smoothing” on Assets** Asset values will more closely follow the ups and downs of market fluctuations.
- **More Volatility on Liability Measures** Under current law, liability values are based upon a discount rate that was either (1) the actuary’s best estimate of long-term future investment experience under the plan (which typically was not volatile at all) or (2) for less well-funded plans, represented a four-year smoothing of corporate bond rates. Under pension reform, liability values will be based upon a bond-yield discount rate curve that will react much more quickly to changes in the bond market.
- **Restrictions on Use of Credit Balances** Many employers use credit balances to mitigate the volatility of annual funding requirements. Under pension reform, the use of credit balances will be sharply restricted.

If, as is expected, pension reform becomes law, some employers that are currently close to the existing trigger for accelerated funding (the Deficit Reduction Contribution) may see less near-term volatility. However, many employers will find that the near-elimination of asset and interest rate smoothing makes it harder to budget for minimum contributions.

WHAT RESPONSE, IF ANY, IS REQUIRED?

In response to the new minimum funding rules, employers generally will ask three questions:

1. What is the impact of the new law on the plan’s projected funding requirements?
2. What is the volatility (or risk) inherent in those new expected funding requirements?
3. What can be done to mitigate the volatility and risk?

To answer the first two questions, employers will need to project future outcomes. These projections typically can employ deterministic or stochastic techniques. Deterministic projections represent future outcomes assuming that all assumptions (e.g., investment performance of equities or the level of interest rates) will be realized. Although these projections are relatively simple and straightforward, they give no insight into the volatility of those determined outcomes. Accordingly, most employers will turn to stochastic asset-liability modeling (ALM),

¹ This *Spotlight* was prepared with assistance from Segal Advisors, Segal/Sibson’s investment-consulting affiliate. For more information about Segal Advisors, visit www.segaladvisors.com

which illustrates the probability of various outcomes. And, while stochastic ALM projections had value under the old law (because of the volatility of asset values), they will have much greater application under the new law because both asset *and* liability values will have significantly increased volatility.

Of course, while stochastic projections are extremely valuable in assessing and understanding risk and volatility, their true worth is in helping plan sponsors to answer the third question: What can be done to mitigate the volatility and risk? In general, although employers often think of design strategies (such as plan freezes) as a means of *eventually* mitigating risk, this powerful tool can be used to help employers make many decisions with confidence, including developing two additional strategies that may have more immediate effects:

- **Investment Strategy** Restrictions on asset smoothing will encourage the development of asset allocation strategies utilizing less volatile asset classes or the use of hedging techniques designed to mitigate the impact of price and/or interest rate volatility. Stochastic ALM can play a role in the development of these asset allocation strategies by taking into account newly increased volatility in the measurement of liabilities.
- **Funding Strategy** Increased funding requirements (especially for certain underfunded plans) and restrictions on the use of credit balances will encourage employers to consider long-term funding strategies geared toward mitigating the impact of more unpredictable asset and liability values. Stochastic ALM can help employers understand the range of projected funding requirements and to establish a funding strategy that aligns both the level and range of projected outcomes with the employer's projected operating capital needs and risk tolerance.

Also worth noting is that strategies intended to mitigate volatility created by the new funding law will also help mitigate volatility created by the new disclosure rules for pensions and other postretirement benefits that the Financial Accounting Standards Board (FASB) is expected to release this fall.²



When the anticipated pension reform bill is signed, employers should rely on their attorneys for legal advice on the interpretation of the new law. To discuss the tactical and strategic implications of the new pension reform law for your pension plan, and how stochastic ALM can help mitigate volatility, contact your Segal/Sibson consultant or the nearest Segal/Sibson office.

² Earlier this year, FASB issued an Exposure Draft for Phase I of a two-phase project to revamp its accounting requirements for pensions and other postretirement plans. FASB's proposed change to reflect plans' immediate funded position on balance sheets will add a great deal of volatility, especially in low-interest-rate environments. For more information, see Segal's May 2006 *Bulletin*, which is available on the following Web page: <http://www.segalco.com/publications/bulletins/may06FASB.pdf>

THE NEWS IN BRIEF

On July 28, 2006, the House of Representatives passed the Pension Protection Act (H.R. 4), * the long-anticipated pension reform bill. On August 3, 2006, the Senate overwhelmingly passed the bill without attaching any amendments. President Bush is expected to sign the bill into law.

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

* H.R. 4 is available on the following Web page: http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_cong_bills&docid=f:h4cph.txt.pdf

For a summary of the key provisions, see Segal/Sibson's August 2006 *Bulletin*, which is available on the following Web page: <http://www.segalsibson.com/publications/bulletins/au06penref.pdf>

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