AMERICAN BENEFITS COUNCIL

January 2, 2009

LEGISLATION NEEDED TO ADDRESS FUNDING CRISIS

What is the problem?

The Worker, Retiree, and Employer Recovery Act of 2008 ("2008 Act") provided much needed aid to help workers, plans, retirees, and companies weather the pension funding crisis created by the market downturn. However, more relief is desperately needed.

An example based on national data will illustrate both how much the 2008 Act helped and how much more is needed. According to the Boston College Center for Retirement Research, the aggregate funded status of plans had fallen from 100% at the beginning of 2008 to 75% as of October 9, 2008. A comprehensive study by Watson Wyatt Worldwide similarly estimated that the average funded status of plans would fall from 97.2% for 2008 to 75.1% for 2009.

Based on the national data set forth above, we base our example on a hypothetical average plan that started 2008 with $100 of assets and $100 of liabilities and accordingly was 100% funded. In addition, we assume that the annual cost of funding benefits accruing during 2008 is $2 (the plan's "normal cost"). Since the plan's assets equal its liabilities, the plan's total funding obligation for 2008 is the $2 normal cost. Assume, however, that during 2008 assets fall to $75 and liabilities remain at $100, for a funded ratio of 75% as of January 1, 2009 (i.e., the projected national average).

Set forth below are the 2009 funding obligations with respect to this plan under various funding rules:

- **Pre-2008 Act Funding Rules**: The plan's $25 shortfall (i.e., $100 - $75) must be amortized over seven years, creating an amortization obligation of approximately $4.72. When added to the $2 normal cost for 2009, the total 2009 funding obligation is $6.72, more than triple the 2008 obligation. (For a typical large plan with $10 billion of liabilities, that would be $672 million.)

- **After 2008 Act**: Under the 2008 Act, the value of the plan's assets can be smoothed, i.e., unexpected gains or losses can be recognized over 24 months. Unlimited smoothing would create an asset value of approximately $95 for 2009. But the 2008 Act preserved the rule in the Pension Protection Act ("PPA") requiring the smoothed value of assets to be within 10% of the fair market value of assets ("10% corridor"). So application of that rule would mean that the asset value for 2009 would be $82.50 (i.e., 110% of $75). Also, the 2008 Act permitted plans that are less than 94% funded to use the 2009 phased-in funding target of 94%. So, under the 2008 Act, the plan's funding shortfall is $94 - $82.50 = $11.50. This creates an amortization obligation of approximately $2.17. When added to the $2 normal cost, that creates a $4.17 funding obligation, more than double the 2008 contribution ($417 million for a $10 billion plan). This is a huge improvement over pre-2008 Act law, but for a $10 billion plan, an increase of $217 million - - more than double - - is unmanageable in this economic climate.

- **After 2008 Act (but increasing the 10% corridor to 20%)**: Increasing the 10% corridor to 20% for 2009 would return the corridor to its pre-PPA level. Briefly, in that case, the total amortization obligation would be reduced to approximately $0.76, for a total funding obligation of $2.76, almost 40% higher than the 2008 contribution.

- **After 2008 Act (but increasing the 10% corridor to 30%)**: Increasing the corridor to 30% for 2009 would increase the corridor to address the extraordinary events of 2008. Under this rule, there would be no funding shortfall, so the funding obligation would be $2, the same as for 2008.

National studies have reached conclusions very similar to those illustrated by the above example. Boston College, Watson Wyatt, and Milliman have estimated that without any legislation, funding obligations would have almost tripled for 2009 (compared to 2008). Watson Wyatt estimates that the effect of the 2008 Act will be that instead of tripling, minimum funding obligations will increase by 132%, i.e., more than double; Milliman estimates the increase at 93%, almost double. Either way, that is a great improvement, but in this economic environment, it will still lead to many lost jobs and plan freezes.

What should be done?

- Most importantly, the 10% limit on smoothing should be increased to 30% for 2009 and 20% for 2010, then return to 10% thereafter. This proposal would go a long way towards making 2009 contributions manageable for most plans.

- Companies should be given the right to elect asset smoothing for 2009 without regard to whether the company used fair market value in 2008. It would be quite unfair not to allow such elections since asset smoothing did not exist in 2008.

Other changes are also important. We would be pleased to provide examples with respect to any of the additional proposals described below.

- Plan losses incurred during 2008 should be amortized over nine years, instead of seven. (In the Administration's original funding proposal, the Administration suggested an amortization period of seven to ten years.) Moreover, the amortization schedule would provide that only "interest" on the losses is payable for 2009 and 2010. Regular seven-year amortization of the principal amount of the loss would commence in 2011. This proposal would provide a transition period of manageable payments during the worst of the economic downturn.

- Companies should be allowed to use the spot yield curve for 2009 and/or 2010 without regard to what they used in prior years and without being locked into using the spot yield curve for future years. This proposal simply gives companies the right to use a funding method available under current law in order to preserve jobs and their plans.

- Also, consistent with the statutory language, it should be clarified that the spot yield curve for any plan year may be the spot yield curve for any "applicable month" with respect to such year, which generally can be the first month of the plan year or any of the four preceding months. Contrary to the legislative language, Treasury's proposed regulations generally require that the spot yield curve be determined as of the month preceding the plan year, rather than permitting employers to elect one of the "applicable months". Such "applicable month" elections, which are clearly provided for in the statute, must be applied consistently to all future years, except as approved by the IRS. For 2009, this one change to simply conform the regulations to the statute could help companies to a significant extent in addressing the funding crisis.

- Two "clean-up" provisions are also needed. First, the technical corrections legislation included "plan-related expenses" as part of normal cost. It should be clarified that this only includes administrative expenses, not investment-related expenses. The inclusion of investment-related expenses in normal cost would be an unprecedented and unjustified new burden on employers that could be quite significant in many cases. Second, the funding target transition rule, which was expanded in the 2008 Act, should be made applicable to all plans, including plans subject to the deficit reduction contribution regime in 2007. These troubled plans are likely the ones most in need of relief for 2009.

Why is the asset smoothing corridor so important?

Increasing the asset smoothing corridor is critical because it addresses two fundamental problems: (1) unmanageable funding burdens created by unexpected asset losses, and (2) the imposition of benefit restrictions on participants.

The Boston College study estimated that as of October 9, 2008, more than 20% of plans were under 70% funded. For discussion purposes, let us assume that a plan was 90% funded as of January 1, 2008 and became 65% funded as of January 1, 2009. Because the plan is under 80% funded, the plan could only pay, at most, one half of the lump sum distributions to which employees are otherwise entitled. This will present employee relations issues for employers and will create hardships for employees who were relying on those lump sums and had made corresponding retirement plans.

If the 10% corridor is retained, this plan will be 71.5% funded, creating an amortization obligation that is more than double the 2008 obligation and subjecting the company's employees to the benefit restriction described above. If the corridor is increased to 20%, the funded ratio is 78%, which does not solve the benefit restriction problem, and still creates an amortization obligation that is more than 50% larger than the 2008 obligation. It is only if the corridor increases to 30% that (1) the plan becomes 84.5% funded and ceases to be subject to the benefit restriction and (2) the 2009 funding obligation becomes comparable to the 2008 obligation.

It should be emphasized that this plan does not even present anything close to a worst case scenario. For example, if this plan were 92% funded as of January 1, 2008, the application of the 10% corridor could result in a total funding obligation that is far more than double the 2008 obligation—perhaps triple or more, depending on the level of current benefits provided.

Are there other ways to provide 2009 relief?

There are many other ways to provide the relief that is needed. For example, increasing the 10% corridor to 20% (instead of 30%) could be combined with additional proposals listed above - - such as the nine-year amortization proposal - - to provide needed relief. Or alternatively, employers could be given the option of having their funding obligations for 2009 and 2010 be, for example, 105% and 110%, respectively, of their 2008 required funding obligations. Similarly, if the 10% corridor is not raised to 30%, all 2009 and 2010 benefit restrictions could apply based on 2008 funding ratios.

We look forward to a dialogue on the ideas set forth above and/or other possible means of providing relief that is very much needed.