AMERICAN BENEFITS COUNCIL

January 29, 2009

# PENSION FUNDING PROPOSALS

The severe market downturn has had a devastating effect on the funded status of defined benefit plans across the country. According to estimates by Watson Wyatt Worldwide and Milliman, companies will be required to make pension contributions for 2009 that are approximately double the amount required for 2008 (even after taking into account the very helpful provisions enacted in December of 2008). In this economy, that is an unmanageable burden, which can be in the hundreds of millions of dollars or more for a large employer. If relief is not provided, the result will be widespread job loss, plan freezes, bankruptcies, and a material slowing of our economic recovery.

It is critical to address this problem with a solution that is consistent with the following principles:

- The solution must not undermine the funding reforms enacted in the Pension Protection Act of 2006 ("PPA").
- The solution must ensure that plans return to a fully funded status as soon as is practicable. This is important from the perspective of both benefit security and the security of the Pension Benefit Guaranty Corporation.
- The solution must protect employees from reduction or elimination of protected benefits.

We have five solutions that are consistent with these principles:

- Amortize 2008 losses over seven years starting in 2011; for 2009 and 2010, employers would be required to pay interest on the 2008 losses.
- Expand the 10% asset smoothing corridor to 30% for 2009, 20% for 2010, and back to 10% thereafter.
- For 2009 and 2010, apply the benefit restrictions and credit balance rules based on plans' 2008 funded status.
- Ensure that the transition relief provided by the 2008 Act applies to all plans.
- Clarify that the 2008 Act did not require plan investment expenses to become a current-year cost, which would be a major new burden on employers.

These proposals are discussed in more detail below.

**First Relief Proposal: Amortization of 2008 Losses.**

**In general.** Under the PPA, 2008 asset losses must be amortized over seven years. The problem is that these losses are so large that seven-year amortization creates the unmanageable funding obligations described above. Employers need time to recover before they can begin making up for these losses. On the other hand, if no contributions are made, the funding shortfall will only grow larger.

Accordingly, we propose that for 2009 and 2010, employers shall be required to pay interest on their plans' 2008 losses to prevent the plans' shortfall from growing, but seven-year amortization of those losses would not commence until 2011. So all 2008 losses would be fully funded, but only two years later than would otherwise be the case.

In addition, it is important that the relief not give employers a funding holiday under which they are required to contribute less for 2009 and 2010 than they were required to contribute for 2008. So under this proposal, all companies electing to use this special amortization rule must, for 2009, contribute at least 105% of the amount required to be contributed for 2008. For 2010, this would be increased to 110% of the amount required to be contributed for 2008.

**Technical clarifications of amortization proposal.** Technically, the reference to "2008 losses" in this proposal would be a reference to the 2009 "shortfall amortization base" under Code section 430(c)(3) and ERISA section 303(c)(3). The 2009 shortfall amortization base is the amount that would, under current law, be amortized over seven years starting in 2009. Also, the shortfall amortization base is measured by reference to the funding target transition percentage (94% in 2009) (to the extent such transition percentage is applicable). So, in the case of plans to which such percentage applies, "2008 losses" would be measured by reference to the 94% funded level.

Also, for purposes of the 105%/110% rule for 2009 and 2010, the minimum required contributions would be determined without regard to reductions by any prefunding balance or funding standard carryover balance. This, for example, prevents the minimum required contribution for 2008 to be treated as zero for purposes of the 105%/110% rule by reason of the use of such balances. Of course, except as discussed below, the present-law PPA rules would apply to the availability or unavailability of such balances to pay for minimum required contributions, such as the interest payments on the 2009 shortfall amortization base.

**Second Relief Proposal: Expanding the Asset Smoothing Corridor.**

Under the 2008 Act, the value of a plan's assets may be smoothed, i.e., unexpected gains or losses can be recognized over 24 months. But the 2008 Act preserved the PPA rule requiring the smoothed value of assets to be within 10% of the fair market value of assets ("10% corridor"). Since 2008 losses were typically far greater than 10%, application of the 10% corridor will require companies to immediately recognize most of the 2008 losses, leaving companies with an unmanageable obligation.

An example illustrates this issue. Assume that a plan had $90 of assets and $100 of liabilities as of January 1, 2008; as of January 1, 2009, its assets have fallen to $65 and its liabilities remain at $100, leaving the plan 65% funded. If the 10% corridor is retained, this plan will be 71.5% funded, creating an amortization obligation that is far greater than the 2008 obligation. If the corridor is increased to 20%, the funded ratio is 78%, which still creates an amortization obligation that is very materially larger than the 2008 obligation. It is only if the corridor increases to 30% that the plan becomes 84.5% funded and the 2009 funding obligation becomes somewhat 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.

**Third Relief Proposal: Protection of Employees and Employers.**

Under PPA, employees can lose certain benefits and rights if their plan falls below 60% or 80% funded and thus becomes subject to certain "benefit restrictions." For example, if a plan falls below 80% funded, participants who have been promised the option of receiving their benefits in the form of a lump sum distribution are not permitted to receive more than half of their benefit in a lump sum. This is unfair to the employees since they may have made plans based on the benefits promised by their plan.

Similarly, employers can be very adversely affected by falling below certain funding thresholds. Specifically, if a plan falls below 80% funded for a year, the employer may not use prefunding balances or funding standard carryover balances to satisfy its minimum required contribution obligation for the following year. This can impose a very material new cash flow burden on employers that, like employees, were victimized by the 2008 market downturn.

Accordingly, under the proposal, for 2009 and 2010, all benefit restrictions would apply based on a plan's funded status for 2008. Employees who have seen their 401(k) plan benefits and other savings plummet should not be denied promised benefits or any other pension rights by reason of the market collapse. Similarly, a plan's funded status for 2008 shall be deemed to remain in effect for 2009 and 2010 for purposes of determining whether the plan sponsor may use its prefunding balance or funding standard carryover balance in the next year. Like employees, companies should not be hit with large unexpected cash demands during this difficult time.

**Application of the Above Proposals to Certain Fiscal Year Plans.**

With respect to the above proposals, in the case of plans with plan years beginning after October 31, but before January 1, the rules would apply to plan years beginning in 2008 and 2009 rather than in 2009 and 2010. So, for example, if a plan's plan year began on November 1, 2008, the plan sponsor would only pay interest for that year and the next year, and would begin seven-year amortization for the plan year beginning November 1, 2010. This reflects the fact that plans with plan years starting late in 2008 will have incurred substantial losses as of the first day of the 2008 plan year.

Of course, in the case of plans with plan years beginning on or after January 1 but before November 1, the above proposals would apply to plan years beginning in 2009 and 2010.

**Fourth Relief Proposal: Ensuring Transition Relief Applies to All Plans.**

The 2008 Act generally amended the PPA transition rule to provide that for purposes of determining a plan sponsor's funding shortfall, the plan's funding target is 94% of liabilities for 2009, 96% for 2010, and 100% thereafter. For example, if a plan is 91% funded for 2009, its funding shortfall is 3%, rather than 9% as under the pre-2008 Act law. However, certain plans were left out of this provision—new plans and plans that were subject to the deficit reduction contribution ("DRC") regime in 2007. For such plans, the funding shortfall in the above example would be 9%. DRC plans, which were less well-funded, are probably the ones most in need of help during this market downturn. The law should be amended to measure the funding targets for all plans by reference to the phased-in targets of 94% for 2009 and 96% for 2010.

**Fifth Relief Proposal: Critical Clarification.**

In the technical corrections portion of the 2008 Act, the definition of target normal cost was amended to include "plan-related expenses". The inclusion of plan administrative expenses in normal cost was supported by prior practice. However, there are indications that Treasury may well interpret this language to include plan investment expenses in normal cost. This has never been required and is not common practice, so the interpretation of a technical correction to make a major policy change would not be appropriate. And the burden could be very material. For example, for large plans for 2007, the plan investment expenses averaged 44 basis points; the average for smaller plans is materially higher. The law should be clarified by changing the term used to "plan-related administrative expenses".