

Hewitt Examples Highlighting the Need for Further Pension Funding Relief

During 2008, the typical qualified defined benefit pension plan in the U.S. experienced asset losses of between 25% and 30%. When combined with these historic asset losses, the funding rules contained in the Pension Protection Act of 2006 (PPA) will require a substantial increase in cash contributions from many plan sponsors in 2009 and beyond. These increased cash contributions come at a time when many businesses have a much greater need to preserve capital due to current conditions in the credit markets.

Without legislative relief from this funding volatility, many plan sponsors may determine that they can no longer afford to maintain an ongoing defined benefit plan for their employees. Employers who were previously committed to maintaining a defined benefit plan as part of their overall retirement program may conclude that such plans are no longer a viable option in the current environment. This could lead to more plan freezes or closures and further emphasis on defined contribution programs, at a time when many employees already face a less secure retirement due to market losses in their 401(k) plans and Individual Retirement Accounts. Even if an employer wants to maintain an ongoing defined benefit plan, PPA may actually require the employer to freeze the plan or otherwise limit the benefits paid from the plan if the plan's funded status falls below a certain threshold.

The Worker, Retiree, and Employer Recovery Act of 2008 (WRERA) provided limited funding relief that will be helpful to some plan sponsors. However, many plan sponsors are in need of more extensive relief than that provided by WRERA—for example, plan sponsors who are concerned about the impact of certain PPA benefit limitations on plan participants.

Hewitt believes that many provisions of PPA are beneficial, and help to strengthen defined benefit plans. However, in today's unprecedented market environment, we also believe that certain refinements are needed to enable plan sponsors to maintain their defined benefit plans and help ensure retirement security for their employees.

This document contains a number of examples that highlight the critical need for further pension funding relief in 2009. These examples describe the impact of the 2008 market losses on actual plan sponsors, analyze the relief provided by WRERA, and analyze the additional relief that would be provided by certain legislative proposals.

To provide context for these examples, below are statistics on the funded status of the pension plans of large corporations at 2007 year-end, before the historic 2008 market losses. As noted above, the typical funded ratio of a qualified pension plan is expected to be about 25% to 30% lower at 2008 year-end than at 2007 year-end.

Distribution of S&P 500 Companies' Funded Ratios at 2007 Year-End

At 2007 year-end, the distribution of ABO funded ratios for the companies in the S&P 500 was as follows:

- Total number of companies disclosing ABO funded status was 321
- Average ABO funded ratio was 104%
- 6% of companies had an ABO funded ratio of 140%+
- 14% of companies had an ABO funded ratio of 120%–139%
- 39% of companies had an ABO funded ratio of 100%–119%
- 32% of companies had an ABO funded ratio of 80%–99%

- 5% of companies had an ABO funded ratio of 60%–79%
- 1% of companies had an ABO funded ratio of 40%–59%
- 3% of companies had an ABO funded ratio of <40%

Source: Hewitt Associates, *Survey Findings: Benefit Plan Disclosure Under FASB Statements No. 87 and 106 From the 2007 Financial Statements of the Standard and Poor's Companies*

While this summary includes some companies with fiscal years ending on a date other than 12/31, most companies have a 12/31 fiscal year-end. We believe the ABO funded ratio at 2007 year-end provides a reasonable estimate of PPA funded status for the 2008 plan year for many companies.

Company A

Company A has six qualified pension plans. All six plans were at least 92% funded for the 2008 plan year, so they qualified for the funding transition rule. The total minimum required contribution for the 2008 plan year was about \$21 million before the application of funding balances and about \$1 million after the application of funding balances.

The plans all experienced asset losses of approximately 30% during 2008. As of 1/1/2009, five of the plans are estimated to be between 60% and 70% funded. The sixth plan was overfunded in 2008, and remains so for 2009.

Of the five plans that are estimated to be between 60% and 70% funded for 2009, one is a salaried cash balance plan that offers a 100% lump sum option and four are union plans that have a level income option. Company A is very concerned about the limitation on accelerated benefit distributions as well as PBGC section 4010 reporting. Thus, Company A will likely need to waive any remaining funding balances and make additional contributions by 9/15/2009 to reach a funded status of at least 80%.

Prior to WRERA, Company A had elected to determine the plans' funded status using the market value of assets and the 24-month average segment rates. On this basis, the minimum required contribution for the 2009 plan year would be about \$47 million before reflecting the WRERA changes to the funding transition rule and any waiver of funding balances. The remaining funding balances potentially available to cover a portion of this minimum required contribution would be about \$16 million. However, in order to avoid the limitation on accelerated benefit distributions and PBGC section 4010 reporting, Company A would need to waive all remaining funding balances and contribute about \$60 million by 9/15/2009 to reach a funded status of 80%. After this waiver of funding balances and additional contribution, Company A would still have a minimum required contribution of about \$35 million for the 2009 plan year before reflecting the WRERA changes to the funding transition rule.

Company A's fiscal year runs from 7/1 to 6/30, so they would prefer to be 90% funded to eliminate uncertainty in fiscal 2010 cash flow (if the plans are only funded to 80% at 9/15/2009, they will be presumed to be 70% funded at 4/1/2010, possibly requiring additional contributions at that point in order to avoid the PPA benefit limitations). However, this would require a contribution of about \$100 million by 9/15/2009—almost half of the company's annual payroll—and it is unlikely they will be able to make such a contribution in the current economic environment.

Since WRERA allows the use of an expected rate of return in calculating an average value of plan assets, Company A may decide to switch from market value to asset averaging for 2009 if the IRS provides automatic approval for such a change. In combination with the WRERA changes to the funding transition rule, this would reduce the minimum required contribution for the 2009 plan year to about \$39 million. As noted above, the remaining funding balances potentially available to cover a portion of this minimum required contribution would be about \$16 million. However, in order to avoid the limitation on accelerated benefit distributions and PBGC section 4010 reporting, Company A would need to waive all remaining

funding balances and contribute about \$33 million by 9/15/2009 to reach a funded status of 80%. After this waiver of funding balances and additional contribution, Company A would still have a minimum required contribution of about \$31 million for the 2009 plan year.

If Congress were to enact additional funding relief legislation that allows: (1) a lookback to 2008 funded status for purposes of both benefit limitations and PBGC section 4010 reporting; and (2) an interest-only amortization of the funding shortfall arising during 2009; then Company A would not need to make any additional contributions by 9/15/2009 to reach a funded status of 80%, and the minimum required contribution for the 2009 plan year would be about \$28 million before the application of funding balances and about \$12 million after the application of funding balances.

If Congress does not provide relief from PBGC section 4010 reporting, then Company A may still feel compelled to waive any remaining funding balances and make additional contributions to fund its plans to 80%. Company A is a U.S. subsidiary of a foreign parent, and it would place an extreme administrative burden on the company to aggregate and file information with the PBGC on the non-U.S. members of the controlled group.

Company A has already determined that it will lay off a number of employees this year. It is unclear what impact the need for additional pension contributions may have on the number of employees who will be laid off.

Company B

Company B has one qualified pension plan. The plan was just under 90% funded for the 2008 plan year and was subject to the Additional Funding Charge for the 2007 plan year, so it did not qualify for the funding transition rule in 2008. The minimum required contribution was about \$11 million for the 2008 plan year. Company B has no funding balances to apply against the minimum required contribution, so all of the minimum required contribution must be made in cash.

The plan experienced an asset loss of approximately 30% during 2008. As of 1/1/2009, the plan is estimated to be between 60% and 70% funded.

The plan offers a 100% lump sum option to certain participants and a lump sum death benefit to other participants, so the plan sponsor is concerned about the limitation on accelerated benefit distributions and associated participant reporting. Thus, they will likely need to make additional contributions by 3/31/2009 to support an "at least 80%" range certification for the 2009 plan year in order to avoid benefit limitations.

Prior to WRERA, Company B elected to determine the plan's funded status using the market value of assets and the full yield curve. On this basis, the minimum required contribution for the 2009 plan year would be about \$28 million. However, in order to avoid the limitation on accelerated benefit distributions, Company B would need to contribute about \$50 million by 3/31/2009 to reach a funded status of 80%. After this contribution, Company B would still have a minimum required contribution of about \$20 million for the 2009 plan year. Company B is in the financial services sector, so credit is much less available than it was a year ago. It is unclear whether Company B will make the additional contribution or simply allow participants' benefits to be negatively impacted by the benefit limitations.

Since WRERA allows the use of an expected rate of return in calculating an average value of plan assets, Company B may decide to switch from market value to asset averaging for 2009 if the IRS provides automatic approval for such a change. This would reduce the minimum required contribution for the 2009 plan year to about \$23 million. However, in order to avoid the limitation on accelerated benefit distributions, Company B would need to contribute about \$20 million by 3/31/2009 to reach a funded status of 80%.

After this additional contribution, Company B would still have a minimum required contribution of about \$20 million for the 2009 plan year. Since Company B was subject to an Additional Funding Charge for the 2007 plan year, it is not eligible for the funding transition rule even after WRERA.

If Congress were to enact relief legislation that allows: (1) a lookback to 2008 funded status for purposes of all benefit limitations; and (2) an interest-only amortization of the funding shortfall arising during 2009; then Company B would not need to make any additional contributions to reach a funded status of 80% and would have a minimum required contribution of about \$15 million for the 2009 plan year.

Company C

Company C is a not-for-profit employer with one qualified pension plan. The plan has historically been so well funded that Company C has not been required to make contributions for 15 to 20 years. The plan's funded ratios for the 2006, 2007, and 2008 plan years were 112%, 109%, and 114% respectively on a current liability and Funding Target Attainment Percentage basis.

The plan experienced an asset loss of approximately 30% during 2008. As of 1/1/2009, the plan is estimated to be between 75% and 85% funded.

The plan offers a 100% lump sum option to all participants, so the plan sponsor is concerned about the limitation on accelerated benefit distributions and associated participant reporting. Company C would prefer to be 90% funded to eliminate uncertainty in fiscal 2010 cash flow.

Prior to WRERA, Company C had elected to determine the plan's funded status using the market value of assets and the full yield curve. On this basis, the minimum required contribution for the 2009 plan year would be about \$1.5 million, with funding balances covering approximately \$0.1 million of the minimum. However, in order to avoid the limitation on accelerated benefit distributions and eliminate uncertainty in fiscal 2010 cash flow, Company C would need to contribute about \$2.5 million by 9/15/2009 to reach a funded status of 90%. After this contribution, Company C would still have a minimum required contribution of about \$1.1 million for the 2009 plan year.

Since WRERA allows the use of an expected rate of return in calculating an average value of plan assets, Company C will likely smooth assets for 2009 if the IRS provides automatic approval for such a change. This would reduce the minimum required contribution for the 2009 plan year to about \$1.2 million, with funding balances covering approximately \$0.1 million of the minimum. However, in order to avoid the limitation on accelerated benefit distributions and eliminate uncertainty in fiscal 2010 cash flow, Company C would need to contribute about \$1.3 million by 9/15/2009 to reach a funded status of 90%. After this additional contribution, Company C would still have a minimum required contribution of about \$1.0 million for the 2009 plan year.

Company C has been experiencing a sizeable budget deficit since 2007, as the recession has led to declines in their endowment. Through the end of 2008, Company C has already undergone some layoffs and conducted an early retirement window (without enhanced pension benefits) in an effort to avoid further layoffs. The expected \$1.3 million contribution on 9/15/2009 amounts to almost one third of Company C's 2009 budget deficit. Because of this, the board is recommending that the pension plan be frozen. It is unclear what level of benefits would be provided in a replacement defined contribution plan, or if the pension plan would be replaced in the short-term at all.

If Congress were to enact relief legislation that allows: (1) a lookback to 2008 funded status for purposes of all benefit limitations; and (2) an interest-only amortization of the funding shortfall arising during 2009; then Company C would not need to make any additional contributions to reach a funded status of 90% and would have a minimum required contribution of about \$0.8 million for the 2009 plan year.

Company D

Company D has three qualified pension plans. All three plans were at least 92% funded for the 2008 plan year, so they qualified for the funding transition rule. The total minimum required contribution for the 2008 plan year was about \$189 million before the application of funding balances.

The plans all experienced asset losses of approximately 25% during 2008. As of 1/1/2009, two of the plans are estimated to be between 60% and 70% funded. The third plan was overfunded in 2008, and remains so for 2009.

Of the two plans that are estimated to be between 60% and 70% funded for 2009, both are traditional final average pay plans that offer a 100% lump sum option. Company D is very concerned about the limitation on accelerated benefit distributions as well as PBGC section 4010 reporting. Thus, Company D will likely need to make additional contributions by 9/15/2009 to reach a funded status of at least 80%.

Prior to WRERA, Company D had elected to determine the plans' funded status using a two-month average of the market value of assets and the 24-month average segment rates for the September preceding the valuation year. On this basis, the minimum required contribution for the 2009 plan year would be about \$264 million before applying funding balances and about \$218 million after applying funding balances. However, in order to avoid the limitation on accelerated benefit distributions and PBGC section 4010 reporting, Company D would need to waive all remaining funding balances and contribute about \$191 million by 9/15/2009 to reach a funded status of 80%. After this waiver of funding balances and additional contribution, Company D would still have a minimum required contribution of about \$224 million for the 2009 plan year. Additional contributions may also be required to achieve 80% funded status as of 1/1/2010 depending on 2009 interest rate and asset movements.

Since WRERA allows the use of an expected rate of return in calculating an average value of plan assets, Company D may decide to switch from a short-term average to long-term asset smoothing for 2009 if the IRS provides automatic approval for such a change. However, such a change would not impact the minimum required contribution for the 2009 plan year or the 9/15/2009 contribution needed to reach a funded status of 80% due to the application of the 10% asset corridor. After reflecting the WRERA changes to the funding transition rule, the minimum required contribution for the 2009 plan year would be \$247 million before applying funding balances and \$201 million after applying funding balances. In order to avoid the limitation on accelerated benefit distributions and PBGC section 4010 reporting, Company D would need to waive all remaining funding balances and contribute about \$191 million by 9/15/2009 to reach a funded status of 80%. After this waiver of funding balances and additional contribution, Company D would still have a minimum required contribution of about \$207 million for the 2009 plan year.

If Congress were to enact additional funding relief legislation that allows: (1) a lookback to 2008 funded status for purposes of all benefit limitations; and (2) an interest-only amortization of the funding shortfall arising during 2009; then Company D would not need to make any additional contributions to reach a funded status of 80%. The minimum required contribution for the 2009 plan year would be about \$198 million before applying funding balances and about \$152 million after applying funding balances.

If Congress does not provide relief from PBGC section 4010 reporting, then Company D may still feel compelled to fund its plans to 80%. Alternatively, Company D may decide to fund to at least a 75% funded ratio in order to avoid increased contributions and other restrictions in 2010 associated with "at risk" status.

Company E

Company E has four qualified pension plans. Two of the plans were just over 80% funded for the 2008 plan year and were subject to the Additional Funding Charge for the 2007 plan year, so they did not qualify for the funding transition rule in 2008. The third plan was just under 80% funded for the 2008 plan year, so Company E needed to make an elective contribution by 3/31/2008 to avoid the benefit limitations during the

2008 plan year. The fourth plan was just over 90% funded for the 2008 plan year and was not subject to the Additional Funding Charge for the 2007 plan year, so it did qualify for the funding transition rule in 2008. The total minimum required contribution was about \$3.4 million for the 2008 plan year. Only the plan that was at least 90% funded for 2008 had the ability to apply a funding balance against the minimum required contribution.

The plans experienced an asset loss of approximately 25% during 2008. As of 1/1/2009, all plans are estimated to be between 60% and 70% funded.

One of the four plans offers a 100% lump sum option to certain participants so the plan sponsor is concerned about the limitation on accelerated benefit distributions and associated participant reporting. Thus, they will likely need to make additional contributions by 3/31/2009 to support an "at least 80%" range certification for the 2009 plan year in order to avoid benefit limitations. It is unclear whether Company E will make the additional contributions or simply allow participants' benefits to be negatively impacted by the benefit limitations. Company E has indicated that they may have difficulty in meeting this obligation by 3/31/2009.

Prior to WRERA, Company E was using a 3-month averaging method to determine the Value of Plan Assets and the 2008 minimum required contribution. Unless the IRS provides automatic approval for a change to a longer averaging period in 2009, Company E will need to maintain the same averaging period as used in 2008—even though averaging over a longer period of time would likely prove more advantageous for the 2009 plan year. On this basis, the minimum required contribution for the 2009 plan year would be about \$6.7 million before applying funding balances and about \$4.4 million after applying funding balances. However, in order to avoid the limitation on accelerated benefit distributions for the 2009 plan year, Company E would need to waive any remaining funding balance for the affected plan and contribute an additional \$16 million by 3/31/2009. After making this contribution, Company E would still have a minimum required contribution of about \$3.4 million for the 2009 plan year after applying funding balances. Since only one of the four plans was not subject to an Additional Funding Charge for the 2007 plan year, three of the four plans are not eligible for the funding transition rule even after WRERA.

If Congress were to enact relief legislation that allows a lookback to 2008 funded status for purposes of benefit limitations or the IRS were to provide automatic approval for a change to a longer averaging period for 2009, then Company E would not need to make any additional contributions to reach a funded status of 80% for 2009.

We believe these examples present a compelling argument for refining the PPA funding rules in light of today's historic market environment. Relief proposals such as those discussed above would better enable plan sponsors to maintain their defined benefit plans, and strengthen retirement security for millions of employees.

Please contact the undersigned if you have any questions regarding the examples summarized above.

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