



AMERICAN BENEFITS COUNCIL

November 5, 2008

THE NEED FOR FUNDING LEGISLATION: QUESTIONS AND ANSWERS

The recent market downturn has created huge defined benefit plan funding obligations. These funding obligations are of such a magnitude that they will almost certainly trigger job loss and significantly slow down our economic recovery. Three factors have contributed to this problem:

- The rapid decline in the market has dramatically reduced the value of pension plan assets.
- Treasury has interpreted the Pension Protection Act (the “PPA”) in such a way that effectively forces companies to value pension assets at their fair market value instead of permitting limited asset smoothing as intended by Congress. Thus, every dollar of market loss must be taken into account at once for funding purposes.
- The state of the economy makes it very difficult for companies to cope with huge new funding obligations.

Is there really a funding problem or are companies just trying to avoid funding promised benefits?

A November 2008 study published by the Center for Retirement Research at Boston College concluded that as of October 9, 2008:

- In the 12-month period ending October 9, 2008, equities held by private defined benefit plans lost almost a trillion dollars (\$.9 trillion).
- For funding purposes, the aggregate funded status of defined benefit plans has fallen from 100% at the end of 2007 to 75% (see footnote 5 of the study).
- The aggregate contribution that employers will be required to make to such plans for 2009 could almost triple, from just over \$50 billion to almost \$150 billion.

The study goes on to state:

The incidences of underfunding raise the possibility that some companies may not be able to meet their obligations without placing enormous pressure on the firm. This challenge raises the question of firms laying off workers, freezing their pensions, or going bankrupt
[R]equiring firms to increase their funding dramatically just as the economy slips into recession also does not make sense. [Study at 3,5.]

What funding changes are needed?

There are four key changes that are needed, each of which is explained further below.

- Consistent with Congressional intent in the PPA, asset smoothing needs to be permitted.
- For 2009 and 2010, asset smoothing needs to be permitted without the applicable restrictions, as a mean of easing the transition to the PPA funding rules.
- For 2009 and 2010, companies need the ability to choose a funding method without being compelled to continue using that method. This will enable companies to use the December corporate bond yield curve to value liabilities, rather than the 24-month average of the corporate bond yield curve. The December “spot” yield curve rate is likely to be much higher than the 24-month average. Under current law, plans can use either a spot yield curve or a 24-month curve, but they cannot switch the type of yield curve used without IRS approval.
- The transition to the 100% funding target needs to apply to companies both above and below the phased-in funding target. And the phase-in level for 2008 needs to apply again in 2009.

What is asset smoothing and why is it needed?

Under asset smoothing, unexpected asset gains and losses are taken into account over 24 months, rather than immediately. This would allow the recent dramatic losses to be recognized over time, rather than all at once.

What restrictions apply to asset smoothing and why do they need to be temporarily suspended?

Under current law, the smoothed value of pension assets needs to be within 10% of the fair market value of those assets. Prior to the PPA, the applicable figure was 20%. Since many plans have lost 30% or more this year, application of those limits would require most of the 2008 plan losses to be recognized immediately.

Why does use of the December corporate bond yield curve make such a difference?

Naturally, corporate bond rates have risen sharply in recent months. If those higher rates are used to value pension liabilities, the present value of those liabilities is reduced. Accordingly, for 2009, it will be very helpful to use the “spot” yield curve for December. But on an ongoing basis, use of a spot yield curve would create far too much unpredictability with respect to funding obligations.

How does the PPA transition rule work and how would the rules change under the proposal?

Before the PPA, the “funding target” for pension plans was 90% funded. Under the PPA, the 90% figure was phased up to 100%; in 2008 and 2009, the phase-in levels are 92% and 94% funded, respectively. So if a plan is 92% funded in 2008, there is no shortfall to fund. But if a plan is 91% funded, its funding obligation is based on a 9% shortfall, not a 1% shortfall. In other words, the transition relief is only available to plans at or above the phase-in level. With a huge number of plans falling below 92% funded next year, it is critical that (1) the phase-in level stay at 92% for another year, and (2) the transition relief be available to plans below the phase-in level, as well as above.

What are the benefit restrictions? And why don't the proposals address those restrictions?

Here are the key restrictions (though there are more):

- A plan that is less than 60% funded cannot provide any additional benefit accruals and cannot pay out lump sum distributions.
- A plan that is at least 60% funded, but less than 80% funded, may only pay 50% (or less) of the otherwise payable lump sum.

If Congress is inclined to suspend benefit restrictions for 2009 and/or 2010, we would very much support that. But if Congress enacts the proposals we recommend,

substantially all of the plans that would otherwise become subject to the benefit restrictions due to the 2008 market decline, would not become subject to those rules.

Why not just suspend the benefit restrictions and do nothing else?

If the huge funding obligations remain in place, companies would be effectively forced to freeze their plans, which is the ultimate benefit restriction. Also, those huge funding obligations will cause enormous job loss and damage to the economy.

Do the recommended reforms undo the PPA reforms?

No. Asset smoothing was clearly intended by Congress, as reflected by its inclusion in House and Senate-passed technical corrections bills. The other recommended changes simply provide a temporary transition to the PPA rules, consistent with what we believe Congress would have done if it had foreseen the market decline of 2008.

Why is legislation needed now?

Some companies need to increase their January 1, 2009 funded status in order to avoid benefit restrictions or qualify for the funding target transition rule. Those payments are due by September 15, 2009 or, in some cases, by April 1, 2009. Other companies must make quarterly funding contributions for 2009 starting April 15, 2009. Finally, and most importantly, the obligations due in 2010 are so enormous -- such as contribution increases of over \$2 billion -- that companies would need to "act" immediately to save for those liabilities. The needed actions will almost certainly include layoffs and plan freezes.