Impact of PPA on Defined Benefit Plans

Jerry Mingione

EBRI Policy Forum

May 3, 2007

At a High Level, PPA Funding Rules Imply

- Increased funding target
  - set to 100% of a solvency liability vs. 90% previously
  - target further increased – but only temporarily – for plans deemed at-risk
- Faster recognition of capital market results
  - smoothing period reduced to two years vs. four years previously
  - seven-year amortization of unfunded amounts once recognized
- Reduced ability to delay contributions for poorly funded plans – since the application of credit balances is restricted
- New constraints on plan operations for plans that fall below funding thresholds
- Greatly improved ability to advance fund pension plans
- Some expansion of plan sponsors’ access to accumulated surplus

Different Plans Will See Different Impacts

<u>Poorly funded plans</u>

- Unfunded amounts are amortized over seven years – this represents a *decrease* in amortization amounts when compared to amortization rates as high as 30% under prior rules.
- Credit balances can't be used to delay contributions.
- At-risk designation essentially raises the amortization rate gradually over a period of years (until the funding level recovers); also raises PBGC premiums.
- Sponsors can't pay full lump sums or make plan improvements until the funded level recovers.

Bottom Line → **a mixed bag**

Different Plans Will See Different Impacts

Moderately funded plans (near 90%)

- Significant increase in funding requirements – increased target hits these plans directly.
- If capital market conditions deteriorate, credit balance utilization may be restricted, at-risk designation and constraints on benefit operations may kick in.

Bottom Line → **increased contributions**
greater downside risk

Different Plans Will See Different Impacts

Well funded plans

- Contributions are not required unless the funded level drops below 100%.
- Greatly increased advance funding opportunity – up to 150%. Resulting credit balances available to offset future contribution requirements (unless funded level drops below 80%).
- Expanded opportunity to utilize surplus assets to pay retiree medical benefits – albeit with significant restrictions attached.

Bottom Line → **more flexibility**

less downside protection (against contribution increases)

Will Contributions Be More Volatile?

- Given the key parameters of PPA funding rules, you'd expect the new rules to add volatility to pension plan funding, since
  - smoothing is reduced to two years
  - application of credit balance is curtailed
  - at-risk designation increases contribution requirements during adverse periods.
- However, when looking more closely at the details, the picture gets complicated
  - the amortization rate is likely to be reduced for the most poorly funded plans
  - amortization amounts per $ of unfunded liability (essentially) stay constant, while under prior rules there were major “cliffs” in funding requirements.
- Also for plan sponsors who wish to manage contribution requirements proactively
  - there is an enhanced ability to implement effective ALM/LDI strategies
  - there is added flexibility to fund the plan in advance of funding requirements.

How Alternative Funding Requirements Perform --

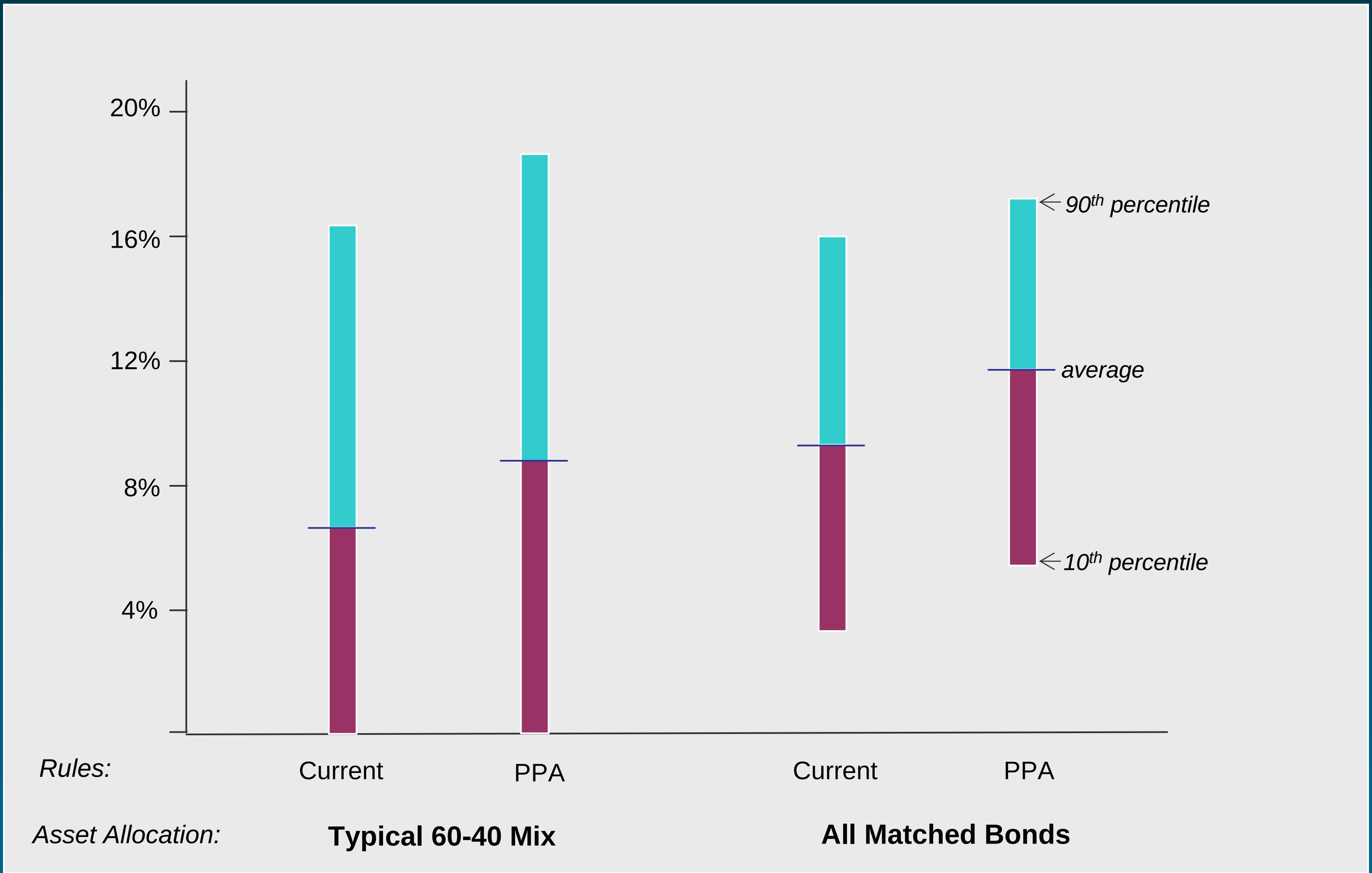
Traditional Plan / Typical 60-40 Asset Mix

	Prior Rules	*New Rules/PPA*	*Change*
Contributions			
average over time	6.6%	8.7%	+2%
10-90 percentiles	0 - 16%	0 - 19%	more variable
percent > 20% of payroll	5%	7%	more variable
Funded Levels			
average, end of period	97%	108%	+11%
10-90 percentiles (end of period)	75 - 123%	83 - 136%	increased chance of large surplus
percent < 80% funded	16%	8%	reduced chance of large unfunded

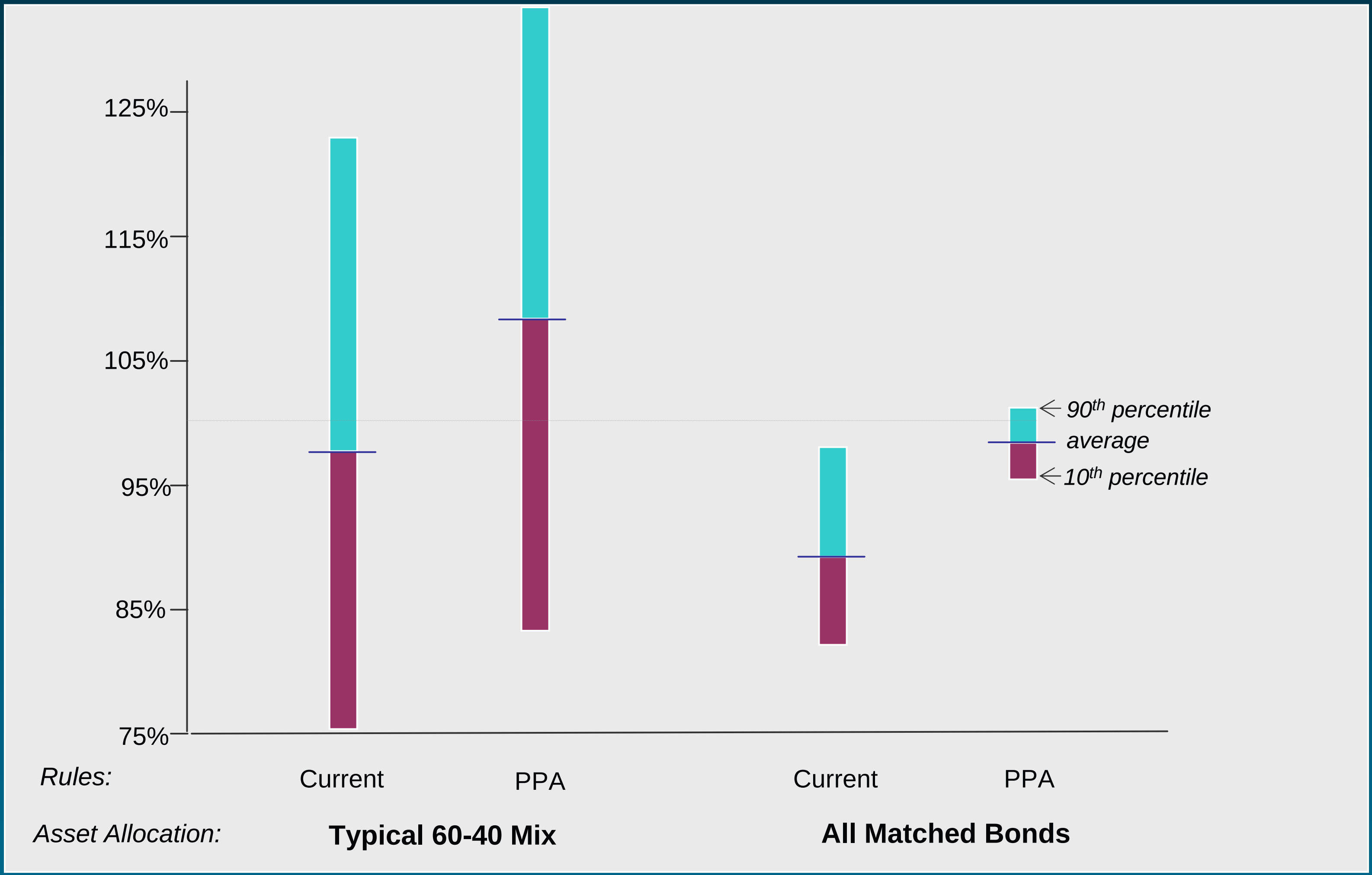
Methodology:

- 10-year forecast, including transition period
- minimum contributions paid each year
- plan starts out about 90% funded
- no initial credit balance

How Alternative Funding Requirements Perform –
Range of Contributions (10-year average)



How Alternative Funding Requirements Perform – Funded Status (10th year)



Concerns About Surplus

The increased funding target implies that plans investing in equities are more likely to accumulate surplus assets over time.

- Costs related to ongoing benefit accruals can siphon off only some of this surplus -- especially problematic for mature or frozen plans.
- The expanded section 420 transfer opportunity will be an attractive option for sponsors providing retiree medical benefits. However, its relevance is limited by:
  - the need to maintain a 120% funded level for the entire payout period
  - the requirement to vest all accrued pension benefits
  - the requirement to maintain retiree medical benefits (or costs) at existing levels for an extended period of time.
- Plan termination is generally not a viable option due to the cost of annuitization and the prohibitive excise tax applied on surplus.

> The potential for creating surplus and the limited avenues for effectively utilizing it (once created) affects the perceived risk/reward tradeoff – and makes lower-risk strategies more appealing.

How Will Plan Sponsors Adapt?

Employer Survey Results

- Are pension financial risks expected to be manageable?
  - 63% said yes
  - 30% said acceptable
  - 7% said significant risk.
- Will pension benefits be curtailed further?
  - 17% intend to close the plan to future hires
  - 5% intend to freeze benefits for existing employees
  - 9% intend to reduce future benefit accruals
  - 49% do not plan any changes.
- How will investment policies change?
  - 32% said they would were likely to put greater emphasis on bonds
  - 25% said they were likely to increase their use of derivatives
  - 5% said they would consider annuities (pricing is viewed as problematic).