



# The Pension Protection Act of 2006

## Effect on Single-Employer Defined Benefit Plans

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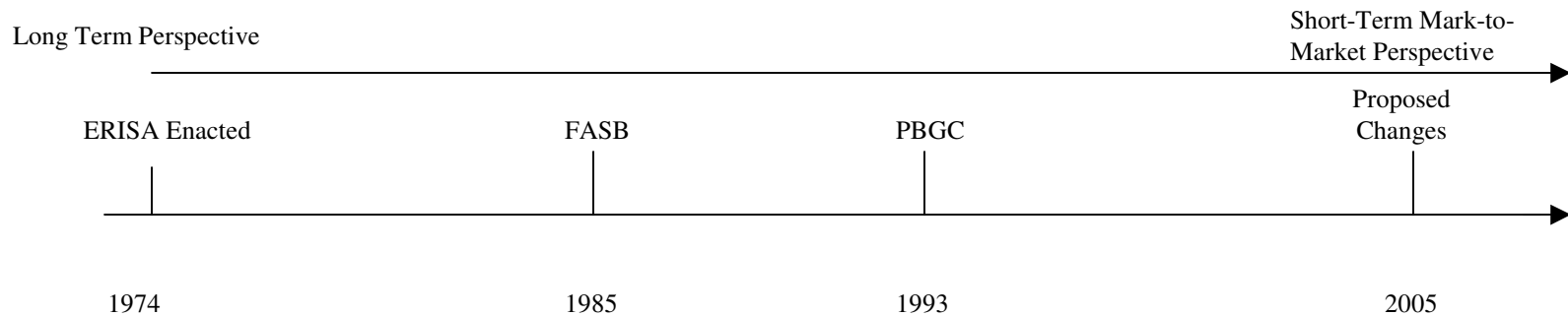
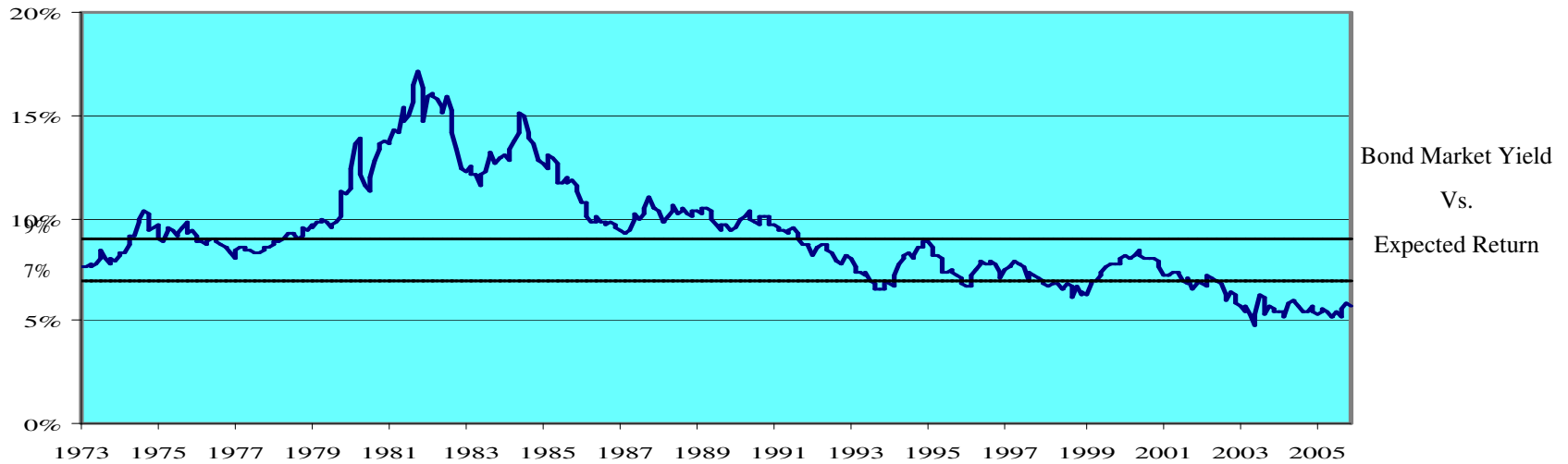
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# Agenda

- Where we've been, and where we're going
- Single employer pension funding changes
- Funding based benefit limits
- Expanded retiree medical transfer opportunities
- Reporting and disclosure
- PBGC Premiums
- Minimum lump sums
- What sponsors should be thinking about

# The Changing Point of View on Retirement Plan Costs



## Whatever You Like era (before 1974)

- Long-term perspective
- Expense = Cash Contribution
- Insurance Contracts were main investment vehicle

## ERISA era (1974 – 1985)

- Required contributions based on long-term perspective
- Expense = Cash Contribution
- Reversions common when interest rates are high

## FASB era (1985 – 1993)

- Separate cost accounting for retirement programs (SFAS 87/88/106)
- Combination of short-term view:
  - Market based discount rate
  - Balance sheet adjustment
- And of long-term view:
  - Significant smoothing still allowed

## The PBGC weighs in (1993 – 2005)

- Solvency valuation based on 4-year weighted average yield of 30-year T-bills
- Based on smoothed asset values
- Interest rates continue to drop
- Asset returns are great for a while then drop sharply
- Airline & Steel defaults – PBGC surplus ->deficit

## Scope of Today's Webcast

The information presented today summarizes certain provisions of the 907 page bill related to single-employer defined benefit plans. Not every issue addressed is covered in detail, and many of the special provisions dealing with small plans, special industries, non-calendar years, etc. are not discussed. Other aspects of the bill will be covered in subsequent webcasts

## Timing of Funding Related Changes

- Most changes effective in 2008 plan years
- Changes effective in 2006 / 2007
  - 2005 minimum funding rules continue
    - Extension of corporate bond rates for current liability
  - Maximum deductible contribution raised from 100% to 150% of current liability, less assets
    - Combined DB/DC plan limit applies to DC contributions over 6% of pay

## Key Elements of New Funding Rules

- Switch from two-tier to single-tier system
- Move toward mark-to-market assets and liabilities
  - 3-segment yield curve
  - Less smoothing of asset & interest rates
- Amortize unfunded liabilities over 7 years
- “At-risk” rules for poorly funded plans
- Higher deduction limits

## Funding Target / Target Normal Cost

- Funding target similar to current liability
  - Present value of accrued benefits
- Target normal cost is present value of benefit accrual during current year
- Valuation date to be first day of plan year
  - Small plan / company exception

## Interest Rates

- Funding target / target normal costs determined based on segmented yield curve issued by Treasury
  - Based on corporate bonds maturing in
    - First 5 years, next 15 years, and after 20 years
  - Uses top 3 quality levels
  - Average over 24 months
  - Segmented yield curve can be phased in 1/3 per year
- Option to use full yield curve without 24 month averaging and without phase in

## Mortality Tables

- Secretary of the Treasury to prescribe mortality table
  - Based on pension plan experience and projected trends
  - Updated at least every 10 years
- Sponsors with credible data to support alternative mortality assumption may request to use their own table

## Asset Values

- Fair market value, unless averaging elected
- Averaging permitted subject to the following restrictions:
  - Method must be permitted under Treasury regulations
  - Limited to 24-month period
  - Value constrained to 90%-110% of fair market value

## Carryover Balance / Prefunding Balance

- Carryover balance is current law credit balance
- Prefunding balance is cumulative contributions in excess of minimum under new rules
- Both adjusted for actual asset returns after 2007
- Sponsor may elect to eliminate these amounts at any time
- May be used to offset minimum contribution if funding target attainment percentage in preceding year is 80%
  - Carryover balance must be used first

## Funding Target Attainment Percentage / Shortfall

- Funding target attainment percentage
  - Ratio of assets to funding target
  - Expressed as a percentage
- Funding shortfall
  - Funding target less assets
  - Used to determine amortization bases
- Assets generally reduced by carryover and prefunding balances

## Shortfall Amortization Charge

- Shortfall amortized over 7 years in level installments
  - New “shortfall amortization base” each year equals current shortfall less value of remaining payments from previous years’ bases
  - Unlike original bills, amortize both gains and losses
- Exempt from establishing new base if assets exceed 100% of funding target
  - Without reduction for carryover & prefunding balances
  - Lower percentages may apply in 2008 (92%), 2009 (94%) and 2010 (96%)

## Basic Minimum Funding Rule

- Minimum contribution is the sum of:
  - Target normal cost
  - Shortfall amortization charge (7-year amortization)
- If asset value (reduced by carryover and prefunding balances) exceeds funding target
  - Target normal cost less such excess

## At-Risk Funding Target

- Plan is deemed “at-risk” if funding target attainment percentage for preceding year does not meet either of:
  - 80%, using regular actuarial assumptions
    - 65% for 2008, 70% for 2009, 75% for 2010
  - 70%, using special “at-risk” assumptions
    - Assume employees eligible to retire in next 10 years will retire at earliest possible date and elect most valuable option
- Must use the “at-risk” assumptions for valuation
- If at-risk for 2 or more of last 4 years, add:
  - \$700 per participant + 4% of regular funding target
  - 4% of regular target normal cost

## At-Risk Minimum Contribution

- Based on at-risk funding target and at-risk normal cost
- Extra at-risk contribution phased in 20% for each consecutive year plan has been at-risk
  - All pre-2008 years deemed not at-risk
- Small plan / company exemption

## Maximum Tax-Deductible Contributions

- Amount to bring assets up to funding target, plus “cushion”
  - 50% of funding target
  - Expected increase in funding target for
    - Salary increases in pay related plan
    - Benefit increases in non-pay related plan
    - Increases in maximum benefit and compensation limits
- Combined plan limit does not apply starting in 2008

## Funding-Based Benefit Limits

- Apply if funding level below specific percentages
  - Assets reduced by carryover and prefunding balances unless assets exceed funding target without reductions
    - May use lower funding target percentages for 2008-2010 if applicable (92%, 94%, 96%, respectively)
  - Generally must notify participants within 30 days if restrictions apply

## Benefits Limited and Their Thresholds

- Shutdown benefits – 60%
- Plan amendments – 80%
  - Not applicable if benefits not based on compensation and increase does not exceed increase in average compensation
- Lump sums – 60/80%
  - If Under 60%, fully restricted
  - If 60-80%, payout limited to lesser of 50% of benefit or present value of PBGC guaranteed benefit
  - Also applies in bankruptcy if funded less than 100%
  - Not applicable to plans frozen before September 1, 2005
- Benefit accruals – 60%

## How to Prevent the Limits from Applying

- Contribute amount to raise funding percentage to threshold
  - In cash, or by posting security
- Contribute funding target increase due to shutdown or plan amendment
  - Amounts are in addition to the regular funding requirement
- Plans forced to elect to reduce their carryover and prefunding balances to avoid:
  - Application of lump sum limitations
  - Other restrictions, but only for collective bargained plans

## Funding Based Benefit Limits – The “Gotcha”

- Use preceding year’s funded percentages until current year percentages certified by actuary
- Preceding year’s percentages adjusted as follows:
  - Presumed to be 10% lower after 3 months
  - Presumed to be less than 60% after 9 months!!!

## Expansion of Retiree Healthcare Transfers

- Expands transfer of excess pension assets
  - Can transfer expected costs for up to 10 years (“transfer period”)
- Pension plan assets must remain 120% over funding target during the transfer period
  - Contribute shortfall or transfer amounts back to pension plan
- Cost maintenance requirement
  - Requires average pre-transfer employer costs to be maintained during transfer period plus 4 years
- Additional transfer opportunities for collectively bargained post-retirement plans

## Disclosure to Participants

- New Defined Benefit Plan Funding Notice -- effective 2008
  - Due 120 days after close of plan year
  - Contains a variety of plan financial information
    - Funding target attainment percentage for current and two prior years
    - Assets, funding target, carryover and prefunding balances
    - Assets and liabilities at end of year on PBGC premium basis
    - Funding policy, asset allocation
  - Also other information such as numbers of participants, summary of amendments, description of PBGC guarantees
  - DOL to publish sample notice
- SAR eliminated in 2008
- Participant notices (ERISA 4011) eliminated in 2007

## Disclosure to Participants (continued)

- Basic and actuarial information from Form 5500 to be posted in corporate intranet – effective 2008
  - Treasury to also post on its internet 90 days after receipt
- Benefit statements – effective 2007
  - Accrued benefits, explanation of permitted disparity and floor offset features
  - Once every 3 years, unless inform employees once a year of availability of information

## PBGC Section 4010 Requirements

- Required if funding target attainment percentage less than 80% of any plan in controlled group
  - Measured at the end of the preceding year
  - Repeal of \$50 million aggregate unfunded vested benefits may result in smaller plans reporting
- New information required
  - Funding target attainment percentage
  - Funding target assuming plan was at-risk for five years

## PBGC Premiums

- Variable premium based on excess of vested funding target over market value of assets
  - Based on single month 3-segment yield curve interest rates at end of prior year
  - \$9 per \$1,000 rate retained
- Special assessment of \$1,250 per participant for companies emerging from bankruptcy made permanent
- PBGC authorized to pay interest on premium overpayments

## Lump Sum Payments

- Starting in 2008, minimum lump sum payments based on
  - Updated mortality table
  - Three segment corporate bond yield curve
    - Without 24 month averaging
    - Phased in over 5 years starting in 2008
- Interest rate generally determined in month before lump sum distribution date
  - Subject to Treasury regulations
  - Presumably will allow look-back and stability periods as under current regulations

## Other Key Items Affecting DB Plans

- Tax penalties if fund non-qualified deferred compensation for top five executive officers –effective on enactment
  - If any qualified pension plan of controlled group is “at-risk”
  - Sponsor is in bankruptcy
  - During year beginning six months before termination
- Changes in Qualified Joint and Survivor Annuity rules
  - Requires additional optional form of payment
    - If QJSA is less than 75%, add 75% joint and survivor form
    - If QJSA is 75% or more, add 50% joint and survivor form
  - Notice and consent period begins 180 rather than 90 days before annuity starting date
  - Effective in 2008

## What Plan Sponsors Should Be Thinking About...

- Revisit investment policy and strategy
  - Consider defensive use of derivative strategies
- Review contribution policy (short and long term)
  - Maximize ability to use funding target phase-in percentages
    - Fund for 2006 to avoid deficit reduction contribution in 2007
  - Develop strategy related to minimum funding changes
    - Minimize contribution volatility
  - Keep anticipated GAAP accounting changes in mind
- Project funding requirements for 2008 and beyond based on a number of scenarios
  - Deterministic or full stochastic forecast
- Revisit actuarial assumptions
  - Including those around lump sum utilization
- Review plan design

# Thank You For Attending/Question & Answers

If you have a question, press star, then one on your phone. If you wish to be removed from the queue, please press the pound sign or the hash key.

You can also email your question to: [Lorraine.Sarutto@buckconsultants.com](mailto:Lorraine.Sarutto@buckconsultants.com)



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