

Not Much Relief in the Recent Pension Legislation



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Plan sponsors had been lobbying for pension funding relief for a while and on June 25, 2010, they got their wish as President Obama signed the Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010 (aka "Pension Relief Act of 2010"). But will this piece of legislation really help plan sponsors with their future contribution requirements? In short, no, as I explain in this article.

Pension Relief Act of 2010 in Summary

You will notice that the funding relief legislation — as summarized below — comes with strings attached that may result in a very limited reduction in future contribution requirements. Under the current law, sponsors of single-employer defined benefit pension plans must amortize funded status shortfalls over a seven-year period. With the Pension Relief Act of 2010, plan sponsors have two options for extending the amortization period in any two plan years between 2008 and 2011:

1. Method #1 (the "2 + 7" amortization period): Pay only interest on the shortfall for two years, after which the shortfall is amortized over the next seven years.
2. Method #2: Amortize the shortfall over a 15-year period.

(Note that the seven-year amortization period under the current law is still available to those plan sponsors that do not wish to extend the amortization period.)

There are additional variables to consider. For three years beginning with the election year in the case of Method #1 and five years in the case of Method #2, the required contribution for any year would be increased by:

1. *Excess Compensation*, which is defined as compensation in excess of \$1 million paid to any employee during the calendar year in which the plan year begins.
2. *Extraordinary Dividends and Redemptions*, which is defined as the sum of dividends declared during the plan year plus the aggregate fair market value of the stock redeemed during the plan year minus the greater of the company's adjusted net income for the preceding plan year or, if a sponsor paid dividends in the same manner for at least five consecutive years preceding the current year, the amount of dividends determined in that manner.

Note that the total contributions under the Pension Relief Act of 2010 would be limited so as not to exceed the amount that is required under the current seven-year amortization period. Also, sponsors electing an extended amortization period must give notice of such election to plan participants and to the Pension Benefit Guaranty Corporation (PBGC).

Analysis: Which Method Is More Beneficial?

For this example, let us assume a \$100 million shortfall. Based on a 6% effective interest rate, the table below shows the annual amortization amount

Annual amortization scenarios

\$ in millions	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10	Yr 11	Yr 12	Yr 13	Yr 14	Yr 15
Current Law: 7-Year Amortization Period	\$16.9	\$16.9	\$16.9	\$16.9	\$16.9	\$16.9	\$16.9	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Method #1: 2 + 7 Amortization	\$5.7	\$5.7	\$16.9	\$16.9	\$16.9	\$16.9	\$16.9	\$16.9	\$16.9	N/A	N/A	N/A	N/A	N/A	N/A
Method #2: 15-Year Amortization Period	\$9.7	\$9.7	\$9.7	\$9.7	\$9.7	\$9.7	\$9.7	\$9.7	\$9.7	\$9.7	\$9.7	\$9.7	\$9.7	\$9.7	\$9.7

Source: ING Investment Management

under both the current law as well as the two new methods provided by the Pension Relief Act of 2010.

As you can see in the table, the 2 + 7 method is helpful, as it buys a sponsor some time to improve its overall financial position; however, the reduced contribution requirements over the first two years of the amortization period must be made up in years eight and nine. Also, one has to wonder how the term "interest only" will sound to participants and other stakeholders given the very negative publicity associated with interest-only mortgages during the financial crisis.

The bigger the shortfall, the more attractive the 15-year amortization method appears; therefore, a large shortfall in any two plan years between 2008 and 2011 is likely needed to justify the use of this method. However, I am not convinced that there was a single year in this period that generated a disproportionately larger shortfall than the others. For example, although 2008 was a very bad year investment-wise, it was not as bad from a liability perspective (as explained below) and thus did not have a significantly negative impact on that year-end's funded status.

As I have discussed in several articles in *ING Investment Weekly*, the Pension Protection Act of 2006 dictates that plan sponsors must choose between two methodologies to establish the discount rate used to calculate the present value of future pension liabilities. Sponsors may employ either 1) a one-month average of A-Aaa rated corporate bond yields or 2) a 24-month average of these same yields. In theory, each plan sponsor must abide by its chosen method unless a change in method is requested and approved by the Internal Revenue Service (IRS). Following the financial crisis, however, the IRS introduced a number of exceptions. In March 2009, the IRS allowed plan sponsors to choose the most favorable method with respect to the 2009 plan year. In October 2009, the IRS allowed plan sponsors to switch their discount rate method for the 2010

plan year without seeking approval by the IRS. And with the 2011 plan year, sponsors are permitted to switch from the 24-month-average method to the one-month-average method. Changes after 2011 will again require IRS approval.

Going from the 24-month-average method to a one-month-average method as of January 1, 2009, resulted in a discount rate increase of more than 175 basis points in many cases, decreasing the value of the liability significantly and offsetting a large portion of 2008's investment losses. So unless this change in method is undone for calculating 2009 plan year liabilities — which may impact PBGC variable rate premiums and quarterly contribution requirements, among other things — the level of funding relief offered by either of the two new extended amortization periods with respect to the 2009 plan year is likely to be limited. Also, any "Excess Compensation" or "Extraordinary Dividends and Redemptions" incurred by the sponsor, which increase the amount of required contributions to the pension plan, will also mitigate the advantages of the Pension Relief Act of 2010's provisions.

Finally, this relief will be of little help for plan sponsors subject to benefit restrictions or those who want to avoid such restrictions because of the low funded status of their pension plans (i.e., less than 80%), as they will have to contribute an amount in excess of the minimum required contribution. Given the low equity returns and decline in interest rates so far this year, many more plan sponsors are likely to be facing this situation by December 31, 2010, than there were at the beginning of the year.

Conclusion

Obviously, every plan sponsor will have to analyze the impact of this pension funding relief based on its own facts and circumstances. Having said that, I am afraid that most plan sponsors will conclude that the provisions within the Pension Relief Act of 2010 are not compelling enough to offset the additional complexity attached to them. ■

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