



## THE PENSION PROTECTION ACT OF 2006: EXPECTED IMPACT ON RETIREMENT PLAN FINANCING — AND HOW EMPLOYERS ARE LIKELY TO RESPOND

The recently enacted Pension Protection Act (PPA) will have a significant impact on the financial environment for U.S. retirement plan sponsors. Signed by the President on August 17, this long-awaited reform of the pension funding rules increases the funding target for qualified plans while simplifying the funding environment in a number of ways. The new law is designed to increase the level of retirement benefit security over time and, thus, reduce the financial exposure of the Pension Benefit Guaranty Corporation (PBGC).

# WHITE PAPER

The new law brings increased flexibility for plan sponsors to advance fund their pension plans during periods when funds are available, while expanding their ability to access surplus pension assets to pay for retiree medical benefits. Offsetting these advantages are new constraints on plan operations and the application of credit balances (i.e., accumulated past contributions in excess of minimum requirements) when plans become underfunded.

On the other hand, plan sponsors would have faced significant funding challenges in the absence of the new legislation because the second of two interest-rate relief provisions enacted by Congress had expired at the end of last year. This meant that, absent new legislation, a number of key pension liability calculations would have reverted back to a basis that reflected long-term Treasury rates, rather than higher corporate bond yields.

In short, the new funding reform provisions represent a mixed bag for plan sponsors. Some changes may make the financial operation of pension plans more straightforward and better enable companies to fund their plans prudently over time. Other provisions will expose plan sponsors to added financial risks and new restrictions on their ability to manage their plans.

To gain a better understanding of how pension plan sponsors are likely to respond to this new environment, Towers Perrin conducted an online pulse survey of major employers immediately after Congress passed the PPA. A total of 126 companies responded, providing a representative cross section of pension plan sponsors across a broad range of industries. (See sidebar below for more about the survey and survey sample.)

In general, the survey responses suggest that, despite the new law's more stringent funding requirements, most companies that offer pension benefits continue to view the costs and financial risks of the plans as manageable and acceptable in view of the important role pensions play in workforce management and employee relations. And more companies appear likely to maintain their current levels of pension benefits than to "freeze" their plans or close them to new hires, at least for the immediate future.

At the same time, our survey results make it clear that the new law is expected to have an impact on most plan sponsors' pension costs and contribution levels — and a very significant impact on costs for some employers. However, a clear consensus has not yet emerged around the plan design or financial strategies that companies might employ to address these cost issues. Instead, many of our respondents appear to be carefully evaluating the new funding requirements and considering a range of possible actions to respond.

Here's a closer look at our survey findings, along with our preliminary analysis of the new law's financial impact on pension plan sponsors.

#### ABOUT THE SURVEY

Our online pulse survey on the impact of pension funding reform legislation was conducted in August 2006 via an online questionnaire of corporate financial executives working for large organizations sponsoring one or more defined benefit pension plans in the United States. On average, the 126 companies participating in the survey reported having annual revenues of just over \$5 billion, almost 9,000 employees worldwide and more than four pension plans. The majority (85%) of the companies surveyed maintain traditional final-average-pay pension plans, while about a third (35%) offer cash balance plans.

The new funding reform provisions represent a mixed bag for plan sponsors.

## PPA'S EXPECTED IMPACT ON PLAN FINANCING

Under existing rules, plan sponsors have only been required to fund their plans up to a 90% funded ratio, as determined on a plan solvency basis. The new law increases that target to 100%. This represents a substantial increase in the near-term financial commitment for many plan sponsors.

Plan funding requirements will also be affected by a number of other PPA provisions (*Exhibit 1*, pages 4-5). Here's an overview of the most significant ones.

### Amortization of unfunded liability

The new law replaces a range of amortization periods for unfunded liabilities (that could extend as long as 30 years under current rules) with a fixed seven-year period. While seven-year amortization sounds rather short, it may actually represent a reduced rate of amortization from prior law for plan sponsors with significant amounts of unfunded liability on a solvency basis. Existing rules call for plan sponsors to fund amounts ranging from 18% to 30% of their unfunded solvency liability (with the percentage varying inversely to the plan's funded ratio). Under the new rules, the amortization rate for newly created liability amounts will generally be around 17%.

### More conservative assumptions

Plan liabilities will continue to be valued using discount rates based on high-quality corporate bond yields, as they have since the Pension Funding Equity Act was enacted in 2004. However, there will be a difference in the effective rate for various plans because a simplified yield curve (expressed as three segment rates) will be employed. This will increase measured liability values for mature plans, while reducing liability values for plans covering

younger populations. In addition, an updated mortality table will be mandated for valuing liabilities. For a typical plan sponsor, the mortality table change may result in a liability increase in the range of 5% to 10%.

### Reduced smoothing

Under existing rules, interest rates are averaged over a four-year period, with the averaging weighted to more heavily reflect rates in more recent years. Investment results can also be reflected over a four-year period (i.e., by averaging asset values for the current and prior four years). Under the new rules, the averaging period is cut to two years for both asset and liability measurements. This increases the pace for recognizing capital market changes, which presumably adds volatility.

### New "at risk" liability assessments

Plan sponsors that do not maintain an 80% funded level (without considering any credit balance) against the regular funding target (or 70% against the more conservative at-risk target) will be exposed to additional amortization amounts and PBGC premiums under the new law because special termination-type assumptions are triggered for measuring liabilities when plans fall below these funding thresholds. These added assessments will be most significant for plan sponsors with more mature populations and with plan designs that offer more significant early retirement subsidies.

### Reduced ability to apply credit balances

Plan sponsors can no longer count on having ready access to credit balances to offset required contributions. These credit balances will essentially be available only to plan sponsors with funded levels above

80% (without considering the post-2007 portion of the credit balance). There will also be pressure to waive credit balances in order to avoid this or other constraints (at-risk assessments, benefit restrictions). Plan sponsors may need to evaluate multiple scenarios over a period of years to determine whether it is more advantageous to waive or retain their credit balances.

### New benefit restrictions

Plans will need to maintain a funded level of 80% or more (without considering any credit balance) in order to provide benefit improvements or pay full lump sum amounts (although 50% of lump sum payments are generally allowable if the plan's funded level is between 60% and 80%). Funded levels of at least 60% must be maintained or regular benefit accruals will also need to be curtailed. These funded levels are determined based on current-year valuation results and reflect asset values net of credit balances. In order to avoid these restrictions, the plan actuary needs to certify the plan's funded level by certain dates — either April 1 or October 1 for calendar-year plans, depending on the prior year's funded ratio. Plan sponsors may waive a portion of their credit balances as needed to maintain the required funding thresholds. (In fact, the law provides for a number of situations in which the forfeiture of credit balances is involuntary.) Companies may also choose to contribute additional funds or provide security outside the plan in order to avoid benefit restrictions.

**EXHIBIT 1****Overview of Key Provisions Affecting Retirement Plan Financing**

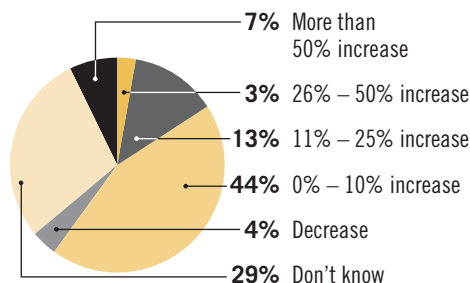
	<b>Current Law</b>	<b>Pension Protection Act</b>
<b>Funding Target</b>	<ul style="list-style-type: none"> <li>■ 90% of solvency liability</li> <li>■ 100% of long-term liability</li> </ul>	<ul style="list-style-type: none"> <li>■ 100% of solvency liability, based on assets net of credit balance (starting in 2008)</li> <li>■ Reduced targets applicable for transition period, grading up from 92% over 2008-2010 (based on assets including credit balance) — but must meet transition target in each year to qualify</li> </ul>
<b>Amortization of Unfunded Liability</b>	<ul style="list-style-type: none"> <li>■ 18% to 30% of unfunded solvency liability</li> <li>■ Five- to 30-year amortization for unfunded long-term liability</li> </ul>	<ul style="list-style-type: none"> <li>■ Seven-year amortization of unfunded amounts (typically about 17% of initial amount per year)</li> </ul>
<b>Interest Rate</b>	<ul style="list-style-type: none"> <li>■ Four-year weighted average of long corporate bond indexes (based on 30-year Treasury bonds before interest-rate relief in 2004)</li> <li>■ Long-term liability measure reflects expected investment return</li> </ul>	<ul style="list-style-type: none"> <li>■ Rates based on three time period segments (developed from a yield curve for high-quality corporate bonds)</li> <li>■ Rates averaged over 24 months</li> <li>■ Option to use full yield curve without averaging</li> </ul>
<b>Mortality Table</b>	<ul style="list-style-type: none"> <li>■ GAM 83 table required for current liability purposes</li> </ul>	<ul style="list-style-type: none"> <li>■ Treasury to specify an updated table (presumably RP 2000 table with projection)</li> <li>■ Sponsor may substitute experience-based tables</li> </ul>
<b>Asset Smoothing</b>	<ul style="list-style-type: none"> <li>■ Four years' investment experience can be smoothed</li> <li>■ Must remain within 80% to 120% of market value</li> </ul>	<ul style="list-style-type: none"> <li>■ Two years' investment experience can be smoothed</li> <li>■ Must remain within 90% to 110% of market value</li> </ul>
<b>Added Liability for At-Risk Plans</b>	<ul style="list-style-type: none"> <li>■ N/A</li> </ul>	<ul style="list-style-type: none"> <li>■ Considered at risk if funded less than 80% for regular solvency liability <i>and</i> less than 70% for at-risk liability (reduced thresholds apply for 2008-2010)</li> <li>■ Thresholds based on results for the prior year and assets net of credit balance</li> <li>■ At-risk measure is based on more conservative (termination-type) assumptions for retirement and optional form</li> <li>■ 4% load plus \$700 per participant also added if plan is deemed at risk in two of last four years</li> <li>■ Additional amounts are phased in over five years for funding purposes</li> </ul>
<b>Application of Credit Balance</b>	<ul style="list-style-type: none"> <li>■ Can be applied to reduce required contributions</li> <li>■ Balance indexed at long-term interest rate</li> </ul>	<ul style="list-style-type: none"> <li>■ Can be applied to reduce required contributions</li> <li>■ Application requires funding over 80% threshold level in prior year, based on assets net of post-2007 portion of credit balance</li> <li>■ Balance indexed at actual plan asset return</li> <li>■ Balances can also be waived in order to meet thresholds that allow credit balance application and avoid benefit restrictions and at-risk designation</li> </ul>
<b>Funding Waivers</b>	<ul style="list-style-type: none"> <li>■ Can request contribution waiver for three of 15 years</li> <li>■ PBGC requires collateral</li> </ul>	<ul style="list-style-type: none"> <li>■ Similar waiver opportunity</li> <li>■ Revised repayment schedule — five-year amortization</li> </ul>

**EXHIBIT 1 (continued)****Overview of Key Provisions Affecting Retirement Plan Financing**

	<b>Current Law</b>	<b>Pension Protection Act</b>
<b>Maximum Contribution</b>	<ul style="list-style-type: none"> <li>■ Up to 100% of solvency liability</li> <li>■ 10-year amortization to fund long-term liability</li> </ul>	<ul style="list-style-type: none"> <li>■ 150% of solvency liability plus allowance for pay/benefit increases</li> <li>■ Most provisions effective for 2006; some delayed to 2008</li> </ul>
<b>Surplus Reversion</b>	<ul style="list-style-type: none"> <li>■ Limited opportunity to fund current retiree medical benefits (one year's payments)</li> <li>■ Based on amounts above 125% funding for solvency liability</li> <li>■ Otherwise must terminate plan to access surplus — excise tax applies</li> </ul>	<ul style="list-style-type: none"> <li>■ Expanded opportunity to fund up to 10 years of retiree medical</li> <li>■ Based on amounts above 120% of solvency liability</li> <li>■ Otherwise must terminate plan to access surplus — excise tax applies</li> </ul>
<b>PBGC Premiums</b>	<ul style="list-style-type: none"> <li>■ \$19 per-participant premium increased to \$30 earlier this year</li> <li>■ Additional per-participant assessment for underfunded terminating plans</li> <li>■ Variable premium based on 0.9% of unfunded vested benefit amount, valued at 85% of corporate bond rate — without averaging</li> <li>■ Plan sponsors contributing to full funding limit exempt from variable premium</li> </ul>	<ul style="list-style-type: none"> <li>■ Per-participant premiums retained without changes</li> <li>■ Variable premium based on 0.9% of unfunded vested benefit amount, valued at full segment rates — without averaging</li> <li>■ Unfunded vested amount measured using at-risk assumptions if plan is deemed to be at risk</li> <li>■ No exemption to variable premium assessment</li> </ul>
<b>Benefit Restrictions</b>	<ul style="list-style-type: none"> <li>■ Restrictions on benefit increases and lump sum payments in limited circumstances</li> </ul>	<ul style="list-style-type: none"> <li>■ Benefit increases prohibited, lump sum payments partially restricted when plan falls below 80% threshold</li> <li>■ Plan benefits frozen and lump sum payments prohibited when plan falls below 60% funding threshold</li> <li>■ Thresholds reflect results for the current year and assets net of credit balance</li> <li>■ Actuary must certify results by certain deadlines during the year in order to avoid restrictions</li> </ul>
<b>Basis for Lump Sum Conversions</b>	<ul style="list-style-type: none"> <li>■ Based on 30-year Treasury bond yield</li> <li>■ 1994 GAR mortality table</li> </ul>	<ul style="list-style-type: none"> <li>■ One-month average segment rates (i.e., high-quality corporate bond yields)</li> <li>■ Treasury to specify mortality table, consistent with that used for funding purposes</li> <li>■ New interest rate phased in over 2008-2012</li> </ul>

As *Exhibit 2* shows, two-thirds of survey respondents expect that the new law will result in higher levels of required pension plan contributions for their organizations. One in 10 of the companies surveyed expect very significant increases of 26% or more, while 44% expect more modest increases of 10% or less. A small minority of companies expect reduced contribution levels under the new rules.

**EXHIBIT 2**  
**Expected Change in Required Pension Plan Contribution Levels Under the New Funding Rules**



The relatively modest anticipated impact on required contribution levels for many companies probably helps explain why the vast majority of our survey respondents continue to view the financial risks posed by their pension plans as manageable. When asked to choose between several alternative descriptions of those risks, almost two-thirds (63%) characterized the risk as “manageable...like others that we are monitoring closely” and another 30% chose “acceptable...and appropriate

for the value we see in the program.” Less than one in 10 of the surveyed financial executives view their pension plans as a “significant risk that consumes an excessive amount of staff resources.”

Similarly, more than 90% of the respondents seem undaunted by the challenge of managing their organizations’ pension plans in the new PPA funding environment. Fully 39% of the financial executives surveyed believe their organizations are well prepared to handle the added complexity of the new funding rules, while more than half (53%) say they’re at least somewhat prepared.

On the other hand, relatively few respondents believe the new law offers a fully effective solution to the financial challenges facing the PBGC. Despite the PPA provisions that will bring increases in variable PBGC premiums and the sharp increase in flat-rate PBGC premiums enacted earlier this year, only 3% believe these changes will enable the PBGC to manage its liabilities without further action by Congress.

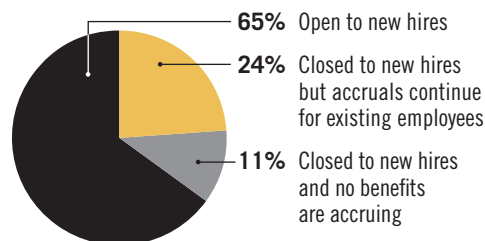
**EXPECTED CHANGES IN RETIREMENT PLAN DESIGN**

Uncertainty about the funding rules and the legal status of cash balance plan designs has contributed to the movement away from defined benefit plans in recent years — and the widely publicized decisions by a number of major U.S. companies to freeze their pension plans and deliver future retirement benefits primarily via defined contribution arrangements (e.g., 401(k) plans). Our survey sample clearly reflects this trend. For example, over a

third of the companies responding to our survey have already closed their largest pension plans to new hires, and a smaller segment (11%) has frozen plan benefits (i.e., no additional pension benefits accrue). On the other hand, almost two-thirds of respondents continue to maintain pension plans that remain open to new hires and accrue benefits (*Exhibit 3*).

Will the new law — together with expected changes in the U.S. accounting rules for pensions — accelerate this trend, as some commentators predict? While companies are only beginning to analyze the law’s impact on their specific situations, it seems clear from the survey responses that the movement away from defined benefit plans will continue. Still, many companies — slightly more than half of our respondents with fully operating plans — remain committed to offering pensions to current and future employees.

**EXHIBIT 3**  
**Current Status of Responding Companies’ Largest Pension Plans**



Relatively few of our survey respondents seem inclined to consider converting to cash balance plans in this new environment.

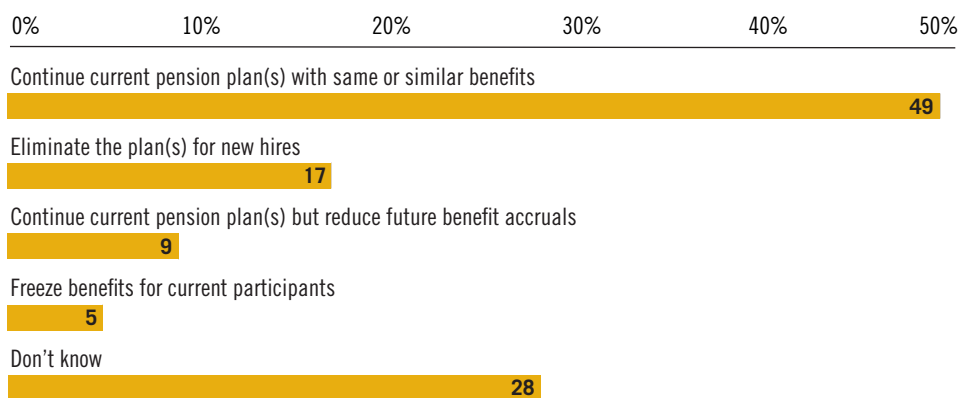
As *Exhibit 4* shows, 17% of the respondents with fully operating plans intend to close their plans to future hires as a result of the new PPA requirements, while 5% of the companies surveyed plan to freeze benefits for current participants. However, almost half (49%) of the respondents plan to continue their current pension plans with the same or similar benefits as are offered today, and another 9% plan to continue their plans while reducing future benefit accruals. This suggests that traditional defined benefit plans will likely continue to cover a significant minority of the country's workforce — despite the changes in the regulatory environment.

Almost one in three (29%) of the respondents with collectively bargained employees also indicate that their companies are likely to de-emphasize pension benefits in future bargaining, putting more emphasis on defined contribution plans, other benefits and/or cash compensation. Another third (33%) of these companies say the new law will have no impact on their bargaining strategies, while 38% are unsure how the new law will impact their bargaining strategies.

Interestingly, although the new law provides long-awaited clarity about the legal status of cash balance pension plan designs and new guidance about the requirements for future cash balance conversions, relatively few of our survey respondents seem inclined to consider converting to cash balance plans in this

#### EXHIBIT 4

##### How Plan Sponsors\* Are Likely to Respond to the New Law



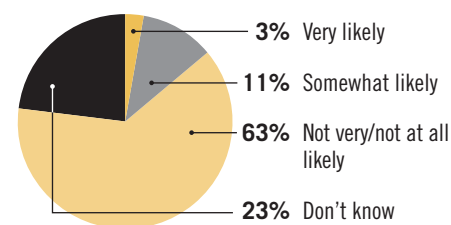
\*Based on responses of survey participants with open pension plans, multiple responses were permitted.

new environment (*Exhibit 5*). Keep in mind that Congress ultimately decided not to make the PPA's cash balance provisions retroactive, leaving some lingering uncertainty about the legality of existing plans and past conversions. However, the favorable ruling recently issued by the Second Circuit Court of Appeals in the IBM cash balance litigation may offer added comfort to sponsors of existing cash balance plans.

The survey respondents also show only limited interest in introducing lump sum benefit options under the new law. In order to pay full lump sums under the new rules, plan sponsors will need to keep their funding level at 80% or higher (without considering credit balances). Only one in seven (14%) of the survey respondents report that their companies are very or somewhat likely to introduce lump sum benefit features, although many of these companies (41%) already offer lump sums.

#### EXHIBIT 5

##### Likelihood of Considering Conversion to Cash Balance Under the PPA Provisions



Our results suggest that corporate financial executives have only begun to analyze the available financial strategies for responding to the new law.

The new law also makes important changes in the rules for 401(k) and other defined contribution retirement plans, including provisions designed to encourage automatic enrollment and the provision of investment advice to plan participants. As shown in *Exhibit 6*, these changes are likely to be embraced by many employers and should lead to enhanced levels of participation in company-sponsored savings plans in the future.

**IMPACT ON COMPANIES' RETIREMENT FINANCIAL MANAGEMENT STRATEGIES**

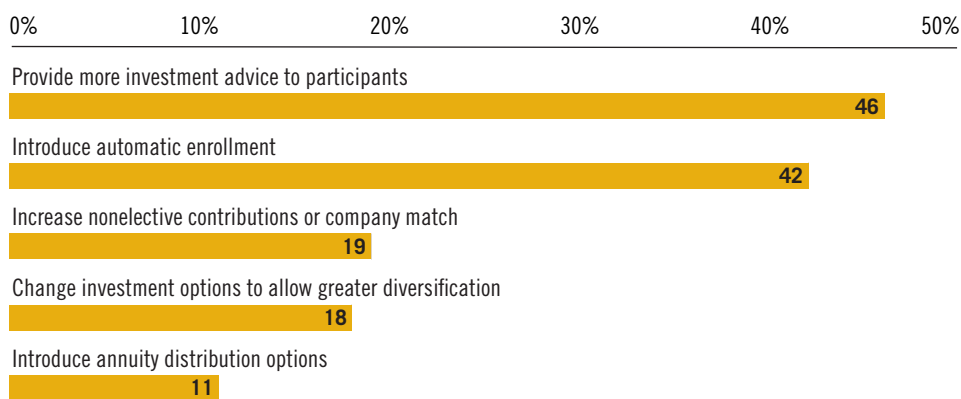
During the Congressional debate over the funding reform legislation, many pension plan sponsors voiced concern that the new rules would impose contribution requirements that are both higher and more volatile in response to changing capital market conditions. (See sidebar on page 9 for a closer look at the likelihood of added volatility under the new rules.) Given

these concerns, plan sponsors are now likely to reevaluate their current investment and contribution policies, and consider changes that may help mitigate the expected impact on corporate financial performance.

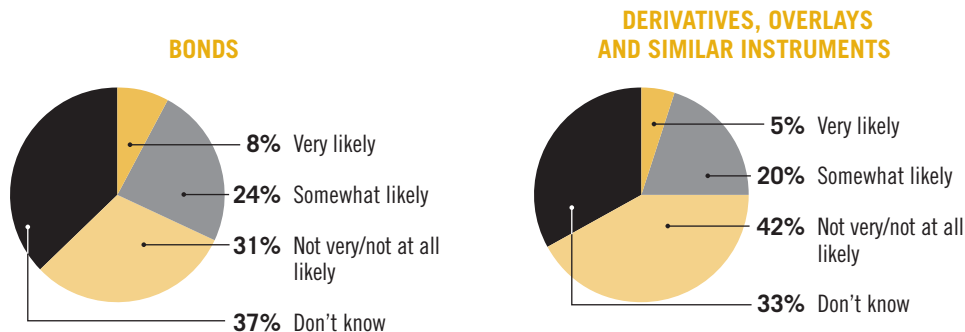
Our survey results suggest that corporate financial executives have only begun to analyze the available financial strategies for responding to the new law. Almost a third of the respondents indicate that their companies are very or somewhat likely to increase the level of bonds in their pension asset mix (*Exhibit 7*). Investing more pension funds in bonds can help reduce the volatility of funding requirements by more closely matching plan assets to liabilities. A quarter of the companies surveyed are very or somewhat likely to make greater use of derivatives, overlays or similar risk mitigation techniques.

Relatively few of the respondents (5%) view annuities as a potentially viable funding approach, although 16% say their companies would consider transactions designed to transfer pension financial risks to outside parties at prices more favorable than purchasing annuities. Slightly more than half (51%) of the executives surveyed say they need to do more analysis of such approaches.

**EXHIBIT 6**  
**Likely Enhancements in 401(k) and 403(b) Plans Under the PPA**



**EXHIBIT 7**  
**Likelihood of Putting More Investment Emphasis on...**



## WILL CONTRIBUTIONS BE MORE VOLATILE?

While the overall level of contributions for defined benefit plans should be expected to increase over the near term — an essentially inescapable outcome, given the increase in the funding target from 90% to 100% of the solvency liability value — many plan sponsors are equally concerned about the prospect that funding reform will entail added uncertainty and greater volatility in required contribution amounts.

However, Towers Perrin's analysis of the new law suggests that contribution amounts may not be more variable from year to year than under current law. That's because there are PPA provisions that can be expected to add volatility and others that may help in suppressing it.

Factors adding to the volatility of contribution amounts include the following:

- There will be a reduced period of years for smoothing assets and liabilities, making both amounts more variable and less predictable.
- Accumulated credit balances can't be counted on as an offset to contribution requirements if a plan's funded status drops below the 80% threshold, adding another element of unpredictability for plan sponsors with credit balances.
- Plans falling below the 80% threshold may be deemed at risk, which increases the effective funding target (and thus contribution amounts) over time.

Factors that may help reduce contribution volatility include:

- The new law entails a reduced rate of amortization in many cases, particularly for amounts assessed in earlier years and those applicable to more poorly funded plans.

- Under the new rules, each dollar of unfunded liability is amortized in level amounts over a fixed period. In contrast, under current law, a plan's exposure to deficit reduction requirements is less predictable and, once triggered, these requirements have greater implications for contribution amounts. The removal of this potential "cliff" will tend to stabilize contribution amounts over time.

- The PPA allows plan sponsors an opportunity to develop more effective asset/liability matching strategies through the use of market values for assets and liabilities. The mandated use of averaged assumptions for determining liability amounts under current law has been a substantial barrier to the implementation of effective duration-matching strategies.

- The new law provides more flexibility to advance fund the plan during favorable economic periods, when cash may be more readily available.

The relative effects of these factors will vary based on each plan sponsor's particular situation, depending on plan funded status, investment strategy, contribution policy, plan design and the level of credit balance that is maintained.

Ultimately, plan sponsors adhering to typical financial strategies may find that these factors essentially net out, so that they're left with higher contributions — but amounts that are no more variable than under current law. Other plan sponsors choosing to avail themselves of more proactive asset/liability and contribution strategies facilitated by the new rules may have an opportunity to achieve more stability and predictability in contribution patterns, beyond what was achievable under current rules.

## LAW'S IMPACT WILL VARY WIDELY BY PLAN FUNDING LEVEL

Towers Perrin's analysis shows that the new PPA requirements are likely to affect different plan sponsors in dramatically different ways. Here's a look at the expected impact of the new rules for plans at various funding levels:

### Well-funded plans

Plans that start out funded over 100% on a solvency basis will not require contributions unless the amount of surplus becomes insufficient to cover their normal cost. And, when business conditions are favorable, these companies can consider contributing additional amounts on a tax-deductible basis to "save for a rainy day" because the new law permits contributions up to a 150% funded level. This offers companies a greatly expanded opportunity to create a security margin as a safeguard against future capital market volatility.

However, before making this decision, employers will need to consider the following issues:

- Advance contributions entail the creation of credit balances that can presumably be drawn down as needed in future years. However, there are new constraints on the application of these balances should the plan's funded level fall below the 80% threshold.
- Opportunities for using surplus assets remain limited. Surplus can be used to offset the cost of ongoing benefit accruals, but for mature plans these may not be significant. Section 420 transfers (to pay retiree medical benefits) are also available, but come with significant restrictions attached. Any surplus assets remaining upon plan termination can be retrieved

only with the payment of a prohibitive excise tax. (See sidebar on page 11 for more on these considerations.)

### Moderately funded plans

Plans that start out funded near 90% on a solvency basis will face significantly higher contribution requirements than under existing law. After a phase-in period (that may delay the application of the higher target), sponsors of these plans will be required to contribute until they reach the 100% funding target. Current law allows contributions to be cut off once a 90% funded level is achieved.

What's more, if capital market conditions deteriorate, sponsors of these plans could quickly find themselves flirting with the 80% threshold that triggers limitations on the application of credit balances and an at-risk designation that can significantly ramp up funding requirements and PBGC variable premiums. They may also be restricted in their ability to pay lump sums or make plan improvements.

### Poorly funded plans

The new law includes pluses and minuses for sponsors of poorly funded plans. For example, the new rules will require these companies to make up their initial funding deficiency over seven years, which can be expected to reduce amortization amounts in the initial years from those required under current law.

On the other hand, other PPA provisions that are triggered by poorly funded plans may make these plans more costly.

- If the sponsor maintains a credit balance, it cannot be applied against contribution requirements until the plan's funded level reaches 80%.

- The at-risk designation will likely be triggered, which implies significant added contributions and PBGC premiums. These effects are somewhat mitigated by a long phase-in schedule for these new liabilities, and the at-risk designation is lifted when the plan's funded level reaches 80%.

Sponsors of poorly funded plans will also be unable to make plan improvements or pay full lump sum benefits — and may be unable to continue accruing additional plan benefits.

## THE BOTTOM LINE

In evaluating the PPA's effect on pension plan financing, it's important to keep in mind that a fundamental rule underlying pension plan funding still applies. In promising pension benefits to employees, plan sponsors (absent bankruptcy) become committed to pay those benefits when they become due at participants' retirement. While the new funding rules may in some cases accelerate the timing of contributions employers must make to meet these commitments, the value of the obligation remains essentially unchanged. In other words, higher contributions now should imply lower contributions at some point in the future.

For more information about how the Pension Protection Act may affect your organization's retirement plans and overall financial results, please contact your local Towers Perrin consultant.

## DOES BUILDING A CUSHION OF SURPLUS ASSETS MAKE SENSE UNDER THE NEW RULES?

Surplus assets are more likely to accumulate under the new PPA rules. This is primarily because the PPA brings an increased funding target — set to 100% of a solvency liability measure determined based on high-quality corporate bond yields. For plan sponsors that continue to invest in diversified portfolios that include significant equity investments, the return on plan assets can be expected to exceed the discount rate over the long term.

Costs related to ongoing benefit accruals will siphon off a portion of any surplus, although that portion may be relatively small for mature pension plans and, of course, will not be a factor at all for frozen plans.

The PPA also offers plan sponsors an expanded opportunity to make Section 420 transfers — i.e., to move pension assets into a separate account used for paying retiree medical benefits. The retiree medical benefits that can be considered in determining the allowable transfer amount are increased from one year's payments under current law to as many as 10 years' payments, and the funding threshold required for making these transfers is reduced from 125% to 120% (based on solvency liability). However, a rather onerous set of requirements accompanies this opportunity that may reduce its appeal for many plan sponsors:

- The plan is required to maintain the 120% funded level over the entire payment period or assets must be transferred back to the regular pension account.
- All accrued pension benefits must be vested at the date of transfer, including very small amounts payable to employees terminating with short service.
- Retiree medical benefits (or costs) must be maintained at existing levels for a period that extends four years beyond the period covered by the Section 420 transfer.

Of course, terminating the plan to retrieve the surplus is not a viable option, since assets that remain upon plan termination are assessed a prohibitive excise tax. Although Towers Perrin and others argued for giving plan sponsors more flexibility to recapture surplus assets, the lawmakers ultimately decided not to go beyond the liberalized rules for Section 420 transfers described above.

Where does this leave plan sponsors? Clearly, the relatively high potential for creating surplus assets — coupled with the inability to effectively use these assets — affects the perceived risk/reward trade-off for employers. The imbalance between the treatment of experience gains (which may have limited value) versus experience losses (which must be funded) may prompt many plan sponsors to revisit their investment policy decisions.

For some plan sponsors, the result may be a shift to lower-risk strategies, through reduced equity allocations and increased investments in long-term bonds and other high-duration instruments. Indeed, the architects of the PPA sought to support such risk-mitigation strategies by providing an option to value plan liabilities at “market rates,” rather than using interest rates averaged over a two-year period. A similar opportunity is provided to value assets at market rather than smoothed values.

Of course, lower-risk investment strategies can generally be expected to reduce expected returns and potentially increase plan cost over time. The appeal of these strategies may also be reduced as a result of some of the potential pitfalls in the new law's approach to valuing plan liabilities:

- Based on the new law's text, it appears that the segment rates for valuing liabilities at market rates will be based on a one-month average of interest rates. This could create some variance between measured asset and liability values even if they are closely matched in actuality.
- The option to measure liabilities at market rates must be applied to the entire liability. However, some plan sponsors may want to employ matching strategies that cover only a portion of their benefit obligations, while continuing to invest in equities with another portion of plan assets. It does not appear that such partial-matching strategies will be facilitated.
- Should a plan sponsor later want to revoke an election to value liabilities at market rates, Treasury Department approval will be required. The parameters that the Treasury would use to approve or deny such requests are uncertain at this point.



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Towers Perrin is a global professional services firm that helps organizations around the world optimize performance through effective people, risk and financial management. The firm provides innovative solutions to client issues in the areas of human resource strategy, design and management; actuarial and management consulting to the financial services industry; and reinsurance intermediary services.

The firm has served large organizations in both the private and public sectors for over 70 years. Our clients include three-quarters of the world's 500 largest companies and three-quarters of the *Fortune* 1000 U.S. companies.

Our businesses include HR Services, Reinsurance and Tillinghast.

The HR Services business of Towers Perrin provides global human resource consulting and related services that help organizations effectively manage their investment in people. We offer our clients services in areas such as employee benefits, compensation, communication, change management, employee research and the delivery of HR services.