



How Will the Market Crash Impact Defined Benefit Plans?

This bulletin will discuss the potential ramifications on Defined Benefit (“DB”) plans as we head into 2009.

[FAS 87/158 Accounting](#)

The drop in the market value of plan assets will directly hit balance sheets, and be taken as a charge to Other Comprehensive Income and a reduction in Net Asset Value of the enterprise. Pension expense for the following year may increase dramatically. The impact will be mitigated to a degree by the rise in discount rates over the past year, as credit spreads have widened, thus increasing yields on Corporate Bonds.

[IRS Valuations under the Pension Protection Act \(“PPA”\)](#)

The funded ratio of assets over liabilities, named the Funding Target Attainment Percentage (“FTAP”), will be directly reduced by the drop in the market value of plan assets. Depending on the FTAP position at the beginning of the year, many plans will cross the critical thresholds under PPA. Plans that drop below 80% will have to restrict lump sum payments to half of what would otherwise have been payable, plan amendments increasing benefits will be prohibited and participant notices distributed. Deferred compensation plans for executives may not be permitted to be funded. In addition, for plans that fall below 60%, benefit accruals must be frozen altogether and no lump sums are payable at all.

Contributions generally will rise by a seven year amortization of the decrease in market value (measured against an assumed increase of about 6%).

Shown below is a numerical example of the impact on these items for a sample plan.

First, we will describe some actions that plan sponsors can take now to plan for these developments.

[Review Investment and Funding Policies Now](#)

Severe drops in plan assets will almost certainly generate additional scrutiny by interested parties in how the assets are invested and managed. Plan sponsors should meet with their investment advisors and managers to review their policies and procedures, to ensure prudence and compliance issues are being addressed. Funding policies and asset allocation decisions will be critical in the near term. Forecasts of funding levels, pension expense and asset/liability studies are steps that can be taken to demonstrate that care and due diligence are being exercised. For example, USI Consulting Group can provide an asset/liability study that can model the expected impact on financials, cash contributions and FTAPs under a range of asset mixes and capital market assumptions.

[Consider a Plan Freeze](#)

Plan sponsors could freeze future benefit accruals (“hard freeze”), at least temporarily. Plans could also be closed to new participants (“soft freeze”). For IRS purposes, these will not change

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the FTAP immediately, but will slow the increases. This would also immediately reduce the required contribution by the amount of the Normal Cost (the value of benefits that would accrue to active participants in the coming year, absent a freeze). For FAS accounting, a pay related plan that becomes frozen would see a drop in the Projected Benefit Obligation (“PBO”), since future pay increases would no longer be reflected.

Reduce Future Benefit Accruals

Short of a freeze, plans could be amended to change the benefit formula so that future accruals are reduced substantially. The percentage accrual per year of service could be reduced, a final average pay plan could be changed to a career average plan and any plan could be changed to a cash balance plan with modest accruals.

Note that any plan amendment reducing or eliminating future accruals must be in place and participants provided with a 204(h) notice generally 45 days before the amendment could take effect.

Consider Changes to Methods and Assumptions

The PPA caused plan sponsors to make several decisions regarding implementation, including discount rate selection, asset valuations/averaging methods, mortality tables and the treatment of credit balances. Many of these decisions were made with a long-term view in mind (e.g., reducing future volatility of contributions and FTAPs). The long view will now most likely take a back seat to minimizing the impact of these markets in the near term, and each decision should be re-visited. However, the issue of whether it is permissible to change now is quite complex.

Many plan sponsors have already “finalized” these decisions for 2008, since calendar year plans had to have FTAPs certified by October 1, 2008. These elections generally are deemed permanent, and may only be changed with application to the Secretary of the Treasury (who appears to be a tad busy at the moment) and procedures for doing so have not been implemented by the IRS yet. A plan sponsor is permitted to change certain elections until the Form 5500 is filed (typically October 15, 2009). However, it is not permissible to change a given election if that would cause an FTAP to fall below the 80% or 60% threshold for 2008 (i.e., this may “lock in” the elections already made for 2008). These issues should carefully be considered before taking action.

Sample Plan Illustration

The following illustrates the potential impact on the numbers due to this market plunge:

The plan at the beginning of 2008 was invested 60% equities, and 40% fixed income. Equities fall 40% for the year, and fixed income returns plus 4%. The total portfolio would fall by 22.4%. Assume benefit payments of \$5 million, and contributions made at year end of \$5 million.

FAS 87/158 Figures		
In Thousands	12/31/2007	12/31/2008
PBO	\$105,000	\$98,600
Market Value of Assets	\$92,000	\$71,400
Net Pension Liability (on balance sheet)	\$13,000	\$27,200
Pension Expense for Year Following	\$4,000	\$6,800
Discount Rate	6.1%	7.1%

We see that the asset value has fallen by over \$20.6 million, liabilities fall by \$6.4 million. The net balance sheet impact is an additional \$14.2 million. Pension expense increases by 70% to \$6.8 million.

There are not many tools at our disposal to manage these numbers. Consideration could be given to certain assumptions, including pay increases, turnover and expected retirement ages.

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IRS Valuation		
(In Thousands)	January 1, 2008	January 1, 2009
Target Liability	\$100,000	\$103,900
Market Value of Assets	\$92,000	\$71,400
Funding Shortfall	\$8,000	\$32,500
FTAP	92.0%	68.7% (1)
Normal Cost	\$5,000	\$5,300
Amortization Charge	\$0	\$5,500 (2)
Minimum Contribution	\$5,000	\$10,800
Effective Discount Rate	6.1%	6.3% (3)

Notes:

1. FTAPs below 70% for 2009 may trigger an “at-risk” calculation, which can result in additional liabilities and loads to Normal Cost.
2. Amortization is over a seven year period (plan was exempt for 2008).
3. The Effective Discount Rate depends on the election of the plan sponsor. Shown are illustrative single rates based on the 24 month average segment rate basis (without phase-in).

Impact of Changes in Methods and Assumptions

- Discount Rates: Plan sponsors can elect to use the full Yield Curve method for discount rates. This could add several basis points to the rates and bring down the Target Liability. For the sample plan above, this could increase the FTAP by 7 – 10% (depending on the Yield Curve in effect on the valuation date). Values will be more volatile in the future with this method. It appears that plan sponsors may move from the Segment Rates for 2008 to the Yield Curve for 2009 without special approval.
- Asset Valuation: Plan sponsors can elect to use Asset Averaging over a two year period. This will generally lower the 2008 value but increase the 2009 value. For calendar year plans, this would lower the FTAP by 6% at 1/1/2008, but raise it by over 10% for 2009.
- Mortality: If a plan sponsor had originally elected the “generational” table, choosing the static table can lower the Target Liability by about 2%.

Again, care must be taken that any revisions to the methods and assumptions do not change the 1/1/2008 figures such that the plan would cross either the 80% or 60% threshold.

Legislative Relief

We are not aware of any proposal at this time, but we would expect to see something eventually.

Summary

These will be trying times for plan sponsors. Advance planning on plan design, investments and funding strategy will be helpful in navigating these hurdles. Your USI consultants will be in contact regarding specifics for your plans.