

## IRS Permits Additional Flexibility in Choosing Funding Interest Rates

On March 31, 2009, the IRS released technical guidance in selecting interest rates for determining ERISA defined benefit plan Funding Liability and Target Normal Cost. These figures drive a plan's funded ratio, as well as the minimum required contributions. The funded ratio determines whether a plan is subject to any benefit restrictions. The new guidance could have a very significant impact on each of these determinations.

The interest rate basis under the Pension Protection Act ("PPA") generally was a choice between a relatively stable 24 month average of spot rates ("segment rate" basis) versus a more volatile one month average of daily spot rates ("yield curve" basis). The segment rate basis was determined for an "applicable month," which could be the first month of the plan year, or any of the four preceding months, at the election of the plan sponsor. The applicable month for the yield curve basis was limited to only the first month of the plan year. Spot rates used for any applicable month are those ending the day before that month.

Guidance provides that the yield curve basis may now also be based on any of the "applicable months" available for the segment basis. Choosing this basis for 2009 is now permitted (without any special approvals). However, it is not clear whether the basis will be available for change in the future without special approval from the Treasury.

### Analysis

Many plan sponsors have opted for the segment basis for interest rates under PPA. While the December yield curve rates (for a calendar year plan) may have provided a somewhat higher effective interest rate for 2008 and 2009, and therefore somewhat lower liabilities and contributions, the general consensus was that the result was not worth the potential future volatility. In fact, 2008 saw tremendous swings in the monthly yield curve rates.

Guidance does not change how volatile the yield curve basis will be in the future. What it does allow is additional choice on which month the yield curve can be based. Instead of just the December rates, any rates from August through December could be used (again, for calendar year plans). In the normal course of events there would be no inherent reason for choosing a particular month to use for this purpose. However, in October and November of 2008 the yield curve rates rose dramatically. For example, the equivalent single rates for some plans were as high as 8.0% if the November 2008 yield curve rates were used (compared to 6.3% to 6.5% for the November segment rates). This in turn could increase funded ratios by 12 to 20 percentage points, relative to the segment basis. Those plan sponsors who have already elected to use the yield curve methodology will almost certainly choose now to use the yield curve for an earlier applicable month.

USI Consulting Group continues to caution plan sponsors that use of the yield curve will likely produce volatile results in the future. Also, making smaller plan contributions now will result in the need to make higher contributions in the future. However, given the recent volatility we have experienced on the asset side, some sponsors may wish to take advantage of this new choice to mitigate the impact for 2009. Your USI Consulting Group consultant will be contacting you to discuss these issues.