FOLEY

FOLEY & LARDNER LLP

Pension Fund Issues in the Boardroom: Is Your Pension Plan Becoming Too Expensive?

2007 NATIONAL DIRECTORS INSTITUTE

PENSION FUND ISSUES IN THE BOARDROOM: IS YOUR PENSION PLAN BECOMING TOO EXPENSIVE?

The Pension Protection Act of 2006 (PPA), which was signed into law on August 17, 2006, resulted in arguably the most sweeping changes to pension laws since ERISA was enacted in 1974. A large number of the changes affected single-employer defined benefit pension plans, especially with regard to funding and disclosure rules. Most of these changes are not effective until 2008 and many are phased in over a multi-year period.

The PPA also provided new rules for determining the amount of premiums that a plan must pay to the Pension Benefit Guaranty Corporation (PBGC). The PBGC is the federal government agency that insures a portion of a defined benefit plan's benefits in the event the plan is terminated without being able to pay all benefits due.

The purpose of many of the PPA changes affecting pension plans is to strengthen the funded status of the plans, permit increased oversight of plans by the PBGC and increase the assets of the PBGC.

On September 29, 2006, the Financial Accounting Standards Board issued its final Statement of Financial Accounting Standards Number 158, dealing with the rules for reporting the obligations and expenses of pension plans, retiree health plans, nonqualified deferred compensation plans and other postretirement benefits. Among the many changes, FAS 158 moves information about the funded status of the pension plans and these other postretirement employee benefit plans from the footnotes to the financial statements to the balance sheet. The purpose of FAS 158 is to create more transparency and to make information about pension plans and other postretirement employee benefit plans more useful for investors.

The confluence of these changes has caused many employers to wonder whether defined benefit pension plans are now "too expensive." The new funding rules and increased PBGC premiums have increased the cost of these plans. At the same time, the new PPA disclosure requirements and accounting disclosures provides transparency as to both the costs of these plans, as well as their funding problems.

Countering this is the recent strong increase in the financial markets, which has ameliorated the under funded status of many pension plans as their plan asset values have risen, making them potentially good deals for employers once more.

As a result of these changes, boards should be asking management (with the help of the plan's actuary) to present to the board (or an appropriate committee of the board) an analysis of the impact of the new legal and accounting changes on the company's cash flow and balance sheet. In this analysis, management should include projections showing the best case scenario (i.e., continued strong investment returns of plan assets) and worst case scenario (i.e., decline in asset value due to poor investment return) so that the board can best judge the future viability of its pension plans.

PPA's New Funding and Disclosure Rules

Minimum Funding Rules. The PPA has completely changed the minimum funding rules for pension plans. Under the PPA, if the plan's assets are less than the "funding target," then the minimum required contribution the plan sponsor must make for the year is equal to the plan's "target normal cost" plus the amortization of the "funding shortfall." If the plan's assets equal or exceed the funding target, the minimum required contribution for the year is the plan's target normal cost.

- The "funding target" is 100% of the present value of all benefit liabilities accrued to date. (This 100% target is phased in over four years starting in 2008.)
  - The interest rate used to determine the funding target has changed from the interest rate for investment grade long-term corporate bonds to a monthly rate published by the IRS based on a modified yield curve of investment-grade corporate bonds of varying maturities and that are in the top three quality ratings (AAA, AA and A grade). The new interest rate is phased in over three years, although plan sponsors can make a one-time election to opt-into the new rate immediately.
  - The mortality table used to determine the funding target will be established by the IRS, although some plan sponsors with large plans may be able to elect to use a substitute mortality table.
- The "target normal cost" is the present value of benefit liabilities expected to accrue for the current plan year, including increases in previously accrued benefits due to current year compensation increases.
- The "funding shortfall" is the excess of the plan's funding target over the value of the plan's assets. The funding shortfall must be amortized over seven years.
- Special rules apply to commercial passenger airlines and companies that provide catering services to airlines.

Quarterly Contributions. Prior to the PPA, plan sponsors were required to make quarterly contributions to their pension plans if their plan was less than 100% funded. This rule continues in a modified form. Under the PPA, if a plan has a funding shortfall in the prior year, it must make its minimum required contributions in quarterly installments in the current year. Each quarterly installment is equal to 25% of the lesser of (i) 90% of the minimum required contribution for the current plan year, or (ii) 100% of the minimum required contribution for the preceding plan year.

At-Risk Provisions. The PPA added an entirely new set of rules for a plan that is "at risk."

- A plan is at risk for a plan year, if for the prior year the plan is less than 80% funded using the normal funding assumptions AND less than 70% funded when calculations are run using special "at-risk" actuarial assumptions (to be determined by the IRS).
- In general, if the plan is at-risk, the plan sponsor must make a larger contribution.
- Plans with 500 or fewer participants are exempt from these rules.

Plan Asset Valuation. Prior to the PPA, plans were allowed to "smooth" the value of their assets over a period of not more than five years, provided that the "smoothed" value was within 80-120% of the current actual fair market value of the assets. Under the PPA, while smoothing is still allowed, it is limited to a 24-month period and to a range of between 90-110% of actual fair market value of assets. This results in larger contributions in years with declining asset values.

Credit Balances. A pension plan's credit balance is generally the amount of contributions a plan sponsor has made in one year in excess of the minimum required contributions. A credit balance could generally be used to offset minimum required contributions due in future years. The PPA has changed the way these credit balances can be used.

Limits on Benefit Increases, Payments and Accruals. Under the PPA, if a plan is under funded below a certain percentage, limits are imposed on benefit increases, benefit payments, and benefit accruals. In addition, there are new limitations on a plan sponsor's ability to increase benefits if the plan is less than 80% funded or would become less than 80% funded after the proposed benefit increase becomes effective. Finally, if a plan is less than 60% funded, the plan must freeze all future benefit accruals (unless the plan sponsor makes sufficient contributions to satisfy the 60% funded threshold). This last rule does not apply to plans within their first five years of existence.

New Disclosures.

- Plan sponsors must provide annual notices to participants, the PBGC and unions (if applicable) disclosing, among other items, the value of the plan's assets as compared to its liabilities, its funding status, and its funding policy and allocation of investments. The DOL will provide a model notice for this purpose.
- If a plan is less than 80% funded, the plan sponsor must file a notice with the PBGC disclosing its funded status (calculated both on a normal basis and on an "at-risk" basis).
- Plan sponsors must disclose on its Web site (or intranet) the actuarial assumptions used by its actuaries in projecting future retirement benefits and forms of benefit.

Increased PBGC Premiums

Premium Structures. For single employer plans, the annual premiums due to the PBGC are the sum of a flat-rate portion and a variable-rate portion.

Flat-Rate Portion. Effective for plan years beginning in 2006, the rate increases from $19 to $30 for each participant. For multiemployer plans, the flat-rate premium increases from $2.60 to $8.

Variable-Rate Portion. This rate is based on a charge of $9 per $1,000 (or fraction thereof) of unfunded vested benefits, divided by the number of participants as of the close of the preceding plan year. PPA capped this variable-rate portion for plans maintained by small employers who have 25 or fewer employees as of the first day of the plan year. For these plans, the variable-rate portion *for each participant* is limited to $5 multiplied by the number of plan participants in the plan at the end of the preceding plan year. For example, if a plan has 20 participants, the variable premium for each participant cannot be more than $2,000 [($5 times 20) times 20]. Therefore, the total variable-rate premium for this 20-participant plan could not be more than $40,000 (20 times $2,000).

This variable-rate premium cap is available to very few employers because in determining if the employer has 25 or fewer employees, all employees of the employer's controlled group must be counted.

Termination Premiums. The Deficit Reduction Act of 2005 created a new Termination Premium, which is a special premium of $1,250 per participant for the year of termination and each of the following two years. This Termination Premium applies when the PBGC terminates a plan in a distress termination (1) due to the sponsor's bankruptcy, (2) due to the inability of the employer to pay its debts when due, or (3) to avoid unreasonably burdensome pension costs caused solely by a decline in the workforce. PPA revised this rule by repealing the sunset provision, making the Termination Premium permanent.

New Accounting Rules

Entities Subject to FAS 158. Statement FAS 158 applies to publicly traded, privately held, and non-governmental not-for-profit organizations that currently report obligations and expenses for pension plans, nonqualified deferred compensation plan, and other postretirement employee benefits under prior Statements 87, 88, 106 and 132R.

Effective Dates:

- Publicly traded companies are required to report under the new rules in the first fiscal year ending on or after December 15, 2006. Therefore, a public company with a calendar year fiscal year must reports its December 31, 2006 financial statements in compliance with Statement 158.
- Private employers (employers with no publicly traded equity securities) are required to report under the new rules in the first fiscal year ending on or after June 15, 2007. For example, for a private employer with a fiscal year end of June 30, the first reporting under the new statement will be for the June 30, 2007 financial statement.

Major Rule Changes:

- More Transparency. Under the old reporting rules, detailed reporting of a pension plan's funded status was included *in the footnotes* to the financial statements. The balance sheet reflected either an asset or liability equal to the amount of prepaid or accrued pension expense. If a plan's accumulated benefit obligation was greater than the fair market value of assets, then there may have been additional reporting of these contingent obligations as a form of accumulated other comprehensive expense, which is a component of stockholder's equity.

  Under the new rules, the funded status of these plans will appear on a company's balance sheet. "Funded status" is defined as the excess of the projected benefit obligation over the fair market value of assets. The projected benefit obligation includes a factor reflecting future salary growth in plans where the benefit is based on salary. Therefore, this change moves a contingent, long-term liability or asset from the footnotes to the financial statement directly onto the balance sheet. Because many pension plans and other employee benefit plans are underfunded, the expected impact of this change is, in many cases, to replace a significant asset in the form of prepaid pension expense with a significant long-term liability on the balance sheet.

Note: Retiree healthcare and other postretirement benefits are dealt with in a similar fashion. The obligation for these types of benefits are reflected in the accumulated postretirement benefit obligation. This obligation also moves from a footnote to the financial statement to the balance sheet. Because the accumulated postretirement benefit obligation includes a factor to reflect future medical cost inflation, this too becomes a form of contingent liability reflected on the balance sheet.

- Timing of Measurement of Assets and Obligations. Beginning with financial statements for fiscal years ending after December 15, 2008, employers are required to measure pension plan assets and obligations as of the date of the employer's statement of financial position, or the balance sheet date. Currently, employers are able to measure these components up to three months earlier than the gauges for all other balance sheet items. The purpose of this change is to improve financial information by being more complete and more representationally faithful.

For More Information

To learn more about this topic, feel free to contact the authors of this summary:

Leigh C. Riley
Foley & Lardner LLP
lriley@foley.com

Katherine L. Aizawa
Foley & Lardner LLP
kaizawa@foley.com