

Session 9: Check Your WRERA View Mirror

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Topics for Discussion

- Asset smoothing methods
- Plan expenses
- Benefit limitation issues
- Funding transition rules
- Final regulations
- Proposed funding relief
- Methodology choices for 2009, 2010 and beyond
- Cash flow planning
- Credit balance management
- Effects of final regulations on 2010 valuation planning

Asset Smoothing Methods

- WRERA clarified that an expected return on assets can be used in calculating a smoothed VPA
- Notice 2009–22 provided guidance on implementing WRERA asset smoothing
 - How to calculate expected return on assets, including interest rate limitation
 - How to determine 90%–110% corridor
 - Provided automatic approval for changes in asset method in 2009
 - Allowed continued use of pre-WRERA asset averaging for 2008

Asset Smoothing Methods

- Many plan sponsors are expected to switch to WRERA asset smoothing for 2009+
- Can smoothing be applied prospectively, as under Rev. Proc. 2000-40?
 - Not based on guidance in Notice 2009-22 or final §430 regulations
 - Possible subject of future proposed regulations?
 - Really a 2010 plan year question
- Final §430 regulations allow automatic approval for changes in asset method in 2010
 - Unclear whether automatic approval will be provided in 2011+, and if so, under what circumstances

Asset Smoothing Methods

- Most plan sponsors using asset smoothing will likely use three-point averaging with annual determination dates
- Mathematically equivalent to method under Approval 15 of Rev. Proc. 2000–40, with three-year smoothing period and expected rate of return varying by year
- Using more frequent determination dates would likely have no impact on 2009 VPA and be expected to make little difference over the long term
- In the short term, more frequent determination dates may (or may not) produce a higher VPA for 2010
 - Can evaluate once 2010 market values are known

Asset Smoothing Methods

- Does the number of data points matter in the long run?
- Based on expected distribution of results, not much
 - Mean and median results are approximately the same regardless of number of data points used
- 90%–110% corridor may be hit more frequently with more data points
 - Using more data points makes it more likely that the adjusted asset values for some data points will be much higher or lower than current market value (i.e., the distribution of adjusted asset values is wider)

Asset Smoothing Methods

- Comparison of expected results for 2-year smoothing:

Distribution of Simulation Results by Frequency of Data Points

	Monthly	Quarterly	Semi-Annual	Annual
Mean	99.4%	99.4%	99.4%	99.3%
Median	99.0%	99.0%	99.1%	99.0%
St. Dev	6.8%	6.8%	6.7%	6.5%
33rd %-tile	95.3%	95.3%	95.4%	95.5%
67th %-tile	102.8%	102.7%	102.6%	102.5%
% of Trials at 90%	13.8%	13.0%	12.6%	11.4%
% of Trials at 110%	12.2%	12.1%	11.7%	10.8%

Results for sample plan: 50% U.S. equity; 15% International equity; 35% core bond allocation (median annual return = 7.7%; expected volatility = 11.2%; 3rd segment rate assumed to be 6.5%). Source: Hewitt Associates.

Asset Smoothing Methods

- Median expected value will be less than 100% if actual return on assets is expected to exceed third segment rate
 - For a typical plan, “drag” on median value is about 1% for two-year averaging
- May require disclosure under ASOP 44
 - Should a 1% drag be considered a “significant systematic bias”?
 - Probably makes sense to be on the safe side and disclose bias

Reflecting Plan Expenses–TNC

- As originally enacted, PPA did not include a provision for plan expenses
- WREERA amended definition of target normal cost to include “plan-related expenses” expected to be paid from plan assets during the plan year
- WREERA also required offset to target normal cost for employee contributions
- Expense and employee contribution changes are generally effective beginning with 2009 plan year
 - Can elect to apply for 2008; must apply both or neither

Reflecting Plan Expenses–TNC

- Question: Does it make sense to pay expenses from an underfunded plan given that they will just become part of the minimum required contribution?
- May make sense if plan sponsor desires some cash flow flexibility, since expenses won't need to be funded immediately
 - Timing for quarterly and final contributions may delay contribution of expense amounts to plan
 - Plan sponsor may apply funding balances to reduce or eliminate minimum required contribution

Reflecting Plan Expenses–TNC

- Key issue: What is included in “plan-related expenses”?
 - Unclear whether expenses are just administrative, or also include investment management fees
- Including investment management fees could significantly increase target normal cost
- Final §430 regulations reserve a section for future guidance on this issue, so it will likely be addressed in future proposed regulations
 - In the meantime, need to do something reasonable
- Many plan sponsors may choose to reflect only administrative expenses for 2009
 - Investment management fees historically viewed as part of investment return

Reflecting Plan Expenses–TNC

- Proposed legislation (H.R. 2989 and Pomeroy proposal) would clarify that only administrative expenses are included
- Examples of administrative expenses that could be included:
 - Valuation fees
 - Nondiscrimination testing fees
 - PBGC premiums
 - Trustee fees
 - Audit fees
 - Outsourcing fees

Reflecting Plan Expenses–VPA

- If using asset smoothing, must adjust asset values as of each determination date for subsequent contributions and distributions
- Per final §430 regulations and Notice 2009–22, distributions include administrative expenses
- Similar issue to target normal cost–do “administrative expenses” include investment expenses?
 - If excluding investment expenses from TNC, seems consistent to exclude them from administrative expenses for VPA calculation; i.e., treat investment expenses as part of expected return on assets
- Not a big issue for 2009, since most plans will be at 110% of market value either way

Reflecting Plan Expenses–FSBC/PB

- Investment expense issue also extends to calculating return for adjusting FSCB/PB
- If treating investment expenses as part of return for purposes of calculating target normal cost and VPA, seems consistent to use return net of investment expenses for adjusting FSCB/PB
- If treating investment expenses in same way as administrative expenses, seems consistent to use gross return for adjusting FSCB/PB
- Further IRS guidance on this issue is not anticipated, so do something reasonable and document rationale for your approach

Prohibited Payment

- Underfunded plans are restricted in their ability to pay lump sum benefits – 436(d)(5)
 - As originally written in PPA, any payment in excess of the monthly single life annuity is prohibited, including an annuity purchase
 - New regulations add transfers to another plan intended to avoid benefit restrictions as a prohibited payment
 - WREERA exempts any “*benefit which under section 411(a)(11) may be immediately distributed without the consent of the participant*”
 - New regulations do not address this – will be addressed in future proposed regulations

Prohibited Payment

- Underfunded plans are restricted in their ability to pay lump sum benefits – 436(d)(5)
 - 411(a)(11) allows a plan to mandatorily distribute a lump sum of up to \$5,000 without participant consent
 - Many plans provide for mandatory cash-outs up to \$1,000 and require participant consent for larger amounts
 - In such a case, can a plan pay out up to \$1,000 or \$5,000 if restrictions apply?
 - 411(a)(11) applies to nonforfeitable accrued benefits
 - Some plans provide for the payment of a lump sum not related to a nonforfeitable accrued benefit
 - What about lump sum death benefit that is not available as an annuity (\$5,000?, \$10,000?)

New Regulations - Prohibited Payment

- New regulations discuss benefit restrictions and terminated plans
 - In general, any limitation in effect at the time of termination continues to apply
 - Exception for prohibited payments that are made to carry out the termination of the plan in accordance with the applicable law (e.g. purchase of annuity contracts)

Small Plans and Benefit Restrictions

- Small plans are permitted to designate any day of the plan year as their valuation date
- Benefit restriction provisions are based on the AFTAP as of the first day of the plan year
- Presumed underfunding kicks in on the first day of the 4th and 10th month of the plan year
- What's a small plan to do?
- WREERA added 436(k) which says that the "Secretary may" provide guidance in this area

Limitation on Benefit Accruals

- Generally if the AFTAP is less than 60%, all future benefit accruals must cease as of the first measurement date as of which the AFTAP or presumed AFTAP is less than 60%
- Benefit accruals remain frozen until the first measurement date as of which the AFTAP is at least 60%
 - AFTAP 10/1 or later (calendar year) is not an AFTAP measurement date, but does impact the presumed AFTAP for the following 1/1
- For the first plan year beginning during the period from 10/1/2008 through 9/30/2009, the limitation provisions are applied using the prior year's AFTAP (only if the prior year's AFTAP is higher)

Technical Corrections

- Prohibition on increases in benefits while a waiver is in effect
 - 412(c)(7)(A)
 - The prohibition on retroactive plan amendments is limited to those amendments that increase the plan's liability
- IRS approval for funding method or plan year change
 - 412(d)(1)
 - The words “valuation date” were removed from the list of items requiring approval since the valuation date is part of the funding method

Technical Corrections

- PPA prohibits an account balance from being reduced below the aggregate amount of contributions
 - WRERA clarifies that failure to comply with this rule is treated as a violation of the age discrimination rules under ERISA or the Code, as applicable
- 3-year vesting applies to all participants covered by a hybrid formula with an hour of service after 2007 plan year

Technical Corrections

- Updating deduction rules for combination of plans
 - If defined contributions are less than 6% of compensation, the defined benefit plan is not subject to the overall deduction limit
 - If defined contributions exceed 6% of compensation, only defined contributions in excess of 6% are counted towards the overall deduction limit

Required Minimum Distributions

- No required minimum distributions for 2009
 - Only applied to defined contribution plans
 - If the year of age 70½ is 2008, the first distribution that is deferred until 4/1/2009 must still be made
 - If the year of age 70½ is 2009, even though the first distribution is not required until 4/1/2010, it is the 2009 distribution and is not required, and the 2010 distribution must be made by 12/31/2010

Mortality Table for Section 415

- WRERA clarifies that the 417(e) mortality table is used when adjusting benefits and limits under section 415
- Effective for years beginning after 12/31/2008
- Plan sponsor can elect to apply this change to any year beginning after 12/31/2007, or for any portion of such a year

Multiemployer Plans

- Delay of endangered or critical status
 - Plan sponsor may elect to treat the plan's status as the same status as the prior year
 - Applies to the first plan year beginning between 10/1/2008 and 9/30/2009
 - If a plan elects to retain its endangered or critical status from the prior year, the funding improvement or rehabilitation plan does not need to be updated that year
- Temporary extension of funding improvement and rehabilitation periods
 - May elect for a plan year beginning in 2008 or 2009 to extend the period by 3 years

New Regulations – Frozen Accruals

- If accruals are frozen due to <60% AFTAP, and plan provides for restoration of lost accruals when restriction no longer applies, proposed regulations treat the restoration as an amendment (subject to amendment restrictions) unless accruals were limited for 12 months or less
- Final regulations clarify that the exception is only available if the AFTAP is at least 60% taking into account the restored accruals

New Regulations – Plan Amendments

- Plan amendment that did not go into effect due to 436(c) limitations
- If an additional contribution is made or an AFTAP is certified allowing the amendment to go into effect during the year, it must automatically take effect as of the first day of the plan year (or, if later, the original effective date)
- If the plan amendment cannot take effect during the year, it must be treated as if it were never adopted, unless the plan amendment provides otherwise

New Regulations – Union

- Mandatory release of credit balance only applies to prohibited payments, unless the plan is considered collectively bargained
- Proposed regulations define a plan as collectively bargained if at least 25% of plan participants are members of a collective bargaining unit for which benefit levels under the plan are specified under a collective bargaining agreement
- The final regulations keep the proposed rule, but also treat a plan as collectively bargained if at least 50% of the employees benefiting under the plan are members of a collective bargaining unit for which benefit levels under the plan are specified under a collective bargaining agreement

New Regulations – Range Certification

- Can certify
 - <60%
 - $\geq 60\%$ and $< 80\%$
 - $\geq 80\%$
 - $\geq 100\%$
- AFTAP is deemed to be at the bottom of the certified range
- Need to complete final certification prior to the end of the plan year (proposed regulations required final certification prior to 1st day of 10th month)
- If no final certification is issued, AFTAP is retroactively deemed to be <60% as of 1st day of 10th month

New Regulations – Change in AFTAP

- Not material if due to certain events after initial certification
 - Additional contributions for the preceding plan year
 - Sponsor election to reduce carryover or prefunding balance
 - Sponsor election to apply carryover or prefunding balance to offset prior year's minimum required contribution
 - Change in funding method or actuarial assumption (where the change required actual approval of the Commissioner, rather than deemed approval)
 - Plan amendment for which a section 436 contribution was made
- Required recertification of AFTAP if one of the events listed above occurs, otherwise may be deemed material change

Pomeroy Legislative Proposal

- Allow use of the 2008 AFTAP to determine if a benefit freeze applies for 2009 and 2010
- Allow use of the 2008 funded status to allow credit balance usage for 2009 and 2010
- Modify PBGC 4010 reporting replacing the 80% trigger with a new trigger of more than \$100 million unfunded vested benefits and <90% funded

Pomeroy Legislative Proposal

- Social Security level-income options are excluded from the lump sum restrictions
- Prohibits early retirement windows that pay lump sums unless plan is 120% funded after taking into account the additional benefits or sponsor funds the full cost of the additional benefit

Pomeroy Legislative Proposal

- Allows multiemployer plans that meet solvency tests to elect one of two approaches to fund 2008 and 2009 losses over 30 years
- Extends the multiemployer rehabilitation and funding improvement periods by 5 years, inclusive of any 3 year extension elected under WRERA
- Facilitates the merger of multiemployer plans
- Updates the level of PBGC guarantees for multiemployer plans

Automatic Approvals for 2010 Method Choices

- Final regulations grant automatic approval for
 - Any change in interest rate basis or asset methodology for 2010 plan year
 - First change after 2010 to yield curve, or from segment rates to segment rates with lookback
- No longer need to choose 2009 methods you can “live with” for 2010, or even 2010 interest rate methods you can live with (other than segment rates with lookback)
 - Can use yield curve with look-back, reduce 2009 wrap-up and 2010 quarterlies, and change for 2010

Finalization of 2009 Method Choices

- 2009 method choices can be changed until 2009 Schedule SB is filed
- Some plan sponsors' 2009 method choices were influenced by uncertainty about inability to change
 - e.g., did not elect yield curve with lookback because wanted to use segment rates long term
- Potential to change allows reconsideration after:
 - October final regulations are digested
 - Additional final or proposed regulations are issued
 - Fate of pension funding relief legislation is clearer
 - Movement of interest rates and markets in the next year is known

Considerations for Changing 2009 Method Choices

- Ability to change choices may be limited by:
 - Need to avoid a “material change” in AFTAP
 - Analysis of any other adverse effects
 - Late quarterlies for 2009 or 2010?
 - Potential participant notices if 60 days late
 - PBGC reportable event if 30 days late
 - Liens and PBGC Form 200 if unpaid contributions in excess of \$1,000,000
 - Interest penalties at a 5% rate
 - Missed PBGC 4010 filing?
 - Underpaid PBGC variable premiums?
- Weigh benefits of a change against any adverse effects

Interest Rate Environment

Applicable month (rates from prior month)	Segment rates (no averaging) – Proxy for Yield Curve			Comments
	First	Second	Third	
October 2009	2.73%	5.63%	6.07%	Best estimate of rates underlying December YC
November 2008	7.35%	8.61%	7.26%	Lookback used by many plans at 1/1/2008 → EIR > 8%
24 Month Averages based on Applicable Month				
Projected January 2010	4.64%	6.66%	6.74%	Assuming 9/09 rates above continue → EIR about 6.7%.
October 2009	4.92%	6.71%	6.80%	
September 2009	5.03%	6.73%	6.82%	Likely to be marginally highest for 1/1/2010 valuation
January 2009	5.32%	6.45%	6.69%	These were highest segment rates for a 1/1/2009 valuation

1/1/2010 Interest Rate Alternatives

- Segment rates likely will produce lower funding obligations for 2010 than December 2009 yield curve
 - And can switch to yield curve in future
- September applicable month should be most favorable, but differences are small
 - Can choose segment rates without lookback and be able to change in future to with lookback with automatic approval, but
 - May make sense to elect with lookback for 2010 because
 - Slightly better for 2010
 - Should be better at 1/1/2011 due to high rates in late 2008
- Most favorable approach for 2010 (September applicable month segment rates) will produce an EIR
 - About 20 bps higher than January 2009 applicable month segment rates
 - At least 100 bps lower than November 2009 applicable month yield curve (based on October 2009 rates)

1/1/2009 Plan Assets Compared to Likely 1/1/2010

- 1/1/2009 smoothed assets likely 110% of MV
- At 12/31/2009, at least 2/3 of 2008 asset loss will be recognized in plan assets, but already was in most cases at 1/1/2009 (due to 110% limit)
- Returns YTD September 2009
 - Stock portfolio (70% large cap; 20% small cap; 10% international) – about 22%
 - Bond portfolio – intermediate to long corporates – about 5%
- Typical portfolio returns YTD September 2009 (stocks/bonds)
 - 40%/60% - 12%; 60%/40% - 15%; 80%/20% - 19%
- Assuming flat markets remainder of year, 30% 2008 loss/15% 2009 return → 1/1/2010 smoothed assets again likely to = 110% of MV

Asset Method Choices for 2009 and 2010

- No change in asset method choice after 2010 without approval
- Plans moving from yield curve based on October 2009 bond yields will already have a significant increase in funding requirements due to declines in interest rates
 - May want to stay with smoothed assets to retain 10%
- But switching to market value may conform better with client's funding/investment strategies
 - Particularly where hedging strategies will be employed and/or yield curve will be used
 - Smoothing methods still expected to lag market value if plan returns exceed corporate bond returns, by 2011 when full 2008 loss is reflected
- Cash flow projections likely needed to assist clients in making these decisions

Considerations for Changing 2009 Method Choices Better Funded Plans as of 1/1/2009

- May have been able to make long term strategic choices for 2009; e.g.,
 - Asset averaging/24-month average segment rates if no intent to employ significant hedging strategies, OR
 - Market value (or one month smoothing) and YC if:
 - Hedge 50% or more of liabilities, OR
 - Frozen or closed plan and want to avoid surplus
- Alternatively, may have had large credit balance and chosen YC with Oct/Nov rates for tactical reasons, e.g.,
 - To keep CB while avoiding 4010 filing/at-risk in 2010
 - Because the ability to change interest rate method in 2010 with automatic approval was perceived as more likely if the YC with an applicable month was used
- Such sponsors likely to implement their preferred, long-term asset choice for 2010
 - But may move to segment rates for now even if intend to change later

Considerations for Changing 2009 Method Choices Lesser Funded Plans as of 1/1/2009

- Sponsors facing benefit restrictions/large contributions may have elected asset smoothing and the Oct/Nov YC
 - Less likely to change 2009 methods due to adverse effects on restrictions/2009 funding requirements
- Drop in interest rates will increase 1/1/2010 obligations
 - May forfeit CB (mandatorily or voluntarily) to avoid benefit restrictions or 4010 filings
- Will need to change interest rate methods in 2010
 - May be able to make a strategic decision between segment rates and YC based on plans regarding investment strategy and DB plan continuance, or
 - May be forced to again make tactical decision to use methodology that minimizes the pain in 2010
 - But will be able to move to yield curve in future

Cash Flow Planning

- Sponsors typically budget cash for calendar years, not plan years.
- There is likely to be a significant increase in required cash from 2009 to 2010, and 2010 to 2011
 - Plan sponsors who used yield curve with an applicable month of October/November will in all likelihood have a materially higher 2010 MRC than 2009 MRC
 - Cash flow requirements in 2010 will then be suppressed by lower 2010 quarterlies and 2009 wrap-up contribution
 - Cash flow requirements in 2011 will reflect a relatively larger 2010 wrap-up in addition to higher 2011 quarterlies
 - Effect exacerbated if using up credit balance in 2009
 - Sponsors who elected asset smoothing will be affected by full recognition of 2008 losses by 1/1/2011 (dropping asset values from 110% of MV at 1/1/2010 to perhaps below MV at 1/1/2011)

Credit Balance Management

Forfeitures of 1/1/2009 CB by 12/31/2009

- Unused 1/1/2009 CB can be forfeited by 12/31
 - Should plan sponsor do so?
 - Forfeiting may guarantee no benefit restrictions will apply at next 4/1 if no valuation is completed (i.e., if forfeiting brings 1/1/2009 AFTAP \geq 90% or \geq 70%), or avoid 2010 4010 filing or at-risk status (i.e., brings 1/1/2009 AFTAP above 80%).
 - Waiting and forfeiting 1/1/2010 credit balance instead won't avoid 2010 4010 or at-risk
 - In many cases, no guarantee that a forfeiture of 1/1/2010 credit balance based on presumed 4/1/2010 AFTAP will avoid restrictions at 4/1/2010 even if a forfeiture of 1/1/2009 CB by 12/31/2009 would have

Forfeitures of 1/1/2009 CB by 12/31/2009

- Assets likely to have positive returns during 2009 → forfeiting CB somewhat less attractive than in 2008
- Evaluate whether retention of the credit balance is a more powerful contribution reduction tool than avoiding at-risk status. May be, due to
 - Plan design
 - At-risk phase-ins (20%/year,) and absence of loads until the third plan year a plan is at-risk
 - Lack of funded, nonqualified plans
- Final regulations made clear that changes away from at-risk assumptions will not fall under rule requiring IRS approval for changes reducing funding shortfall by either (a) \$50 million or (b) \$5 million and $\geq 5\%$ of the FT.
 - Reduces need to avoid at-risk status

Creating 1/1/2010 PFB

- Should plan sponsors create 1/1/2010 PFB?
 - Must make election before 2009 Schedule SB filed
 - If election made after AFTAP is certified, make sure it isn't a material change for IRC 436, or doesn't cause other adverse effects due to drop in AFTAP
- Creating PFB can lead to anomalous results, because
 - Must use or forfeit all FSCB before **any** PFB is used or forfeited
 - If plan has FSCB, and is close to a relevant funding threshold, creating PFB can lead to forfeiting FSCB
 - FSCB is more valuable than PFB - Only PFB subtracted from assets for these purposes
 - 80% threshold to use CB next year against MRC
 - Exemption from new SAB, if applying PFB to offset MRC

Creating PFB – Effect on Ability to Use Credit Balance

- Establishing PFB can cause loss of use of CB if near 80%
 - Plan is > 80% funded at 1/1/2010 (total assets)
 - After subtracting the PFB, the 1/1/2010 FTAP < 80%
 - No CB can be used to reduce the 2011 MRC
 - The PFB cannot be forfeited until the entire FSCB is gone, but the FSCB can't be applied to 2011 MRC
- Sponsor could make additional contributions for 2009 by 9/15/2010, and not add to PFB, to increase 1/1/2010 FTAP back to 80%
 - Better not to have created the PFB with the earlier contributions in the first place
- Sponsor in this situation might be forfeiting FSCB for other reasons (benefit restrictions, 4010, at-risk, etc.)

WRERA Changes to Shortfall Amortization Base [SAB]

- WRERA changed the SAB to be based on asset shortfall relative to 92% (2008), 94% (2009), 96% (2010), 100% (2011+) of FT, with no need to hit threshold every year to keep transition
 - Did NOT eliminate requirement to be exempt from 412(I) in 2007 to be eligible for the transition
 - SAB still determined relative to 100% of FT if subject to 412(I) in 2007 (even if AFC=0)
 - WRERA change only applies for IRC 430 (funding)
 - Must still hit threshold each year or lose phase-in for IRC 436 (benefit restrictions)

Effect of Using PFB on SAB

- Using PFB against MRC can increase required contributions in specific situations
- If even \$1 of PFB is applied against MRC, entire PFB removed from assets in determining whether to set up SAB i.e.,
 - For 2009, in determining whether $[\text{assets-PFB}] / \text{FT} \geq 94\%$
 - No reduction for FSCB
 - Assets/FT used instead if no PFB applied against 2009 MRC
- Pre WRERA, could lead to setting up very large SAC (based on 100% of FT compared to assets less PFB) when using small amounts of PFB
- WRERA has mitigated this problem somewhat (since now only set up SAB based on 94% of FT), but can still be true for plans
 - with large PFB (so unfunded to 94% is significant), or
 - subject to 412(l) in 2007 (still must use 100% FT)

Effects of final regulations – Amendment/UCEB Planning

- Amendment/UCEB planning
 - Need to understand when legal rights to improved benefits are created to reflect them for funding/benefit restrictions at the appropriate time
 - May want to structure amendment to have a legal right created before higher benefits are paid
 - Less opportunity under final regulations to delay effects of UCEBs and plan amendments on funding requirements and benefit restrictions
 - Need to evaluate whether to assume a non-zero probability of UCEBs in funding valuation

Effects of final regulations – Programming issues

- Revisit how ancillary benefits are attributed between funding target and target normal cost
- Review whether to change methodologies for valuing of annuity options in cash balance plans or lump sums in traditional plans
- Review at risk programming – earliest age and most valuable form rules apply to deferred vesteds and actives