Behind The Bill

An in-depth look at the specific impacts the new Pension Protection Act will have on employers.

By Robert Stowe England

When President Bush signed the Pension Protection Act of 2006 into law in August, he described it as "the most sweeping reform of America's pension laws in over 30 years." It would be difficult to find someone who disagrees with that statement; experts say you'd have to go back to 1974's Employee Retirement Income Security Act to find a similar effect on retirement law as you'll find in this 906-page behemoth.

The impact of the new law is spread across the landscape of employer plan types. It tightens the funding rules while also setting up less-flexible methods of calculating the plan's funding obligation. It clarifies the legality of cash-balance plans, many of which have been in legal limbo since 1999. And it strengthens the appeal of 401(k) plans by encouraging automatic enrollment; a development many believe will significantly raise employee participation and the overall level of retirement savings.

The landmark status of the bill is due partly to the fact that it is "the single-largest rewrite of the funding rules since the enactment of ERISA," says Ethan Kra, chief actuary at Mercer Human Resources Consulting in New York. With a host of new rules to be phased in by 2011, employers are focusing on how it will affect their level of funding obligations and their annual contribution requirements in the coming years.

Employers see the funding changes as a mixed blessing, more pain than gain, and made without due consideration as to how they will impact the viability of the defined-benefit plan. "This bill was about addressing the solvency of the Pension Benefit Guaranty Corporation [which insures pension plans and administers terminated plans] and making the funding obligation more transparent to the investor," says Lynn Dudley, vice president of retirement policy at the American Benefits Council, an employer lobby.

"No one took a step back to see, in 10 years, where people will be. It includes nothing that is an incentive to maintain a defined-benefit plan," she says. "That said," she's quick to add, "a lot of companies will be maintaining their defined-benefit plans," which she considers to be valuable tools for recruiting and retaining people in the middle of their careers.

Wins and Losses

Employers won a key argument in the Washington debate over what interest rate to use for calculating the benefit obligation when legislators opted for a blend of corporate bond rates. "The corporate rate is a much more accurate measure of the liability," says Janice Gregory, senior vice president of the ERISA Industry Committee, a Washington employer lobbyist. While gaining on this point, employers lost some wiggle room to smooth out liabilities and assets.

Prior to 2004, employers had to use the 30-year Treasury bond, which employers argued did not match the liabilities in the plan and which tended to unduly increase the funding requirement over what it would be if the higher corporate-bond rate were used. For 2004 and 2005, plan sponsors could use the spot rate on investment-grade (AA) long-term corporate bonds, and they could also use a four-year weighted average, which allowed employers to smooth the obligation so that it would not be a highly volatile from year to year.

Under the new law, the temporary replacement corporate-bond rate in effect for 2004 and 2005 will continue to apply for 2006 and 2007 but, beginning in 2008, the interest rate will be based on a modified yield curve of investment-grade corporate bonds of varying maturities that are in the top

three quality levels (AAA, AA and A). Liabilities will be classified into three major segments: those due within five years of the valuation date, those payable after five but before 20 years and those payable after 20 years.

Plan sponsors will match the various points on the corporate-bond yield curve to the duration of the plan's liabilities. To determine when and how much a plan will have to pay out in benefits, employers will calculate the rate at which employees will retire and whether or not they will choose a lump sum, and how long they will live, based on the company's own experience and projected trends. Importantly, plans will be able to average or smooth interest rates over only two years instead of four, as now allowed. Similarly, assets cannot be smoothed for more than a 24-month period and the smoothing cannot be lower than 90 percent or higher than 110 percent of the fair-market value of the assets at the time of the valuation.

"As a result of these changes, the funding obligation is going to be more volatile and more difficult to predict," says Gregory. This volatility will be magnified, she adds, by the announcement in October by the Financial Accounting Standards Board that its new Statement of Financial Accounting Standards No. 158 will require publicly-traded companies beginning in 2009 to provide an estimate of the company's future pension liabilities on the balance sheet of their annual report, instead of in a footnote. That number will be based on a valuation of the plan's assets on a single day -- the last day of the fiscal, or corporate, year.

Employers are waiting to see how the Treasury Department interprets the language in the law, Gregory says, and a chief concern will be how much weight employers will have to give to AAA bonds. Since those bonds have a lower interest rate, the more holdings in AAA bonds required, the higher the funding liability.

The net effect of the rules governing the calculation of the plan's liabilities and assets, along with the tighter funding rules, is likely to lead plan sponsors to adjust their investment strategies, says Bill Quinn, chairman of American Beacon Advisors Inc. in Fort Worth, Texas, which manages the pension fund for American Airlines.

"Smoothing is basically going away or being dramatically reduced," says Quinn. This will make the plan more expensive, he says. "People may be forced into making decisions to lower the volatility [of the funding obligation] rather than seek the best return on assets."

By requiring plans to mark the liability and assets to market every year and to raise funding levels, plan administrators may decide to invest more in fixed-income assets matched to the plan's liabilities and reduce the plan's exposure to equities, he adds. Since equities, over the long term, have higher returns, it could mean the cost of funding benefits will rise in order to reduce volatility, says Quinn.

Closing the Funding Gap

Plans will be required to move more quickly to close funding gaps under the new law. "I think when you really get to the core purpose of the Pension Protection Act, it's to improve funding," says Tonya Manning, chief actuary of Aon Consulting in Winston-Salem, N.C.

In general, the new rules increase the amount of contribution required if the plan is underfunded, says Kyle Brown, retirement counsel for Watson Wyatt Worldwide in Arlington, Va. There are several funding-level thresholds that plan sponsors will want to avoid, he says.

In general, plans will want to move from their current target of 90 percent to 100 percent, Brown says. Under current rules, if the funding level was 90 percent or higher, a plan sponsor's deficit-reduction contribution in any given year is "zero," says Brown. However, if it fell below 90 percent, employers

could expect to have to make a "very large" deficit-reduction contribution, he says. For this reason, many plans targeted a 90-percent funded level.

Now, however, plans that are less than 100 percent funded by 2011 may face benefit restrictions such as limitations on benefit increases, benefit payments, benefit accruals and shutdown benefits. There is a four-year phase-in to 100-percent funded status to avoid the benefit limitations in the new law: 92 percent in 2008, 94 percent in 2009 and 96 percent in 2010.

In addition, plans will have to speed up the funding process -- that is, make larger annual contributions -- to bring their funding levels into line because the amortization period of shortfalls is being reduced from up to 30 years for plan amendments to only seven years for all shortfalls.

"As a result of these rules, the minimum contribution requirement will be much more volatile," says Kra.

Plans will want to avoid, at all costs, being classified "at risk," which the new law defines as being less than 80 percent funded in 2011. There is a transition period beginning at 65 percent funding in 2008, 70 percent in 2009 and 75 percent in 2010.

If a plan is found to be "at risk," it will have to calculate its benefit obligation under a more stringent rule that assumes all participants who are eligible for benefits for the current and following 10 years retire at the earliest possible date and make selections that will result in the highest liabilities for the plan, such as taking early retirement. Further, companies that are at risk cannot fund their executive retirement programs and rabbi trusts, he adds.

Finally, the new law states that if a plan falls below 60 percent funding, it will be frozen.

These changes will encourage companies to "not promise more than they can deliver, so that promises made are promises kept," says Kra.

On the plus side, plans will be able to deduct contributions up to 150 percent of funding by 2008. This will allow companies to put in "extra money in good times as a rainy day fund," Kra says. However, credit balances that accrue from overfunding cannot be counted in calculating funding levels and cannot be added into assets when determining if the plan has fallen below 100 percent, 80 percent or even 60 percent funding.

Specific Fixes

While defined-benefit plans may become more of a corporate headache because they are more volatile and more costly, the news for cash-balance plans and other hybrids was pretty much all good.

"The hybrid plan provision did, indeed, break the logjam that had such plans in limbo for the past several years," says Gregory. "The law gives people a much clearer road map and endorsement of their plan going forward," she says.

In early September, the Seventh U.S. Circuit Court of Appeals ruled in favor of IBM in the case of Cooper vs. IBM, ruling that IBM's cash-balance plan, to which the computing giant converted in 1999, was not age-discriminatory. The ruling helped assure that existing cash-balance plans are legal, according to Gregory. IBM, which was sharply criticized by some employees at the time of the conversion, was pleased with the outcome.

"We are gratified that the Court of Appeals has vindicated IBM's long-held position that its pension-plan formula is both lawful and age-neutral," says Clint Roswell, manager of media relations. "The

Court's decision gives much-needed certainty to employers and employees alike in this important area of employee benefits."

The IRS is already moving to issue letters of determination for an estimated 1,250 people who had sent in requests since 1999, when the IRS put a moratorium on such letters. The Treasury and IRS "are working to get guidance out as to how those determination letters will be handled," says Sean Kevelighan, senior adviser in the office of tax policy at Treasury. "We expect that the moratorium will be lifted by the end of [2006]," he adds.

In the case of automatic enrollment, the Pension Protection Act of 2006 offers an important breakthrough for employers that sponsor defined-contribution plans with its endorsement of this type of savings incentive. Coupled with the Department of Labor's proposed default investment regulation that was released in September, the new rule gives employers a great deal of comfort about enrolling new employees in the plan and placing them into one of the default investments identified in the new regulation, including life-cycle or target-date funds, balanced funds and managed funds, according to Ed Ferrigno, vice president of the Profit Sharing/401(k) Council of America.

The movement toward auto enrollment is likely to gain steam, according to Barbara Hogg, senior retirement consultant with Hewitt Associates in Lincolnshire, Ill. According to a Hewitt survey of 227 employers last year, 24 percent were already doing automatic enrollment. Hewitt's surveys have found that only about 10 percent of employees opt out of automatic enrollment, which translates to a 90-percent participation rate for employers. Further, "Employees typically stay in the plan even as the savings rate escalates," she says.

While the new law clears up any doubt about enrolling new hires, it is not entirely clear whether employers "can auto-enroll current employees who are not participating," says Hogg.

A federal stamp of approval of the new set of default investments "will have a profound impact" on improving the overall level of retirement savings, according to Richard A. Davies, senior managing director of defined-contribution services for AllianceBernstein in New York.

Because of the new law and the new DOL guidance, employers will be more willing to automatically enroll employees and place them in default investments, Davies says, because the new law and the new guidance give them more comfort in terms of their exposure to fiduciary liability. In the past, employers that were worried about fiduciary liability for the default investment choice tended to place employees in very safe investments, such as money market funds. The proposed regulation, however, gives the DOL's "blessing" on a number of options that will provide a better long-term return since they contain a mix of equities and fixed-income assets.

"A lot of employers are going to defined-contribution-only benefit structures," says Brown. "We need tools to provide an adequate benefit."

The new pension law taps two powerful forces, he says. One is inertia, which raises participation rates dramatically when employees are automatically enrolled and few opt out of the plan. The other is the power of compound interest, which participants will be better able to tap through default investments.

The strong appeal of defined-contribution plans was underscored in early November when Citigroup announced it would end future benefit credits in the company's cash-balance pension plan for its 150,000 workers in the United States. Citigroup is, instead, beefing up its 401(k) plan by increasing the current 3 percent match to 6 percent and adding a 2 percent contribution from the employer for all employees who earn less than $100,000 a year.

In a memo to workers, Citigroup Chairman and CEO Charles Prince told employees the changes were "based on feedback we have received" from employees and "a thorough study of market practices"

which, together, found current and prospective employees value and understand the 401(k) plan better than other types of retirement benefits, including the cash-balance plan.

The automatic enrollment provision is likely to make it easier for employers to pass nondiscrimination tests, even if they do not meet the safe-harbor requirements in the new law. Nevertheless, "a lot of employers are interested in the safe harbor," says Hogg. Employers need not test if they automatically enroll employees with at least a 3 percent-of-pay contribution and automatically escalate the employee contribution to 6 percent, increasing it one percentage point a year. However, some employers may be deterred because of the cost of the safe harbor, Hogg says.

The new pension law also provides a breakthrough in the pricing of annuities offered by defined-contribution plans, according to Brown. Presently, pension plans have to purchase the safest available annuity. The new law asks the Department of Labor to issue guidance stating that the "safest available" rule does not apply to distribution options in 401(k) plans.

"With a less-onerous fiduciary standard, MetLife believes that [this] will help pave the way for more companies to feel comfortable offering annuities," says Kathleen Henkel, senior vice president of institutional business in MetLife's Jersey City, N.J., office. Some believe it may also make the pricing of annuities more attractive.

Finally, the new pension plan also makes permanent a number of changes from the Economic Growth and Tax Relief Reconciliation Act of 2001. "This is huge," says Gregory, because it ends a lot of uncertainty around those provisions. For example, it makes permanent a host of higher contribution limits and makes the Roth 401(k) permanent instead of temporary, he says.

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