CLIENT ACTION BULLETIN

October 28, 2008 **CAB 08-22**

Strategies for Pension Plans in the Global Financial Crisis

SUMMARY

The current global financial crisis has caused unprecedented turmoil for defined benefit retirement plans in 2008, with volatility remaining extremely high. As of October 27, a pension plan with a 60% equity/40% fixed income mix may have experienced losses of about 25% year-to-date. At the same time, pension liabilities have decreased due to the rise in the high-quality corporate bond yields (the “discount rates” that are used to measure pension benefit obligations). Given the uncertainty of the markets and the requirements set by the Pension Protection Act’s (PPA) funding rules, many single-employer plan sponsors are under pressure to consider steps in the near-term, while maintaining a long-term outlook, to secure their pension promises. For most sponsors, keys to managing the pension plans may entail a current assessment of the plan’s funded status to determine contributions needed to remain above the threshold that will trigger benefit restrictions or to assess the restrictions that might apply, as well as a review of the plan’s investment policy to ensure that it remains appropriate and that the plan continues to adhere to it.

DISCUSSION

Plan Funding Issues

Pension plan sponsors must annually calculate their plan’s funding percentage, which in turn determines if restrictions on benefits payable to participants apply. The restrictions vary according to the level of underfunding. In general, plans that are less than 80% funded must limit lump-sum payments and may not improve plan benefits; those that are less than 60% funded must suspend benefit accruals, are precluded from paying lump sums or other accelerated payments, and cannot pay emerging plant shutdown claims. Once restrictions apply, plan sponsors must notify participants within 30 days. (See ***Client Action Bulletin 07-11*** for a summary of the IRS’s rules applicable to pension funding and the benefit restrictions that may apply.)

At this point in the year, a plan’s actuary has already certified the calendar year 2008 funding levels. But the recent and ongoing turmoil in the financial markets is fueling uncertainties about next year’s pension plan funding (i.e., as of 1/1/2009). Absent significant asset gains between now and year’s end, 2009 funding levels are almost certainly less favorable than those for 2008. This is particularly worrisome for plans with 2008 funding levels that were certified within 10% of a critical threshold because, under the funding rules, the IRS will assume the worst until the plan’s actuary certifies the 2009 funding levels.

- *Plans certified as at least 90% funded in 2008* – The IRS will deem these plans to be over 80% funded as of 1/1/2009 and no benefit restrictions will apply until the 2009 certifications, which can be as late as 10/1/2009.
- *Plans certified as less than 90% funded in 2008* – The IRS will deem these plans to be less than 80% funded as of 4/1/2009, and thus subject to benefit restrictions on lump sums and amendments that improve benefits as of that date.
- *Plans certified as less than 70% funded in 2008* – The IRS will deem these plans to be less than 60% funded as of 4/1/2009, and the most severe restrictions on benefits will apply.

Plan Funding Strategies

Options exist under the funding rules that may help to mitigate the impact of asset losses:

- Asset averaging may permit plans to recognize higher asset levels, essentially 110% of 1/1/2009 market value.
- Use of current spot discount rates can be expected to significantly decrease liabilities.

In combination, these two options can be expected to increase funding levels by 15% to 20%. When considering these options, plan sponsors need to revisit their 2008 certifications and make sure to avoid any operational deficiencies under the revised 2008 funding certifications. Use of these asset averaging and spot rate options may prove particularly useful for plans that were less than 90% funded in 2008 on the old basis if, on the new basis, 2008 funding levels can be improved to at least 90%, thus delaying the need for a 2009 certification until October 1, 2009.

Because contributions deposited as late as 9/15/2009 can be recognized in the calculation of the 1/1/2009 funding level, there is little reason to make plan contributions between now and the end of 2008. However, contributions made to avoid benefit restrictions must be made at the time of the actuary's certification. Plan sponsors that want to avoid benefit restrictions but that cannot escape a presumed funding level below 80% as of 4/1/2009 will need to have their actuary certify the 1/1/2009 valuation results in the first three months of 2009 and may have to contribute sufficient funds no later than 4/1/2009. Somewhat better funded plans will have as late as 10/1/2009 to address benefit restrictions.

Investment Strategies

Pension plan investment policies are long-term in nature and, therefore, are subject to short-term market volatility. And because a plan's investment policy takes market fluctuations into account, plan sponsors should avoid making hasty decisions during periods of market upheaval. During the current economic climate, plan sponsors should consider:

- Adhering to a long-term investment policy while rebalancing portfolios with incremental increases toward target equity allocations over the next six to 12 months, subject to certain fundamental and technical indicators. Also, consider lengthening the duration of the fixed income portfolio while credit spreads are at historically high levels to hedge the potential interest rate risk when credit spreads narrow to historical norms (which will, in turn, increase the valuation of the liabilities). The best buying opportunities typically occur before economic and market recoveries are clear to investors.
- Reviewing risk management practices to mitigate any further erosion of funded status and increases in contribution requirements, in the case of companies with relatively weak financial statements.
- Minimizing changes to plan investment managers due to short-term underperformance. High market volatility and illiquidity have decoupled the relationship between price and value and increased transaction costs in several markets. Many high quality managers have historically produced strong returns after a period of poor relative performance.

If recent asset declines have exceeded a plan sponsor's risk tolerance, consider adopting a liability-driven investing (LDI) approach. Doing so may reduce risk levels (i.e., volatility of funded status, annual cash contributions, and balance sheet) by changing the equity/fixed income mix and/or duration of fixed income assets to better align with the behavioral characteristics of the plan liabilities (particularly as a plan's funded status improves).

ACTION

During the current highly volatile market conditions, pension plan sponsors face uncertainties about plan funding and investments. The plan's funding level will determine some of the actions to take, such as whether and when to make contributions, whether to apply prior credit balances, and, if necessary, whether benefit restrictions must apply. In addition, plan sponsors should review their plan's investment policy and determine whether adjustments to their strategies are warranted. Plan sponsors also should monitor the effects of any actions taken with regard to the pension plan for implications on their nonqualified deferred compensation plans that are funded.

In addition to continuing to monitor plan assets and projected liabilities for the remainder of the year, plan sponsors should discuss with their actuaries options for revising asset valuation methods and discount rate elections.

For additional information about plan funding or investment issues or to discuss strategies during a volatile market, please contact your Milliman or EAI consultant.

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