Impact of PPA on Defined Benefit Plans

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At a High Level, PPA Funding Rules Imply

- Increased funding target
  - set to 100% of a solvency liability vs. 90% previously
  - target further increased – but only temporarily – for plans deemed at-risk

- Faster recognition of capital market results
  - smoothing period reduced to two years vs. four years previously
  - seven-year amortization of unfunded amounts once recognized

- Reduced ability to delay contributions for poorly funded plans – since the application of credit balances is restricted

- New constraints on plan operations for plans that fall below funding thresholds

- Greatly improved ability to advance fund pension plans

- Some expansion of plan sponsors’ access to accumulated surplus
Different Plans Will See Different Impacts

Poorly funded plans

- Unfunded amounts are amortized over seven years – this represents a decrease in amortization amounts when compared to amortization rates as high as 30% under prior rules.
- Credit balances can’t be used to delay contributions.
- At-risk designation essentially raises the amortization rate gradually over a period of years (until the funding level recovers); also raises PBGC premiums.
- Sponsors can’t pay full lump sums or make plan improvements until the funded level recovers.

Bottom Line a mixed bag
Different Plans Will See Different Impacts

Moderately funded plans (near 90%)

- Significant increase in funding requirements – increased target hits these plans directly.
- If capital market conditions deteriorate, credit balance utilization may be restricted, at-risk designation and constraints on benefit operations may kick in.

Bottom Line  

increased contributions greater downside risk
Different Plans Will See Different Impacts

Well funded plans
- Contributions are not required unless the funded level drops below 100%.
- Greatly increased advance funding opportunity – up to 150%. Resulting credit balances available to offset future contribution requirements (unless funded level drops below 80%).
- Expanded opportunity to utilize surplus assets to pay retiree medical benefits – albeit with significant restrictions attached.

Bottom Line
- more flexibility
- less downside protection (against contribution increases)
Will Contributions Be More Volatile?

- Given the key parameters of PPA funding rules, you’d expect the new rules to add volatility to pension plan funding, since
  - smoothing is reduced to two years
  - application of credit balance is curtailed
  - at-risk designation increases contribution requirements during adverse periods.
- However, when looking more closely at the details, the picture gets complicated
  - the amortization rate is likely to be reduced for the most poorly funded plans
  - amortization amounts per $ of unfunded liability (essentially) stay constant, while under prior rules there were major “cliffs” in funding requirements.
- Also for plan sponsors who wish to manage contribution requirements proactively
  - there is an enhanced ability to implement effective ALM/LDI strategies
  - there is added flexibility to fund the plan in advance of funding requirements.
### How Alternative Funding Requirements Perform --
#### Traditional Plan / Typical 60-40 Asset Mix

<table>
<thead>
<tr>
<th>Contributions</th>
<th>Prior Rules</th>
<th>New Rules/PPA</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>average over time</td>
<td>6.6%</td>
<td>8.7%</td>
<td>+2%</td>
</tr>
<tr>
<td>10-90 percentiles</td>
<td>0 - 16%</td>
<td>0 - 19%</td>
<td>more variable</td>
</tr>
<tr>
<td>percent &gt; 20% of payroll</td>
<td>5%</td>
<td>7%</td>
<td>more variable</td>
</tr>
<tr>
<td>Funded Levels</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>average, end of period</td>
<td>97%</td>
<td>108%</td>
<td>+11%</td>
</tr>
<tr>
<td>10-90 percentiles (end of period)</td>
<td>75 - 123%</td>
<td>83 - 136%</td>
<td>increased chance of large surplus</td>
</tr>
<tr>
<td>percent &lt; 80% funded</td>
<td>16%</td>
<td>8%</td>
<td>reduced chance of large unfunded</td>
</tr>
</tbody>
</table>

*Methodology:*
- 10-year forecast, including transition period
- plan starts out about 90% funded
- minimum contributions paid each year
- no initial credit balance
How Alternative Funding Requirements Perform –
Range of Contributions (10-year average)

- Current Rules:
  - PPA Current PPA
  - Asset Allocation:
    - Typical 60-40 Mix
    - All Matched Bonds

- Range of Contributions (10-year average):
  - 20%
  - 16%
  - 12%
  - 8%
  - 4%

- 90th percentile
- 10th percentile
How Alternative Funding Requirements Perform – Funded Status (10th year)

Rules: Current PPA Current PPA
Asset Allocation: Typical 60-40 Mix All Matched Bonds
Concerns About Surplus

The increased funding target implies that plans investing in equities are more likely to accumulate surplus assets over time.

- Costs related to ongoing benefit accruals can siphon off only some of this surplus -- especially problematic for mature or frozen plans.

- The expanded section 420 transfer opportunity will be an attractive option for sponsors providing retiree medical benefits. However, its relevance is limited by:
  - the need to maintain a 120% funded level for the entire payout period
  - the requirement to vest all accrued pension benefits
  - the requirement to maintain retiree medical benefits (or costs) at existing levels for an extended period of time.

- Plan termination is generally not a viable option due to the cost of annuitization and the prohibitive excise tax applied on surplus.

The potential for creating surplus and the limited avenues for effectively utilizing it (once created) affects the perceived risk/reward tradeoff – and makes lower-risk strategies more appealing.
How Will Plan Sponsors Adapt?

**Employer Survey Results**

- Are pension financial risks expected to be manageable?
  - 63% said yes
  - 30% said acceptable
  - 7% said significant risk.

- Will pension benefits be curtailed further?
  - 17% intend to close the plan to future hires
  - 5% intend to freeze benefits for existing employees
  - 9% intend to reduce future benefit accruals
  - 49% do not plan any changes.

- How will investment policies change?
  - 32% said they would were likely to put greater emphasis on bonds
  - 25% said they were likely to increase their use of derivatives
  - 5% said they would consider annuities (pricing is viewed as problematic).