

The Latest on Pension Reform ...and the Big Freeze

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Consultants and Actuaries

Pension Reform

- What's become law/recent developments
- Status of current proposals
 - Defined Benefit Plans
 - Defined Contribution Plans
 - Hybrids
- What are plan sponsors doing?



What's become law/recent developments



Pension Reform/New Law

- Pension Benefit Guarantee Corporation
 - Congress oversees, but funded through annual employer premiums
 - Premium level not adjusted since 1991
- Increased PBGC fixed premiums from \$19 to \$30 per participant beginning in 2006
- Increased for managers of multiemployer pension plan from \$2.60 to \$8 a participant



Status of current proposals



Proposed Pension Reform

- H.R. 2830, The Pension Protection Act of 2005 passed House on December 15, 2005
- S. 1783, The Pension Security and Transparency Act of 2005 passed the Senate on November 16, 2005



Proposed Pension Reform

- Differences being reconciled during conference
- Started meeting March 8
- Passage initially predicted mid-to-late April- May.
- The White House has threatened to veto any bills with industry-specific provisions because they believe it

“will weaken the incentives for plan sponsors to fund their pension promises adequately.”



Proposed Pension Reform

- Three major components
 - Simplifying the Defined Benefit Funding Rules
 - Single and Multiemployer Plans
 - Defined Contribution Plan Reform
 - EGTRRA Permanence
 - Automatic Enrollment
 - Default Investments
 - Investment Advice
 - Diversification Requirements
 - Hybrid Plan Clarity
 - Currently prospective only in both bills
 - Substantially different approaches in bills
 - Oral Arguments in Cooper appeal



Defined Benefit Funding Rules



Proposed Pension Reform

- Simplifying the Funding Rules
 - Single funding requirement with the goal of being 100% funded in a short period of time
 - 5 years for House
 - 3 years for Senate
 - Interest rates derived from corporate bond yield curve
 - Updated mortality table



Proposed Pension Reform

■ Simplifying the Funding Rules

- Funding target is 100%
- In general, minimum contribution is the sum of the plan's normal cost and the required shortfall amortization charge
- No amortization charge if safe harbor target is met
 - 92% in 2007, 94% in 2008,...100% in 2011
 - Less than these amounts must be amortized over 7 years



Proposed Pension Reform

- Simplifying the Funding Rules – Other issues
 - Credit Balance – in general, you lose ability to use some or all of your credit balance if the plan is less than 80% funded
 - Smoothing of asset values
 - Treatment of contributions made after the end of the plan year
 - Risk Assessment



Proposed Pension Reform

- Single funding method
 - Reflect current year accruals including effect of salary increases and any plan amendments

- Contribution limits
 - 150% of liability – House
 - 180% of liability – Senate

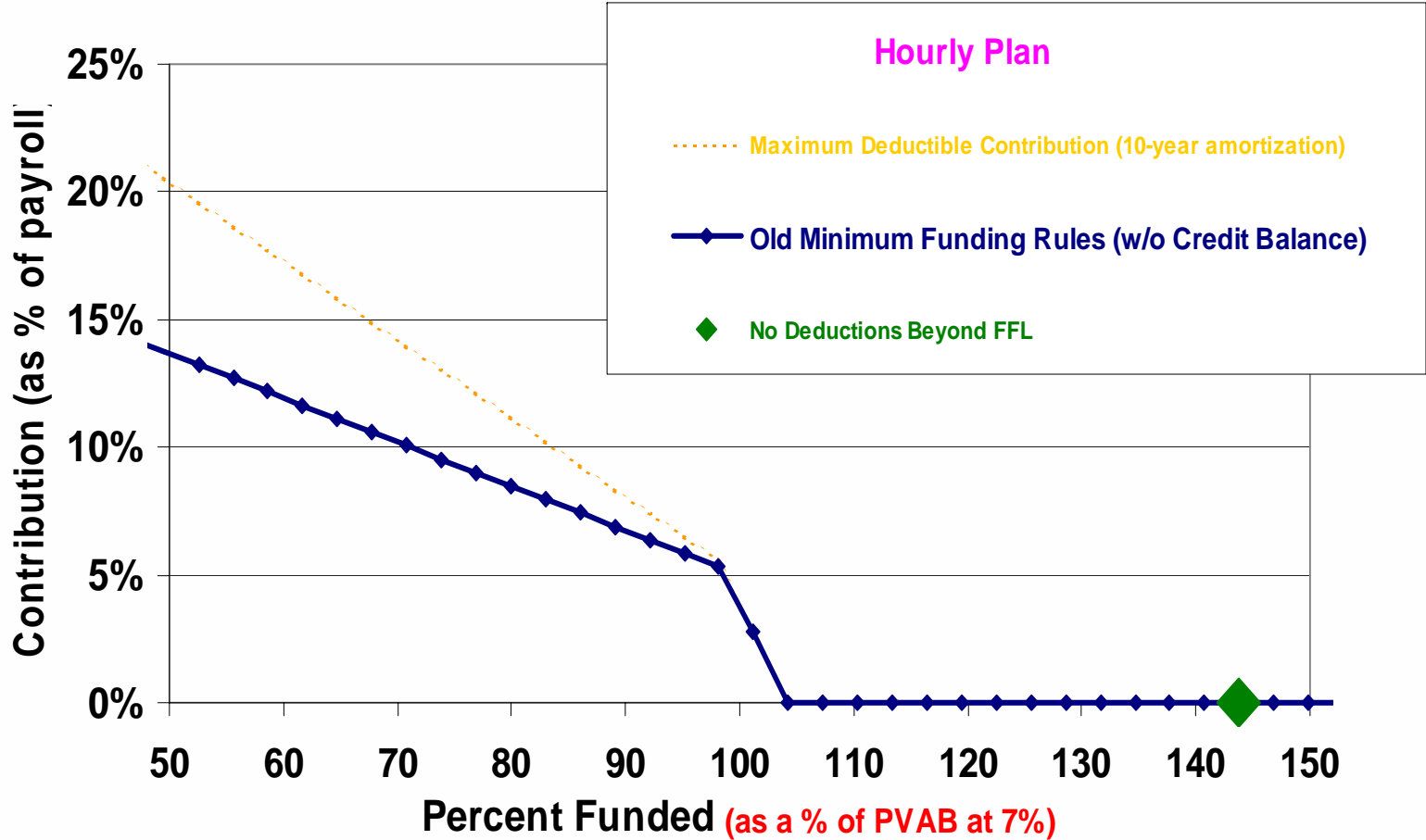


Proposed Pension Reform

- Effect on Funding for a single employer plan
 - Two examples:
 - Subject to DRC
 - Not subject to DRC
 - Following slides provided by Ron Gebhardtsbauer and American Academy of Actuaries

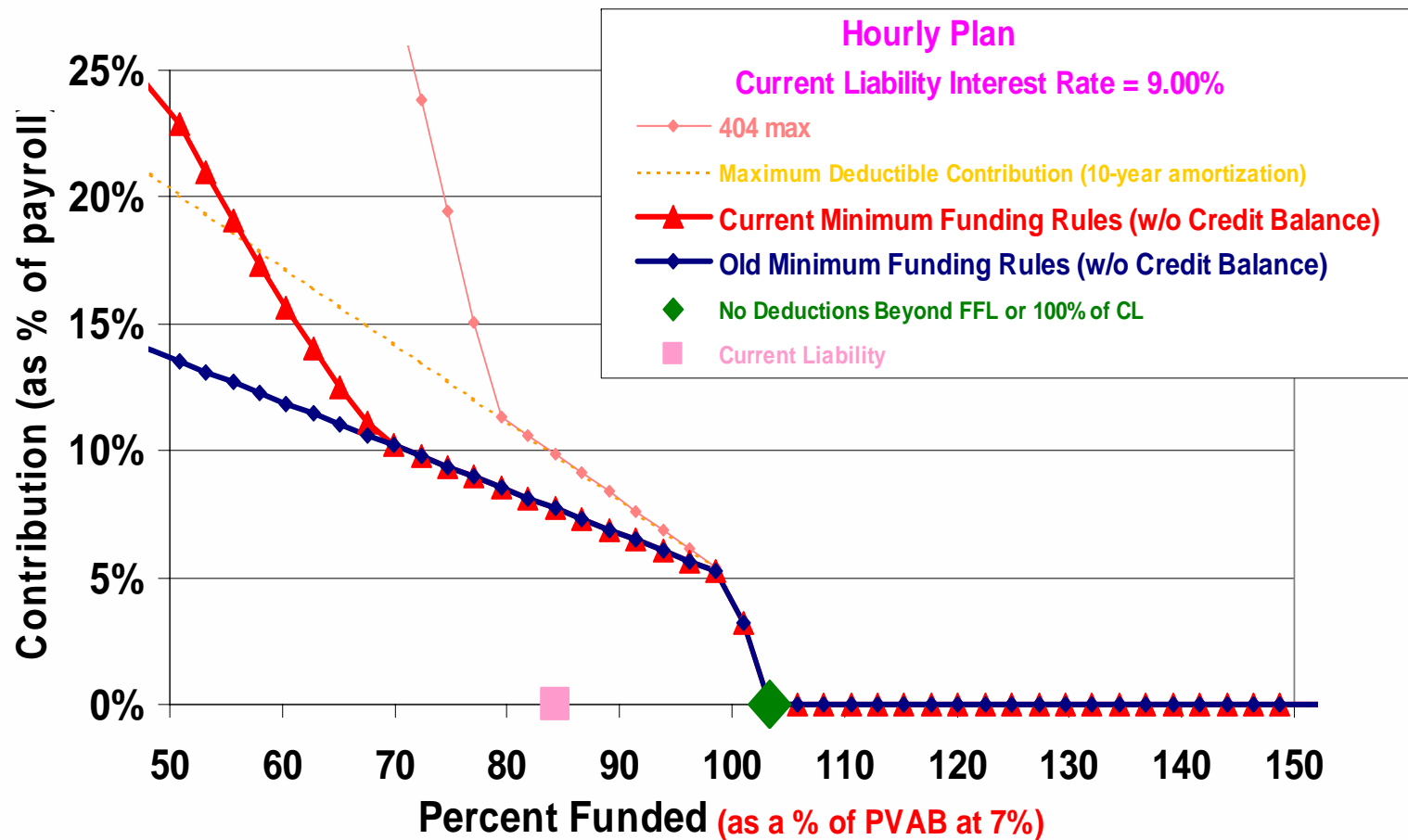


Funding Rules



The Original ERISA funding rules gave sponsors of pension plans 40 years to reach 100% full funding on an ongoing basis (liabilities determined using projected wage levels and a long-term expected return - typically 7% or 8% for the past 20 years). The object was to gradually get to 100% funding; not to get there fast, or once there, to stay fully funded. It wasn't the good ol' days for PBGC.

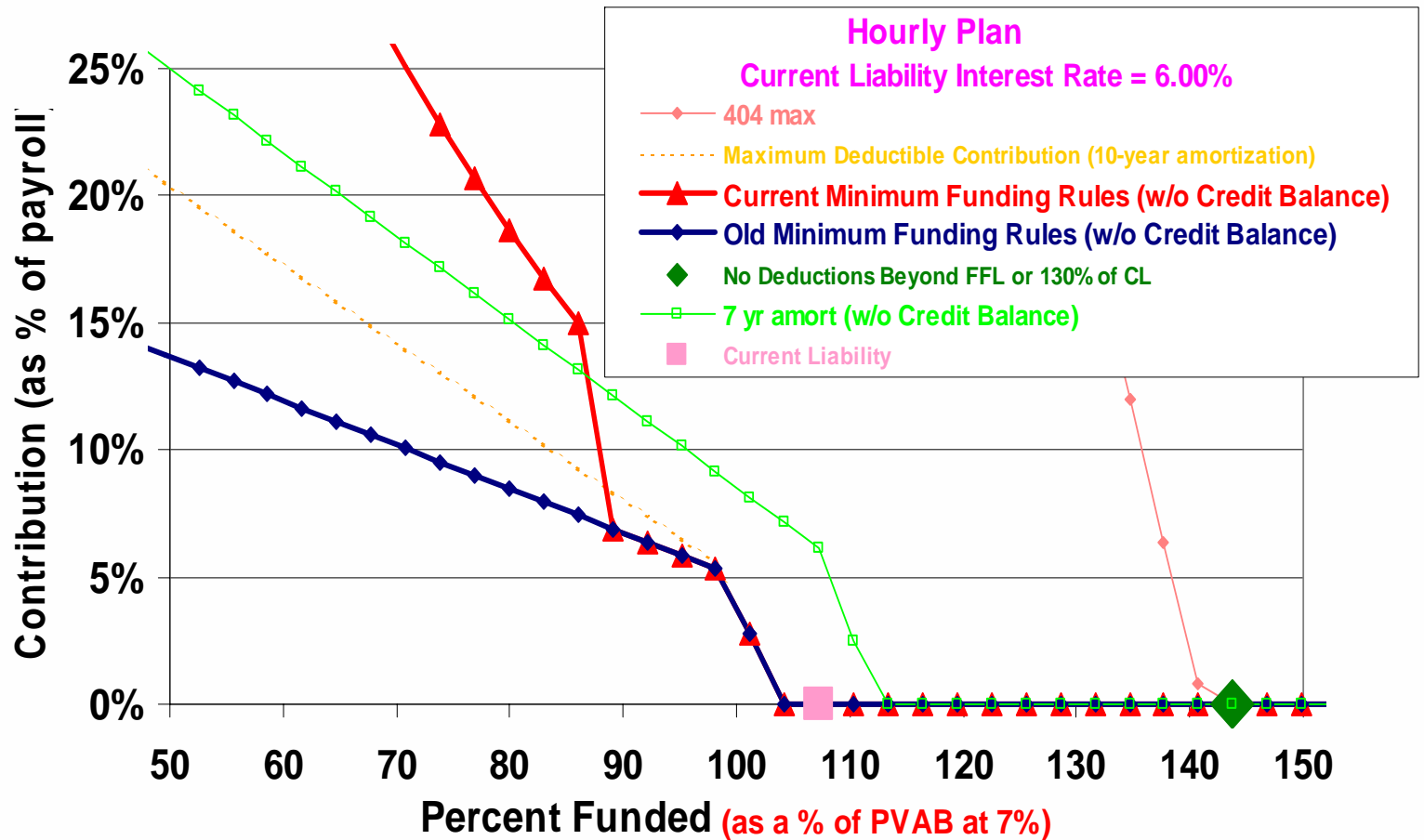
Funding Rules



In 1987 & 1994, the funding rules were strengthened to require faster funding for poorly funded plans (under 80%/90% funded). The new calculation (red line) determining the DRC (Deficit Reduction Contribution) was based on accrued benefits and smoothed bond rates. Since bond rates were high then, the new rules only affected poorly funded plans.



Funding Rules



One funding rule in Administration proposal and bills before Congress smooths out the cliffs. Contributions are reduced for plans subject to DRC, but increase for plans funded around 90% to 100%. There's still a cliff at 100% of Current Liability. Raising deductible amount provides flexibility to build margins, but sponsors won't use unless they can get economic benefit from surplus

Proposed Pension Reform

- Simplifying the Funding Rules – Other issues tied to funded status of the plan
 - Amendments to increase benefits – cannot be made generally if the plan is less than 80% funded
 - Limitations on lump sums
 - Limits on accruals



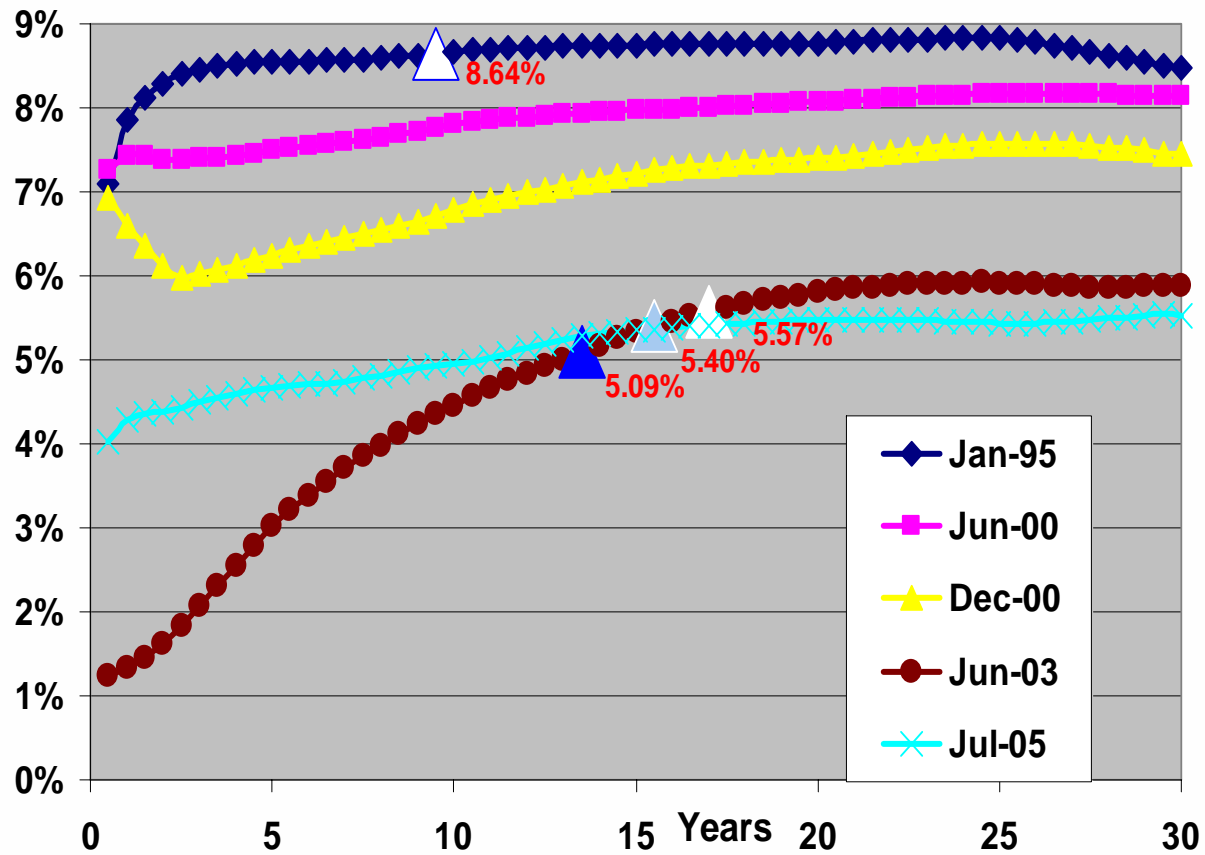
Simplicity?

■ Except for Yield Curve

- Complicates administration & communication
- Cost-Benefit analysis would show: not worth the cost



CitiCorp (Salomon) Corporate Bond Yield Curves (Spot rates at end of month)



This chart shows yield curves at various times. It points out that yield curves can be steep (October 2002 and June 2003 are the steepest in recent history) or flat (June 2000) or inverted (December 2000). *Treasury* yield curves were more inverted in 2000 & the early 1980's. The inversion after 25 may be due to thin markets there and especially above 30. Mature plan liabilities would not be affected much using the top 3 flat yield curves. The chart also shows how rates have declined from 9% in 1995 down to 6% in June 2003. This has a much more powerful affect on liabilities than the much smaller affects of using yield curves. The triangles show the equivalent rate to the yield curve for a typical blue collar plan, typical plan, & a typical white collar plan.



Proposed Pension Reform

- DB and DC Combined Plan Deduction Limits
 - House bill would allow the DC plan to be disregarded if employer contributions do not exceed 6% of participant's compensation
 - Senate bill, for 2006, same as House, but after that, the limits would no longer apply to single employer plans covered by the PBGC



Proposed Pension Reform - PBGC

- Termination premium provision
 - Legislation establishes employer-paid termination premium of \$1,250 per participant for plans terminated by the PBGC or in a distress termination.
 - Will apply for three consecutive years following termination or a plan's exit from bankruptcy proceedings



Hybrid Plan Clarity



Proposed Pension Reform

Hybrid Plans - House

- Clarifies legal status of hybrid pension plans
 - **Hybrids** not inherently age-discriminatory
 - Uniform age discrimination standard for all DB plans; i.e., plan is not age discriminatory if worker's entire accrued benefit is equal to or greater than that of similarly situated younger worker; and
 - “Whipsaw” rule – lump sum distribution from hybrid pension plan equals worker's theoretical account balance.



Proposed Pension Reform

Hybrid Plans - Senate

- Clarifies legal status of qualified cash balance plans
 - Prospective basis only
 - Legalizes cash balance plans going forward but imposes mandates for future CB conversions
 - 5 years of old plan benefits
 - Accelerated vesting (from 5 to 3 years)
 - Similar treatment for other hybrids
 - Like House – no whipsaw if using market rate of return



Proposed Pension Reform

Hybrid Plans - Senate

- Clarifies legal status of qualified cash balance plans – Conversions
 - Five-Year transition period
 - No wearaway at ERD/NRD &
 - 5 year maintenance or
 - Greater of or choice for ages ≥ 40 & age+svc ≥ 55)
 - The Greater of /Choice approach for all
 - The Equivalence approach

Can't combine other plan benefits

Choice elections require projections & restrictions on benefit decreases in next 5 years



What are plan sponsors doing?



Pension Reform

- The big freeze of DB plans and enhancing DCs announced just recently

As of last September...

of the 627 traditional sponsored pension plans by Fortune 1000 companies, 115 have been terminated, frozen or closed to new entrants.*



* Based on a survey by Watson Wyatt Worldwide Inc.

Pension Reform

- The big freeze of DB plans and enhancing DCs

2005 analysis of FORTUNE 100 Companies*

37% offered traditional DB plan to new hires
(50% 3 years ago)

25% offering DC only in 2004 (36% in 2005)

27% offering a hybrid plan in 2005 (33% in 2004)

* Based on a survey by Watson Wyatt Worldwide Inc.



Pension Reform

- The big freeze of DB plans and enhancing DCs announced recently
 - Unisys
 - GM
 - Coca-Cola
 - IBM
 - Northwest Airlines Pilots Plan
 - Nissan North America
 - UAL Corp
 - Verizon Communications
 - Hewlett-Packard
 - Sprint Nextel
 - Lexmark International
 - Alcoa



Reason for change

- Cost
- Predictability of Cost
- Employee desires and understanding
- Changing demographics of workforce



Proposed Pension Reform

- While we wait....
- The interest rate reverts back to the rate on the 30-year Treasury bond rate on January 1, 2006
- Will congress extend the provision to use a mix of long-term high quality corporate bonds? Both bills have in a provision to change it to a rate based on “investment grade corporate bonds” of varying maturities.
- From 6.10% to 5.10%???



Proposed Pension Reform

- In summary - three major components
 - Simplifying the Defined Benefit Funding Rules
 - Defined Contribution Plan Reform
 - Hybrid Plan Clarity



Passage may happen, before July recess???

Proposed Pension Reform

- Helpful sources of information
 - Benefitslink.com
 - Edworkforce.house.gov
 - The texts of *S. 1783 and H.R. 2830* and the motion by Rep. Miller are available through the Library of Congress on-line legislative service (<http://thomas.loc.gov>)

