CHEIRON CLIENT ADVISORY

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Staying Out of Endangered or Critical Status Under PPA – Case Studies

This is the second Cheiron Client Advisory on the new special funding rules for multiemployer plans under the Pension Protection Act of 2006 ("PPA"). The first Advisory discussed general approaches for plans to avoid becoming subject to the special funding rules, and the major uncertainties of the new rules. This Advisory shows some situations we have encountered, and solutions we have developed with our clients. These examples illustrate changes that plan sponsors can make this year to avoid an adverse certification in 2008.

Background

PPA requires the plan actuary to certify each year whether a Defined Benefit Taft-Hartley Plan is "safe," "endangered," "seriously endangered," or "critical." The certification is due by the 90th day of a plan year and the first certification is due for the 2008 plan year. If a plan is not "safe," it is then subject to the new special funding rules of PPA.

As described in our first Advisory, there are some major uncertainties regarding the implementation of PPA. As a result of these uncertainties, if the Trustees and plan counsel believe that it is best for the plan to be "safe" initially, there are several actions that can be taken. The case studies below illustrate some of these approaches.

Note that we are still very early in the "PPA era." Many plans are considering the options available to them and have not made final decisions on the best course of action. In addition, IRS guidance, which will affect the implementation of PPA funding rules, has not yet been issued. Therefore, these case studies are based on actual situations but may not have been fully implemented as yet.

Case Studies

1. Merge Well-Funded Single Employer Plan into Multiemployer Plan

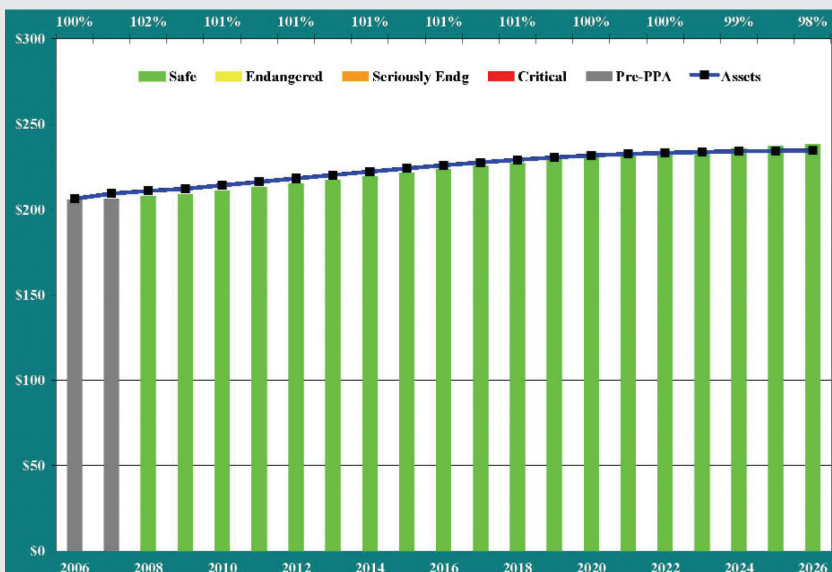
Multiemployer Fund A has been in existence for many years. As a result of contraction in the industry and other factors, its Funded Ratio has declined over the past 5 years from 95% to 75%. A Minimum Funding Deficiency is projected in the 2009 plan year, causing it to be projected as critical in 2008. A major contributing employer to Fund A sponsors a negotiated single employer plan (Plan B), which has a funded ratio of 120% on ongoing plan assumptions and has made no contributions for several years. The investment return assumption for Plan B that has been used by the plan actuary for many years is 8%.

Under PPA, the single employer funding rules will require that actuarial valuations be based on a "yield curve" using high-grade corporate bond yields, instead of the plan actuary's investment return assumption. This will effectively result in the rate used for Plan B's actuarial valuation dropping from 8% to roughly 6%. This lower interest rate, combined with the new funding rules, will cause Plan B to have a significant increase in its required contributions starting in 2008.

Union employees participate in both Fund A (the multiemployer plan) and the single employer plan. The employer is considering a proposal to merge Plan B into Fund A. This merger would result in an improvement of Fund A's Funded Ratio and its projected Funding Standard Account Credit Balance. Plan B and the sponsoring employer will have a lower required contribution under the PPA multiemployer funding rules compared to PPA single employer funding rules.

Funded Ratio Projection - Before Changes:

Funded Ratio Projection - After Changes:



Displayed are two sets of graphs illustrating the effect the change would have on Fund A. The graphs represent projections of the Fund's actuarial status over a twenty-year period. The first set shows the Funded Ratio (before and after the changes), with the bars color-coded to indicate PPA status. The second set shows the Funding Standard Account Credit Balance (before and after the changes). A Credit Balance less than zero indicates a funding deficiency. After the merger, Fund A will have a Funded Ratio over 80% and no projected Minimum Funding Deficiency. Thus, it is expected that Fund A will not be endangered or critical in 2008.

2. Actuarial Changes – Cost Method and Amortization Bases

Another strategy to avoid falling below "safe" status is a change in actuarial methods used to determine a plan's Funding Standard Account. Actuarial methods which can be reviewed include the actuarial cost method, the asset valuation method, and the possible combining of amortization bases, among others.

Plan C has a funded ratio of 84%. However, it is projected to have a Funding Deficiency in 2010. As a result, Plan C would be classified as "critical" in 2008. A review of the actuarial methods being used by Plan C produced two areas where a change could be beneficial.

There are a number of different actuarial cost methods that were acceptable under the pre-PPA funding rules and continue to be acceptable under PPA. The most commonly used methods for multiemployer plans are the Unit Credit Cost Method and the Entry Age Normal Cost Method. Although the effect can vary depending on the demographics of the plan, Unit Credit frequently produces a lower cost. The cost method can be changed under existing IRS procedures without prior approval, if certain requirements are satisfied (one requirement being that there has not been a change in cost method in the prior five years).

In addition to the change to Unit Credit, combining amortization credit bases can also help extend the date of the expected Funding Deficiency. Under pre-PPA funding rules, which

remain in effect, a plan establishes bases to be amortized for various reasons, including plan amendments, actuarial gains or losses, changes in actuarial assumptions, and change in actuarial cost method. These bases can be increases (charge bases) or decreases (credit bases) in liability and are amortized over IRS-specified periods of time. For example, plan amendments had been amortized over 30 years (however, PPA reduces this to 15 years) while actuarial gains or losses are amortized over 15 years. Plan C has a large outstanding credit base that will be fully amortized in three years. At that time the minimum contribution requirement increases significantly. By combining Plan C's credit bases, which is permitted under IRS regulations without prior approval, the expected Funding Deficiency is eliminated.

The effect of these changes on the projected Funding Standard Account Credit Balance is shown by the set of graphs on page 4.

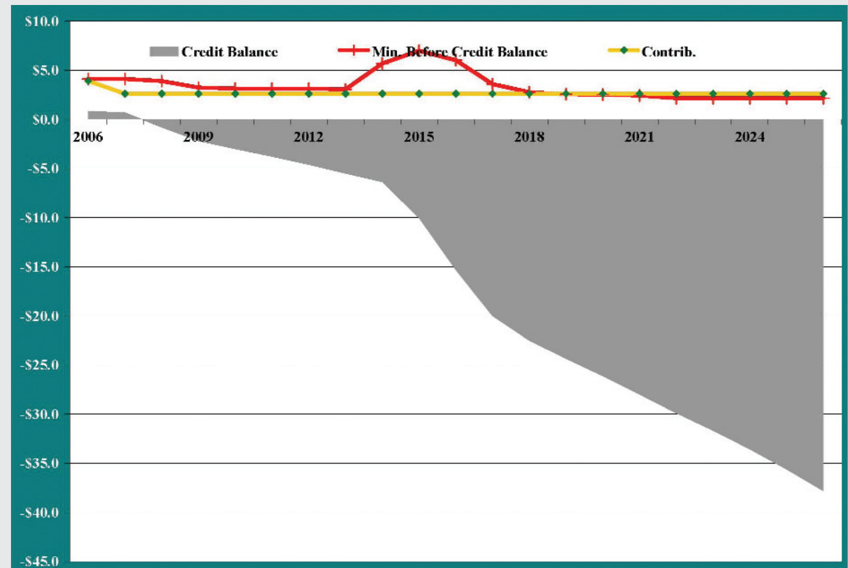
Other changes may be needed to stabilize the plan's long-term actuarial status, but the change in cost method will give the Trustees and the bargaining parties time to address the financial issues and long-term changes.

Other Approaches

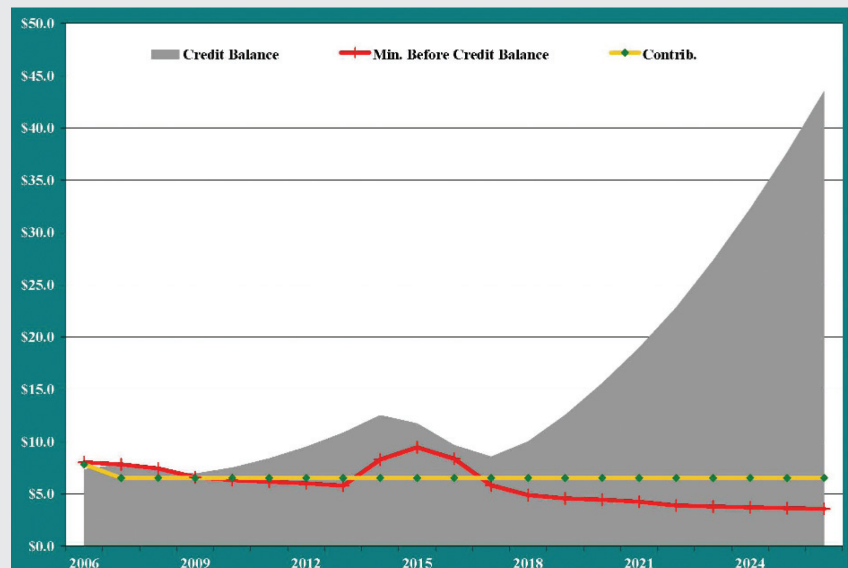
In some situations, increases in contributions or reductions in the rate of future benefit accruals may be necessary. However, in certain instances a re-allocation of contributions can be used to address the need for additional contributions for the Pension Fund. Where there is a Health & Welfare Fund and/or an Annuity Fund, some Collective Bargaining Agreements provide for a change in the allocation of future contributions among the Funds. Subject to review of potential fiduciary issues by Fund counsel, this may be a possible alternative.

With regard to reductions in the rate of future benefit accruals, if this is necessary, the immediate effect on those retiring in the next few years will in many cases be relatively small. Since the benefit that an individual has earned over his career cannot be reduced, the effect on his total pension if he retires during the next year or two will only be a reduction in a year or two of accruals, and not on the benefit he had earned prior to the change. Thus the Trustees will have

Projected Funding Standard Account Credit Balance - Before Changes:



Projected Funding Standard Account Credit Balance - After Changes:



an opportunity over the next several years to address the financial stability of the plan and consider other actions.

Conclusion

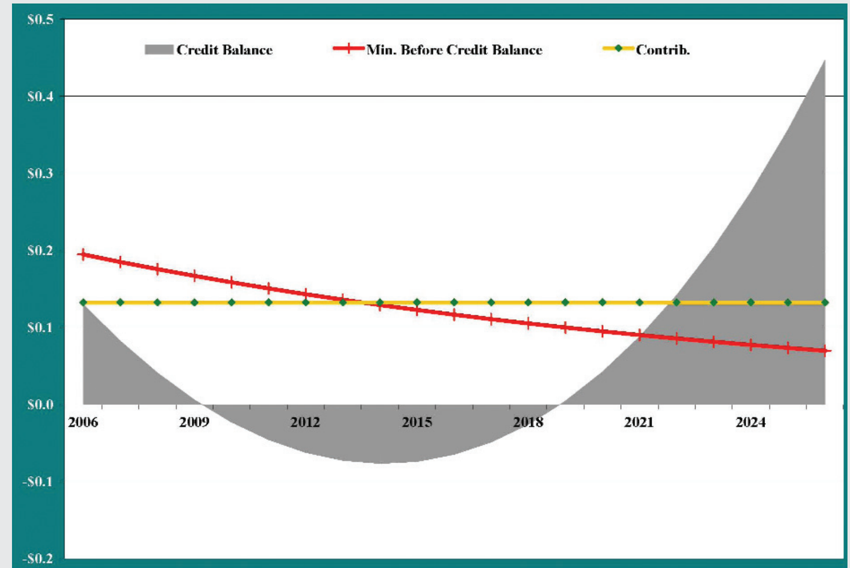
These case studies illustrate some of the options and strategies that have actually been used to address potential PPA funding issues. As the case studies show, each plan has its own unique set of circumstances which must be considered in formulating an appropriate strategy. Factors such as the economic prospects in the industry, number of retirees compared to active employees, contribution levels, and history of plan changes, among others, need to be considered. Moreover, dealing with PPA funding issues will require that employer and union trustees, as well as the plan actuary and legal counsel, work together to determine the optimum solution.

In some cases critical or endangered status may only be postponed, not permanently avoided. Thus, while tweaking the funding rules may save the plan from being classified as endangered or critical for 2008, it will simply put off the day of reckoning. In those cases, Trustees and bargaining parties should begin working together as soon as is feasible to develop mutually acceptable solutions to the impending stricter funding rules.

Our next Advisory will discuss strategies and actions that trustees should consider for plans that expect to be classified as endangered or critical next year.

Cheiron is a full-service actuarial consulting firm assisting corporations, public employers and Taft-Hartley sponsors to manage their benefit plans proactively to achieve strategic objectives and safeguard the interests of plan participants and beneficiaries.

Projected Funding Standard Account Credit Balance - Before Changes:



Projected Funding Standard Account Credit Balance - After Changes: