



Pension Protection Act of 2006 — Taking Stock and Keeping Pace

IN THIS
ISSUE

Key Provisions of the Pension Protection Act

Nearly two years have passed since Congress enacted the Pension Protection Act (PPA) of 2006. This landmark legislation marks the most comprehensive overhaul of the nation's retirement benefit laws since the Employee Retirement Income Security Act (ERISA) of 1974. It is timely to take stock of the PPA. The broad scope of this regulatory reform impels plan sponsors to review their retirement plans to ensure compliance with PPA.

In this edition of *Measuring Up*, we summarize key provisions of the PPA for single-employer defined benefit and defined contribution plans. We also discuss methods to help plan sponsors maintain compliance with the PPA.

Although our discussion of defined benefit plans focuses on single-employer plans, we acknowledge that the PPA includes provisions that address the unique features of multi-employer plans.

Single-Employer Defined Benefit Plans

PPA Provisions

The PPA strengthens funding standards for pension plans. The PPA targets more stringent funding standards by addressing the following issues:

- Funding levels
- Contribution amounts
- Asset valuation methods
- Liability valuation methods
- Benefit restrictions
- Reporting and disclosure requirements

The PPA imposes minimum plan funding standards based on the following funded ratios:

FIGURE ONE

Funded Ratios

PLAN YEAR BEGINNING	FUNDING LEVEL
2008	92%
2009	94%
2010	96%
2011	100%

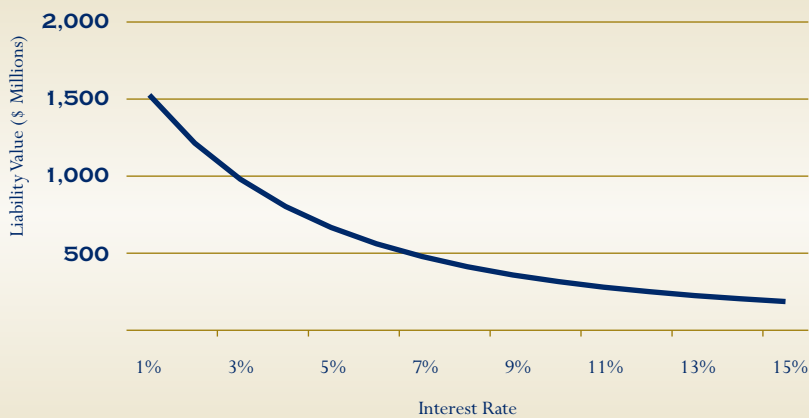
The funding level measures the plan's ratio of assets to the liability. The plan must amortize any unfunded liability over seven years. The minimum required contribution in a given year is the sum of the normal cost (the present value of benefits accrued during the current year) plus the amortization of any unfunded liability. A plan will not be considered in an unfunded position if it meets the transitional funding levels in *Figure One*. If the plan does not meet the above transitional funding requirements, it will not benefit from the transitional relief afforded by the above transitional percentages.

Plans must compute the funded ratio in accordance with guidelines for valuing assets and liabilities. IRS regulations prescribe asset valuation techniques based on market values. A plan can compute the asset value based on a 24-month window subject to the requirement that the computed value must fall within a band of 90% to 110% of the fund's market value on the valuation date.



FIGURE TWO

Interest Rates & Pension Plan's Liability Relationship



The PPA calls for the IRS to specify mortality tables to guide sponsors in their computation of liability values. The IRS will construct such tables based on pension plans' actual mortality experience and projected trends. The PPA prescribes methods for determining the discount rates that plan sponsors will apply to derive liability values. In 2008, the IRS began issuing discount rates based on corporate bond yields. The IRS blends rates from the three highest quality categories (AAA, AA and A), and it segments the rates based on benefit payment schedules: 0 – 5 years, 5 – 20 years, and over 20 years. The IRS averages these corporate rates over the past 24 months.

The PPA restricts benefits under certain conditions. For example, a plan with a weak funded ratio will be limited in its ability to pay lump sums. Moreover, a plan will not be able to increase benefits if its funded ratio falls below a certain level.

The PPA imposes comprehensive reporting requirements. A plan must disclose data pertaining to participant characteristics, funded position, investment structure and other information to the PBGC, participants and beneficiaries.

Management Implications

The PPA re-enforces the importance of linking the management of a plan's investment portfolio with the economic characteristics of the liability. Congress has mandated that each plan must maintain an asset level close to the liability amount. Moreover, the PPA has stipulated a liability measurement framework that pegs the liability to capital market conditions – corporate interest rates, albeit with a 24-month smoothing provision. A plan's asset value will also exhibit sensitivity to market conditions, even though the PPA permits certain smoothing provisions. Inadequate asset/liability management might expose a plan to a significant funding shortfall. Such a shortfall might jeopardize the plan participants' benefit security and imperil the financial health of the sponsoring organization.

Plan sponsors generally understand how a balanced investment portfolio of equities and fixed income can fluctuate over time. It is equally important to recognize how the value of the liability can fluctuate. *Figure Two* displays the sensitivity of the liability of a typical pension plan to changes in interest rates. Many plans bear a high degree of interest rate sensitivity in liability values given the long duration of the stream of benefit payments. Benefit payments extend for over 50 years for a typical plan. The long duration of the liability exposes the plan to the risk of a decline in interest rates. A decline in interest rates will raise the liability, thereby reducing the plan's funded position and increasing the risk of higher contributions.

For multi-employer plans, the method for computing the liability differs from the method for single-employer plans. Multi-employer plans discount liabilities based on the long-term expected investment return rather than on recent interest rates. The calculation of a multi-employer plan's funded ratio is therefore more sensitive to the assumed long-term investment return and less so to changes in recent interest rates as a single-employer plan.



A sponsor can apply several policy levers to improve a plan's funded position and to reduce the risk of a funding shortfall:

- **Duration of fixed-income portfolio** – change the duration of the fund's fixed-income portfolio to more closely match the interest rate sensitivity of the liability.
- **Asset allocation** – change the fund's allocation between equities and fixed income to alter expected return and risk.
- **Contributions** – accelerate the pace of contributions to increase the funded ratio.
- **Benefit Provisions** – reduce the level of future benefit accruals to curb liability growth.

An integrated asset/liability model can help a plan sponsor quantify how a given change in one or several of the policy levers might affect the plan's funded position in probabilistic terms. This framework can help a sponsor to reach informed judgments about the appropriate applications of financial resources and prudent levels of capital market risk. *Figure Three* illustrates the output from such a model. The chart shows how changes in each policy lever might affect a typical plan's funded ratio in probabilistic terms. The various percentiles (1st, 5th, 25th, 50th, 75th, 95th, 99th) represent potential funding ratio results, thereby conveying the potential benefits and risks of various policy decisions.

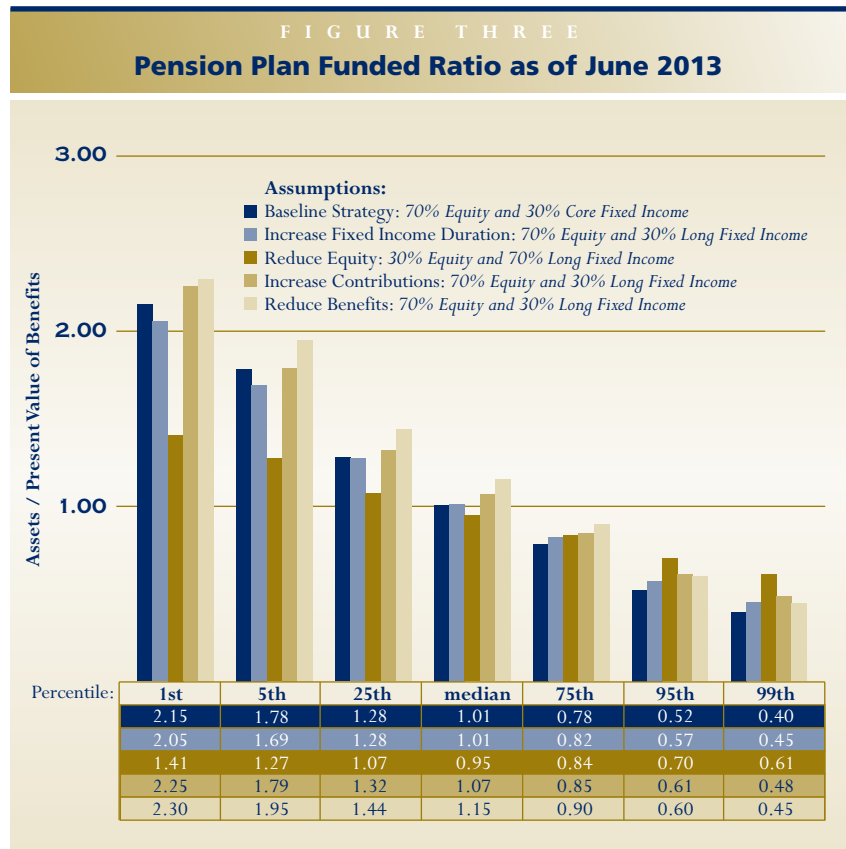
Defined Contribution Plans

PPA Provisions

The PPA stipulates key provisions:

- Automatic enrollment
- Vesting rules
- Contribution limits (EGTRRA permanence)
- Investment advice
- Investment diversification
- Distributions

The PPA permits automatic plan enrollment, subject to safe harbor deferral percentages, contribution limits and opt-out features.



The new vesting rules call for either 3-year cliff vesting or a six-year graded schedule. The PPA makes permanent the increase in contribution limits under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Several such limits apply to an individual's plan contribution, the amount of compensation that the plan can consider for a participant, deferral limits, discrimination tests and hardship provisions.

The PPA now permits plan sponsors to provide customized investment advice to participants. Previous law prohibited such advice. The PPA provides for a new class of advisors "fiduciary advisors" to counsel plan participants on investment strategy subject to two conditions:

- The advisor's fees must not vary depending on the participant's choice of investment option.
- The advisor's recommendations must be based on computer modeling.



Yanni Partners
A Division of CBS Investment Consulting, LLC

310 Grant Street, Suite 3000
Pittsburgh, PA 15219-2302



The investment diversification provisions provide safe harbor relief for plans that include options such as life cycle, asset allocation and balanced funds. For plans with employer securities, there must be at least three “materially different” investment options, and participants must have the ability to diversify out of employer securities, subject to certain three-year “phase in” rules.

The distribution provisions apply to rollovers from retirement plans to Roth IRAs, distributions to qualified charities, and other features.

Management Implications

Sponsors need to review plans’ designs to ensure compliance with PPA administrative provisions. The sponsor must also review the plan’s investment options to ensure that they conform to the PPA’s requirements as well as sound management standards such as adherence to the fund’s mandate. It is important to evaluate the firm that manages each investment option to discern organizational stability and rigor of investment process.

The PPA also provides plan sponsors with fiduciary protection in circumstances when plan sponsors make investment decisions on behalf of plan

participants. For example, a plan sponsor might select a participant’s fund as a result of automatic enrollment. Pursuant to the PPA, the Department of Labor has issued regulations pertaining to Qualified Default Investment Alternatives (QDIA). These QDIA regulations relieve a plan sponsor of fiduciary liability for investment approaches that account for a participant’s unique circumstances (such as age, target retirement date, or life expectancy) or characteristics of the entire participant population. Life cycle, balanced and individually managed accounts offer solutions to QDIA requirements. It should be noted, however, that the QDIA regulations do not absolve plan sponsors from the fiduciary obligations to evaluate, select and monitor investment vehicles in a prudent and rigorous manner.

Conclusions

For defined benefit plans, the PPA accentuates the importance of effective asset/liability management. For defined contribution plans, the PPA prompts the need to review the plans’ designs from both administrative and investment standpoints. Yanni Partners and Gallagher Benefit Services look forward to helping plan sponsors meet their obligations under the PPA.

Yanni Partners provides a full range of consulting services vital to the management of various portfolios. Our ultimate goal is to offer a basis for improved investment monitoring and performance.

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Yanni Partners thanks Lee J. Buchele, Senior Consultant with Cowden & Associates, Inc., Pittsburgh, PA for his review and input for this issue. Mr. Buchele is an Enrolled Actuary, a Fellow of the Society of Actuaries and the Conference of Consulting Actuaries, and a Member of the American Academy of Actuaries.

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If you have any questions or comments concerning *Measuring Up*, please contact: Lisa M. Marcotullio, Director of Operations Phone: 412.232.1000 Email: marcotullio@yannipartners.com Web: www.yannipartners.com