

## Defined Benefit Summary (March 2009): Why CFOs need more funding relief to limit the impact of pensions on financial statements

The Worker, Retiree, and Employer Recovery Act (WREERA) was signed into law in December 2008, providing modest funding relief for pension plan sponsors. However, as many financial executives are determining their pension's 2009 funded status and subsequent cash requirements, it is apparent that additional funding relief is needed. In fact, a recent statement from the ERISA Industry Committee (ERIC) suggested US employers face some \$65 billion in unexpected additional pension contributions in 2009<sup>1</sup>.

Corporations sponsoring pension plans are already under extreme financial pressures as access to cash continues to be a challenge. As many organizations report year-end financials, it is clear that many are, or will soon be, facing cash flow concerns due to decreased revenues, reduced shareholder equity and ongoing dry credit markets. Without further funding relief this year, pensions will have a significant impact on corporate operations with under-funded liabilities draining needed cash flow from plan sponsors' operations. The overall state of the pension funding problem was recently put into perspective when the president and CEO of the ERISA Industry Committee (ERIC) said "there are companies out there faced with paying their pension plan or staying in business."<sup>2</sup>

This summary is designed to provide senior financial executives with a brief overview of why more pension funding relief is needed, the potential impact pensions can have on corporate finances this year and specific components of what additional relief might contain.

### WHY IS MORE FUNDING RELIEF NEEDED?

Simply put, WREERA was not enough and the impact is much less than anticipated. Even with WREERA relief, in 2009 plan sponsors are still expected to fund pensions toward a 94% funded level. Contribution requirements in 2009 are expected to be two to four times 2008 contribution requirements which will be extremely difficult for many organizations. Despite relief, the substantial losses incurred during 2008 are still being funded over a seven year period, forcing large increases in contribution amounts and in many cases threatening the sponsor's viability.

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<sup>1</sup> Lack of Pension Funding Relief in Stimulus Bill Will Harm Recovery and Jobs The ERISA Industry Committee (February.10 2009)

<sup>2</sup> [Pension bombs going off](#) Crain's Chicago Business (March 2, 2009)

These challenges face plans that were well funded heading into 2008, but for poorly funded plans prior to last year the situation is even worse:

- **Plans under-funded in 2007 received no relief – costs will actually increase**

These plans were making headway in funding their deficits in 2007 and 2008, although that was before 2008 losses were incurred. The specifics of WRERA contained new relief measures as well as technical corrections to the Pension Protection Act (PPA) of 2006. One of the relief provisions was to ease the transition rule in PPA for plans to fund to 100%. The amendment specifically excluded from relief plan sponsors that made deficit reduction contributions for 2007. This would include any plan that was under 80% funded in 2007 as well as some plans that were 80-90% funded. Based on industry data, SEI determined that more than 10% of all US plan sponsors fall into this category and are therefore not even eligible for the funding relief.

Furthermore, technical corrections to PPA that were part of WRERA added a measure around normal cost and the inclusion of administrative expense that had previously been excluded. As a result, plan sponsors now will need to include administrative expenses being paid from the plan's assets in calculating the plan's cash funding cost. This is a cost that had not previously existed and will increase the overall pension expense. In conclusion, many US plan sponsors will not only see no funding relief but will actually see pension cost increase.

## WHAT IS THE PENSION IMPACT ON CORPORATE FINANCES?

The dramatic increases in contribution requirements for 2009 will be significant for plan sponsors. Companies with positive cash flow in 2007 (the most recent fully available year), can expect 2009 contributions to be approximately 55% of 2007 free cash flow. Consider further that the cash flow has decreased for most industries and geographies for 2009, driving this statistic much higher. To put it another way, pensions are going to make a difficult business environment worse.

To best illustrate the impact pensions can have on corporate finances, consider a case study example of an active pension plan that started 2008 with assets of \$92 million and liabilities of \$100 million using a 6.10% discount rate. The plan's portfolio was invested in 70% equity and 30% fixed income. The plan had benefit payouts of \$4 million a year with accruals of \$2 million a year.

Under PPA and now WRERA funding rules, the plan sponsor would not have been required to fund the deficit as a result of the 92% funded status, only the Normal Cost of \$2 million would have needed be contributed for 2008. Fast forward to the close of 2008 and the updated liabilities would have been about \$104 million. The updated assets would be about \$67 million at market value and \$74 million on a smoothed basis.

On the funding side, there would be a loss amortization resulting in increased contributions of \$4M for a total contribution for 2009 of almost \$6 million. The plan's funded status would have decreased from 92% to 71%, meaning that payouts will be restricted along with the ability to improve benefits.

## WHAT SHOULD ADDITIONAL RELIEF INCLUDE?

While WRERA was a solid first step, SEI believes that it did not provide corporations with enough relief to offset the devastating impact pensions are having on corporate finances. Additional relief is needed and some components that should be considered include:

- **Allowing all plans to be eligible for the current phase-in of the funding target**  
The approximate 10% to 18% of ineligible plan sponsors should be included in the current relief provisions.
- **More smoothing of assets**  
Prior to PPA, plans could smooth asset gains and losses as long as the resulting assets were within 20% of market value. PPA reduced the asset smoothing corridor from 20% to 10% which has become extremely restrictive in today's environment. The corridor should be extended from 10% of market value to 20% or more. Additionally, consideration should be given to lengthening the smoothing period beyond 24 months.
- **Lengthening period for recognition of 2008 losses**  
Additional relief should include an extension of the amortization period beyond seven years to ten years.
- **Allow re-selection of funding methods**  
Under the current rules, once plan sponsors select a funding method for 2008 they are bound to that method for the next five years. This could potentially result in plan sponsors implementing benefit reductions. Relief should try to avoid this by permitting plan sponsors to make a re-selection of funding methods for 2009 and 2010 which would allow plan sponsors to take advantage of some benefits on the yield curve (smoothing vs. spot) and perhaps some benefits in the way that assets are smoothed (market vs. smoothed).

## CONCLUSION

While WRERA provided needed technical corrections to the Pension Protection Act of 2006, it fell short in providing relief from the minimum funding rules for the losses suffered in 2008. In many cases the businesses sponsoring defined benefit programs have no choice - they are in positions where they must choose between continuing to provide historical benefits to their employees or continuing to run a viable business. Further relief from the contribution requirements of 2009 may help sponsors to adequately plan for the cash payments needed for their pension plans in future years without compromising the viability of their businesses.

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