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Addressing Pension Funding Issues Caused by a Stock Market Downturn

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One of the many things that often cause sleepless nights among financial and human resources professionals is the pension plan. In addition to the myriad of compliance and technical issues, a new more basic uncertainty has emerged–funding. The market downturn of 2000–2001 has materially altered the funded status of privately held defined benefit plans, particularly those that were heavily invested in equities during the market run up that began in 1995.

From the beginning of 1995 until the end of 1999, the U.S. Stock Market grew at an amazing pace. During this period, the Dow Jones Industrials Average (DJIA) grew by about 232%, the Standard & Poors (S&P) 500 Index grew by about 251%, and the NASDAQ Composite Index grew by about 450% (annualized return of about 40.5% per year). However, beginning in early 2000, stock values began declining at a rapid pace. During 2000, the DJIA declined by 5%, the S&P 500 Index declined by about 9% and the NASDAQ Composite Index declined by about 39%. During the first quarter of 2001, the DJIA declined by about 8%, the S&P 500 Index declined by about 12% and the NASDAQ Composite Index declined by about 25.5%. Because of this recent stock market turnabout, many single employer defined benefit pension plans may suddenly become "underfunded."

Human resources and financial professionals would do well to take a fresh look at the current funded status of their plans. This article discusses various measures that are used to determine a pension plan's funded status (Table 1 below summarizes these measures) and offers some suggestions for addressing pension funding issues.

Table 1

Provision	Required Interest Rate (for Plan Years Beginning 1/1/2001	For Plans Covering Than 100 Participants	For Plans Covering 100 or Fewer Participants
1. *Additional Contribution Requirements*	6.21%	a. If Current Liability Percentage (CLP) ≥ 90%, exemption for current plan year.	a Exemption for current plan year (even if CLP < 80%)
		b. If CLP ≥ 80% and <90%, possible exemption for current plan year	
		c. IF CLP < 80%, subject to additional contribution requirements for current plan year.	
2. *Quarterly Contribution Requirements*	5.32% to 6.21%	a. If CLP ≥ 100%, exemption for next plan year.	a.) If CLP ≥ 100%, same as for plans covering more than 100 participants.
		b. If CLP < 100%, generally subject to quarterly contribution requirements (including liquidity quarterly contribution requirements) for next plan year	b.) If CLP < 100%, generally subject to regular quarterly contribution requirements, (but exempt from liquidity quarterly contribution requirements) for next plan year.
3. *PBGC Variable Premium Requirements*	4.67%	a. If Unfunded Vested Current Liability (UVCL) ≤ 0, exemption for current plan year.	a. If UVCL ≤ 0, same as for plans covering more than 100 participants.
		b. IF UVCL > 0, generally subject to PBGC variable premium require ments for current plan year.	b. If UVCL > 0, same as for plans covering more than 100 participants.

Table 1 (continued)

Provision	Required Interest Rate (for Plan Years Beginning 1/1/2001)	For Plans Covering More Than 100 Participants	For Plans Covering 100 or Fewer Participants
4. *Participant Notification Requirements*	Based on required interest rates for additional contribution requirements and PBGC	a. If PBGC variable premium payments are $0 for current plan year, exemption for current plan year	a. If PBGC variable premium payments are $0 for current plan year, same as for plans covering more than 100 participants.
		b. If PBGC variable premium payments required for current plan year and plan is exempt from additional contribution requirements for either current or prior plan year, exemption	b. If PBGC variable premium payments required for current plan year and plan would have been exempt from additional contribution for current plan year. requirements for either current or prior year (based on rules for plans covering more than 100 participants), for current plan year.
		c. If PBGC variable premium payments are required for current plan year and plan is subject to additional contribution requirements for current and prior plan year, subject to participant notification requirements for current plan year.	c. If PBGC variable premium payments are required for current plan year and plan would have been subject to additional contribution requirements for current and prior plan year (based on rules for plans covering more than 100 participants), subject to participant notification requirements for current plan year.
5. Lump Sum Payment Restrictions For 25 Highest Paid Highly Compensated Participants	"Reasonable" and "consistent" method must be used for determining the interest rate (e.g., current liability interest rate in effect at proposed distribution date).	a. If CLP will be ≥ 110% following distribution or distribution is ≤ $5,000 or distribution is less than 1% of plan's current liability before distribution, exempt from restrictions.	a. Same rules as for plans covering more than 100 participants are applicable.
		b. If None of above requirements can be met, lump sum distributions not allowable unless participant provides "security agreement."	b. Same rules as for plans covering more than 100 participants are applicable.
6. Additional Accounting Disclosure Requirements on Balance Sheet	Determined at accounting disclosure date based an interest rate agreed to by company and its auditor.	a. If Accumulated Benefit Obligation (ABO) ≤ assets, exempt from additional disclosure requirements.	a. Same rules as for plans covering more than 100 participants are applicable.
		b. If ABO > assess, subject to additional disclosure requirements.	b. Same rules as for plans covering more than 100 participants are applicable.

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Additional Contribution Rules

Certain underfunded single-employer plans covering more than 100 participants are subject to rules requiring them to make contributions (referred to as additional contributions) that are in addition to those otherwise necessary under the minimum funding provisions. How well a plan is funded is measured by its Current Liability Percentage (CLP). CLP is equal to the ratio of a plan's assets to a plan's liabilities accrued to date. Liabilities are determined based on a mandated interest and mortality table.

For plan years beginning on January 1, 2001, plan sponsors must use an interest rate of 6.21% to determine whether the plan is subject to the additional contribution requirements. The interest rate is redetermined on a monthly basis and is based on 105% of a four-year weighted average of the 30-year Treasury rate.

Plan sponsors of plans that have a CLP greater than or equal to 90% are subject to regular minimum funding requirements but they automatically are exempt from the requirement to make additional contributions for a plan year. If a plan's CLP is greater than or equal to 80% but less than 90%, the plan sponsor may be exempt from the additional contribution requirements for a plan year if the plan's CLP during two consecutive out of the prior three plan years was greater than or equal to 90%. A plan covering 100 or fewer participants is exempt from the additional contribution requirements, even if the plan's CLP is less than 80%.

Quarterly Contribution Rules

In general, a plan sponsor must make four quarterly contributions and, thereafter, one final contribution to satisfy minimum funding requirements (including any required additional contributions) for a given plan year.

For plan years beginning on January 1, 2001, plans must use an interest rate of between 5.32% and 6.21% for determining whether any quarterly contributions for the following plan year are required. This range is determined based on 90% and 105% of a four-year weighted average of the 30-year Treasury rate for the period ending December 31, 2000.

If a plan's CLP is greater than or equal to 100%, the plan sponsor need not make any quarterly contributions (including required liquidity contributions) for the following plan year.

A plan is considered to have liquidity problems if, in general, its liquid assets do not cover three times the plan's disbursements for the 12-month period ending before the date of the plan's next required quarterly contribution. Plans with 100 or fewer participants are exempt from the liquidity quarterly contribution requirements, even if the plan's CLP is less than 100%.

PBGC Premium Provisions

The Pension Benefit Guaranty Corporation (PBGC) is the governmental agency responsible for insuring participants against the loss of pension benefits in the event that their plans terminated with insufficient assets.

For this coverage, all single-employer defined benefit plans, no matter how well funded, must annually pay PBGC flat premium payments ($19 per participant) and possibly variable premium payments.

To determine whether a plan sponsor must pay any variable PBGC premiums for a plan year, the PBGC measures a plan's Unfunded Vested Current Liability (UVCL). UVCL equals a plan's vested liabilities accrued to date (determined based on mandated interest rate and mortality assumptions), less the plan's assets. Liabilities are generally considered vested when a participant has five or more years of service.

If a plan's UVCL is positive, the plan sponsor generally must pay a variable PBGC premium equal to $9 for each $1,000 of UVCL for the plan year. For plan years beginning on January 1, 2001, the required interest rate for determining UVCL is 4.67% (i.e., 80% of the 30-year Treasury rate for December 2000).

Participant Notification Rules

If a sponsor is required to pay PBGC variable premiums for a plan year, participants must be notified of the plan's underfunded status unless the plan is exempt from the additional contribution requirements for either the current plan year or the prior plan year (without regard to the 100-participant or less exception). The special notice also must inform participants about the possible consequences of being in an underfunded plan. Plans with 100 or fewer participants do not escape the notification requirements.

Highly Compensated Participant Lump Sum Restriction Rules

Plans that would have a CLP less than 110% following the payment of a lump sum distribution to certain "highly compensated" participants (i.e., for plan years beginning on January 1, 2001, generally a participant making greater than $85,000 during the 2000 calendar year) generally are precluded from paying the lump sum. If a plan does not meet the above requirement (or other possible exceptions), the lump sum could still be paid, but only if the plan document requires that a "security agreement" be procured from the participant.

FAS132 Pension Plan Disclosure Rules

Plans that have an "Accumulated Benefit Obligation" (ABO) that exceeds assets as of a given disclosure date are required to disclosure on the sponsoring company's balance sheet the plan's unfunded ABO (i.e., a balance sheet liability) rather than the prepaid expense (i.e., a balance sheet asset) that otherwise would have been shown. ABO equals a plan's liabilities accrued to date determined based on

assumptions agreed to by the company and plan auditor. The interest rate used to determine to ABO is typically set equal to a rate no higher than AA qualify corporate bond rates in effect at the date of disclosure (e.g., for a disclosure as of December 31, 2000, the Moody's AA corporate bond rate was about 7.5%).

Addressing Various Underfunded Plan Issues

The current low interest rate environment (which increases plan liabilities) combined with recent poor investment performance greatly increases the possibility that a plan will be affected by one of the above "unfunded" plan issues.

Plan sponsors will want to take steps to eliminate the need to make the additional contributions for a plan year if the plan has a CLP below 80%. Having a CLP at that level could result in plan sponsors:

- Having unexpected cash outlays and a volatile situation with respect to future pension contribution requirements; and
- Likely paying higher annual PBGC premiums having to provide a notice to participants about the plan's underfunded status.

Many plan sponsors with a CLP below 100% also will find it desirable to avoid having to make the quarterly minimum required contributions for an ensuing plan year. Quarterly contributions can create financial hardships for plan sponsors with cash flow problems who would prefer having the flexibility of making the required plan contributions on the latest possible date.

Plan sponsors will want to eliminate having to pay the PBGC variable premiums because this is money that might be better spent elsewhere (e.g., funding existing pension benefits, other corporate uses). Like the additional contribution requirements, variable premium payments may result in an unexpected cash outlay that prospectively can be volatile.

Most plan sponsors will want to avoid having to issue the special notice to participants because it can create participant misunderstanding about a plan's financial situation and its ability to pay pension benefits. Thus, the notice could lead to employee relations and morale problems. Likewise, most plan sponsors will not want to deal with having to inform any highly compensated participant that they may not be allowed to receive a lump sum distribution of their pension benefit.

Most companies will want to avoid the additional pension plan disclosure rules since this could affect their ability to borrow money (i.e., a bank is less likely to loan money to a company with an unfavorable balance sheet) and, in the case of publicly traded companies, affect stock prices.

Practical Solutions to Unfunded Plan Issues

The solution to most of the concerns raised in this article is to maintain a funding policy requiring the plan's CLP always to be greater than or equal to 90%. This will eliminate the additional contribution requirements and participant notification requirements and help reduce the need to pay variable PBGC premiums. If a plan's funding policy requires that the CLP always be greater than or equal to 100%, quarterly contribution requirements also will be eliminated and PBGC variable premium requirements will be further reduced or possibly eliminated.

If a defined benefit plan offering lump sum distributions maintains a funding policy that requires the CLP to be always greater or equal to 110%, lump sum distribution restrictions for all highly compensated participants will be eliminated.

An advantage of maintaining these types of funding policies is the enhancement of a company's income statement/balance sheet by improving Financial Accounting Standard #87 and #132 pension expense results. Also, the plan sponsor will reduce exposure to possible large, immediately payable contribution requirements if an underfunded plan must be terminated.

An additional option to consider at this time is the possibility of changing the plan's asset method for funding purposes in order to defer recognition of recent adverse investment performance. This would be in lieu of making unexpected additional contributions that would otherwise be necessary to bring the plan's CLP up to a given level. It should be noted that an asset method change for funding purposes would not address the additional balance sheet disclosure issue. The IRS has several automatically approved asset methods available to plan sponsors. However, the IRS only allows a plan to change its asset method with automatic approval every five years.

On an annual basis, an enrolled actuary should help the plan sponsor develop a recommended contribution schedule. This entails carefully selecting and monitoring all nonmandated actuarial assumptions and methods, advising on and monitoring the timing of all plan contributions and projecting any future problems due to known events (e.g., adverse investment performance, legislative changes, benefit improvements and demographic changes) **(tables 2 and 3 provide an example of this type of proactive consulting).**

Conclusion

The combination of the current low interest rate environment (which increases plan liabilities) and recent unfavorable investment performance make it imperative to minimize all unfunded pension plan related financial problems now. Pension plan sponsors should carefully review their latest actuarial results and identify any potential issues. An action plan should be immediately developed to resolve any existing funding, PBGC premium, participant notification and balance sheet concerns.

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Table 2

ABC COMPANY PENSION PLAN

Overview
The ABC Company Pension Plan had a CLP greater than or equal to 90% for its January 1, 1998 and January 1, 1999 actuarial valuations and a CLP equal to about 84% for its January 1, 2000 actuarial valuation. Therefore, a CLP at least equal to 80% is required for the January 1, 2001 actuarial valuation to avoid additional minimum funding requirements for the 2001 plan year. Quarterly contributions are required for the 2001 plan year since the plan's CLP was less than 100% as of January 1, 2000.

Due primarily to very poor 2000 investment performance (i.e, the plan earned about a 1% return), the plan was almost subject to additional FAS132 disclosure requirements as of December 31, 2000 and will be subject to additional funding requirements for the 2001 plan year due to having a January 1, 2001 CLP of about 75% *unless* action is taken to bring the plan's CLP as of January 1, 2001 up to at least 80%.

The plan's actuary completes the January 1, 2001 actuarial valuation prior to September 15, 2001 (i.e., the deadline for making additional contributions for the 2000 plan year) and provides ABC Company with various options (see below) for bringing the plan's CLP up to at least 80% as of January 1, 2001.

The plan's minimum funding requirement for the 2000 plan year has already been satisfied as of December 31, 2000.

Making an additional contribution for the 2000 plan year would reduce the possibility of losing the plan's prepaid pension cost on the ABC Company balance sheet in conjunction with FAS 132 disclosure requirements as of December 31, 2001.

SUMMARY OF FUNDING OPTIONS FOR 2000 PLAN YEAR BASED ON JANUARY 1, 2001 ACTUARIAL VALUATION RESULTS

Option	Implications
1. No asset method change on 1/1/01 and make no additional contributions for the 2000 plan year.	Additional minimum funding requirements applicable for 2001 plan year and possible underfunded notice for 2002 plan year. CLP will need to be at least 90% as of 1/1/02 to avoid additional minimum funding requirements and underfunded notice for the 2002 plan year.
2. No asset method change on 1/1/01 and contribute an additional amount by 9/15/01 for the 2000 plan year year to make CLP as of 1/1/01 at least equal to 80% (option 2A) or equal to 90% (option 2B).	Avoid additional minimum funding requirements for the 2001 plan year and underfunded notice for 2002 plan year. CLP will need to be at least 90% as of January 1, 2002 to avoid additional minimum funding requirements for the 2002 plan year.
3. Change to asset "smoothing" method on 1/1/01 and contribute an additional amount by 9/15/01 for the 2000 plan year to make CLP as of 1/1/01 at least equal 80% (option 3A) or equal to 90% (option 3B).	Avoid additional minimum funding requirements for the 2001 plan year and underfunded notice for 2002 plan year. CLP will need to be at least 90% as of January 1, 2002 to avoid additional mini-to mum funding requirements for the 2002 plan year.

Table 3

ABC COMPANY PENSION PLAN

JANUARY 1, 2001 ACTUARIAL VALUATION RESULTS

	2000 Plan Year Results	2001 Plan Year Results (Option 1)	2001 Plan Year Results (Option 2A)	2001 Plan Year Results (Option 2B)	2001 Plan Year Results (Option 3A)	2001 Plan Year Results (Option 3B)
Regular Minimum Funding Requirements*	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 400,000
Additional Minimum Funding Requirements*	0	750,000	0	0	0	0
Credit Balance**	0	0	(500,000)	(1,500,000)	(100,000)	(1,100,000)
Minimum Required Contribution	$ 400,000	$1,150,000	$ 0	$ 0	$ 300,000	$ 0
Current Liability Percentage (assets divided by the present value of accrued benefits using IRS mandated interest rate and mortality assumptions)***	84%	75%	80%	90%	80%	90%
Additional 2000 Plan Year Contribution Made By 9/15/2001	N/A	$ 0	$ 500,000	$1,500,000	$ 100,000	$1,100,000
FAS87 Pension Expense	$ 200,000	$ 300,000	$ 300,000	$ 300,000	$ 300,000	$ 300,000
FAS 132 Prepaid (Accrued) Pension Cost at end of year****	$1,100,000	$1,200,000	$1,700,000	$2,700,000	$1,300,000	$2,300,000
Market Assets at end of year****	8,100,000	8,850,000	9,350,000	10,350,000	8,950,000	9,950,000
Accumulated Benefit Obligation (ABO) at end of year****	8,000,000	8,850,000	8,850,000	8,850,000	8,850,000	8,850,000

* Regular requirements are made by the ABC Company by the end of the year. Additional requirements are made by the ABC Company during the following year prior to September 15, 2002.

** The "credit balance" represents contributions greater than minimum funding requirements and can be used to reduce future minimum funding requirements.

*** Asset method change (options 3A and 3B), effective January 1, 2001, results in a $400,000 increase in assets for funding purposes as of January 1, 2001.

**** Results as of December 31, 2001 are estimated. If ABO exceeds assets at December 31, 2001, the Prepaid (Accrued) Pension Cost would be reduced to the unfunded ABO.