PENSION PROTECTION ACT REGULATORY UPDATES AND THEIR EFFECTS ON LIABILITY DRIVEN INVESTMENT STRATEGIES

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Introduction

When the Pension Protection Act (PPA) was released in 2006, the general thrust for defined benefit retirement plans was to require more stringent funding requirements with less flexibility in setting the assumptions used to calculate plan contributions. The new regulations also created many questions on various implementation approaches and calculations. Yet, when PPA became effective for pension plan years beginning in 2008, many of these questions were left unanswered. This meant that actuaries had to use their best judgment in interpreting the regulations and deciding how to apply them to their clients' pension plans. Every few months since that time, the IRS has been providing additional pieces of guidance and clarification on the new rules.

The impact of the lack of clarity was amplified by the market decline of 2008 and early 2009 and the accompanying volatility, and ultimate decline, in interest rates. Over this time, pension assets declined by roughly 25%, and interest rates fell to historical lows, just in time for year-end FAS accounting disclosures and funding valuations for calendar year pension plans. The "perfect storm" had just occurred for the second time in this decade.

In March 2009 the IRS responded with some positive changes regarding interest rate choices for valuations; then, in October 2009, the most recent regulatory update stated that any acceptable interest rate methodology, asset valuation method, and valuation date change will have automatic approval in plan years 2008, 2009, and 2010. Thus, plan sponsors, along with their actuaries, can choose assumptions that most benefit the plan (i.e. highest discount rates and highest asset value) without any repercussion on these decisions until the 2010 plan year. The rate and asset methodology used in 2010 will then be the methodology that plans must use going forward, unless approval is sought from the IRS. So, what does this mean for pension plans?

Funding Relief

While formal funding relief was debated in Congress, no bill was passed. The IRS guidance in March of 2009, however, allowed pension plans to choose the highest discount rate out of the last 5 months before their plan year to value 2008 and 2009 liabilities. The new guidance was a form of "relief", especially for many plans with calendar valuation dates, since it allowed the inflated corporate bond yields from October 2008

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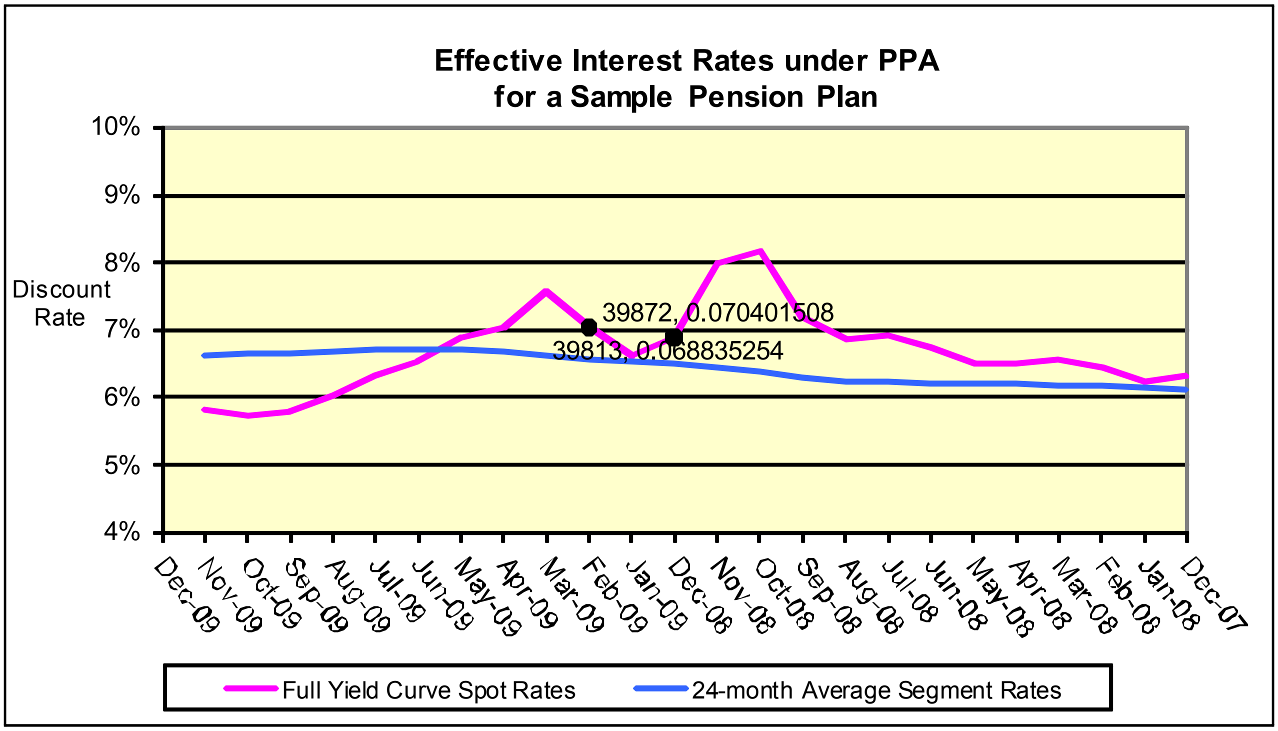
(approximately 8.2% effective rate) to be used to discount January 1, 2009 liabilities, versus using the lower rates as of December 31, 2008 (around 6.9% according to the IRS full yield curve under PPA).

For the average pension plan with liability duration of 12-16 years, this change in discount rate choice could mean a 20% lower liability value when discounted with the higher October 2008 rates. For some plans, this liability decrease was almost equivalent to the decrease in pension assets for 2008, thus resulting in virtually no decline in funded status from January 1, 2008 to January 1, 2009. Now that's pension relief!

After the March regulation update, one question still remained: if plans used the full yield curve rate methodology in 2009, would they have to use the full yield curve in 2010 and beyond, or would they have the choice of using the 24-month average segment rates would most likely provide a higher discount rate in 2010, since the inflated rates from October and November 2008 would be included in the averaging. The recent IRS rulings answered this question by stating that any discount rate methodology would receive automatic approval from the IRS in 2010, thus giving plan sponsors no reason NOT to use the highest possible rates from the PPA full yield curves that were allowed.

For those pension plans with plan years between April and October, however, this new IRS guidance offers less relief. This includes many healthcare companies and educational institutions with July 1 valuation dates. Look-back months for choosing discount rates for these plans are June 30 back through February 28, months in which corporate bond spreads had begun to tighten from historic wides at the end of 2008. Therefore, these plans have not had the same windfall in 2009 valuations as calendar year plans which were able to employ unusually high discount rates. Sponsors of these plans may still be looking for relief from Washington before their 2009 valuations and contributions are due.



Asset Valuation Methods

In addition to flexibility on liability discounting assumptions, the asset valuation method selected can also change without IRS approval for plan years 2008 through 2010. Plan sponsors typically smoothed asset values prior to PPA. Switching between smoothed asset values and current market values required IRS approval which discouraged plan sponsors from "gaming" the process. PPA regulations effective in 2008 shortened the acceptable smoothing period from 5 years to 24 months, and reduced the corridor limit around market value from 80%-120% to 90%-110, therefore limiting the value of smoothing. Further, plan sponsors who hedged their plans' interest rate volatility with Liability Driven Investment (LDI) strategies are better served using non-smoothed asset values as assets and liabilities were better matched.

Because of the sharp decline in pension assets in 2008 and the first quarter of 2009, for their 2009 valuations, many plan sponsors may decide to smooth their assets over the longest possible period. This would allow for the recognition of 2008 asset losses to be spread over three valuation years but may provide only marginal relief under the tighter smoothing rules. With most plans losing 20% to 30% of their assets in 2008, the choice to smooth their actuarial value of assets may provide only limited smoothing since most plans' assets will be capped at 110% of market value for 2009 valuations.

It is important to note that changing from market value to smoothing, or vice-versa, without IRS approval is only a temporary situation. The asset valuation method in place for the 2010 valuation will have to be used in subsequent years unless IRS approval is obtained. Switching from smoothed to market value is usually automatic, but the reverse will not be.

Impact on Liability Driven Investing Strategies (LDI)

Hedging liabilities is easier when both assets and liabilities are marked to market. The recent PPA regulations will most likely cause plan sponsors to value liabilities with the October 2008 full yield curve (market) and a smoothed value of assets. In 2010, plan sponsors will most likely choose the 24-month average segment rates (smoothed) and continue to use a smoothed value of assets.

By smoothing assets and liabilities, the benchmark for a liability hedge becomes less clear. Nevertheless, we believe the importance of hedging interest rate movements remains. While assets and liabilities may be smoothed in the near future, the underlying economic funded status of the pension plan still exists. It is the volatility of this underlying ratio that we aim to reduce by better asset-liability matching.

It is important to recognize that the recent IRS regulations will dampen contribution volatility in the short term while pushing ultimate funding out to future years. Once the temporary funding relief passes, we believe that LDI strategies will be an essential tool for managing funded status of defined benefit programs in the long term on both an accounting and economic basis. Lastly, coordinating actuarial funding decisions and investment strategies has always been important, but it will be even more so given the new regulatory landscape.

At NEPC we strive to help our clients meet their investment objectives given the changing regulatory landscape. For further discussion of these important matters, please speak with your consultant.

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