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The New Pension Law “PPA”: Main Provisions and Possible Implications

Q Group Seminar

Mark J. Warshawsky,
Director of Retirement Research
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Agenda

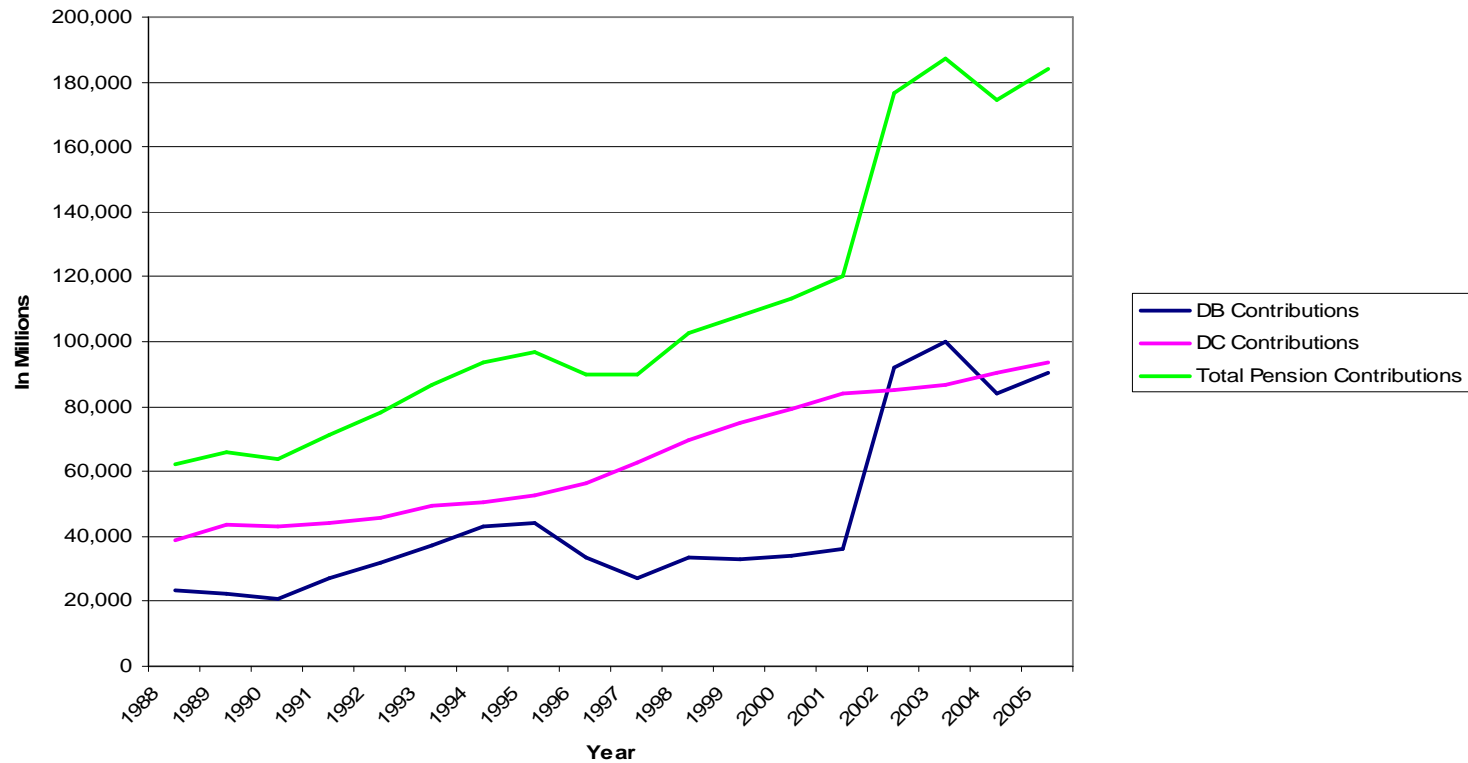
- Key changes in funding requirements (and opportunities) for single-employer DB plans
- Benefit Limitations and At-risk plans
- Simulated illustrations of Funding Rules: New vs. Old
- PBGC Premiums and Disclosure requirements
- Hybrid plans
- Multiemployer plans
- Other notable DB changes
- Significant new DC rules
 - Automatic Enrollment
 - DoL Proposed Regulation on Default Investment
 - Watson Wyatt Survey Results on DoL Proposal
 - Simulations of Balanced and Life Cycle Funds
 - Other PPA Provisions
- Possible Implications

Some Initial Quotes about PPA

- “Change to boost 401(k)s, put brakes on pensions: Bush likely to sign bill that experts say will doom defined-benefit plans”
Dallas Daily News, August 7, 2006
- “The Pension Era, R.I.P.” Wall Street Journal editorial, August 4, 2006
- “...but the new law’s funding regime for most pension plans – including most well-funded plans – is troubling. By injecting more volatility into employers’ pension funding obligations, the law is likely to accelerate the trend away from defined benefit plans.” James Klein, President, American Benefits Council, press release.

Historical Contributions by Private Employers to Pensions: Actual Operation of Old Law

Nominal \$ Contributions by Private Employers to Pensions: 1988-2005
Source: Bureau of Economic Analysis



Key Changes in Funding Requirements

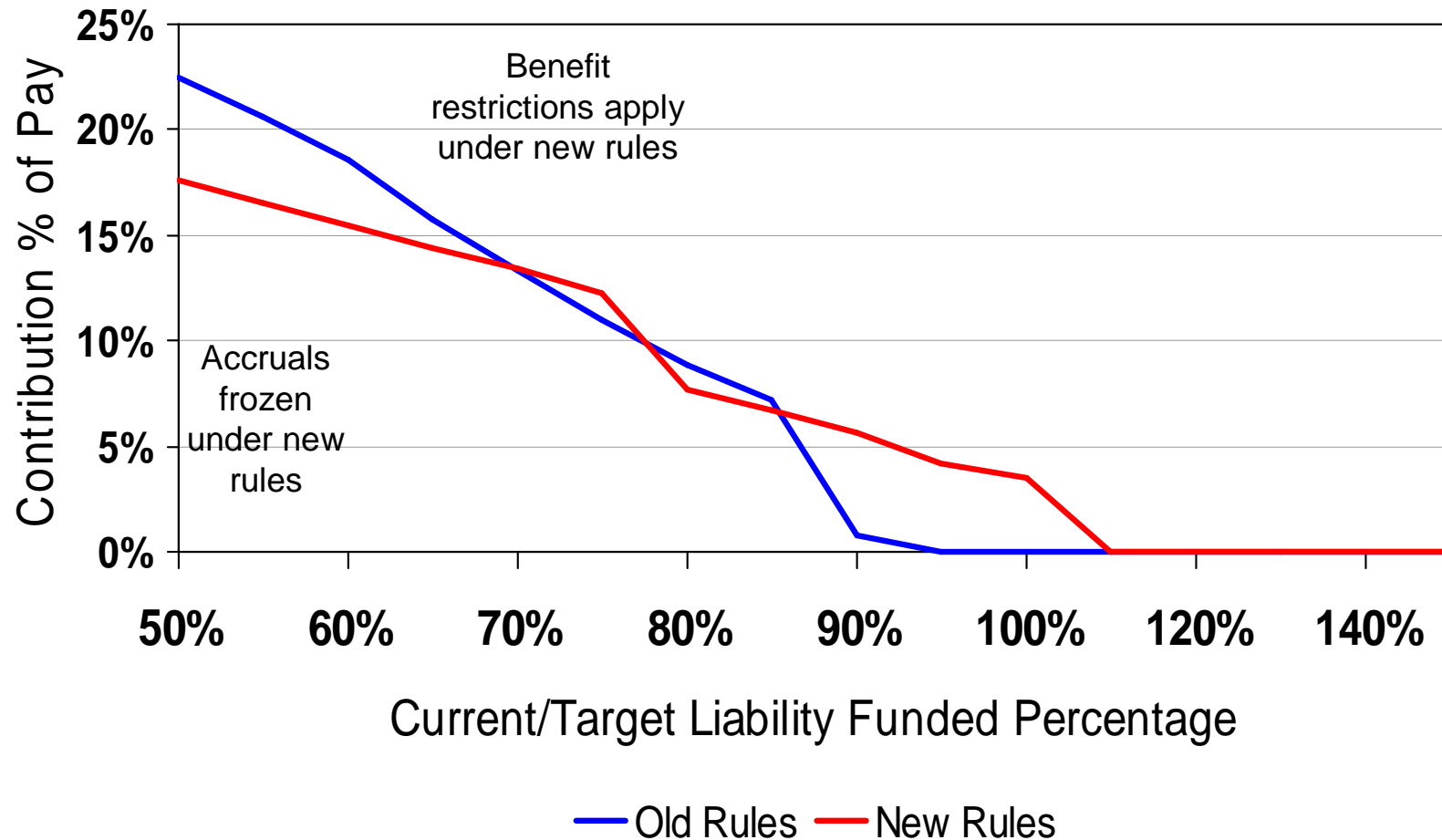
- Now one essential measure of target liability for plan, akin to the ABO in financial accounting parlance. (Old law used (somewhat less than) 90% of “current liability” or 100% of “actuarial liability”.)
- Corporate bond spot curve (instead of 30-year Treasury) and projected mortality table used for liability measurement; subsidized lump sums reflected.
- Funding shortfall amortized in seven years plus the normal cost (instead of deficit reduction contribution regime).
- “Credit balances” may be used to reduce funding requirements, within constraints, but are marked to market and generally subtracted from measured assets (in old law this area was subject to abuse).
- Many transition rules and some exceptions and elections.
- Maximum deductible contributions allowed until funding reaches 150% of target liability plus value of usual future increases.
- Also aggregate limit on deductible contributions of 25% of pay is considerably loosened.

Benefit Limitations and At-risk plans

- If DB plan has funded status of less than 60%, it is essentially required to be frozen; also no lump sums may be paid.
- Between 60 to 80%, benefit increases are generally not allowed and limitations on lump sums.
- Above 80% (or 100% even considering credit balances), no benefit limitations.
- Credit balances automatically reduced if benefit restrictions are triggered.
- Plan is at-risk if it is less than 80% funded (standard target liability) and less than 70% funded reflecting immediate utilization of subsidized early retirement and lump sums for those nearing retirement (“at-risk liability”). Also sometimes an administrative load is added.
- Result is slightly higher funding required for at-risk plans; also sets off restriction on funding of NQDC plans and higher PBGC premiums.

Minimum Required Contributions: New versus Old Law

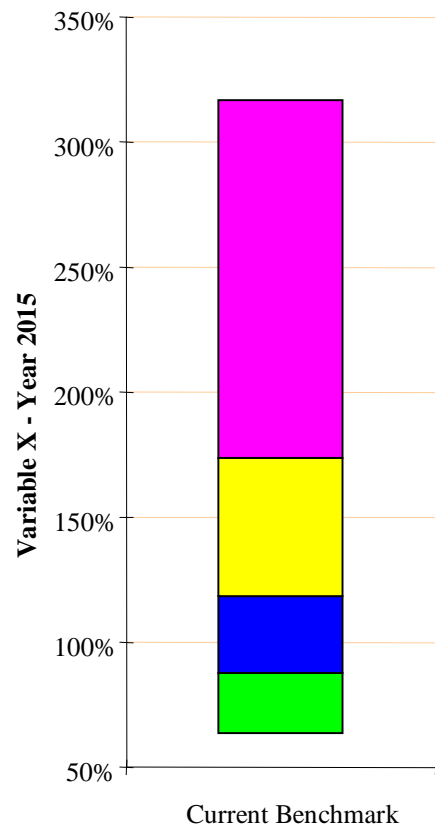
Minimum Required Contribution



Stochastic Modeling For a Moderately Well-funded, Active but Older, Plan with Few Credit Balances, Typical Investment Portfolio

SAMPLE

Variable X - Year 2015



■ 5th-25th percentile ■ 25th-50th ■ 50th-75th ■ 75th-95th

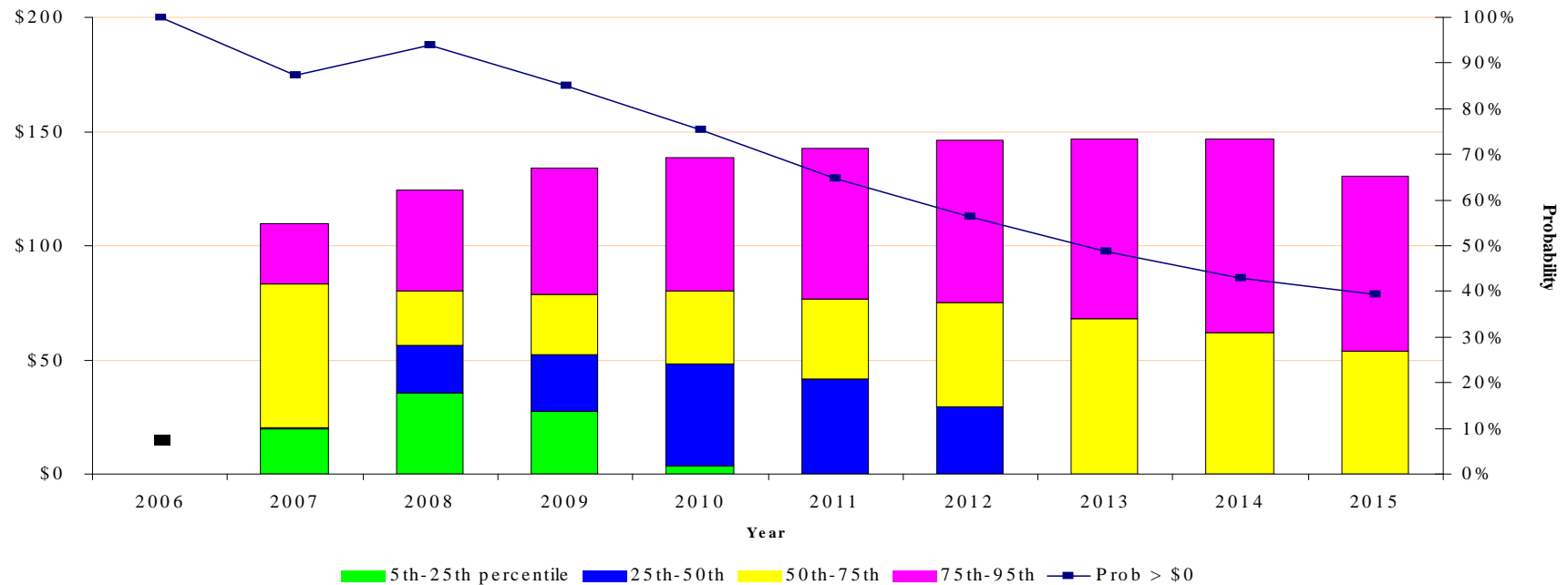
Presentation of Results

In following charts, we have summarized our results in the form of “Best Case” to “Worst Case” outcomes.

- The “Best Case” outcome is that achieved by the most favorable 5% of simulations; i.e., the outcome can be expected to be as good or better than this result in the best 5% of circumstances.
- The “Most Likely” outcome is that which is in the middle of the distribution of results; i.e., 50% of the situations are better than the most likely case and 50% of the situations are worse.
- The “Worst Case” outcome is the opposite of the “Best Case” outcome. Namely, only 5% of the situations are expected to be as poor or worse than this result.
- The “Upper Quartile” and “Lower Quartile” results are those that are 25% and 75% of the way down the distribution respectively; i.e., there is a 25% chance of being above/below these results respectively.

Minimum Funding Under PPA

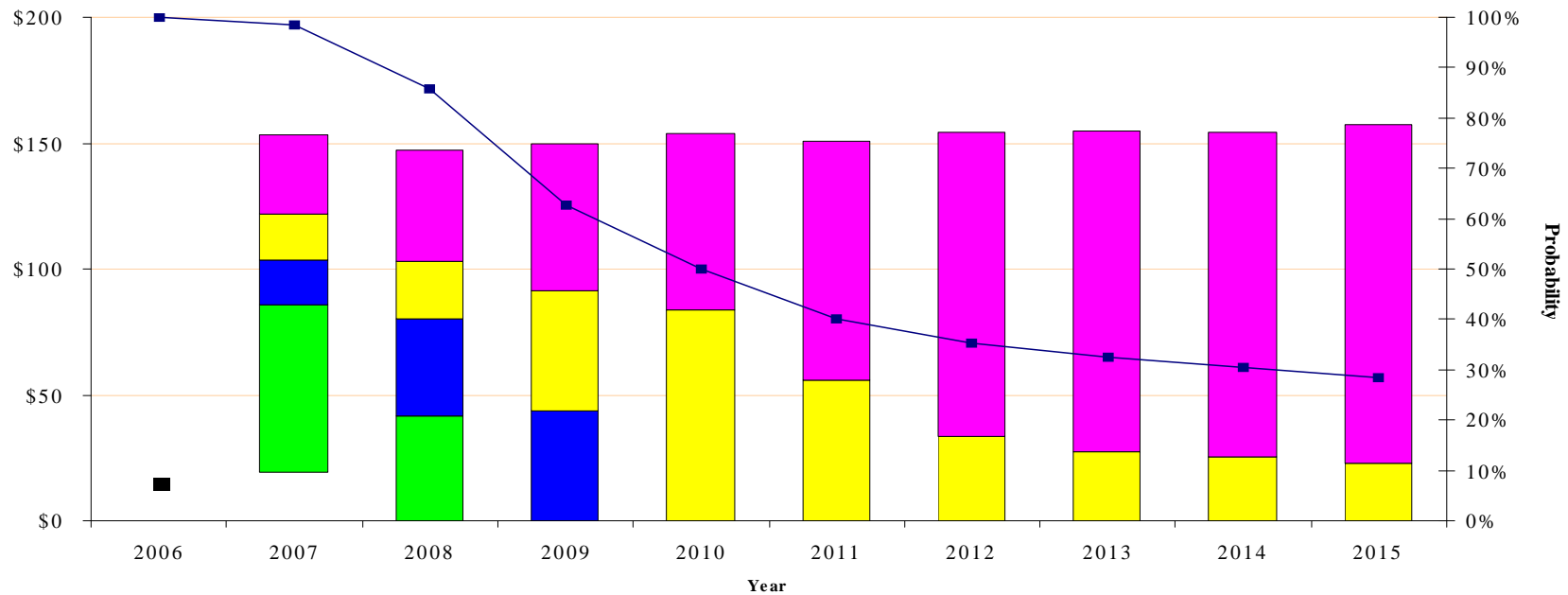
XYZ Retirement Plan
 Contributions (\$M) - Target Policy
 Funding Policy: Minimum Required Contributions under PPA



Percentile	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
5th	\$15	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0
25th	\$15	\$20	\$36	\$28	\$3	\$0	\$0	\$0	\$0	\$0
50th	\$15	\$20	\$56	\$52	\$48	\$42	\$29	\$0	\$0	\$0
75th	\$15	\$83	\$80	\$79	\$80	\$77	\$75	\$68	\$62	\$54
95th	\$15	\$110	\$124	\$134	\$139	\$143	\$146	\$146	\$147	\$130
Prob > \$0	100.00%	87.38%	93.84%	84.96%	75.42%	64.76%	56.26%	48.78%	42.84%	39.32%

Minimum Funding Under Old Law

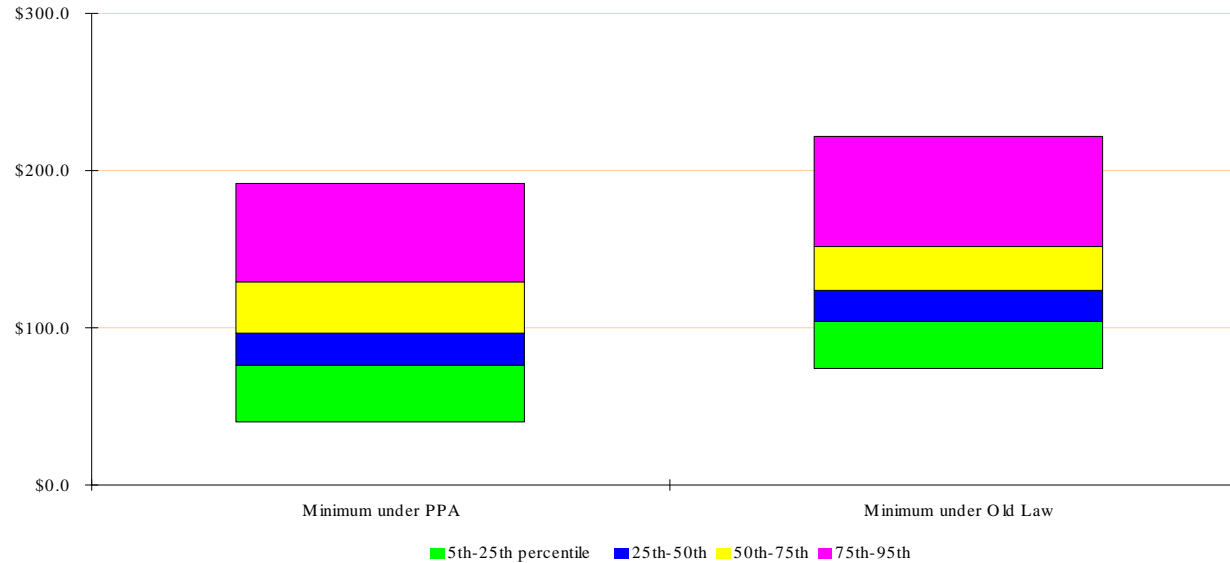
XYZ Retirement Plan
Contributions (\$M) - Target Policy
Funding Policy: Minimum Required Contributions under "Old Law"



Percentile	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
5th	\$15	\$19	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0
25th	\$15	\$86	\$42	\$0	\$0	\$0	\$0	\$0	\$0	\$0
50th	\$15	\$103	\$80	\$44	\$0	\$0	\$0	\$0	\$0	\$0
75th	\$15	\$122	\$103	\$91	\$84	\$56	\$33	\$28	\$25	\$23
95th	\$15	\$153	\$147	\$150	\$154	\$151	\$154	\$155	\$154	\$157
Prob > \$0	100.00%	98.44%	85.84%	62.76%	49.98%	40.16%	35.36%	32.52%	30.54%	28.46%

Distribution of Highest Required Contribution through 2015: PPA vs. Old Law

XYZ Retirement Plan
Highest Contribution (\$M) - 2015



Percentile	Minimum under PPA	Minimum under Old Law
5th	\$39.8	\$73.8
25th	\$76.4	\$103.9
50th	\$96.8	\$124.0
75th	\$129.4	\$151.5
95th	\$192.0	\$221.6

PBGC Premiums and Disclosure Requirements

- PBGC premium is \$30 (indexed) per plan participant plus \$9 per \$1000 of underfunding defined by plan's target (vested) liability (no loopholes). Also added premium for most plans terminated in distress.
- Added premium income for PBGC over decade is estimated to be \$3.8 billion in PV.
- Annual funding notice
 - To PBGC, participants, beneficiaries, unions and (for multiemployer plans) contributing employers
 - Funded status, funding policy, asset allocation, effect of benefit improvements, extent of PBGC insurance coverage.
- Periodic benefit statements every three years or upon request
- 30-day notice for benefit restrictions

Hybrid Plans

- Cloud of legal uncertainty has largely been lifted by new pension law and recent IBM and other court cases.
- Time value of money is not age discriminatory, and removing a feature that favored older workers is not age discrimination.
- Under new pension law, three-year cliff vesting required for these plans. Also interest rate credited cannot be greater than a market rate (negative returns are OK in variable rate plan, but principal cannot be reduced).
- Conversions to hybrid plan after 06/29/05 are governed by an A + B rule, where A reflects early retirement subsidies. (No “wearaway”.)
- Old law allowed “whipsaw” where minimum PV for lump sum could be different than current account balance, depending on interplay of plan and law interest rates. Now, lump sum can be account balance.

Multiemployer Plans

- Traditional ERISA funding rules still apply (considerable actuarial discretion, etc.), but
- Amortization shortened to 15 from 30 years (with automatic extension by 5 years).
- Endangered plan (less than 80% funded, in general) must adopt funding improvement plan, possibly including funding increases and/or benefit cuts.
- Critical plan (less than 65% funded and cash flow problems, in general) must adopt improvement plan, as above, plus employer contribution surcharge and lump sum restrictions.
- Limitation on withdrawal liability repealed for insolvent employers, and maximum deductible contribution increased to 140% of current liability.
- New regime sunsets in 2014; subject of Administration study.

Other Notable DB Changes

- In-service distributions allowed after age 62.
- Conditions liberalized allowing asset transfers to retiree health plans by well-funded pension plans.
- Lump-sum calculations changed, so that in general and eventually, will be reduced somewhat for participants, particularly young, compared to annuity form of distribution.
- For small employers (<500), a DB/401(k) combination plan is now allowed, subject to specified benefit, contribution, vesting and non-discrimination requirements.
- PBGC missing participant program expanded to multiemployer and DC plans.

PPA Provisions on Automatic Enrollment in DC Plans

- Main legal barriers (e.g. state garnishment laws) to automatic enrollment are removed.
- Relief for quick distribution of small amounts
 - Total withdrawals allowed within 90 days of first contribution
 - No excise tax for persons under age 59 ½
- Safe harbor gives pass from IRS “non-discrimination” testing, if auto enrollment is combined with specified matching contributions and automatic contribution increases.
- Annual notice requirements
 - Effective for 2008 plan years
 - Act requires all eligible persons who have not made an election to be automatically enrolled
 - Applies to current employees, not just new ones
 - To be excluded, those who have made an election under a predecessor design must still be provided minimum contributions and vesting
 - Unclear if they need to receive the annual notice

PPA Provisions on Automatic Enrollment (continued)

- Automatic enrollment safe-harbor to avoid ADP and ACP and top heavy (“non-discrimination”) tests
 - Enroll employees at 3 percent of compensation
 - Automatic 1% increases annually to at least 6% (but not more than 10%) of pay
 - Minimum employer contributions subject to two year vesting required
 - Employer match equal to 100% on first 1% of pay deferred and 50% on next 5% of pay deferred
 - Minimum employer match (for those deferring 3%) is 2% of pay
 - Maximum required employer match (for those deferring 6%) is 3.5% of pay
 - OR
 - 3% non-elective contribution

DOL Regulation on Default Investment

- Intended to provide fiduciary relief and encourage equity investments, especially for auto enrollment.
- Applies to other situations as well – employee non-selection, temporary changes in investment options or providers, etc.
- DOL proposed regulation gives green light to only :
 - Lifecycle funds
 - Balanced funds
 - Managed accounts
- Red light to money market and stable value funds for default.
- Final reg past due date; over 100 comment letters received; reportedly vigorous lobbying.

Watson Wyatt Survey Results

- Focus of November 2006 Survey on Automatic Enrollment, Default Investments, and DOL Proposed Regulation.
- Web-based survey of recipients of *Insider* newsletter; 95 respondents, mainly large employers in manufacturing and services industries, many with open DB plan, representing 1.5 million employees and \$96 billion in plan assets.
- Median number of funds offered in primary DC plan is 15; average is 23. About third currently have automatic enrollment. The rest have been dissuaded, mainly, by its cost and the potential legal liability; about half of these are now considering the possibility.
- Nearly all (94%) have a default investment in their plan. Most use it for circumstance when participant has not made a selection. In addition, other uses are for automatic enrollment, rollovers, or changes in investment options or service provider.

Watson Wyatt Survey Results (continued)

- The most common current default investment is the life cycle fund (38%), followed by stable value (27%), money market (18%) and balanced (8%) funds.
- Equity-based funds are more common now for use in auto enrollment (70%) than for other purposes, e.g. employee non-selections (47%).
- If regulation is put in place as published, 48% will have to change their default fund; 53% are considering doing so. The life cycle fund is first choice of the vast majority (94%) of respondents.
- Nonetheless, some (34% and 18%) said they were still interested in stable value and money market funds, respectively, if allowed by the DOL. The preference for stable value and money market funds is positively related to the respondent-assessed significance of outflows from plans.

Simulated Investment Performance: Comparison of Balanced and Life Cycle Funds

Terminal Wealth at 65 (\$1000)

Decile	<u>Median</u>		<u>Mean</u>		<u>Standard Deviation</u>	
	Balanced Fund	Lifecycle Fund	Balanced Fund	Lifecycle Fund	Balanced Fund	Lifecycle Fund
1	194.5	200.7	187.8	194.9	32.1	30.3
2	260.5	263.3	260.1	262.9	15.9	15.3
3	313.9	312.6	313.4	312.5	15.1	13.7
4	363.9	360.4	364.3	360.4	14.9	14.0
5	417.9	410.9	418.2	411.2	16.5	15.5
6	479.0	468.3	479.5	468.8	19.1	17.9
7	553.3	537.0	553.8	537.9	24.1	22.3
8	650.8	627.8	652.5	629.7	33.4	31.5
9	796.0	764.7	802.7	770.2	57.5	53.8
10	1136.2	1082.4	1254.6	1202.4	391.2	377.2
Overall	447.5	438.6	528.7	515.1	324.8	307.2

- Motivation – DOL proposed regulation for individual account plans; also (implicit) comparison of DC and DB plan investment approaches

Simulated Investment Performance: Comparison of Balanced and Life Cycle Funds

- Assumes steady contributions of 6% of earnings over a 40 year career, with earnings, starting at \$40,000 at age 25, growing 4% annually thereafter through age 50 and flat thereafter– best case scenario of no plan leakages and continual work profile.
- Assumes stochastic asset real returns based on 1960 – 2004 experience; investment expenses are not included.
- Assumes equity/bond/cash mixes of average Balanced and Life Cycle funds in the marketplace
- Table shows distribution of account balance outcomes (inflation-indexed) at end of career.
- Overall mean is \$529K for balanced fund vs. \$515K for life cycle; life cycle outcome is higher in first two deciles. Balanced fund outperforms life cycle 57.3 percent of the time. But standard deviation for balanced fund, particularly in the age 55 to 65 period (not shown), is much higher than for life cycle fund.
- Other simulations have been done and more are possible.
- Interpretations – life cycle fund makes more sense for individual account investor with shortening horizon, but longer investment horizon of DB plan sponsor (balanced fund) gives a higher expected return.

Other PPA Provisions Relevant to DC Plans

- Modest encouragement to annuities in DC plans by removing old DOL regulation on “safest available”.
- Requirement to allow diversification from employer securities after three years of plan participation; also notice of risks must be given.
- EGTRRA (2001) provisions made permanent, including overall increased contribution limits and special catch-up contributions for those above age 50.
- But, despite DB-like features -- automatic enrollment and life cycle default investment, higher allowable contributions for older workers, annuities(?), and diversification of employer securities -- even the best-designed and managed “auto” 401(k) plans still place risks (of investment, point-in-time annuity purchase price, opt-out, cash-out, etc.) on plan participants. It is not a substitute for a DB plan.
- The HR interest of the plan sponsor in retention and retirement patterns of employees is also a relevant consideration.

Possible Implications of New Law for DB plans

■ On benefit security:

- Average funded status of corporate DB plans in 2005 was 95%, on a ABO basis, according to financial accounting, with variation.
- Our estimate for 2006 indicates average is above 100% on a PBO basis.
- For those plan sponsors with an ongoing plan or interested in avoiding complexity, probably would want to improve status to around 100% quickly and maintain status going forward to avoid possible benefit restrictions/maximize future funding flexibility/further reduce volatility.
- Generally, still hesitancy to significantly overfund plans, however, unless reversion tax is changed.

■ On sponsorship:

- Environment should stabilize or improve for DB plans – less scope for future systemic abuses (moral hazard) and more sponsor flexibility and less volatility. Image of plans to participants should improve. Legal and regulatory regime likely to be stable. PBGC financial situation and prospects improved in 2006.
- Hybrid plans, in particular, are boosted.

Possible implications for DB plans (continued)

■ On plan design:

- Early retirement and lump sum subsidies more expensive and risky to plan.
- Hybrid plan now again a legitimate choice – allows mix of DB and DC features. Closest comparison is to auto enroll/default invest DC plan with no points of leakage.
- Also need to appeal to larger cohort of older workers, and encourage longer working careers – phased retirement distributions.

■ On investment policy:

- Fundamental determinants of optimal investment approach include horizon of plan sponsor, its tolerance for risk and structure of liability.
- For well funded active DB plans sponsored by growing companies, equities have an important role to play.
- Example above and other analysis shows required contributions are less volatile under new law than under old law.
- For older or frozen DB plans, more attention to liability is appropriate; this is consistent with signals sent by PPA.

Possible Implications for DC Plans

- Will auto enrollment become a significant factor in the DC system?
 - For some plan sponsors, auto enrollment plans are probably more costly and administratively burdensome than other safe harbor plans.
 - Example: One large employer with high turnover employees had auto enrollment plan, but dropped it.
- Not robust enough information yet to judge whether it will accomplish public policy goal of increased saving for retirement among lower-income workers, given possible opt-outs, and increase in outflows – loans, in-service “hardship” distributions, and cash-outs – over time.
- Judging appropriateness of policy goal also needs to consider wide range among workers of life phase situations, robustness of public social insurance programs in the lower-income ranges, and overall debate (at least among academics) about savings adequacy and investment risk.

Possible Implications for DC plans (continued)

- Default investment regs, by contrast, could be more important.
- In Sweden PPM, where there are many private investment choices, 90 percent of new participants are now “defaulting” to the default fund AP7.
- In the federal government worker’s TSP, about 9 percent of participants and about 6 percent of assets are invested in life cycle funds one year after their introduction. Marketed as “cruise control”.
- Prediction: with DOL-proposed default investments, more plan participants will tune out on investment information/advice, trade less frequently. Therefore plan sponsor’s initial choice of default investment in 2007 will be critical.
- Macro impact less clear. DOL says that proposed reg will result in slightly higher equity allocation. There is, however, an already high share of DC investment in equities – 62 percent at end of 2005 – little in money market, and life cycle and balanced funds allocate significant shares to bonds.

Conclusions

- Biggest change in regulation of pensions since ERISA.
- Should improve overall private DB system; make DC system somewhat more DB-like.
- But still need to monitor closely regulatory guidance and employer and employee reactions, as well as PBGC situation and multiemployer plans.
- Image and momentum, in particular, will be important.
- Despite the need and hope for permanence, policy issues will/should still arise, e.g.
 - Political trade in the future?: Flexibility for retrieving some DB overfunding by giving up credit balances?
 - Social Security reform?
 - Allowance for new plan features, e.g. combination of life annuity distribution with long-term care insurance coverage.