

The Effect of the 2008 Economic Downturn on Pension Plans

Concerns over the U. S. economy and capital markets have flooded the news over the past two months. Commentators share their predictions on the eventual outcome of the market decline, but none know for sure where or when we will see the “bottom” or how long we will remain at that level. Meanwhile, markets continue to experience high volatility. The declining market presents many unexpected risks and opportunities from several directions. One area of risk – and opportunity – that may not be receiving due attention is the health of a company’s defined benefit pension plan.

Asset values in pension plans have been hit equally as hard as, and in some instances more than, the company sponsor’s own equity, losing the stable funding ground that may have been built over years most significantly in these few short weeks. The good news is that corporate bond interest rates have risen recently, helping to balance some of the loss to the funding status of the plans. In addition, pension plans that have unique asset diversification may be positioned to see the fluctuating economy as merely a bump in the plan’s investment portfolio. Most pension plans, however, have lost value in all investment classes, including equity, commodities, debt (governmental, corporate and structured), real estate, and asset backed securities. The practice of smoothing the assets may not be enough to counterbalance the losses.

The time is approaching, sooner than a plan administrator may be anticipating, for the company to address the depressed asset value in the pension plan. As early as September 2009, plans will need to make contributions to seriously underfunded pension plans to comply with

IRS funding requirements. Companies that do not plan appropriately may not have the liquidity necessary to make the contributions, absorb the impact of adverse economic conditions on operating performance, invest in product development, marketing and other strategies to succeed in an intensively competitive economy, and fund debt service and other obligations. Many reports suggest employees are planning to retire later, giving 401(k) plans the opportunity to recover from current losses. This time will also give the pension plan time to recover. Given the uncertainty of future asset values, however, now is the time for sponsors of underfunded pension plans to assess plan risks, prepare for disclosure and take action.

Assessing the Risks

- Speak with the plan’s actuaries. Determine the extent of the plan’s underfunding and the amount of gain necessary for recovery.
 - Estimate the amount of the 2009 contribution requirement.
- Review the sponsor’s debt instruments. Many credit agreements and other debt arrangements have representations or covenants that can be triggered by significant changes in funding status, or by collateral consequences such as related claims, regulatory compliance or overall material adverse changes. Confirm early whether a default is possible.
- Identify the number of retirement-eligible employees on the redundancy or lay-off lists to determine exposure to plan asset diminution due to benefit payments.
- Seek to avoid plan terminations, especially distressed plan termination forced by the Pension Benefit Guaranty Corporation, that will cost the sponsor more than compliance with the IRS funding rules.

- Evaluate overall liquidity needs and resources, including in light of an extended recession and higher borrowing costs (as governmental borrowing demands grow).

Prepare for Disclosure

- Pension plan funding status is a line item on financial statements.
 - Accounting rules for balance sheet disclosure differ from pension plan funding rules. Current market conditions may exacerbate those differences.
 - Proposed changes to FASB rules may require more detailed disclosure of pension plan investments.
 - Determination of fair value of pension assets requires mark-to-market valuation and new guidance may affect a plan’s historical practice of determining market value for alternative investments (e.g., private equity and hedge fund investments).
- Sponsors that are publicly traded are already aware of the need to address the impact that the state of the economy will have on the company in the MD&A section of their SEC filings. If the health of the pension plan is a material issue, the discussion should disclose it and what measures have been taken to address, and perhaps minimize, overall exposure due to declining asset values.
 - Consider disclosure of how the risks will also impact cash flows and net income as well as debt levels and overall financial condition.
- The Pension Protection Act of 2006 (PPA) places additional requirements on plans that are not sufficiently funded, including additional IRS reporting requirement. (The American Benefits Council and another business coalition recently requested that

Congress reassess the timing and breadth of the funding requirements under the Pension Protection Act of 2006, but no relief has been addressed to date.)

Take Action

- The plan’s investment committee should reach out to its investment advisors for guidance on how best to invest remaining plan assets in this market.
- The plan administrator should work with the plan’s actuaries to determine whether plan assumptions are appropriate and whether they can or should be changed.
- Assess whether a funding waiver may be available to the plan and, if so, request the waiver from the IRS early.
- Consider creative ways to bridge the gap to minimize current plan costs, such as amending plan terms to permit terminating employees to elect to defer the commencement of benefits, allowing the plan more time to recover asset value.

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