Credit balances and contribution timing under PPA

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We've already presented a number of articles reviewing the impact that PPA funding rules and end-of-2008 market turmoil have had on defined benefit funding. Here we turn our attention to a more specific set of issues – the use of credit balances to manage defined benefit funding demands. We first provide an overview of the new rules under PPA, followed by an examination of practical considerations, particularly contribution timing and preserving credit balances.

We have been posting a series of articles reviewing the impact on defined benefit (DB) plan funding of (1) new Pension Protection Act (PPA) funding rules and (2) end-of-2008 market turmoil.

Our first article reviewed funding for 2009, concluding that, for most calendar year plans, IRS guidance allowing use of October 2008 interest rates would drastically reduce or eliminate additional 2009 funding demands resulting from 2008 asset losses. Our second article reviewed funding for 2010-11 and following years, concluding that the ongoing ability to smooth interest rates (if allowed by the IRS) would enhance predictability and reduce volatility, but that unless plans recovered 2008 losses, those losses would have to be funded at some point during the relatively near term. Also related to these issues are our articles on DB contribution timing under PPA and on Congressional proposals for DB funding relief.

In this article we turn to a narrower set of issues, still related to the general theme of the combined effect of PPA and 2008 market turmoil on DB funding demands – the use of credit balances to mitigate and manage those demands. We will review, first, the new PPA rules affecting the use of credit balances and, second, practical considerations, particularly with regard to contribution timing and the preservation of credit balances.

PPA credit balance rules

Generally, credit balances are amounts contributed by the sponsor in excess of the minimum required contribution for the year. And, generally, credit balances (accumulated in prior years) may be used in lieu of actual contributions to satisfy minimum funding requirements for the current year.

PPA includes a number of rules designed to limit the use of credit balances. Generally, a sponsor may not use a credit balance to satisfy a minimum funding obligation if the prior year assets-to-liabilities funding ratio is less than 80%. In addition, credit balances must be adjusted for the actual return on plan's assets (especially relevant in view of 2008 asset losses).
More significantly, for purposes of a number of PPA funding rules, credit balances are subtracted from plan assets. In this regard, in some cases, the rules treat post-PPA credit balances ("prefunding balances") differently from pre-PPA credit balances ("carryover balances").

The following table lists provisions of PPA where credit balances are relevant, indicating when credit balances are subtracted from plan assets and when they are not.

<table>
<thead>
<tr>
<th>PPA provision</th>
<th>Pre-PPA (carryover) balance subtracted?</th>
<th>Post-PPA (prefunding) balance subtracted?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Determination of whether there is any shortfall and thus any required shortfall contribution (94% in 2009, 96% in 2010, 100% thereafter)</td>
<td>No</td>
<td>No; except, if post-PPA credit balance used to satisfy minimum contributions</td>
</tr>
<tr>
<td>Determination of funding shortfall contribution</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Determination of whether a credit balance may be used at all (80% in prior year)</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Determination of exemption from quarterly contribution requirements (100% in prior year)</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Determination of whether the plan meets 60%/80% benefit restrictions triggers</td>
<td>Yes, unless plan is “fully funded” (94% in 2009, 96% in 2010, 100% thereafter), without subtracting</td>
<td>Yes; same exception applies</td>
</tr>
</tbody>
</table>

There is one other exception to these rules. Credit balances are not subtracted from assets for purposes of determining a plan’s funding ratio if there is a binding written agreement with the PBGC that credit balances can't be used to satisfy minimum contribution obligations.

The consequence of these rules subtracting credit balances from plan assets for PPA funding is that a plan that is otherwise “well funded” may, after the subtraction, become "not-well funded.” For instance, a plan with $89 million in assets, $100 million in liabilities and a $30 million credit balance would, for many purposes under PPA, have a funding ratio of 59%. Because of this treatment of credit balances, this plan would have to freeze accruals, even though, in “real life,” the plan is 89% funded.

Credit balance reductions

To avoid this result, the sponsor may, under PPA, voluntarily reduce its credit balance, thereby "increasing" its assets. Indeed, in some cases it may be required to do so. Under PPA, credit balances must be reduced if doing so would relieve (1) a restriction on accelerated payments (e.g., lump sums) in any plan or (2) any other PPA benefit restrictions (e.g., on plant shutdown benefits or benefit accruals) in a collectively bargained plan.
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The obvious point of these rules is to force sponsors of underfunded plans to get rid of their credit balances. And that raises one theme of PPA with respect to funding generally and credit balances in particular.

If your plan is, in real life and without regard to credit balances, fully funded, then you will generally be able to keep your credit balance (so long as that condition continues). But if your plan is not fully funded, you are generally going to be required to get to fully funded status (in real terms and without regard to credit balances) in seven years. You may be able use any credit balance you have to manage, to some extent, the timing – over those seven years – of your contributions. But you will have to put in the money (real money, not credit balance credits) before the seven years are up.

Example: credit balance mechanics

Let’s consider an example to see how this works.

Assume you sponsor a plan with $100 million in liabilities, $80 million in assets and no credit balance. You have a $20 million shortfall that will have to be funded over seven years. (Note, in this example we are not considering transition funding targets applicable for 2009 and 2010.) Our rule of thumb is that year one funding equals about one-sixth of the shortfall. (Why not one-seventh? We need to adjust for interest on the shortfall.) So, in this situation, the first year’s payment on the shortfall is around $3.5 million ($100 million - $80 million = $20 million; $20 million/6 ≈ $3.5 million).

Now assume the same facts but add a $10 million pre-PPA credit balance. Under PPA rules, the plan now has $100 million in liabilities, $70 million in assets ($80 million in actual assets - $10 million credit balance) and a $10 million credit balance. The shortfall now equals $30 million, and the first year’s payment is around $5 million ($100 million - $70 million = $30 million; $30 million/6 = $5 million).

What’s the result? Over the next seven years, the credit balance does not reduce the amount you have to put into the plan. But you can use it (assuming the plan was 80% funded in the prior year after subtracting any post-PPA credit balance) to defer, to years three through seven, contributions that otherwise would have to have been made in years one and two.

The point here is a little tricky. You have a credit balance, which allows you to pay off minimum contributions with “credits” rather than real dollars. But the credit balance also inflates your shortfall and the amount you owe. The net result is that the credit balance allows you (in terms of real dollars) to contribute at a lower rate in the short-term at the expense of having to contribute at a higher rate in the long term.

In our example, the sponsor can satisfy the higher, $5 million annual contribution obligation by using credit balances in the first two years. The sponsor must then pay off the real
Underfunding in years three through seven, contributing at a higher annual rate than it would have had to if it had had no credit balance at all.

The following chart illustrates the difference in cash flows.

**PPA funding**

$30 million shortfall with/without $10 million credit balance

This chart, obviously, includes some drastic simplifications. We provide it simply to illustrate the PPA principle that, with respect to credit balances as with respect to funding generally, you "pay me now or pay me soon."

Note: there may in some circumstances be other funding-related requirements, for example the application of benefit restrictions, at-risk rules or PBGC 4010 filings, that may require or encourage greater contribution front-loading or faster credit balance "burning" than indicated in our example. Thus, in many cases, for plans that are underfunded, and that don't become fully funded over the next few years, credit balances will likely be quickly exhausted.

**Burn now**

The foregoing example/chart also illustrates another element of PPA's anti-credit balance policy. As a general matter, unless your plan is fully funded, PPA rules will force you to exhaust any credit balance over, at most, the next seven years.

For instance, in our example, the existence of the credit balance inflates the sponsor's minimum contribution from $3.5 million to $5 million. In order to maintain its credit balance,
the sponsor must contribute real dollars at the $5 million rate. At that $5 million per year rate, after five years (more or less, and adjusting for interest), it will become fully funded – in real terms – and will no longer have to subtract the credit balance from assets. Its funding obligation will then equal $0. So, in this case, to preserve its credit balance, the sponsor will have had to fund its shortfall over five years rather than seven. The only alternative is for the sponsor, by either formally reducing it or by using it to satisfy minimum funding obligations, to run down its credit balance.

Elections with respect to credit balances

Generally, elections with respect to credit balances (e.g., an election to add to or reduce a plan’s credit balance) must be made by the plan sponsor by providing an irrevocable written notification to the plan’s enrolled actuary and the plan administrator. The notice must set forth the relevant details of the election, including the specific amounts involved in the election.

Elections with respect to credit balances generally must be made on or before the due date (with extensions) for the filing of the plan’s Form 5500 for the relevant plan year. But an election to reduce a credit balance, e.g., to avoid the application of a benefit restriction, must be made by the end of the plan year. To illustrate this second rule, let’s say our plan with $89 million in assets, $100 million in liabilities and a $30 million credit balance as of January 1, 2009, wants to reduce its credit balance by $1 million to avoid an accrual freeze. That election would have to be made by the end of the plan year (December 31, 2009).

It also appears that it is the IRS’s position that an election to apply a credit balance to satisfy quarterly contribution obligations must be made before the due date for payment of the applicable quarterly contribution.

Timing of required credit balance reductions

Under proposed regulations, if a sponsor is required to reduce its credit balance (e.g., if the required reduction will avoid a restriction on payment of lump sums), that required reduction takes effect when the restriction would otherwise apply.

The rules, both with respect to credit balances and benefit restrictions, are very complicated. But a point about the timing of benefit restrictions-related required credit balance reductions must be emphasized. Under the benefit restrictions rules, a plan is presumed to have the same funding ratio it had in the prior year for the first three months of the current year. Then, beginning with the fourth month (April 1 for calendar year plans), that prior-year ratio is presumed to be 10% lower. That 10% haircut may trigger application of a restriction on benefit payments. And, if reduction in the plan’s credit balance will fix that benefit payment restriction, the plan’s credit balance is “automatically” reduced. This is the case even if, later in the year, the plan is certified by its actuary to be above the restriction level without the reduction in the credit balance; the sponsor cannot get the credit balance reduction back.
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It's almost impossible to communicate this rule in the abstract, so let's work through another example. Let's assume that a calendar year plan had $90 million in assets, $100 million in liabilities and a $5 million credit balance for 2009. So its 2009 funded ratio was 85%, and no benefit restrictions applied. For January-March 2010, its ratio is presumed to be 85% – the same as the 2009 ratio. On April 1, 2010, that ratio gets a 10% haircut, and is now presumed to be 75%. Restrictions on lump sum payments would ordinarily apply, but because the plan has a credit balance, that credit balance is "automatically" reduced, plan funding is presumed to be 80%, and no restrictions apply. In September the plan's actuary certifies that the plan (still) has $90 million in assets and $100 million in liabilities. So, in "real life," no credit balance reduction was actually needed. But because of the operation of the benefit restriction presumptions, a reduction was irrevocably made, and the plan's credit balance is now gone.

Note: the calculation, under the proposed regulations, of how much of a credit balance reduction is required in these circumstances considers, for instance, "interim" asset performance and is quite complicated. You cannot simply increase the presumed funding ratio by an amount necessary to get to, e.g., 80%. We have disregarded these complications in the foregoing example.

This rule is obviously designed to discourage the continued maintenance of credit balances. As a practical matter, the only way to avoid its application is to get an actuarial certification (and if necessary make an additional "real dollar" contribution) before any benefit restriction that will require a credit balance reduction applies. How practical that is will vary from plan to plan, sponsor to sponsor and year to year.

There are two other approaches that avoid the application of this rule: (1) Reduce the credit balance in the prior year, so that the funding ratio is 90% or above, thereby avoiding the application restrictions as of April 1 of the current year. (2) "Fully fund" your plan – as discussed above, fully funded plans do not have to subtract credit balances from assets in the funding ratio calculation. In this regard, note that, for 2009, fully funded means 94%. So, funding to 94% for 2009 avoids giving up any credit balances. And, in view of [favorable 2009 interest rate treatment], presents an opportunity that is not likely to arise again soon.

Generally, if (a) your plan pays lump sums or covers collectively-bargained employees, and (b) your 2009 funded ratio, without removing credit balances (i.e., assets / funding target) is less than 90%, you may need to make a contribution by March 31, 2010, to avoid the application of benefit restrictions. The amount of any such contribution will need to reflect actual 2009 experience. So if, for example, assets decrease in the fourth quarter of 2009, plans may need to be prepared to make a significant March 31, 2010, contribution.

Plans that are above 90% funded in 2009, but below 94%, and which maintain a credit balance so that the reported 2009 FTAP is less than 90%, will have a credit balance/presumed reduction issue on April 1, and may consider a waiver of credit balance by December 31, 2009, as the easiest way to avoid the complicated "presumed deemed reduction" rules that would otherwise apply on April 1, 2010.
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In either case, plans may find that most or all of their credit balance is exhausted.

Plans that reach a funded ratio of 94% for 2009, on the other hand, should be able to preserve a larger chunk of their credit balances for future use, such as 2010 quarterly requirements. Also, these plans will not face accelerated April 1, 2010, contribution or credit balance waiver decisions to avoid benefit restrictions. The combination of the October 2008 yield curve and a contribution for the 2008 plan year made by September 15, 2009, contribution may bring this strategy within reach of many plans.

2010 and 2011 are critical years to watch in this regard, because, as we discussed in our articles on 2009 funding and on 2010-2011 funding, it is in those years that 2008 asset losses will be fully recognized in plan funding ratios, with (unless there is a dramatic recovery in asset values) many formerly fully- and over-funded plans dropping below 90%.

As we have seen, credit balances can help sponsors manage cash flow over the short term. It seems to us the critical question, in deciding whether to use a credit balance to satisfy a funding obligation, is “How worried am I that things will get worse and that I will need this credit balance more in the future than I do right now?” For some companies, battered by the current recession, the answer to this question may be easy: use the credit balance now. For others, it may be a tough call.

In our view, the bedrock point remains: unless the continued viability of your company is in question, using a credit balance to meet a current minimum funding obligation has only a short-run utility. In the long run, and even in the “medium” run, any real shortfall will have to be made up with real money.

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