

# PPA: Prepare Now for 2008 Funding Changes on the Horizon

**T**hanks to the Pension Protection Act (PPA), minimum funding rules are in for some big changes beginning in 2008. Under PPA, liability calculations will be more standardized with pension plans essentially using the same interest rate assumptions. Based on the similarities between pension payments and corporate bonds, the assumption chosen to measure pension liabilities under PPA is derived from a high-quality corporate bond yield curve.

Delayed recognition of asset and liability changes will also be reduced under PPA. Asset smoothing will be reduced, so valuation assets will track closer to market value. Amortization periods for most liability increases are shorter under PPA as well, although actuarial gain and loss recognition is actually increased from five years to seven years.

One of plan sponsors' biggest concerns about pension funding before PPA was extreme funding volatility. Under the current rules, an additional funding charge is added to the basic funding calculation for plans whose funding slips far enough. PPA gives relief in this area with a much smoother (and more forgiving) at-risk funding calculation.

*The following compares the current rules to the new rules, which take effect January 1, 2008:*

Key Changes to Defined Benefit (DB) Funding Rules		
	Current Rules	New Rules <i>Effective Jan. 1, 2008</i>
Funding liability	Interest rate chosen by actuary	2-year smoothing of corporate bond yield curve
Asset smoothing limit	5 years / 20%	2 years / 10%
Amortization period for unfunded liability	5, 10, or 30 years depending on unfunded liability source	7 years
Additional contribution for underfunded plans	Volatile and sudden	Smooth and gradual

As mentioned, PPA rules take an indirect approach to encouraging employers to improve the funding levels of underfunded plans. While there is an at-risk calculation that can increase the minimum due for certain plans funded below 80 percent, the calculation phases in so slowly that most plans will never be subject to its full impact.

Although PPA encourages healthy funding ratios for Defined Benefit (DB) plan sponsors, if a plan's funding percentage should fall below 80 percent,

the following consequences apply:

- Only 50 percent of a benefit may be payable as a lump sum;
- Plan amendments must be funded immediately; and
- Credit balance is not available to offset minimum contribution.

If a plan's funding levels fall below 60 percent, PPA requires that plan accruals must be frozen, and lump sum benefit payments are prohibited.

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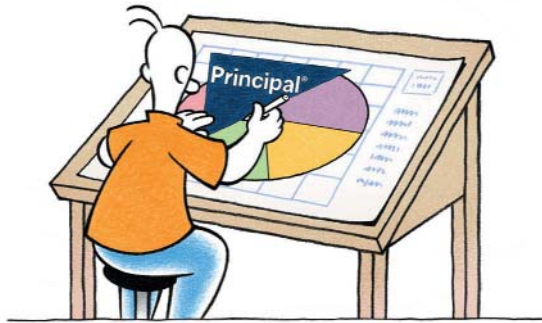
# Horizon

### THE BRIGHT SIDE

The good news is that PPA provides for a much larger maximum deductible contribution equal to the amount to fund the plan to a 150 percent funding percentage. This will allow plan sponsors to better manage pension funding cash flows by budgeting annual contribution payments based on average projected costs and long-term assumptions. In this way, the plan can remain well funded at the same time long-term cost volatility is managed against the company's current cash flow needs.

### CONSIDER THE CASH BALANCE ADVANTAGE

Since Cash Balance plans are funded under the DB funding rules, they may provide more funding flexibility than Defined Contribution (DC) plans when the plans are well funded. More malleable nondiscrimination rules for DB plans as compared to DC plans make it possible for a wide variety of plan designs. These can be used to target older employees, certain classes, or highly compensated employees within the plan. If the interest credit rate is less than the market share of return, the plan's excess returns can be used to reduce plan sponsors' future contributions. So, a 5-percent-of-pay Cash Balance plan can cost less than 5 percent of pay annually.



### Your DB Plan's Funding Percentage

In light of these PPA changes, it is important to pay attention to your funding percentage as you approach the 2008 plan year. The Addendum to your 2007 Actuarial Evaluation illustrates the plan's funding levels and is an excellent resource to help you project the plan's 2008 needs.

The Principal Financial Group® can also provide you with the combined services you need for your DB or combined retirement program including integrated recordkeeping and account valuation services that help make it easier for you to manage the plan(s). For more information on the services available, contact your representative of The Principal®.

**Participant takes  
risk/reward  
(more like DC)**

**Market  
Rate**

## NEW RULES, NEW FREEDOM

PPA rules provide that Cash Balance plans are not age discriminatory as long as no participant receives an annual credit that is less than the credit received by a “similarly situated” younger participant (identical service, compensation, work history, etc.). This means a fixed percentage such as 5 percent of pay for everyone is acceptable. What we more often see used, though, is an increasing credit schedule based on age, or service, or “points” that are equal to age plus service.

The most significant improvement PPA makes to Cash Balance plans is the freedom plan sponsors are given regarding the annual interest credit. Strict rules in the past prevented sponsors from providing high interest credits for fear of paying “whipsaw” lump sums in excess of the account balance. Under PPA, the only requirement for interest is that it cannot exceed a market rate of return.

The expanded interest crediting definition is the most exciting aspect of the PPA Cash Balance rules. The flexibility in interest rates provides an interest rate continuum that allows plan sponsors in different situations – with very different philosophies toward retirement benefits – to consider Cash Balance designs to suit their needs. It allows plan sponsors to “share the risk” by balancing investment risk between them and their participants. The chart below illustrates this continuum.

If you want to tailor your own risk/reward specifications, the interest rate definition of a Cash Balance plan may be right for your organization. For more information, contact your representative of The Principal, or visit [www.principal.com](http://www.principal.com). ■

## Is a Cash Balance Plan for You?

### Advantages for plan sponsors

- Flexible plan design
- Covers all employees (no opt out)
- More flexible funding than DC plans
- Excess asset returns can reduce future contributions
- High tax deductibility
- Risk transfer flexibility through interest definition
- Less volatile liabilities than traditional DB plans
- Participant appreciation

### Benefits for participants

- Typically funded by employer
- Potential guaranteed interest
- Allows for more aggressive asset allocation for contributions in DC plan
- Portability
- Easy to understand
- Can provide subsidized annuities

## Risk Sharing

### Interest Credit Definition

**Variable  
Minimum Rate**

**Fixed  
Minimum Rate**

**Sponsor takes  
risk/reward  
(more like DB)**