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September 16, 2011

The Pension Protection Act of 2006 (PPA) mandates that pension plan liabilities be calculated using interest rates with corporate bond yields as their basis. Unfortunately for plan sponsors, corporate bond yields have been persistently low for several years. The resulting spike in liabilities, combined with negative 2011 asset returns, will have dramatic financial repercussions for most plan sponsors.

Pension Liability Basics

In general, interest rates and liabilities have an inverse relationship. A plan's liability is the present value of the expected benefit payments to be paid in the future, so a lower interest rate simply means that sponsors must put more money into the trust today in order to make those future payments. PPA altered the interest rates used in calculating pension liabilities such that the cash flow from the plan is discounted based on the yield on high-quality corporate bonds.

Interest Rate Environment

As the financial turmoil of 2008/2009 subsided, bond yields fell to record lows and remained there as the recession proved deeper than initially projected. As a result, the segment rates used to determine a plan's liability are lower than at any point since PPA came into effect. Furthermore, these segment rates are based on 24-month averages of the corporate bond yields, and with the Federal Reserve announcing plans to keep interest rates low until mid-2013, bond yields are likely to stay at current low levels. Absent any legislative relief, the end result for most plans will be a large, sustained increase in liabilities.

Consequences for Plan Sponsors

Further complicating matters are the large drops in stock indices since mid-July, making it highly unlikely that plans will be able to offset increases in liability with asset returns. Barring substantial gains during the rest of 2011, the jump in liabilities combined with poor asset returns will mean an increase in unfunded liability and a decrease in funding percentage. For many plans, the end result will be higher required contributions and/or restrictions on certain types of benefit payments (for example, lump sum payments may become restricted). For already struggling plan sponsors, the additional cash requirements may cause severe financial strain.

How Can Harbridge Consulting Group Help?

As the actual 2012 segment rates will be 24-month averages of the monthly interest rates (the bulk of which have already been released), Harbridge has the ability to project a plan's 2012 liability. With this in hand, funding estimates can be developed based on various 2011 asset returns, funding balance strategies, relief options, etc. While not completely alleviating the impact of the drop in the segment rates, the development in advance of a sound funding strategy for 2012-2013 will allow plan sponsors to make better-informed budgetary decisions with regards to their entire organization. However, as

every pension plan and plan sponsor are unique in regard to their current funded status and long-term goals, it is recommended that you discuss the various options available with your Harbridge consultant.

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