Pension Protection Act: A New Opportunity for Risk Management

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“Now is an excellent time to review your plan to be sure it addresses the following issues: compliance with the new regulations, fiduciary issues that concern the plan sponsor, attainment of business objectives, overall expense and compatibility with the present workforce.”

IN THIS ISSUE:
- Pension Protection Act
- From Near and Far
- Happy Holidays

- Higher 415 limits (lesser of 100 percent of compensation or $44,000 in 2006)
- Deemed IRA accounts
- Expanded rollover rules
- Automatic rollover rules

Defined Benefit (DB) programs are protected by the Pension Benefit Guaranty Corporation, a federal agency similar to the FDIC in banking. The bankruptcy of several major U.S. corporations has overburdened this agency’s resources. Some fear a federal bailout requirement comparable to the savings and loan debacle. Consequently, the oversite for defined benefit plans will intensify. Funding requirements will be less flexible, and employers will have a more restricted ability to recognize their liability by simply making entries on the balance sheet. Funding will require real money in real trust funds for participants’ benefits. The immediate reaction might be to terminate an existing DB in favor of a 401(k) plan. Before you take this action, study your options carefully.

A DB plan is generally more expensive to operate, on two levels. First, the sponsor must fund the plan to
FROM NEAR AND FAR

Miami – On October 25, Florida's chief financial officer, Tom Gallagher, announced the arrest of 33 people suspected of staging auto accidents and fraudulently billing insurance companies for about $1 million. Claims were made for non-existing injuries and auto damage claims. The insurance companies that were defrauded are listed on the Florida Department of Financial Services website, www.fldfs.com.

Los Angeles – A four-year investigation by the California Department of Insurance's Fraud Division resulted in the arrest of four suspects in a $39 million workers' compensation premium case. All of the suspects either owned or were principal employees of a group of temporary employment agencies. For more information go to www.claifornia.ca.gov.

Hawaii – The amount of damage caused by the earthquake that rattled Hawaii on October 15 is not expected to add up to enough to be called a catastrophe. The Insurance Services Office, Inc., said that its Property Claims Unit did not think the resulting insured property damage claims would exceed the $25 million mark, which the ISO uses as its minimum number for calling an event a catastrophe.

Alternatives to plan termination might be “freezing the plan,” reducing benefits going forward or changing to a cash-balance plan. One of the provisions of PPA allows up to eight years to “true up funding.” The plan sponsor may utilize this provision to correct underfunding issues without placing severe cash flow constraints on the employer. Freezing the plan provides all participants with benefits up to a date certain. After the date certain, no further benefits accrue, but vested benefits are paid out later. This action stops future funding, with the exception of those deposits required to make payments to beneficiaries or to meet actuarial deficits.

Reducing future benefits will lower future funding requirements, but past benefits will remain the same. The Cash Balance Plan was made popular by IBM. A Cash Balance Plan blends a cash account with DB guarantees. It does not provide the same level of security as a traditional DB plan. The primary focus going forward will be to protect beneficiaries and the solvency of the PBGC.

The major changes addressed in the PPA affect 401(k) plans. There are new vesting schedules, new service crediting requirements, new incentives for plan sponsors and amendments to

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ERISA, and some new Safe Harbors. It is important that each employer that provides a 401(k) plan review these provisions to be sure its plan complies, but more important, their plan must serve a positive business objective.

Vesting for employer contributions has been changed to a three-year cliff or a graded two- to six-year schedule. These provisions will most likely cause the majority of plans to be amended. Service for vesting begins on the earlier of the date of employment or the participant has one hour of service after the effective date of PPA, August 17, 2006. Now is an excellent time to study your workforce to decide which vesting provision will be most cost-effective.

Although several provisions of ERISA have been modified, the most important change is the Automatic Enrollment Provision. An ongoing problem has been what to do with employees who fail to enroll, resulting in a loss of employer contributions for the 401(k) plan. State laws, in many cases, prohibit deductions from an employee’s check without written authorization. The new provision allows an employer to enroll an employee in the plan with the appropriate deduction. (State law in this regard is pre-empted.) The employee subsequently has the right to negate this election, but the employer will have no exposure beyond refunding money deducted from the employee’s paycheck. The employee may opt out at any time, and the employer is required to comply with annual notice requirements. This is an option, not a requirement.

One caution concerning this provision: This provision requires that the employer increase matching by 1 percent annually to a minimum of 6 percent but not to exceed 10 percent.

Do not confuse the Safe Harbor rules for automatic enrollment with the Safe Harbor rules for avoiding ADP/ACP testing. This provision requires that all W-2 income be included for matching purposes. A

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minimum of 3.5 percent match up to a 6 percent match is allowed with this formula. This provision allows highly compensated employees the ability to contribute up to their full limits allowed without a testing restriction. A plan may have one provision and not the other.

One important ruling that has not been issued: The DOL is required by this law to issue regulations on default accounts. A default investment arises when an employee elects to participate without designating his/her investment choices (or in the event of the automatic enrollment option.) Conventional wisdom dictates that a diversified account has the best opportunity for long-term success. The DOL regulations should be available within six months to provide guidance on this issue.

There is a myriad of technical changes that the plan sponsor must implement over the time frame outlined in the law. There are also protections for fiduciaries that follow prescribed rules. It is refreshing to learn that many new provisions will simplify and/or clarify troublesome issues. It is incumbent on all companies who have qualified retirement plans to use this opportunity to review the plans in place. Making sure that your plan meets the needs of your organization and your employees in the most efficient fashion will pay dividends in the future.

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