PENSION POINTERS.....▶

PLEASE FORWARD TO THE LA FOR PENSIONS:
In the near future your office again will be asked to take a position on pension reform. The currently pending bills are the most significant reform bills since ERISA passed in 1974. The choices made in crafting a final bill will encourage employers to establish and maintain defined benefit pension plans – or will encourage them to avoid those plans. The bills also make significant changes to rules governing defined contribution plans.
To assist you in understanding this critical legislation, we will be sending you short briefs on key issues in the bills. This first brief describes – in a page and a half – the current law pension funding rules. Put it in a special folder so you will have it readily available when the time comes for your office to determine whether the bill will help, or hinder, pension coverage in the future.

PLAIN ENGLISH EXPLANATION OF THE ERISA FUNDING RULES

To ensure that a defined benefit pension plan has sufficient assets to pay benefits when participants retire, the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code require the plan's sponsor to make minimum contributions to the pension plan.

● **Basic Rules:** The minimum required contributions are calculated annually using reasonable plan assumptions and are equal to the additional amount of benefits that employees will earn that year under the plan formula (called the "normal cost") plus amounts necessary to amortize over specified periods other outstanding costs.[1] Most defined benefit plans are funded under these original ERISA rules, as modified over time.

● **Backstop Rules:** A plan that is considered either significantly underfunded or persistently underfunded will be subject to an additional set of funding rules. These rules, commonly called the "current liability" funding rules, were added to the law in 1987 and modified in 1994. Basically, these rules look at whether a plan is likely to be able to buy annuities to cover its current level of accrued benefit promises. If a plan is far from being able to buy annuities, the rules require that additional cash be put into the plan currently, accelerating the pace of pension funding.

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[1]Amortized amounts can include **unfunded past service liabilities** (e.g., costs arising from a benefit increase), **experience gains or losses** (such as the investment performance of the plan's assets), **waived funding deficiencies** (which are contributions required but not made in the past under an agreement with the IRS), and certain other items.

● **Mandated Assumptions:** The current liability funding rules require the sponsor to use a specified mortality table and to calculate liabilities using an interest rate that is based on the weighted average of the mandated interest rate for the previous four years. Through 2001, 30-year Treasury bond rates were used to make this calculation, but the Treasury ceased to issue its 30-year bonds on October 31, 2001, causing the 30-year bond rate to drop dramatically and inaccurately inflating calculations of pension liability. For 2002 and 2003, Congress allowed a plan to use a rate of up to 120% of the 30-year bond average (P.L. 107-147). For 2004 and 2005, Congress approved a new bond rate – a composite rate based on high quality, long-term corporate bond rates (P.L. 108-218). But on January 1, 2006, the mandated rate reverted to the 30-year Treasury bond.

● **When Do the Backstop Rules Apply?** The current liability rules come into play if, using these mandated assumptions, a plan is considered either significantly or persistently underfunded -- that is, (1) if plan assets are less than 80% of current liabilities or (2) if plan assets are less than 90% of current liabilities for the current year and two of the preceding three years. Plans with any unfunded current liabilities must also make contributions on a quarterly basis during the plan year instead of making one annual contribution after the end of the plan year.

● **What Else?** Current liability (very generally based on 85% of the 30-year Treasury rate without averaging) is used to determine whether a plan sponsor must pay the Pension Benefit Guaranty Corporation (PBGC) a variable rate premium tax based on the plan's unfunded vested liability. This variable rate premium is in addition to the flat-rate premium payable to the PBGC by all plans regardless of their funded status. The flat-rate premium was just increased by the spending reconciliation bill from $19 per participant to $30 per participant.

The 30-year Treasury rate is also used (without averaging and without the corridor available for funding purposes) to calculate the minimum lump sum that may be paid to a plan participant.

Questions? ***Contact:***

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March 15, 2006