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 briefs on key issues in the bills. This brief examines whether the interest rate and asset values used to determine a plan's funded status should be averaged over time. 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.

CREDIT BALANCES

Current Law

Under the current-law funding rules, if a company contributes more than is required to a defined benefit plan, the company has a "credit balance". A credit balance is simply an amount paid today that otherwise would not be due until some future year. For example, if the required contribution for the current year is $10 and the employer contributes $15, the employer has a $5 prepayment credit - - called a credit balance - - that can be used to offset future minimum contribution obligations.

Encouraging a company to pre-fund its pension obligations is important because putting extra money in during good times means both the pension plan and the company can better withstand future economic downturns.

Administration's Proposal

The Administration proposed eliminating credit balances, so that a company could not use a prepayment to offset future contribution obligations. The rationale for the Administration's proposal was based on the fact that certain companies that shifted plan liabilities to the PBGC used extra contributions from prior years in the years immediately prior to turning the plans over to the PBGC. The Administration concluded that if credit balances did not exist, more money would have been contributed to these plans. The Administration's reasoning had a major flaw. Under the proposed funding rules, if companies do not receive credit for prepayments, companies will generally not make prepayments. Thus, under the new rules (as fully phased in), any plans that are turned over to the PBGC in the future would not have received the prepayments and accordingly would be more underfunded. This means that more liabilities would be shifted to the PBGC.

House and Senate bills in General

The House and Senate bills appropriately preserve credit balances, but modify the treatment of credit balances. Certain modifications should be enacted. For example, both bills would require that credit balances be adjusted to reflect the plan's actual rate of return. Thus, if a plan's assets fall in value by 10% in a year, a $100 credit balance would be reduced to $90.

Concerns with the House bill. Subject to certain exceptions, the House bill determines a plan's funded status by subtracting credit balances from assets. For example, assume that a plan has $100 of liability, $90 of actual assets, and a $40 credit balance. This plan is 90% funded, but would be treated as 50% funded under the House bill (since it would be treated as having $90 - $40 = $50 of assets).

The above subtraction is appropriate for one purpose: i.e., determination of the company's minimum funding obligation with respect to a plan funded below the phased-in funding target. The reason that subtraction is appropriate for this purpose is that credit balances can be used to satisfy minimum funding obligations. Thus, credit balances should not be counted as both plan assets and as contributions to the plan.

In all other contexts, it is not appropriate to subtract pre-paid assets from other assets in the plan. For example, under the House bill, the plan described above would be required to cease providing any new benefits because it is treated as less than 60% funded. To avoid this result, the employer would have to forego part of its credit balance, increasing future contributions that
it had already pre-funded and reducing its incentive to pre-fund its obligations. Under the bill, this is so even though ALL of the plan's assets (pre-funded or not) are available to pay benefits.

Subtraction of credit balances under the House bill will clearly have an adverse effect on participants. In order to be able to provide new benefits, the company in the above example could waive $10 of its credit balance, which would make the plan 60% funded under the House bill. But the company may not want to waive $10 of credit balance, since that would mean giving up a valuable right that the company had earned through prior contributions. Thus, in order not to lose the value of having made advance contributions, the plan sponsor may feel pressure to freeze benefits.

Concerns with the Senate bill. The Senate bill raises a different concern. Under the Senate bill, for minimum funding purposes, credit balances are subtracted from plan assets even if a plan is funded above the phased-in funding target. For example, assume that a plan has $100 of liabilities, $105 of assets, and a $20 credit balance. The House bill would generally treat the plan as 105% funded, but the Senate bill would treat the plan as 85% funded (for minimum funding purposes). The Senate bill's treatment is not appropriate for the following reasons. First, the Senate bill would eliminate a powerful incentive to keep a plan funded at or above the phased-in funding target. Second, the Senate bill would have an unfair retroactive effect.
Existing credit balances are based on contributions that were made in good faith reliance on present law, and present law does not subtract credit balances if a plan is funded at or above the funding target.

Finally, because the Senate provision primarily impacts well-funded plans, it will help chase the healthy plans out of the defined benefit plan system. The result of the Senate bill is that well-funded plans may confront future funding obligations that are unpredictable due to temporary fluctuations in interest rates or asset values. And it is lack of predictability that has been a major reason that plan sponsors have left the defined benefit plan system.

How to Encourage Pre-Funding

A final bill should encourage employers to pre-fund their pension obligations by (1) adjusting the value of a credit balance to reflect the plan's actual rate of return; (2) not subtracting credit balances for purposes other than determining the company's minimum funding obligation; and (3) including the credit balance in determining whether a plan has met the funding target set out in the law.

Questions? ***Contact:***

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