American Benefits Council

American Benefits Council's Views with Respect to Funding Legislation

The House and Senate funding reform bills both reflect careful consideration of the many difficult issues involved in strengthening the funding rules. Both bills would provide greater retirement security for workers, which is the goal of funding reform. Accordingly, the Council supports the enactment of funding reform legislation based on the bills.

With respect to proposed legislation of this magnitude, it is inevitable that there will be provisions that are inconsistent with the very worthy goals achieved by the bills as a whole. It is critically important that these provisions be identified and modified so as not to undermine the important objectives at stake. In that context, this document summarizes the key concerns of the American Benefits Council (the "Council") with respect to the funding proposals in the Senate (S. 1783) and the House (H.R. 2830). Also included below is a list of other significant issues.

Senate Bill Priority Items

Credit rating. Under the Senate bill, certain obligations with respect to a defined benefit plan, including funding, depend on the credit rating of the employer. We strongly oppose this aspect of the bill, which raises very serious concerns in two respects. First, it is a very frightening precedent for the Federal government to rate the viability of companies, either directly (in the case of private companies) or indirectly (in the case of public companies). Second, this proposal can impose enormous additional costs on struggling companies. It is clear that the proposal would cause more struggling companies to go bankrupt. That is against the interests of the companies, the employees, the economy, and the PBGC (which inherits liabilities only from failed companies).

We understand the need to identify high-risk plans. But the question is what to do to those plans once they have been identified. The answer is not to increase their costs and potentially force the sponsoring companies out of business. A company's credit rating should not be a factor with respect to any issue under the bill.

Predictability. It is critically important to companies that pension plan funding obligations be predictable. Without funding predictability, companies cannot make business plans regarding new investments, new products, and new jobs. Under current law, 48-month smoothing of asset values and 48-month smoothing of interest rates provide helpful predictability. The Senate bill reduces both smoothing periods to 12 months. Thus, on January 1, 2008, a company will have very little ability to predict contributions for 2009 and virtually no ability to predict contributions for 2010. Businesses cannot function under those conditions; companies will leave the defined benefit plan system in droves.

The smoothing periods need to be at least 36 months and, with respect to interest rates, the most recent year should not be weighted too heavily. And it should be clarified that the references in the bill to asset "averaging" are meant to include the current-law "smoothing" rules.

Credit balances. The bill requires that a plan's credit balance be subtracted from the value of the plan's assets in determining the minimum required contribution. With respect to underfunded plans, this is appropriate and consistent with present law. The bill, however, also applies this rule to plans that are funded at the phased-in funding target or a higher level, which is inconsistent with the structure of current law. Retaining the current-law structure - - so that a plan's credit balance is not subtracted from the value of the plan's assets if the plan is funded at the phased-in funding target or higher - - would provide a significant incentive for employers to stay at or above the phased-in funding target (i.e., generally, 93% funded in 2007, 96% funded in 2008, and 100% funded thereafter). In addition, with respect to existing credit balances, changing the current-law structure would have an unfair retroactive effect, since it would be applying a new harsher rule to past contributions that were made in good faith reliance on the law in effect at the time. Accordingly, in determining the required minimum contribution to a plan that is at or above the phased-in funding target, credit balances should not be subtracted.

The bill does not subtract credit balances from plan assets for any purposes other than determining required minimum contributions (assuming that one modification described below is made). This is appropriate and is a very important element of the bill.

Transition. In light of the significant effects of the proposals and the large amount of regulatory guidance needed, the general effective date should be 2008 or, at a minimum, a good faith compliance standard should apply during 2007.

The Senate bill generally phases in the 100% funding target over three years. This is not enough. An increase in the funding target from 90% to 100% is an increase of hundreds of millions of dollars for many plans, and billions for others. That type of new obligation needs to be phased in over a period that gives companies time to adjust their long-range business plans. For some companies, a five-year phase-in period would be workable; many other companies will need seven to ten years.

A comparable transition rule is needed with respect to normal cost. For many companies, the new rules would result in a normal cost amount that is far larger than under current law. Similar transition relief is needed with respect to the rule requiring lump sums to be taken into account for funding purposes; for many plans, this new rule would trigger a dramatic increase in liabilities.

Bond quality levels. The Senate bill bases the yield curve on investment grade corporate bonds. The legislation should clarify that all investment grade quality levels, including AAA, AA, A, and BBB, are to be taken into account for this purpose. Bonds at the AAA level should be weighted less heavily due to the thinness of the markets for such bonds.

Amortization. Under the bill, the amortization schedule has an unfair element (which was also in the Administration's proposal). If a plan has unfavorable experience during a year (such as unfavorable investment experience or a decline in interest rates), a new shortfall amortization base must be created immediately. On the other hand, if a plan has favorable experience (such as favorable investment experience or an increase in interest rates), the plan's amortization requirements are unchanged until the plan achieves a 100% funding target attainment percentage. This rule forces companies to ignore favorable experience in funding their plans. As a result, many scenarios can develop in which the effective amortization period is significantly less than seven years. For example, in many cases, where actual pension trust returns are only 2.5% to 3% greater than the interest rate applicable for determining liabilities, the effective amortization period is reduced to three years or less.

The bill should be amended so that existing amortization installments are adjusted by favorable experience, just as negative experience has an immediate effect. In addition, to reduce volatility, the bills should move from seven-year amortization to 10-year amortization, consistent with the Administration's stated view that 10 years is a reasonable amortization period.

Yield curve. The yield curve concept makes the applicable interest rate far less predictable because of the changes in the slope of the yield curve and the amount of extrapolation necessary to create the yield curve. Moreover, in a great number of cases, the yield curve will not have a material effect, as compared to the application of the long-term corporate bond rate. In light of these points, we believe the applicable interest rate should remain the four-year weighted average of the long-term corporate bond rate, not the segmented yield curve.

If the three-segment yield curve in the bills is retained, three modifications are needed. First, the statutory language implementing the yield curve references bond interest rates, which will not produce the contemplated yield curve. The language needs to refer directly to replicating the effect of the yield curve. Second, the yield curve should be promulgated by regulation to ensure that the methodology used is subject to advance notice and comment. Third, it should be clarified that the rate for each segment is the average of all rates in the segment.

Mandatory funding. Under the Senate bill, the benefit restrictions do not apply to collectively bargained plans; instead, the employer is required to make whatever contribution is necessary to prevent an otherwise applicable benefit restriction from applying. This provision appears to be aimed at helping union employees, but could very well have the opposite effect.

Under this rule, an employer with a plan that is less than, for example, 90% funded may well be quite hesitant to agree to any multi-year benefit increase because of the very real risk that a downturn in the market or a fall in interest rates could push the plan below 80% funded, triggering immediate large funding obligations. For a collectively bargained plan that pays lumps sums, the risk is even greater and could cause the employer to seek to terminate the plan to avoid potentially huge liabilities in returning the plan to an 80% funded level.

HOUSE BILL PRIORITY ITEMS

Credit balances. Under the House bill, if the value of a plan's assets is less than the phased-in funding target, assets are reduced by credit balances for numerous purposes, such as benefit restrictions and several disclosure rules (but not all disclosure rules). For purposes of determining whether a plan is at-risk, credit balances are always subtracted regardless of the plan's funded status. These reduction rules treat many well-funded plans as being poorly funded. This could well lead to the freezing of many very well-funded plans with large credit balances, thus undermining the retirement security of the very participants the bill is trying to protect. Plan assets should be reduced by credit balances only for purposes of determining the shortfall amortization base of a plan that is funded below the phased-in funding target (i.e., 92% funded in the first year, 94% funded in the second year, etc.) (determined without subtracting credit balances from plan assets).

There may well be alternative approaches to the credit balance issue that address the legitimate policy concerns that have been raised without the adverse effects described above. For example, all credit balances could be required to be retroactively marked to market under rules that permit estimations and other reasonable means of avoiding excessive administrative burdens. This would ensure that credit balances reflect real plan assets and thus could possibly address the concerns underlying the subtraction provision described above, so that the subtraction provision could be deleted.

Transition. The House bill includes a five-year transition rule, but unlike the Education and the Workforce Committee bill and the Ways and Means Committee bill, the transition rule only applies to plans that are funded at the phase-in level. Thus, there is no transition rule for the many plans funded below the phase-in level. This is a very significant problem. At a minimum, the transition rule should return to the five-year version passed by the two Committees. In addition, as noted above, many companies will need a transition period of seven to ten years. Also as noted above, similar transition rules are needed with respect to normal cost and the requirement that lump sums be taken into account for funding purposes.

Smoothing. With respect to interest rate smoothing, it is important that the most recent year be weighted at less than a 50% level in order to provide needed predictability. As with the Senate bill, it should be clarified that the references in the House bill to asset "averaging" are meant to include the current-law "smoothing" rules.

Bond quality levels, amortization, yield curve. We have the same concerns described above with respect to the Senate bill.

ADDITIONAL SENATE ISSUES

Multiple lump sum interest rates. The bill addresses the whipsaw issue for cash balance plans prospectively, so that the whipsaw problem apparently will continue to apply to benefits accrued on or before July 31, 2005. The continued existence of the whipsaw issue means that the bill's application of the yield curve interest rates to determine lump sums would create whipsaw problems for cash balance plans that never had whipsaw problems. And there is no way for a plan to avoid this. In order to avoid whipsaw, a cash balance plan's interest crediting rate generally must match its discount rate. If older workers have a lower effective discount rate under the yield curve than they do under present law, that means their interest crediting rate will likely be higher than their new discount rate, thus creating a whipsaw problem. The problem cannot be solved by reducing the interest crediting rate for previously accrued benefits since that would violate the anti-cutback rules.

Quarterly contributions. Plans that are subject to the quarterly contribution requirement in 2007 cannot use the prior year safe harbor in determining the amount of each quarterly contribution. That will cause a significant problem for the first two quarterly contributions due in 2007 when the information for 2007 is not available and the prior year's numbers cannot be used. This can be solved by making the 100% of last year safe harbor applicable to those first two quarterly contributions in 2007.

Companies are only required to make minimum contributions with respect to plans that were less than 100% funded in the prior year. For 2007, it should be clarified that the determination of whether a plan was 100% funded in 2006 should be based on the law in effect in 2006.

Anti-cutback rule. The bill provides anti-cutback relief for the new lump sum interest rate. But the relief only applies to amendments required by the new interest rate rule. If a plan is using a lower interest rate now, it is not required to use the higher rate permitted by the bill. So any change to the higher rate would not be protected by the anti-cutback relief. The relief should apply to any change "pursuant to" (as opposed to "required by") the new interest rate rule.

At-risk liability. The at-risk actuarial assumptions in the bill are a "worse than worst case". The point of the at-risk assumptions is to simulate a company bankruptcy with all participants terminating and taking available subsidized benefits. But the bill assumes each eligible participant terminates at the time during an eight-year period when his or her benefits are the most valuable. Since a company cannot go bankrupt at different times with respect to different employees, this assumption does not make sense. The bill should be modified to assume, for example, that all participants terminate within, for example, two years and take all available subsidies. And there should not be a normal cost with respect to employees deemed to have previously retired.

Mortality table. Under the Senate bill, it appears that employers that use their own mortality table must apply a single substitute table to their entire workforce. This would produce an inappropriate result where an employer has more than one plan with very different mortality experience, such as a blue collar plan and a white collar plan. An alternative rule would require companies to use a plan-specific substitute table with respect to each of their plans if they use a substitute table with respect to one plan.

Credit balance subtraction. The Senate bill should be modified so that credit balances are not subtracted for purposes of determining whether a plan has sufficient assets to make a section 420 transfer.

Under the Senate bill, if a plan is less than 80% funded, credit balances can only be partially used to offset the required minimum contributions with respect to the plan; cash contributions are required equal to the greater of normal cost or 25% of the required minimum contribution. This restriction on the use of credit balances would create a pre-funding disincentive with respect to plans below 80% funded, as well as with respect to plans slightly above 80% funded. That is exactly the opposite of what is needed, which is more advance funding with respect to underfunded plans.

Also, the rationale for subtracting credit balances for minimum funding purposes is that credit balances can be used as contributions for minimum funding purposes. As noted above, if a plan is below 80% funded, the bill only permits credit balances to be partially used as contributions, yet subtracts the full amount of the credit balance. If the 80% rule is retained, this inconsistency should be fixed.

Timing of disclosure. Section 501 of the Senate bill requires disclosure of end-of-the-year funded status within 90 days after the end of the year. Asset determinations can be made within that time period, but large plans cannot complete liability determinations by that time. The bill needs to be modified to permit the use of beginning-of-the-year liability data projected forward to year-end, taking into account all significant events during the year (such as plan amendments or mergers) that have a material effect on liabilities.

PBGC premiums. We are quite concerned about the level of PBGC premiums. With respect to the risk-based premium, the elimination of the exemption for plans at the full funding limitation and the taking into account of non-vested benefits will have very burdensome effects. At a minimum, transition relief is needed with respect to the elimination of the full funding exemption.

ADDITIONAL HOUSE ISSUES

Multiple lump sum interest rates, quarterly contributions, at-risk liability, risk-based premiums, anti-cutback rule. The House bill raises the same (or very similar) issues as described above with respect to the Senate bill.

Lump sum prohibition. The rule prohibiting the payment of lump sum distributions by plans less than 80% funded will trigger rushes to retire by older employees who anticipate the prohibition. Such rushes to retire will severely hurt companies and plans. This prohibition will thus be counterproductive and should be significantly modified.

Combined plan deduction limit. The bill modifies the deduction limit on employers that maintain both a defined contribution plan and a defined benefit plan. Under revised Code section 404(a)(7), employer contributions to a defined contribution plan up to 6% of participants' aggregate compensation are disregarded. This will address the vast majority of the problems that currently exist with respect to the combined plan limit. But for employers with, for example, a large proportion of retirees and a generous defined contribution plan, the combined plan limit will still have an unjustified adverse affect. The combined plan limit should be repealed with respect to all employers that maintain a defined benefit plan insured by the PBGC.

At-risk liability. The House bill's at-risk actuarial assumptions are, like the Senate's, worse than worst case and should be modified in the manner described above. In addition, the very large loading factor added to the liability of an at-risk plan under the House bill should be deleted. This loading factor is intended to reflect the cost of purchasing group annuity contracts in connection with a plan termination. Since PBGC does not purchase annuity contracts when it takes over a plan, a plan taken over by PBGC would not need to have assets to pay for this loading factor in order to have sufficient assets to pay all liabilities.

Subtraction of credit balances. Under the House bill, plans that are less than 80% funded are not permitted to use credit balances at all. This would be a severe pre-funding disincentive with regard to plans that are less than 80% funded, or slightly above 80% funded, thus discouraging exactly the behavior that should be encouraged. Also, even though credit balances cannot be used by plans that are less than 80% funded, credit balances are still subtracted from the asset of such plans for minimum funding purposes. If the 80% rule is retained so that credit balances are not usable by plans funded below 80%, there is no reason to subtract credit balances with respect to such plans.

In addition, it should be clarified that credit balances are not subtracted in determining a plan's funded status for purposes of the risk-based premium. And if a company has an agreement in effect with the PBGC that credit balances will not be used, credit balances should not be subtracted for any purpose.

Multiple employer cooperative plans. Multiple employer plans maintained by hundreds of rural cooperatives do not pose any material risk to the PBGC. This is true because even if one or many of the sponsoring cooperatives become insolvent, the multiple employer plan continues with no liability shifting to the PBGC. In light of the ongoing nature of these plans, there is no reason to impose the new funding structure on them. This issue, which was raised after development of the Education and the Workforce Committee bill, should be reflected in the conference agreement. See section 105 of the Senate bill.