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S. 1783: The Pension Security and Transparency Act of 2005

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Summary

This report summarizes the major provisions of S. 1783, the Pension Security and Transparency Act of 2005. The bill combines provisions of S. 219, the National Employee Savings and Trust Equity Guarantee Act, reported by the Finance Committee, and the Defined Benefit Security Act, reported by the Committee on Health, Education, Labor, and Pensions. If S.1783 does not reach the Senate floor before the end of the first session of the 109th Congress, some elements of the bill might be included in the budget reconciliation process because the revenues and expenditures of the Pension Benefit Guaranty Corporation (PBGC) are treated in the federal budget as revenues and expenditures of the U.S. government. The proposed increase in the base PBGC premium that is included in S. 1783 would increase revenue to the PBGC and reduce the federal budget deficit. This report will be updated as necessary.

Funding Requirements for Single-Employer Pension Plans. Federal law requires the sponsors of defined benefit pension plans to fund in advance the benefits earned by participants. The minimum required contribution to the plan is the sum of the benefits accrued by plan participants during the year (the plan's "normal cost") and amortization of any unfunded accrued liability from prior years. If a plan is underfunded, the plan sponsor must amortize (pay off with interest) the unfunded liability, and also may be required to make an additional contribution called a deficit reduction contribution (DRC). The maximum period for amortizing a plan's unfunded liability varies, but it can extend up to 30 years. A plan is considered to be underfunded if the ratio of assets to current liability is below 80% in a single year or is consistently below 90%. Under S. 1783, plans would be required to amortize unfunded liabilities over no more than seven years, but deficit reduction contributions would no longer be required. In general, the plan sponsor would be required to contribute to the plan each year the sum of the plan's normal cost plus an amount sufficient to amortize any unfunded liability over seven years. The current DRC rules would continue in force for the plan year beginning in 2006.

S. 1783 would require all benefits accrued by plan participants up to the beginning of the current plan year — the plan's "accrued liability" — to be 100% funded. The bill

would phase in the new funding target at rates of 93%, 96%, and 100% over three years beginning in 2007. For plans with 100 or fewer participants, the funding target would be phased in over five years. The funding target for small plans would be 92% of accrued liability in 2007, 94% in 2008, 96% in 2009, 98% in 2010 and 100% in 2011.

Financial Condition of the Plan Sponsor. Funding requirements for pension plans reflect the assumption that the plan will continue to operate. If a plan terminates, the assets required to pay off its obligations all at once usually are more than the assets that it is required to have on hand as an ongoing plan. In other words, the "termination liability" of a defined benefit plan often exceeds its "ongoing liability." Under S. 1783, underfunded plans sponsored by firms classified as financially weak would be considered to be "at risk" of terminating. When determining their required contribution, sponsors of these plans would be required to assume that participants would retire at the earliest possible date and elect the form of benefit from the plan that has the highest present value.

Under S. 1783, the plan of a financially weak sponsor would be subject to funding targets for plans that are at risk of default. Bond ratings would be used to measure a plan sponsor's financial strength. If all bond-rating agencies that rate a company rate the company as below investment grade, the plan may have to determine its liability on an at risk basis. However, a plan would not be treated as at risk unless the sponsor has had a declining credit rating for two years. For employers without bond ratings, the Treasury department would issue guidance as to appropriate substitute measures, such as the company's debt-to-equity ratio. Plans with 500 participants or fewer would not be treated as at risk, regardless of their bond ratings.

The increased liability from being at risk would not apply unless the company were at risk for two consecutive years. The at-risk target would be phased in 20% per year. Years prior to enactment would not be counted. If one of the rating bond agencies improves a company's bond rating for a year, that year would be ignored for purposes of the both the gateway and the phase-in. If the company is at risk, the plan would determine its liability by assuming that workers who might retire in the following seven years would retire as soon as they are eligible and take the most valuable benefit at that age. At risk valuations would not apply if the plan would be at least 93% funded without regard to the at-risk measure of plan liabilities.

Valuation of Assets and Liabilities. The present value of a pension plan's liabilities is determined by discounting future benefit payments at a specific rate of interest. The present value is inversely related to the discount rate: lower interest rates increase the present value of plan liabilities and the amount of money that must be put into the pension fund to pay those liabilities. Under current law, in determining their current liability, plans must use an interest rate that is no higher than the weighted average rate on long-term corporate bonds during the four-year period ending on the last day before the beginning of the plan year. Using a four-year average rate smooths the volatility that would occur if plan liabilities were discounted using the current interest rate as of the date of the calculation. The value of a plan's assets also may be smoothed over five years, but cannot be more than 120% or less than 80% of their market value.

Interest rates vary directly with the maturity date of the associated debt. In most cases, short-term interest rates are lower than long-term rates because the money that has been lent is at risk of default and of erosion by inflation over a shorter period of time.

Taken together, the interest rates associated with each year are called the interest rate "yield curve." By using a yield curve to discount liabilities, plan sponsors with older workers or higher ratios of retirees to participants would have to contribute more to their plans than sponsors of plans with younger workers or fewer current retirees because more of the plan's liabilities would be discounted at shorter-term interest rates. For calculating plan liabilities, S. 1783 would require plans to use a segmented yield curve based on investment grade corporate bonds, averaged (unweighted) over 12 months. The new yield curve would be phased in over three years starting in 2007. For valuing plan assets, S. 1783 would require plans to use either the market value of assets or, pursuant to Treasury regulations, the market value averaged over the prior three months plus one day. It would allow smoothing (unweighted) of changes in plan assets over twelve months.

Credit Balances and Contribution. Under current law, plan sponsors that contribute more than the minimum required amount to a plan build up "credit balances" that can be used to reduce future contributions. For example, if the minimum required contribution this year is $1 million and the sponsor contributes $1.1 million to the plan, a $100,000 credit balance is created. If the minimum required contribution next year also is $1 million, the sponsor would have to contribute only $900,000 due to having a credit balance of $100,000. Moreover, credit balances from prior years increase at the interest rate assumed by the plan, regardless of the actual investment gains or losses of the plan's assets. Under S. 1783, credit balances would continue to be allowed, but the value of the credit balances would be adjusted to their current market value, based on investment gains or losses since the date they were contributed to the plan, rather than varying by the assumed rate of return. After enactment, credit balances could arise only from contributions, not from experience gains. The bill provides that if the plan is less than 80% funded and the sponsor wishes to use credit balances to pay the minimum required contribution, the sponsor must make a cash contribution equal to the lesser of 25% of the minimum contribution or the plan's normal cost.

Under current law, employer contributions to defined benefit pensions are tax-deductible up to certain limits. S. 1783 would allow plan sponsors to make additional tax-deductible contributions in excess of a plan's minimum funding requirements in order to build up the plan's assets. In 2006, the deductible contribution would increase to an amount equal to the difference between 180% of the plan's current liability and the value of the plan's assets. For years after 2006, the maximum deductible contribution would be the greater of (1) the excess of the sum of the plan's funding target, the plan's normal cost, and a "cushion amount," over the plan's assets and, (2) the minimum required contribution for the year. For plans that are not in the "at-risk" category, this calculation could be performed as if the plan was in at-risk status, thus allowing a larger contribution. The cushion amount would be equal to the sum of 80% of the plan's funding target for the plan year and the amount by which the funding target would increase, based on future compensation increases. For plans with "flat dollar" benefits (i.e., benefits that are not based on past compensation), the cushion would be based on expected increases in benefits, as calculated from the average benefit increase in the previous six years.

PBGC Premiums for Single-Employer Plans. Under current law, defined benefit plan sponsors pay an annual premium of $19 per participant to the Pension Benefit Guaranty Corporation (PBGC). Sponsors of underfunded plans also pay a variable premium of $9 per $1,000 of underfunding. Only vested benefits are counted for the purpose of calculating the variable premium. Under S. 1783, the annual per-capita PBGC

premium would increase to $30 in 2006. Every five years, the PBGC would submit to Congress a report recommending any necessary change in the base premium. The variable rate premium would not be changed, but the bill would eliminate the full funding limit, and base the interest rate for calculating liabilities on a three-segment spot yield curve of corporate bond interest rates.

Lump-Sum Distributions and Limitations on Benefits. Under current law, a defined benefit plan that allows benefits to be paid as a lump sum must use the interest rate on 30-year Treasury bonds to convert the annuity that otherwise would be paid to the participant into a lump sum. S. 1783 would require plans to use a three-month corporate-bond yield curve of interest rates to determine the amount of lump-sum payments. The interest rates used to calculate a lump sum payment would be based on the participant's age when the lump-sum is paid and the number of years until he or she would reach the plan's normal retirement age. Other things being equal, lump-sum payments would be greater for older participants. The new interest rate rules for lump sums would be phased in over four years beginning in 2007.

Under current law, if a plan with a funding ratio under 60% adopts an amendment that increases benefits under the plan, the sponsor must bring the plan's funding ratio up to at least 60%. Under S. 1783, benefits could not be increased if a plan's funding ratio is under 80%, lump sums could not be paid from a plan with a funding ratio under 60%, and benefit accruals would cease if a plan's funding ratio was under 60% in the prior year. Benefit increases would be permitted if the plan sponsor made contributions (in addition to the minimum required contribution) that would result in the plan being at least 80% funded. Amendments that would increase benefits and the payment of lump-sum distributions both would be prohibited if the plan sponsor is in bankruptcy, unless the plan's funding ratio is at least 100%. The plan administrator would be required to notify plan participants of these limitations before they take effect and also in advance of the date the restrictions would end. In order for the benefit restrictions to end, the plan actuary would have to certify that the plan is at the required funding ratio. The provisions limiting benefit increases, lump-sum payments, and additional benefit accruals in underfunded plans would be effective in 2007 or on the termination of a collective bargaining agreement (or 2009 if earlier).

"Shut-Down" Benefits. The bill would continue to permit benefits triggered by a plant shutdown or other contingent event, but it would limit PBGC guarantees for these benefits. The PBGC benefit guarantee would apply as if the plan amendment adding the contingent benefit had been adopted at the time the shutdown or other event occurred. Therefore, the current law five-year phase-in of the PBGC benefit guarantee would apply.

Disclosure Requirements. Under current law, plan sponsors must provide participants with a summary annual report and, on request, with a copy of the Form 5500 that they filed with the IRS and Department of Labor. S. 1783 would create a 90-day notice of plan funding and other plan information. This notice would replace the 60-day multiemployer notice and the ERISA §4011 notice, which must be provided by single and multiemployer plans under current law. The bill would change the criteria for who must file the §4010 reports, such that plans that are underfunded by more than $50 million would have to file only if the plan is less than 90% funded. A plan with an aggregate funding percentage of less than 60% or a plan less than 75% funded that is in a "troubled industry" also would have to file the §4010 report. In addition, all companies with bond

ratings below investment grade with plans underfunded by more than $50 million would have to file with the PBGC under §4010.

Funding of Deferred Compensation Plans. S. 1783 would prohibit, in certain circumstances, funding of non-qualified deferred compensation plans for a plan sponsor's chief executive officer and four most highly compensated officers. The funding restrictions would apply if (1) a plan sponsor is financially weak and maintains a plan that is less than 80% funded, (2) the plan sponsor is in bankruptcy, or (3) during the 12-month period beginning six months before the distress termination of an underfunded plan.

Airline Pension Plans. S. 1783 would allow airlines to amortize funding shortfalls over 14 years, rather than the seven-year period applicable to other firms, and to use their own actuarial assumptions. Airlines would have to elect the relief, and benefits under these plans and the PBGC benefit guarantee both would be frozen as of the first plan year to which the special funding rules apply. The PBGC benefit guarantee would be applied as if the plan terminated on the first day of the year in which this special airline funding rule was adopted by the plan.

Alternative Funding Arrangements. Under current law, the PBGC has no authority to negotiate alternative funding schedules, although it can negotiate additional contributions to plans by sponsors under the threat of plan termination. Under S. 1783, the IRS, in consultation with PBGC, would be able to negotiate alternative funding schedules with sponsors if the PBGC concludes it would otherwise try to involuntarily terminate the plan or that the plan is likely to file for a distress termination. The PBGC could base its findings on projections for up to six months, but an employer or other party could ask for a PBGC finding that would be based on projections for up to two years.

Mortality Assumptions. Current Treasury regulations require plans to use a specific mortality table (GAM 83). Under S. 1783, the prescribed mortality assumptions would be those in the RP-2000 mortality table, subject to updating every ten years. The IRS would be given more authority with respect to plan-specific mortality findings.

Valuation Date. Most plans use the first day of the plan year as the day on which all liability measurements are made. Changing the date is subject to IRS approval. Under S. 1783, plans with more than 100 participants would be required to use the first day of the plan year as the valuation date. Plans with 100 or fewer participants could use any day of the plan year, but changes would be subject to IRS approval.

Multiemployer Plan Funding Rules. Under current law, multiemployer plans generally are subject to the same funding rules as single-employer plans, except that the DRC rules do not apply to multiemployer plans. Also, multiemployer plans have longer to amortize unfunded liabilities. Generally, multiemployer plans neither terminate nor enter reorganization. If they become insolvent, the PBGC lends them money to pay a reduced benefit. If an employer withdraws from a multiemployer plan and the plan is underfunded, the employer must pay withdrawal liability to the plan based on one of several formulas. Generally, the amount of withdrawal liability is based on the ratio of the employer's contributions to the other active employers' contributions.

S. 1783 would require plans that do not meet certain funding and other tests to adopt financial improvement plans and rehabilitation plans. Plans that have, or are projected

to have, an accumulated funding deficiency and are more than 65% funded would be considered to be seriously endangered. Plans that are between 65% and 80% funded, but that have no real or projected accumulated funding deficiency, would be considered to be endangered. Plans that are less than 65% funded would be considered to be critical. The financial improvement and rehabilitation plans must specify what actions the plans and the bargaining parties will take to exit their underfunded status within 10 to 15 years. The plan actuary must certify each year that the plan is on target, or has been changed as necessary to accomplish the target. The PBGC would be instructed to report in five years on the health of the multiemployer insurance program and the new funding rules. The new rules would sunset three years later.

Contribution Limit for Multiemployer Plans. The bill would increase the limit on tax-deductible contributions to multiemployer plans to an amount equal to the difference between 130% of the plan's current liability and the value of plan assets. The bill would repeal the combined limit on deductions for contributions to combinations of multiemployer defined benefit and defined contribution plans. The bill also would add to the Internal Revenue Code the multiemployer plan funding notice requirement that was added to ERISA as part of the Pension Funding Equity Act of 2004. It would impose an excise tax of $100 per day per participant for failure to meet the notice requirement.

Cash Balance Plans and Other Hybrid Pensions. The bill would provide that "cash balance plans" do not discriminate against older workers merely because interest accrues to younger workers' accounts for longer periods than to older workers' accounts, provided that neither pay credits nor interest credits decrease as workers age. The bill would permit plan sponsors to use a market interest rate instead of the 30-year Treasury rate to discount lump-sum distributions, thus allowing them to pay a lump sum benefit equal to the participant's notional account balance. Treasury regulations would define a "market interest rate," but the bill specifies that a plan's interest credit generally cannot be less than the Federal mid-term interest rate. Benefits under cash balance plans would be required to vest after no more than three years of service. The bill would require plans that convert to a cash balance design to include one of three provisions:

- The conversion cannot result in a period of no new benefits accruals (called a "wear-away" period) and the plan must either (1) provide all participants covered by the plan before the conversion with the greater of accruals under the old formula or new formula for at least five years after the conversion, or (2) provide participants who were at least age 40 at the time of the conversion and had combined age and service of at least 55 years with (1) the greater of the benefit under the old formula or new formula, or (2) a choice between the old formula or new formula;
- The plan must provide all participants who were covered at the time of conversion with (1) the greater of the benefit determined under the old formula or new formula, or (2) a choice between the benefit determined under the old formula or new formula; or
- The plan sponsor must provide additional pay credits or additional opening account balances so as to provide benefits that would be substantially equal to either of the prior two alternatives, as determined under Treasury Department regulations.