July 14, 2005

Concerns Regarding the Funding Rules of H.R. 2830 (As Passed by the House Committee on Education and the Workforce)

KEY ISSUES

Reduction of plan assets by credit balances. Under new ERISA section 303(f)(4), plan assets are reduced by credit balances for numerous purposes, such as at-risk determinations, benefit restrictions, and several disclosure rules (but not all disclosure rules). This erroneously treats many well-funded as underfunded based on a flawed "double-counting theory" that has previously been considered and rejected by Congress. Plan assets should be reduced by credit balances only for purposes of determining the shortfall amortization base of a plan that is less than 100% funded (determined without subtracting credit balances from plan asserts).

Transition to 100% funding target. The bill provides a 5-year phase-in with respect to the 100% funding target, but only for plans that were subject to the DRC in 2005. See new ERISA section 303(c)(4)(B). The rule limiting the transition relief to plans subject to the DRC appears to be a glitch. Plans subject to the DRC were already subject to a 100% funding target and thus are less in need of transition relief. The plans needing transition relief are the plans that were not subject to the DRC (because they were not subject to a 100% funding target).

Further evidence that the rule in the bill is a glitch is that some well-funded plans could owe more than some less well-funded plans. For example, in 2006, when the transition target is 92%, a plan that was subject to the DRC with $89 in assets and $100 in liabilities would amortize $3 over 7 years while a plan that was not subject to the DRC with $91 in assets and $100 in liabilities would amortize $9 over 7 years. Rewarding less well-funded plans in this manner was almost certainly not intended.

Transition to new lump sum rule. New ERISA section 303(h)(4) requires that lump sum distributions be taken into account in determining a plan's funding target, effective in 2006. This new rule would cause an immediate significant increase in liabilities for many plans. Accordingly, this rule should be phased in over 5 years.

Treasury discretion regarding the segment rates. New ERISA section 303(h)(2)(C) directs Treasury to set a single interest rate for each segment, but provides Treasury with no guidance regarding how to determine the segment rates. The bill should clarify that Treasury should choose a rate that represents an average of all yield curve rates within a segment, thereby precluding Treasury from using the lowest rates within each segment.

Yield curve. New ERISA section 303(h)(2)(D) specifies that the segment rates are to be based on a 3-year weighted average of an "investment grade" corporate bond yield curve. The legislative history should clarify that all investment grade quality levels should be taken into account for this purpose, with additional weight given to the second and third quality levels The second and third quality levels reflect conservative rates and, unlike the top quality level, the market for bonds at such levels is relatively substantial.

ASSET VALUATIONS

New ERISA section 303(g)(3)(A) apparently is intended to limit asset smoothing to three years, but refers to smoothing over the current year and the two preceding year. Since valuations are generally performed as of the first day of the current year, the current year cannot be taken into account for asset valuation purposes. Thus, the bill appears to permit 3-year averaging but actually only permits 2-year averaging. This should be corrected by limiting averaging to the 3 preceding years.

DEFINITION OF LIABILITY

Under new ERISA section 4006(a)(3)(E)(iv), for purposes of determining liability for risk-based premiums, funded status is based on spot interest rates and spot asset values. This is a significant problem; in light of the repeal of the full-funding limitation exemption, a large number of plans will be subject to the unpredictability of spot valuations. This spot valuation rule is also directly contrary to the objective of having a single definition of liability.

MINIMUM CONTRIBUTION ISSUES

Normal cost. The bill should clarify that target normal cost does not include the value of benefit improvements that take effect during the current year. Otherwise, all benefit improvements for all plans would be required to be funded immediately. See new ERISA sections 303(b) and 303(g)(5).

Amortization. Under new ERISA section 303(c), the amortization schedule has an odd and 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 is 100% funded. This rule inexplicably forces companies to ignore favorable experience in funding their plans. The bill should be amended so that existing amortization installments are adjusted by favorable experience, just as negative experience has an immediate effect.

LUMP SUM ISSUES

Lump sum prohibition. The rule in new ERISA section 206(h)(2) 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 very counterproductive and should be either significantly modified or eliminated.

Lump sum anti-cutback rule. Bill section 301(c) provides anti-cutback relief for plan amendments "necessary to meet the requirements of the amendments made by this section". This language does not work. To the extent that the new assumption rules would result in a smaller lump sum payment, a plan is not required to be amended. Thus, the anti-cutback relief will not permit plans to be amended to use the higher interest rates. The above language should be changed to "pursuant to the amendments made by this section".

Lump sum mortality rule. New ERISA section 205(g)(3)(B)(i) requires that lump sums be determined under the same mortality table used for funding purposes. New ERISA section 303(h)(3)(C) permits a plan to elect a plan-specific mortality table under certain circumstances. Without additional anti-cutback relief, no plan with lump sums will be able to elect a plan-specific mortality table that includes shorter life expectancies. The reason is that such a mortality table would reduce lump sum payments; anti-cutback relief is needed for such a reduction.

Multiple lump sum interest rates. If the whipsaw issue is not fixed for cash balance plans, applying the three segment interest rates to determine lump sums under ERISA section 205(g)(3)(B) will create major problems for cash balance plans. Under whipsaw, a cash balance plan's interest crediting rate generally must match its discount rate. If older workers have a lower discount rate, then either they will have to receive a lower interest crediting rating (which will not happen and could not happen legally) or all interest crediting rates will have to be reduced. Reducing interest crediting rates would not only be extremely unpopular but would also be prohibited by the anti-cutback rules, leaving employers in a situation where they are forced to create a large whipsaw problem or to violate one law or another.

DEDUCTION ISSUES

<u>Deduction limit.</u> The 150% deduction limit appears to be quite high. In reality, it is our understanding that this limit may only be a 20% to 25% increase for many plans compared to current law. This is so because of the change from the 30-year Treasury rate (which applies for deduction purposes in 2004 and 2005) and the elimination of the 90% to 100% permissible range regarding interest rates.

This is still a helpful increase in the deduction limit. However, in times of high interest rates, this deduction limit will be quite low and will cause problems.

<u>Combined plan deduction limit.</u> The bill modifies the deduction limit on employers that maintain both a DC and DB plan. Under revised Code section 404(a)(7), employer contributions to a DC 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 a large proportion of retirees and with a generous DC 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 DB plan insured by the PBGC.

<u>MISCELLANEOUS ISSUES</u>

<u>Nonqualified deferred compensation.</u> Under new Code section 409A(b)(3), funding nonqualified deferred compensation is restricted when a plan is less than 60% funded. This rule should not apply to the entire controlled group if a plan in one division or subsidiary is less than 60% funded; the rule should be limited to the portion of a controlled group maintaining the plan. And it should be clarified that the rule only applies to new funding of the deferred compensation after the DB plan becomes less that 60% funded, not to pre-existing funding amounts (in, for example, a rabbi trust).

<u>Quarterly contributions</u>. There are two transition problems regarding quarterly contributions. First, new ERISA section 303(j)(3)(A) appears to require quarterly contributions in 2006 if a plan was not 100% funded in 2005 based on the <u>new</u> funding rules. That is an unfair retroactive rule and it would be burdensome for plans to re-measure their prior year information based on the new rules. Second, under new ERISA section 303(j)(3)(D)(ii)(II), if a plan is subject to the quarterly contribution rule in 2006, the employer cannot use the safe harbor permitting the employer to make quarterly contributions based on 100% of the prior year's required contribution. Since current year plan valuations are not complete by April 15 (the date the first quarterly contribution is due), this will result in large numbers of inadvertent violations of the quarterly contribution rule. The "100% of last year" safe harbor should be available in 2006.

<u>At-risk liability.</u> The at-risk actuarial assumptions in new ERISA section 303(i)(1)(B) 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 participant terminates at whatever time maximizes that participant's benefit. 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 two years and take all available subsidies.

Multiple employer plans. The Code provisions of the bill often refer to "single employer plans," which are defined in ERISA to mean plans other than multiemployer plans, but are not defined in the Code. The term should be defined in the Code to clarify the application of the bill to multiple employer plans.