Senate HELP Committee Approves Pension Reform Bill

Defined Benefit Security Act Bolsters DB Funding Requirements, Erects Troubling Hurdles for Hybrid Plans

On September 8, 2005, the Senate Health Education Labor and Pensions (HELP) Committee approved the Defined Benefit Security Act (no bill number available) containing significant reforms to the traditional and hybrid defined benefit system. The bill adapts provisions from both the House Workforce Committee bill (H.R. 2830) and the Senate Finance Committee-passed bill (S. 219). The HELP bill increases the funding targets from 90 to 100 percent, but gives a ten-year phase-in period to reach the new target. It also requires the use of a yield curve similar to the House bill. It increases the Pension Benefit Guaranty Corporation (PBGC) flat-rate premium from $19 to $30, but it does not index the amount for inflation. The most troubling provisions are those attempting to remove the legal uncertainty from existing and future hybrid (cash balance and pension equity) plans. The provisions attempting to provide retroactive clarity will be very difficult for most companies to meet unless they provided choice between the traditional and hybrid plans to all participants. Moreover, the retroactive clarity does not apply to plans that are already in litigation.

Hybrid Provisions Place Existing Plans In Jeopardy and Discourage Future Conversions With respect to hybrid (i.e., cash balance and pension equity) plans, the HELP Committee bill attempts to address the legal status of existing plans as well as future conversions. Unfortunately, the requirements are so difficult to meet that few companies are likely to attempt to fit under the provisions. The rules for prospective relief are the same as the Senate Finance Committee bill. There are three alternative safe harbors allowing for retroactive protection of existing plans. (Plans in litigation prior to August 1, 2005, are excluded from these safe harbors.) The first two prohibit wearaway (the catching up of benefits between the traditional plan and the hybrid plan) of normal and/or early retirement benefits and then each mandates one of several alternatives, such as grandfathering all employees over the age of 40 under the old plan or having obtained an IRS determination letter. The third alternative requires employers to have provided “informed choice” (through examples, estimates of relative value, comparisons or benefits projections) to all participants at the time of the conversion. To fall under the safe harbors, plans must pay any additional amounts within three years from the date the IRS regulations implementing the provisions become final. Like the Senate Finance bill, HELP measure makes the general cash balance plan design legal, stating that the longer period of time that younger employees have to accrue interest credits compared with the accrual period for older employees, is not age discriminatory. The bill prevents the decrease of pension benefits because of the attainment of any age, and it requires lump sum distributions to be calculated using a market interest rate instead of an artificially low statutory rate as under current law.

New Plan Funding Targets Phased in Over 10 Years Like the House Workforce and Senate Finance Committee bills, the HELP Committee bill would make substantial changes to the pension funding rules and interest rates used to calculate plan liability. The bill would increase the required level of plan funding to a target of 100 percent, rather than 90 percent as required under current law. However, the bill would phase-in that increase over 10 years—the longest of any bill so far—to minimize any adverse impact from substantial additional pension contributions. Similarly, any make-up contributions would have to be paid over 10 years, rather than the seven years proposed by the administration and adopted by the Workforce and Finance Committees, further easing the burden on underfunded plans.

Modified, Segmented Yield Curve Adopted to Set Interest Rates With respect to interest rates used to calculate plan liabilities and expected return on assets, the bill would adopt a modified, segmented "yield curve," which is substantially more complex than the current corporate bond rate. A yield curve uses corporate bonds of varying maturities to set different interest rates that proponents claim more directly match timing of the payout of the expected benefit, but they are extremely complex. The yield curve in the HELP Committee bill is similar to the proposal in H.R. 2830, which sought the greater accuracy of a yield curve while limiting somewhat the unnecessary complexity of myriad calculations. The interest rate is divided into three segments, based on the date of expected liabilities—those expected within five years, between five and 20 years and longer than 20 years. To limit the volatility associated with a yield curve and increase predictability of contributions, the bill would permit smoothing of assets and liabilities using a three-year weighted average. The bill increases the deductible contributions that employers may make in any year up to 180 percent of the target liability, as compared with 100 percent under current law, thus allowing greater funding in good economic times.

New "At-Risk" Category Subjects Financially Weak Employers to Higher Contribution Requirements The HELP Committee bill would require plans that fall below 60 percent funding – defined as "at risk" plans—to adopt more conservative actuarial assumptions that increase funding requirements. This requirement is based on an assumption that because the plan is underfunded, participants will retire at the earliest possible date and will take lump sums and early retirement subsidies. The bill also contains stringent benefit limits. It prohibits companies funded at less than 80 percent from increasing benefits unless the increase is funded in advance and puts substantial limits on lump sum payments. If a plan is less than 60 percent funded, it would be required to freeze new benefit accruals and would be prohibited from enhancing nonqualified deferred compensation.

Use of Credit Balances Permitted With Market Adjustments The HELP Committee bill would encourage companies to pre-fund their pension plans by continuing to allow "credit balances" to a greater extent than the House bill. A credit balance results when an employer's pension contribution for a year exceeds the minimum required contribution. Under current law, credit balances can be offset against the next year's minimum contribution. Unlike current law, which does not adjust credit balances to reflect the market value of the underlying assets, the bill requires such adjustments annually, ensuring that the plan is adequately funded. It also requires cash contributions for plans funded at less than 80 percent, regardless of available credit balances.