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The Center On Federal Financial Institutions (COFFI) is a nonprofit, nonpartisan, non-ideological policy institute focused on federal insurance and lending activities.

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H.R. 2830 versus Administration Proposals

A pension reform bill was introduced into the House late last week that is likely to have a strong influence on the ultimate legislation. It was introduced by Chairman Boehner, of the House Education and Workforce Committee, with important co-sponsors such as Chairman Thomas of the Ways & Means committee. (See www.coffi.org for more on pension reform.)

H.R. 2830 has many common features with the Administration's pension reform proposals, but has important differences. This paper highlights some key similarities and differences.

Similarities

- Stricter pension funding rules than under current law
- Higher PBGC premiums
- Limitations on benefit increases in severely underfunded plans
- Elimination of shut-down benefits
- Closer alignment of discount rates with market rates
- Setting of the lump sum discount rate at the level used for funding calculations
- Limitations on use of credit balances
- Increased transparency

Differences

- Addition of multi-employer proposals
- Addition of rules to ease establishment of "cash balance" plans
- Absence of tougher funding rules for junk-rated companies
- Altered proposal for PBGC premiums
- Simplification of yield curve proposal
- Maintenance of more smoothing of assets and liabilities
- Higher limits on maximum deductible contributions
- Ability to use credit balances
- Limitations on executive compensation arrangements

Similarities

The broad outline of H.R. 2830 is close to that of the Administration's pension reform proposal. Some of the most significant aspects that are common to the new bill and the proposal are:

Stricter pension funding rules than under current law. There is broad agreement that current funding rules are insufficient to assure the maintenance of well-funded pension plans. Many have also argued that the two existing sets of funding rules are excessively complicated. H.R. 2830 shares the Administration's overall approach of scrapping the current pension funding rules and replacing them with a single, simpler set. These new rules are generally substantially stricter than existing law, although companies that have been hard hit by the "deficit reduction contribution" rules would actually find their funding requirements eased initially.

Under both the bill and the Administration's proposal, companies would have to make catch-up contributions (over and above those needed to cover the year's newly earned benefits) until the plans are 100% funded, rather than until 90% funded under present law. The initial level of underfunding would have to be covered by catch-up contributions on a straight-line basis over 7 years. Any new underfunding would be given a new 7 year period. Current law sets a funding period of as little as 3 years up to as much as 30 years, depending on the cause of the underfunding and the funding status of the plan.

Higher PBGC premiums. H.R. 2830 and the Administration proposal both require a significant increase in PBGC premiums. The details differ markedly enough that they are discussed later under "differences." (See www.coffi.org for a Primer and other reports on PBGC.)

Limitations on benefit increases in severely underfunded plans. The Administration believes that one cause of pension problems is that companies have been too free to negotiate improved pension benefits with their employees, either directly or through collective bargaining. H.R. 2830 shares the approach of forbidding benefit increases for pension plans that are less than 80% funded, unless the increase is immediately funded. Lump sum payouts would also be prohibited from such plans. In plans that are less than 60% funded, employees would not even receive higher pension promises to reflect their work over the course of the year.

Elimination of shut-down benefits. Both approaches would eliminate pension increases based solely on a plant or company being shut down. Plans with these provisions are confined to collectively bargained agreements in a few industries, particularly steel and autos. However, they have been a substantial source of losses to PBGC in steel industry bankruptcies.

Closer alignment of discount rates with market rates. Funding targets, variable premium charges, and other important factors require the choice of a discount rate to bring future payments back to a value in today's dollars. The Administration has pushed hard to tie these discount rate choices more closely to rates in the financial markets at the relevant point in time. H.R. 2830 endorses this broad approach, but makes simplifying compromises that are discussed further under "differences." (See www.coffi.org for "PBGC: A Yield Curve Primer.")

Setting of the lump sum discount rate at the level used for funding calculations. H.R. 2830 and the Administration proposal both eliminate the separate calculation of a lump sum discount rate, tying it instead to the rate used for funding purposes.

Limitations on use of credit balances. Under current law, if companies fund more than the required minimum in a given year, they can carry over the credit balance and apply it to reduce funding requirements in one or more future years. Unfortunately, the investments purchased with these extra contributions have sometimes declined in value. Thus the credit balance might shield a firm from making contributions, even though the actual level of underfunding was large. Both H.R. 2830 and the Administration proposal constrain the use of credit balances, but the approaches vary significantly, as explained in "differences."

Increased transparency. There is a general consensus that important information about pension plans is unavailable or opaque and is often stale when it is available at all. Current law partially addresses this by requiring companies with pension underfunding of at least $50 million to file a Form 4010 with PBGC, giving detailed information such as the degree of underfunding on a termination basis. Under current law, all of this is confidential. H.R. 2830 and the Administration proposal would require disclosure of all but competitively sensitive information. There is also a requirement for more disclosure and quicker filing of certain critical information on other pension-related forms, particularly on information filings sent to employees and retirees.

Differences

Addition of multi-employer proposals. H.R. 2830 tackles multi-employer pension plan rules, which were not addressed in the Administration proposal. These extensive changes will not be discussed further here. (See "PBGC: A Primer", at www.coffi.org, for an explanation of the multi-employer program.)

Addition of rules to ease establishment of "cash balance" plans. Similarly, there will be text added to H.R. 2830 to deal with the controversy about hybrid pension plan designs.

Absence of tougher funding rules for junk-rated companies. The Administration proposed that pension plans sponsored by companies with junk bond credit ratings would have to set two major actuarial assumptions to worst case levels. The rates of early retirement and of lump sum payouts would have to be assumed to be at the levels that maximized the liability calculations. The effect of this rule would be phased in, so that only firms that had been at a junk rating for five or more years would feel the full impact. This would have been the first time that pension law took account of the credit status of the plan sponsor. The Administration argues that credit risk is strongly related to risk of distress terminations and PBGC losses and should be reflected in the funding rules.

H.R 2830 uses similar provisions, but switches the target to plans that are less than 60% funded, without factoring in the creditworthiness of the plan sponsor in any way.

Altered proposal for PBGC premiums. The Administration proposed that the fixed premium paid to PBGC be raised from $19 per participant per year to $30 per year, to reflect wage inflation since the rate was last changed in 1991. This rate would be indexed to wage inflation for future years. H.R. 2830 phases this increase in over 3 or 5 years, depending on the funding status of the plan sponsor. This is a fairly small dollar change, since the entire increase from $19 to $30 is estimated to bring in only $300 million a year. (For comparison, there are $1.8 trillion of pension assets).

The Administration also proposed that PBGC's Board of Directors, composed of the Secretaries of Labor, Treasury, and Commerce, be given the authority to set variable premium rates going forward, rather than having Congress continue to set the rate legislatively. The current variable premium rate is 0.9% on each dollar of underfunding that falls under the test. However, a large majority of the dollars of underfunding escape the premium, due to various provisions in the law. Only about $100 billion of underfunding was charged such a premium last year, even though systemwide underfunding was in the range of $250 billion on a GAAP basis and $450 billion according to PBGC calculations using a lower discount rate.

H.R. 2830 leaves the authority to set variable rates with Congress. It keeps the rate initially at 0.9% and then raises it at the same pace as wage inflation. (This may be a reasonable way of gradually raising the rate, but the economic rationale for tying it to wage inflation is not evident.) Only vested underfunding would be charged the premium, as opposed to all underfunding under current law. Thus, the underfunding would be lower by the amount of benefits earned by people who have not yet worked long enough at a firm to be guaranteed a payment if they leave today. This is likely to be a noticeable, but not dramatic, difference with the effect varying by company. The biggest impact would be the effective removal of the various provisions that allowed companies to avoid paying the variable premium. All else equal, this could raise another $2-3 billion a year, over the $900 million collected last year. However, this might be partially or fully offset by voluntary new funding by a substantial proportion of the healthy firms that have existing underfunding. These companies might choose to eliminate the need to pay a meaningful variable premium by erasing the underfunding. (See "PBGC: Premium Hike Possibilities.")

Simplification of yield curve proposal. The Administration has proposed that the discount rate for each future pension payment should vary with the number of years until that payment is made. Financial markets generally charge higher interest rates for longer-term obligations, although there have been periods when these rates were lower than for near-term obligations. H.R. 2830 adopted a simplified version of this concept, using one discount rate for payments out five years and less, one for 5-20 years, and one for later years. This should have the same general effect as a full yield curve, but to a lessened extent. Plans with more retirees per employee will have a higher proportion of payments in the first two segments. This would usually lead to a lower discount rate and a higher calculation of the liability and funding requirements.

Maintenance of more smoothing of assets and liabilities. Current law "smoothes" out the discount rates used for various purposes by taking a weighted average of the market rates over the last 4 years. This was intended to make funding requirements more stable and predictable by making them less subject to short-term market movements. The downside is a slower response to changes in conditions that may in fact last. The Administration proposed the virtual elimination of smoothing by confining the smoothing to a 90-working day average of rates. H.R. 2830 splits the difference by using three-year smoothing with more of the weight on the most recent period.

Higher limits on maximum deductible contributions. Existing law makes it very difficult for a plan sponsor to overfund a pension plan during good times in order to have flexibility to minimize contributions during bad times while still maintaining adequate funding. The Administration proposed allowing companies to fund up to 130% of the funding target. H.R. 2830 raises this to 150%. The positive aspect of increasing the limit is clear. Some companies will choose to overfund for a space of time and therefore avoid pension underfunding if they hit a troubled patch. The negative aspect is that this provision is likely to be used much more heavily by highly creditworthy companies who will gain tax deductions for reducing an already very small risk of a future distress termination.

Ability to use credit balances. The Administration proposal effectively eliminates the use of credit balances while H.R. 2830 allows them as long as a plan is at least 80% funded.

Limitations on executive compensation arrangements. H.R. 2830 makes it more difficult for executives of bankrupt companies to offload their pension obligations from pension plans for ordinary workers while securing the future payments to their top executives in supplemental arrangements.

