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Original release date: July 25, 2005
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PBGC: Senate Finance Pension Reform Bill

The leadership of the Senate Finance committee introduced a bi-partisan pension reform bill on Friday. Chairman Grassley, with the support of Ranking Minority Member Baucus, has scheduled a mark-up by the full committee for Tuesday of this week, presumably with the intent of voting it out of committee before the August Recess.

The provisions of the Senate Finance bill are very close to those of the original Administration pension reform proposal, significantly more so than the House version (H.R. 2830) which itself follows the general outline of the Administration proposal. Please see "H.R. 2830 Versus Administration Proposals" on www.coffi.org, for a more detailed explanation of the Administration and House proposals. This paper focuses on key differences between the Senate Finance bill and the Administration and House proposals. The Joint Tax Committee has a fuller description of the Senate Finance bill at http://finance.senate.gov/sitepages/leg/072205chmark.pdf.

The financial effects on the Pension Benefit Guaranty Corporation (PBGC) should be very similar to those expected from the original Administration proposal. COFFI estimates that PBGC's present deficit of $23 billion would rise to the $40 to $50 billion range before stabilizing, but that none of the pension reform proposals would be sufficient of themselves to eliminate this expanded deficit. PBGC would run out of cash to pay claims by 2028, according to this analysis. Please see "PBGC: Legislation May Not Restore Solvency," on www.coffi.org.

The core of all three proposals (Administration, House, Senate Finance) is to replace the existing rules on contributions by companies sponsoring pension plans with a simpler and tougher set of requirements. Firms would be required to make contributions sufficient to produce 100% funding over time. That is, the market value of pension assets would be equal to 100% of the net present value of the promised future pension payments. (Current law effectively shoots for a minimum of 90% funding.) Firms would have seven years to make up for any shortfalls that occur.

The Senate Finance proposal includes three key provisions that were dropped in the House:

Tougher standards for financially weak companies. Pension plans sponsored by companies with non-investment grade ("junk") credit ratings would have to calculate their target liability differently. They would have to assume that all employees retire as early as possible, triggering early retirement subsidies that exist at virtually all major companies, resulting in a higher liability figure. They also have to assume that all employees choose lump sum distributions, if available under the terms of the plan, but only if this would raise the liability figure. Also, a few provisions, such as ones that limit benefit increases, would only apply to financially weak firms. There is a long phase-in period and a novel proposal to exclude from certain calculations any "improvement periods" where at least one rating agency has raised the company's credit rating within the junk range.

Yield curve. The Administration proposed using different discount rates to calculate the present value of pension payments promised in each future year. The House proposes a simplified version with three discount rates for short, medium, and long-term payouts. The Senate Finance bill follows the Administration proposal. See "PBGC: A Yield Curve Primer," on www.coffi.org for more on yield curves.

Smoothing. Current law uses a four-year weighted average to smooth the variation in the discount rate due to market fluctuations. The Administration proposed to essentially drop the smoothing by averaging over only 90 business days. The House bill compromised by somewhat reducing the current level of smoothing. The Senate Finance version has even less smoothing than the Administration proposal, with rates averaged over the most recent quarter (some 60 business days.) ("PBGC: A Yield Curve Primer" also discusses smoothing.)

However, the Senate Finance bill also differs from the Administration on a few points:

Limits on changes in required contributions. The pension reform proposals are likely to significantly increase the volatility of required pension contributions by companies. The Senate Finance bill would explicitly limit this by mandating that required contributions not go up or down each year by more than the greater of 2% of the target liability or 30% of that year's newly earned benefits. This could make the first year's calculations very important, as there may be many firms whose contributions would be much higher or lower under the new law, which would mean that the volatility limitation could be the main determinant of their required contributions in the early years.

Prefunding. The Administration proposed substantially limiting the ability to use credit balances, resulting from funding in excess of the required contributions in past years, to reduce the present year's required contribution. The House version largely retains the ability to use credit balances, although it reforms the calculations to try to avoid certain past problems stemming from these balances. The Senate Finance version takes a somewhat different path to the same goal of allowing credit balances while avoiding known problems.

PBGC premiums. Fixed premiums would be raised to $30 per participant per year and indexed for future wage inflation, as in the Administration proposal. The House version includes a phase-in. Variable premiums would be set at 0.9% of the level of underfunding, as under present law. The Administration proposal would have given PBGC's Board the right to choose the rate and the House version would have it rise with wage inflation, starting at the present level. However, the most significant change to variable premiums is shared by all three proposals; provisions that have allowed the large majority of underfunding to escape paying the variable premium would be eliminated. This change is by far the biggest revenue raiser in each of the proposals. (See "PBGC: Premium Hike Possibilities," on www.coffi.org)

Bankruptcy. The Senate Finance version would freeze pension plans, halting the accrual of benefits, if their sponsors enter into bankruptcy and would also freeze the level of benefits guaranteed by PBGC, which otherwise increase annually until a plan is terminated.

Shutdown benefits. The steel, auto, and tire industries often provide their unionized employees with the promise of higher pension benefits if their plants are shut down. The Administration and House proposals would eliminate PBGC's guarantee of shutdown benefits. The Senate Finance version provides for coverage, but requires it to phase in at 20% a year from the date of plan shutdown, similar to the phase-in for other improvements in benefit formulas.

Multi-employer provisions. The original Administration proposal did not address multi-employer plans, while the House version proposed quite extensive changes to funding and reporting rules. The Senate Finance version increases the ability to make tax-deductible contributions and creates certain reporting requirements, but is much less extensive than the House version. (PBGC insures multi-employer plans through a separate fund, but has much less financial exposure to such plans. See "PBGC: A Primer," on www.coffi.org)

Finally, the Senate Finance bill includes major changes to laws affecting defined contribution plans, as well as various non-pension topics, including the U.S. Tax Court. We will not discuss these further.