



CENTER ON  
FEDERAL FINANCIAL  
INSTITUTIONS

734 15TH STREET, NW  
SUITE 502  
WASHINGTON, DC 20005  
WWW.COFFI.ORG

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

Original release date: February 26, 2006  
Douglas J. Elliott  
202-347-5770  
[douglas.elliott@coffi.org](mailto:douglas.elliott@coffi.org)

## Pension Reform: Issues for Conference Committee

Pension reform legislation will soon be taken up by a Conference Committee, in order to resolve differences between S. 1783, the "Pension Security and Transparency Act of 2005" and H.R. 2830, the "Pension Protection Act of 2005." In practice, the Conference Committee is the last chance to alter the details of pension reform. It seems very likely that whatever bill comes out of the Conference Committee will become law, since the two Houses passed their respective bills by large majorities. The Administration has formally threatened a veto if certain provisions are not altered, but some compromise appears highly probable. The Administration has issued over 150 formal veto threats, but has yet to feel it necessary to exercise its veto power. Pension reform seems an unlikely candidate for a highly visible first veto, although the Administration maintains that this would not stop them if a bill did more harm than good.

This paper highlights some key issues that will be debated by the Conference Committee. As always, our intent is to provide a neutral explanation of the facts and of the arguments on each side. COFFI does not normally take policy positions.

The two bills are complex and comprehensive, with the Senate bill taking up more than 700 pages. Therefore, this paper will focus only on selected issues. These include:

- Airline relief provisions
- Credit balance provisions
- Use of credit ratings in determining funding targets
- Smoothing of asset and liability values
- Yield curve method of calculating discount rates
- Transition provisions
- Transparency issues
- Variable PBGC premium levels
- Defined contribution and "cash balance" issues

## Airline relief provisions

The largest distress terminations in history have been in the airline industry and there is a distinct possibility of more such terminations. Delta and Northwest are already in bankruptcy and both appear likely to be granted distress terminations if they are not given special legislative treatment. The Pension Benefit Guaranty Corporation (PBGC) calculated in September of 2005 that terminations at the two airlines would produce \$11.2 billion of claims on PBGC and another \$5.1 billion of losses to the employees and retirees of those organizations. American and Continental are also significantly underfunded and have the potential to eventually initiate distress terminations, although neither appears to be in imminent risk of bankruptcy. (In practice, distress terminations are rarely granted outside of the bankruptcy process.) United and US Airways have already terminated their plans and therefore present no further risk.

There is very strong political backing for some form of pension relief for the airlines. The Senate bill, which passed overwhelmingly, has a strong measure of relief. The House bill has nothing in it, but many of the votes in favor of House passage were explicitly based on assurances that the airlines' concerns would be addressed in the Conference Committee. The Administration is skeptical of airline relief and has indicated that the Senate's version is unacceptable, although it seems likely that a compromise form of relief would prove acceptable in the end.

**House version:** No airline-specific measures.

**Senate version:** Commercial passenger airlines could choose to operate under a special set of rules. These would require the airline to either "freeze" their pension plans, by ceasing to accrue any new benefits for additional years of service and future pay raises, or to fund any new accruals immediately. The airline would also need to agree that the cap on PBGC's pension guaranty would be frozen at current levels, rather than rising by wage inflation in each year prior to any future termination. (That is, if the airline eventually did a distress termination in the year 2020, each participant would be guaranteed an annual pension payment only up to the PBGC guaranty caps in existence in 2006, or whatever year the airline first availed itself of these special rules.)

In exchange, the airline would be allowed 20 years to correct its current underfunding, rather than the seven years that would be available to everyone else. This effect is considerably magnified by a further provision that allows the airline to use a much more flexible set of rules in calculating the discount rates that it uses to determine its pension liability and funding targets. This flexibility could allow considerable underfunding to remain at the end of the 20 years, as shown in our paper, "Illustration of Discount Rate Effects on Funding Rates," available at [www.coffi.org](http://www.coffi.org). In such case, the airline would have an additional 7 years to correct the underfunding using the same rules as apply to other industries.

### Pros of Airline Relief

**Relief may avoid large future claims on PBGC.** It is possible that Northwest and/or Delta may choose not to terminate their pension plans if these rules are passed. If they do not, and are then able to remain financially viable after emerging from bankruptcy, there may never be a distress termination and claim on PBGC. Absent relief, it appears highly likely that such claims would occur.

**Relief may avoid losses for participants.** If there is no distress termination, then participants would receive their full pensions from the airlines, as these are general corporate obligations, in addition to benefitting from the collateral protection provided by pension fund assets. Even putting off a distress termination for a few years would mean that participants with pensions greater than the guaranty cap would at least receive their full pensions for the period prior to the eventual termination.

#### **Cons of Airline Relief**

**Airlines may terminate their plans anyway.** There is considerable press speculation that Delta will terminate its plans regardless of pension reform legislation. The pilots union at Delta has expressed the same belief and there appears to be an ongoing negotiation as to how much Delta will pay the pilots to obtain their acquiescence in a plan termination, although such an agreement is not a legal requirement. There is a strong economic incentive for a distress termination, since it would wipe a large liability off the books entirely by transferring it to PBGC. In contrast, the airline relief provision merely postpones the payments, albeit for many years.

**Future claims on PBGC could be larger.** It might appear that PBGC is in a no-lose situation, since the guaranty cap is frozen in place. However, this is not the case. From PBGC's viewpoint, the airline relief provisions are a gamble. If the airline avoids a second bankruptcy, then PBGC wins by avoiding an imminent large claim. But, if the airline hits financial trouble and eventually goes into bankruptcy again, the claim on PBGC could be higher. This is not a moot point, TWA and US Airways are both examples of airlines that have been in bankruptcy more than once. TWA went through the process three times.

Why might the claim rise? The combination of 20 year amortization for the underfunding and flexible discount rates means that there is likely to be little in the way of contributions for some years. But, in the meantime, the pension fund would be paying out the full level of pensions, rather than just the guaranteed portion, as would be the case after a distress termination. As shown in "Illustration of Discount Rate Effects on Funding Rates," there are reasonable circumstances in which the claim would increase. The claim could also decline, but generally only if the airline made contributions greater than the minimum required or if the second bankruptcy took place many years after the first.

**Using different "accounting" for a troubled industry can lead to problems.** Some argue that letting airlines calculate their obligations under looser discount rate rules is reminiscent of the special accounting rules passed by Congress to help the Savings and Loan industry through a troubled period. This "regulatory forbearance" contributed significantly to a dramatic ballooning of the government's losses when the crisis did not go away.

**Special treatment for one industry can easily spread.** It is easy to envision a troubled automaker arguing that it is at least as important to the nation and as morally deserving as the airlines. One's viewpoint on the possible broadening of this provision may depend on whether one sees the airline relief provisions as an ad hoc and dangerous response or an intelligent design that would indeed work for any troubled sector.

## Credit Balance Provisions

Current law allows a company that has contributed more than the required minimum to carry over the extra as a “credit balance” to reduce their cash contribution in some future year. This credit balance earns interest as long as it remains unused. The Administration argues strongly that the credit balance rules have added significantly to past claims on PBGC. Most of the largest claims have come from firms which did not need to make any cash contributions for some years prior to their bankruptcies, principally due to carrying over credit balances.

The Administration proposed that credit balances be abolished. Neither House of Congress has agreed to this approach. Both have agreed to eliminate a double-counting that exists under current law. This arises because a firm can both use the assets related to a credit balance to reduce the calculated underfunding and then can apply the credit balance directly to substitute for cash contributions that would otherwise be required. Since underfunding levels have a significant effect on required minimum contributions, these credit balance dollars end up doing double duty.

In addition, both Houses have agreed to raise or lower credit balances based on an index of actual returns in the financial markets, rather than always assuming that they rise by a specific interest rate. This addresses the issue that credit balances created a particular problem when the recent financial bubble burst, since the credit balances went up even when the actual investments went down significantly.

**House version:** The proposed rules on credit balances are quite complex and will only be summarized at a general level here. Existing credit balances go into a “funding standard carryover balance” account and any new contributions over the required minimums go into a new “prefunding balance” account. We will refer to the combination of the two accounts as “credit balances,” since at this level of generality the two accounts act the same. As noted, credit balances will also go up or down based on investment returns on the beginning of year balances.

In general, the amount of underfunding that is used as one determinant of minimum funding requirements would be calculated on a basis that excludes the amount of the credit balances. For example, if the target funding level is \$1,000, assets are \$900, and the credit balance is \$100, then there would be \$200 of underfunding for purposes of determining the funding requirement. (Note that the credit balance of \$100 was created by prior contributions above the minimum requirements and that there is likely to be something in the neighborhood of \$100 out of the \$900 in assets that corresponds to those prior contributions and subsequent investment earnings on them. The match will be far from exact, since the credit balance under current law grows at a given interest rate, regardless of actual investment returns.)

If the assets, excluding those representing the credit balances, are at least 80% of the target funding level, then all or a portion of the credit balances can be used to substitute for cash contributions that year. Credit balances can also be applied to reduce cash contributions if the plan assets, *including* those corresponding to credit balances, exceed the target funding level. Paradoxically, the 80% cutoff means that firms with very large credit balances might not be able to apply those credit balances. Therefore, the bill allows companies to make a voluntary permanent reduction in their credit balances.

Credit balances are also deducted from pension assets for certain other purposes, such as determining whether a firm falls into the “at risk” category, described below.

**Senate version:** The Senate version also subtracts credit balances from plan assets when calculating minimum contributions. Unlike the House version, it does not subtract them for other purposes.

The Senate version allows credit balances to be used more freely, without imposing an absolute 80% funding threshold. Firms that are less than 80% funded can still use their credit balances if they make a cash contribution equal to the lesser of (a) 25% of the required minimum or (b) the full “target normal cost.” Normal cost is a measure of the cost associated with the passage of an additional year.

### **Pros of Eliminating Credit Balances**

**Only cash can pay the pension promises.** Credit balances only protect PBGC and pension participants if they correspond to actual cash and investments in the pension trust. Therefore, the Administration prefers to base calculations of required contributions on the actual investment levels at the relevant point in time, without taking any other account of historical contributions.

### **Cons of Eliminating Credit Balances**

**Firms might be discouraged from contributing more than the minimum.** It is argued that companies will be reluctant to put in extra money unless they know that it can be used to reduce future contributions dollar for dollar, starting in the next year, if so desired. That is, they wish to know that putting in two year’s contribution at once would allow them to skip the next year’s contribution if they needed to do so. This would not be provided under the proposed rules if credit balances were abolished. The new rules provide that any underfunding must be paid off in seven equal installments, at a minimum. This considerably dilutes the benefit of over-contributing in any given year.

**The change could be unfair to companies with existing credit balances.** Corporations argue that they contributed more than required in the past in order to generate credit balances. They feel that eliminating the benefits now is unfair to them.

## **Credit Ratings**

PBGC is a credit insurer, since it only takes over pension obligations if the sponsoring company is no longer financially viable. Not surprisingly, the credit judgements of the major rating agencies, such as Standard & Poor’s and Moody’s, have been good historical indicators of PBGC’s risk of a claim. Companies that are rated “investment grade” by these agencies at a given point in time have rarely presented a claim to PBGC without first descending into “non-investment grade” (or “junk”) status for a period of years. Despite this strong correlation, there is no provision in current pension law that ties a firm’s funding requirements, PBGC premiums, or disclosure requirements to its credit rating.

The Administration proposed three modifications to the calculation of funding targets for pension plans sponsored by junk rated companies. Each modification increases the funding target.

**Everyone is assumed to retire as early as eligible.** Historically, troubled firms experience a substantial increase in early retirements. This almost invariably increases the pension cost, because virtually all plans subsidize early retirement by reducing the annual pension by less than

would be necessary to maintain the same total value as if one retired normally. (More years of pension payments more than make up for the modest reduction in each year's pension payment.)

**Everyone eligible to take a lump sum payout does so, unless this reduces company costs.**

About half of pension plans allow employees to take their pension as a single payment, rather than as a monthly check. Historical experience again shows that the large majority of employees at troubled companies choose to take lump sums. Under current law, a lump sum is generally costlier to the company than the series of monthly checks would be, due to a different interest rate calculation from that used by the funding rules. Other provisions in the pension reform proposal would reduce or eliminate this difference, making this provision less important.

**A PBGC "load factor" would be added.** PBGC faces considerable administrative costs when it takes over a plan. Junk-rated firms would be required to try to fund both their expected pension payments and an additional amount to cover PBGC's administrative costs.

The modified calculation would be phased in over five years from the time that a given company fell to junk status or from the effective date of the legislation for companies that are already junk rated. The calculation would revert to the normal basis if a company regained investment grade status.

**House version:** The House generally kept the Administration's provisions, but changed the trigger from one based on credit rating to one based on funding levels. A plan would be considered "at risk" if it is funded at less than 60% of its target funding level. The PBGC load factor was specified as 4% of the funding target plus \$700 per participant.

**Senate version:** The Senate kept the Administration's broad concept, but considerably narrowed its scope and effect. Plans that are at least 93% funded by normal rules would not be treated as "at risk." Only potential retirements over the next seven years are required to use the tougher assumptions for "at risk" firms. Firms would be "at risk" only if they have two future years in which their ratings drop, even if they were already very weakly rated on the effective date of the legislation. At a minimum, this pushes out the initiation of the five-year phase-in by two years compared to the Administration proposal. Another difference is that the PBGC load factor in the Administration proposal was eliminated.

**Pros of Using Credit Ratings**

**These provisions may model funding needs better than current law does.** The Administration contends that junk-rated firms experience different patterns of retirement behavior than do other companies. Ignoring these differences would lead to underfunding.

**Junk rated firms present far greater risk to PBGC than other companies do.** Proponents argue that this greater risk warrants greater efforts to reduce underfunding, which is helped by setting tougher funding targets and, indirectly, raising the premiums charged to that company. (Variable premiums would be charged based on the level of underfunding compared to the target level, including the effects of these provisions.)

**Investment grade firms currently may bear too great a burden of the underfunding at junk-rated companies.** The large majority of PBGC premiums come from investment grade companies while the claims come almost exclusively from junk-rated companies. Reducing the level of future claims from junk-rated companies would arguably improve the system's fairness.

### **Cons of Using Credit Ratings**

**The provisions may overstate changes to retirement behavior.** Even at troubled firms, many employees do not retire at the earliest possible date and at least a few do not take lump sums.

**Load factor does not reflect direct pension promises.** All other funding rules are based on the premise that a firm should maintain sufficient assets in its pension plan to meet its promises to its employees. The load factor represents PBGC costs, not a promise made to employees.

**Use of credit ratings may encourage bankruptcies.** The biggest potential claims on PBGC tend to be from companies whose pension underfunding is large in relation to the firm's size. Additional pressure to fund could be the straw that breaks the camel's back, resulting in a bankruptcy and distress pension termination that might otherwise have been avoided. On the other hand, there are so many factors determining whether a company will end up in bankruptcy that it seems likely to be a rare event for these provisions to be the deciding factor.

**Not all companies have credit ratings.** The vast majority of pension obligations are at companies that have a credit rating from one or more of the major rating agencies. However, there are some small public firms and small to medium-sized private firms that do not have ratings. The Administration proposed to develop relevant criteria based on financial ratios or other factors that would allow an equivalent distinction to be made between investment grade and junk status. There is concern that such criteria would necessarily be crude and may be unfair to some companies. An alternative would be to treat all non-rated companies as investment grade. This is unlikely to have much effect on the number of firms with credit ratings, since there are strong financial benefits to obtaining such a rating. (Investors charge less to lend to a rated company.)

**Federal involvement in evaluating creditworthiness bothers some.** Even though private agencies would be setting the ratings, there would be a need for the government to choose which rating agencies to use and possibly to establish alternative criteria for non-rated companies. Some have argued that this is an inappropriate intrusion of the government into business judgments. On the other hand, it is hard to reconcile this concern with the billions of dollars in federal government loans and guarantees that are made for the benefit of small businesses, exporters, and other firms. These loans are routinely based on credit criteria.

### **Smoothing**

Current law allows a considerable use of "smoothing" to make pension contributions more predictable. The fair market value of pension assets and liabilities can swing quite substantially over the course of a year, as interest rates change and the stock market moves up or down. The level of underfunding can be even more volatile, since it consists of the difference between the level of pension assets and liabilities. Most pension assets are invested in stocks, whose valuations often do not move in the same direction as pension liabilities, which are principally driven by interest rates.

This volatility is heavily damped down under current law by using long-term average values for the pension assets and liabilities, rather than their recent valuations. For example, the discount rate is based on a weighted average of the interest rate in each of the last four years. The most recent rate is given a 40% weighting, the next most recent 30%, then 20% and 10%. Asset values may be averaged over 5 years, as long as the smoothed value is within 20% of the current fair market value.

The Administration proposed virtual elimination of smoothing, by basing the discount rates on the average of the last 90 working days and using recent market values for assets. Neither House was willing to go that far, although both are willing to reduce the amount of smoothing under current law.

**House version:** The House stayed with an approach similar to current law, but with shorter periods and more weight given to recent rates. Discount rates would be determined by a weighted average of the last three years, with a 50% weighting for the most recent, 35% for the next most recent, and 15% for the oldest. Asset values could be smoothed over 3 years, as long as the resulting values were within 10% of market value.

**Senate version:** The Senate reduced the smoothing periods for assets and liabilities to 1 year.

### Pros and Cons of Smoothing

Please see “PBGC: A Yield Curve Primer”, available at [www.coffi.org](http://www.coffi.org). Despite its name, it also explains smoothing.

### Yield Curve

Discount rates are extremely important in pension calculations, because payouts tend to take place over so many years that the compounding effects of an interest rate become very large. Current law uses a single discount rate to bring all future pension payouts back to today’s dollars. This rate is the 30-year Treasury rate. In recent years, this rate was replaced temporarily by the rate on an index of high-quality, long-term corporate bonds. However, this temporary measure expired at the end of 2005, restoring the 30-year Treasury rate.

The Administration proposed the use of a “yield curve” approach, which utilizes a separate discount rate for each year of future payment. Please see, “PBGC: A Yield Curve Primer,” available at [www.coffi.org](http://www.coffi.org).

Both House and Senate decided to use a simplified version of the yield curve. One discount rate would be used for payments to be made in the first five years from the valuation date, based on an average of investment grade corporate bonds falling in that maturity range. A second rate would be used for the next 15 years of payments and a third rate would cover everything beyond 20 years. Despite objections from the Administration, this simplified version of the yield curve is likely to remain in the final bill, with perhaps modest modification. It is also worth noting that current law allows the Administration to choose to exclude the riskiest categories of investment grade bonds from their calculations of the index rate.

## Transition Provisions

Virtually all policymakers agree that there is a need to provide phase-ins and other forms of transition relief to ease the change-over. Pensions are a long-term corporate commitment and the current state of the system, and of individual pension plans, represents the results of a series of decisions taken over many years. The arguments are over the specific transition provisions.

The most important transition provision would be an ongoing one. Both Houses have agreed with the Administration that plan sponsors should have seven years from the effective date to eliminate their initial underfunding and should have to proceed at at least the rate of one-seventh per year. This same methodology will apply to any new underfunding that may develop in the future.

The second most important transition issue is the rate at which the funding target rises from 90% to 100%. Current law essentially allows firms to reach a level where pension assets equal 90% of pension liabilities and then coast, with a very slow movement towards full funding after that. This funding target will become 100% under the Administration proposal and both bills. The differences are in the timing. The Administration would have moved immediately to the 100% level, believing that the seven year catch-up period provided sufficient transitional relief. Both House and Senate want to move the funding target up over several years.

**House version:** The funding target is 92% in 2007, rising by 2 points per year until hitting 100% in 2011. However, pension plans that were subject to the current law Deficit Reduction Contribution (DRC) rules, as of the end of 2006, generally would face a 100% funding target, without benefit of the phase-in. The DRC rules apply to many substantially underfunded plans.

**Senate version:** The funding target is 93% in 2007, 96% in 2008, and 100% thereafter, except for small businesses, who benefit from a 5-year transition period.

### Pros of a long transition

**Long transition may be fairer to plan sponsors.** The proposed pension reform legislation represents a major change in the rules, with substantial effects on funding requirements. It may be fairer to give companies a longer period to adjust.

### Short transition might modestly hasten exit of companies from defined benefit system.

Firms will clearly be more irritated by a short transition. It is possible that it would push some companies over the edge into freezing or terminating their defined benefit plans, although it is unlikely that the transition period would be a major item in this calculation.

### Cons of a long transition

**Claims on PBGC would likely be somewhat larger.** A longer transition means slower funding and therefore larger claims on PBGC from those firms that do not survive the next decade or so. PBGC's White Paper of October 26, 2005 calculated that adoption of the House or Senate proposals would most likely lead to \$5-6 billion more in claims on PBGC over the next decade than adoption of the Administration's proposal. The use of transition periods is clearly a significant contributor to this total, although the results are not specifically broken out by cause.

## Transparency

There is general agreement that the pension information provided to employees, retirees, and other important constituencies needs to be more timely and informative. This is viewed as fairer to those parties and it is hoped that companies will have stronger incentives to protect their pension promises if constituencies about which they care are more informed and involved.

Most of the issues about the amount and timing of disclosure are too technical to warrant discussion here, but one issue rises to a higher level. The House version dramatically reduces the number of companies that would have to make 4010 filings with PBGC. 4010 filings are intended to give PBGC information about firms which might at some point initiate a distress termination of their pension plans. The filings provide certain confidential information about the firms' finances, as well as more timely and detailed information about the level of underfunding calculated on a termination basis, that is, as if it were about to be taken over by PBGC.

Current law casts a wide net for 4010 filings, requiring them from any firm with an underfunding of \$50 million or more. Given the large size of pension plans these days and the overall level of underfunding in the system, this rule affects a large number of the big pension plan sponsors, even if they are highly creditworthy or \$50 million is very small as a percentage of their pension liabilities.

**House version:** The House bill attempts to narrow the net so that it only catches firms that have a substantial probability of making a future claim on PBGC. It does this by setting the threshold at a 60% funding ratio. That is, firms which have pension assets, excluding credit balances, at least equal to 60% of their funding target would be exempt from filing. There is an exception for firms which PBGC has determined are in industries with substantial unemployment and with depressed or declining sales and profits. These troubled industries would face a 75% threshold.

**Senate version:** The Senate bill has a complicated set of criteria setting the filing threshold at a funding percentage of 60%, 75%, or 90%, depending on the credit rating of the plan sponsor and the PBGC's decision as to whether an industry is particularly risky for PBGC. The combination is presumably intended to avoid forcing healthy firms to file 4010's even if they are fairly heavily underfunded, since they are unlikely to make claims on PBGC. At the same time, it tries to capture the subset of companies that represent real risk to PBGC.

The threshold can have a large effect on the number of firms that have to file 4010's. For example, it appears that at the 60% threshold half or more of the companies that presented claims on PBGC in the past 30 years might never have had to file a 4010 in advance of their distress terminations.

This figure results from a rough calculation based on the fact that PBGC's dollar-weighted average claim has come from pensions that were 52% funded on a termination basis. This number needs to be adjusted for the higher discount rates used in the "funding target" calculation relevant to the filing threshold, as well as other differences in the calculation methodologies. Such adjustments would likely raise the figure to at least the 60% level, meaning that the average firm making a claim on PBGC would not have been required to file a 4010. Time lags created by annual filing deadlines, and the time necessary to make the calculations, exacerbate the effects, since claimants were often deteriorating month-by-month as they approached the point of termination. Finally, the proposed funding thresholds for filing would be even lower during the

transition years when the funding target has not yet reached 100% of pension liabilities. During this time, 60% of the funding target would equate to an even lower termination funding ratio.

These calculations are necessarily rough. For example, the House bill excludes the use of assets related to credit balances in this calculation, which would increase the need for filings to some unknown extent. There are no comprehensive public figures on the average level of credit balances at companies initiating distress terminations, nor can we guess to what extent firms would have chosen to permanently “cancel” portions of their credit balances as they approached such a filing requirement, which is a permitted option under the House bill.

Another measure of the effect on 4010 filings comes from PBGC’s calculation that as few as 1 out of the more than 400 firms that file 4010 filings under current rules would still have to file under the House’s proposal.

### **Pros of 60% filing threshold**

**Avoids false alarms.** The only firms filing would be ones with a high chance of creating losses for PBGC and plan participants. As the bills currently stand, the major benefit would be in reducing the administrative burdens on firms that would have to file if the threshold ratio were higher. If Congress later were to make the funding information in 4010 filings public, as has been strongly proposed in the past, then tougher filing requirements could cause needless panic by employees at firms where there is no significant risk to them.

### **Cons of 60% filing threshold**

**PBGC would lose valuable advance warning information.** It seems counterintuitive to create a filing intended to give PBGC early warning of large potential claims and then to set the filing requirements so that half the claims could come in without a 4010 filing ever being necessary.

**Credit rating is relevant to the level of risk faced by PBGC and plan participants.** A flat 60% threshold might arguably be reasonable for otherwise healthy firms, but could leave out too many potential distress terminations at troubled companies.

## **Variable PBGC Premiums**

Current law provides that firms with underfunded pension plans must pay a “variable premium” annually of 0.9% of the amount of the underfunding. However, current law also provides for exclusions that have, in practice, allowed the large majority of such underfunding to avoid paying any variable premiums.

The Administration proposed eliminating these exceptions, so that all underfunded firms would pay a variable premium. Further, the Administration requested the ability to vary the 0.9% rate in the future, depending on the financial status of PBGC.

House and Senate have taken identical approaches on this issue, agreeing to eliminate the exceptions, but retaining the right of Congress to determine the future rate level. This appears very unlikely to change in the conference committee.

Despite the perfect alignment between the House and Senate bills, it is worth exploring the variable premium a bit further. After all, the President's proposed budget for 2007 counts on over \$16 billion in new revenues from these changes over a five year period and it is likely that large budget savings will be ascribed to the premium provisions that ultimately pass Congress.

"PBGC: Budgeted Premium Hikes Seem Improbable", available at [www.coffi.org](http://www.coffi.org), explains why it is unlikely that variable premium hikes could raise anything close to the \$16 billion figure. The core of the argument is that even a 0.9% premium that actually bit, due to the elimination of the current exceptions, would be enough to cause healthier firms to voluntarily reduce their underfunding by contributing more. (The large majority of underfunding is at companies with investment grade credit ratings who could borrow the cash to fund their pensions.)

Raising the variable premium rate higher in anticipation of this, in order to bring in the same targeted revenue, would just chase still more of the underfunding out of the system. Hiking the rate still further results in a fruitless chase after premium revenue that would eventually drive out the underfunding at all but the unhealthiest firms. These companies could well be pushed into bankruptcy at extreme rate levels.

Thus, it is reasonable to believe that more revenue could be brought in through variable premiums than is currently the case, but there are serious limits on how much more could be squeezed out.

### **Defined Contribution and "Cash Balance" Issues**

Other elements of the bills have important effects on defined contribution plans, including proposals to make it easier to provide investment advice to 401(k) participants and to facilitate automatic enrollment as the default option for 401(k) plans. We will not address these issues, since the impacts on PBGC, and the other federal financial institutions that COFFI studies, appear minimal. PBGC does not insure defined contribution plans and the marginal effect of these provisions on the relative attractiveness of defined benefit plans is likely to be small.

There are also important provisions that would make it easier to create "hybrid" plans, such as "cash balance" plans, that mimic many elements of defined contribution plans within a defined benefit plan. PBGC does insure such plans, but the effects on PBGC of a pension plan changing from a traditional defined benefit plan to a hybrid plan are subtle and long-term. Given the complexities involved, these provisions will also not be addressed.