CENTER ON FEDERAL FINANCIAL INSTITUTIONS

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Pension Reform: July 2006 House Bill (H.R. 4)

The House passed a 907-page pension reform bill on Friday, numbered H.R. 4. This bill apparently contains the pension-related provisions agreed upon by the key negotiators in the pension reform conference committee. There was a dispute in the conference committee as to whether to include provisions relating to repeal of the estate tax and the extension of certain popular expiring tax breaks. The House chose to pass H.R. 4 as a separate bill without these provisions, rather than to wait on agreement in the conference committee.

The Senate may pass H.R. 4 this week, before its August Recess. If it does so without amendment, the bill would go to the President, who is generally expected to sign it. If it is delayed, amended, or rejected outright by the Senate, then pension reform will likely revert back to the existing conference committee. H.R. 4 would remain of interest, however, since it seems to represent the detailed compromises already reached on the substantive issues relating to pension issues.

This paper summarizes H.R. 4's provisions regarding some of the areas affecting defined benefit plans where the House and Senate bills had differed. It needs to be read in conjunction with our previous report, "Pension Reform: Issues for the Conference Committee", available at www.coffi.org. That report describes the issues in dispute and provides a neutral summary of the arguments made for the House and the Senate versions. This report describes the resulting compromises contained in H.R. 4, without discussion of their merits.

Highlighted issues 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

As predicted, negotiators from the two Houses agreed to include "airline relief" provisions, along the general lines of the Senate bill. The House bill had not included anything.

Airlines which choose to "freeze" their pension plans would be allowed 17 years to fund their initial pension deficits. This is 10 years longer than offered to non-airline plan sponsors. In addition, such airlines would be allowed to use a discount rate of 8.85%, which is 2-3 percentage points higher than other firms would be using at current rate levels. Each percentage point of higher discount rate would reduce the calculated pension liability by 10-15%, making a major difference in their funding requirements.

Should interest rates rise by less than 2-3 percentage points over the 17 years, there could be substantial underfunding remaining at the end of that period, as the liability calculation switches to that used by other companies. These airlines would then have another seven years to eliminate that underfunding. This follows from the law's general approach that any additional underfunding arising at a pension plan must be amortized over seven years.

Northwest and Delta have pushed hard for this set of provisions and would be the most likely to use them. American and Continental, which do not plan to freeze their plans, have argued that this would give the other two airlines an unfair leg up. Partially in response to this, a second provision allows airlines 10 years to fund their initial deficits, even if they do not freeze their plans. However, without a freeze, they do not appear to have access to the 8.85% discount rate.

Credit Balance Provisions

The credit balance provisions largely appear to be in line with previously announced compromises. Credit balances can only be used to reduce the minimum contribution in a year in which the plan's assets are at least 80% of their funding target, not counting prefunding balances that have arisen since the new law became effective. Importantly, the large existing credit balances of firms such as GM would not be subtracted from assets in calculating this 80% level.

However, existing credit balances and new prefunding balances would both be subtracted from assets in determining the "adjusted funding target attainment" percentage that is used to determine whether certain benefits can be paid and whether benefit increases are allowed.

Credit Ratings

The two Houses were already in agreement that certain plans that were considered to be "at risk" of a future pension default should use a more conservative method for calculating their liabilities. This would principally consist of assuming that employees eligible to retire in the next decade would retire as early as possible and would choose to take the more expensive option when choosing between a lump sum distribution and a pension for life. The House version also added a "load" for expected PBGC expenses of handling a plan termination.

The major area of disagreement was whether to base the "at risk" determination on the creditworthiness of the plan sponsor or on the level of the pension funding deficit. In the end, the Senate gave up on the creditworthiness criterion in exchange for a tougher deficit level than the 60% originally desired by the House.

A plan will be considered to be "at risk" if it is less than 80% funded on a normal basis and also less than 70% funded when using the higher liability calculation applicable to "at risk" plans.

The "PBGC load" of 4% of the pension liability plus $700 per participant will apply for "at risk" plans that were also "at risk" for 2 of the previous 4 years. Plan years prior to the law's effective date of 2008 will not count for this determination.

Finally, there is an exception for employees at automakers and their suppliers who refused an offer made in 2006 to accept a substantial payment or sweetening of their benefits in exchange for retiring early. (This would clearly apply to GM and Delphi's "buyout" offers made to most of their older employees.) Such employees would not be included as potential early retirees for this calculation.

Smoothing

The discount rates used to calculate liabilities would be smoothed by averaging historical rates over 24 months. Similarly, plan sponsors could choose to average asset values over 24 months. However, the value will limited to no less than 90% and nor more than 110% of current fair market value.

Firms may elect to switch to a yield curve that uses only the most current rates. They may only switch back with permission of the Secretary of Treasury.

Yield Curve

The three-segment yield curve already in both the House and Senate bills was retained. The yields would be based on averages of the rates on corporate bonds of the relevant maturities in the top three rating categories, such as "AAA", "AA", and "A". One of the bills would have included "BBB" ratings as well.

The use of the yield curve will be phased-in at 33% in 2008, 66% in 2009, and 100% thereafter.

Transition Provisions

There are a great number of transition provisions to ease the changeover from current rules. One of the most important is simply the effective date for the new rules. The rules generally took effect starting in 2007 under both the House and Senate bills, delayed from an earlier 2006 target by the slow legislative process. Under H.R. 4, the effective date is now 2008.

All of the pension reform proposals propose ultimately reaching a funding target of 100% of the pension liabilities. H.R. 4 phases this in by setting the funding target at 92% in 2008, 94% in 2009, 96% in 2010, and 100% in 2011 and later years. This phase-in is not available to firms whose substantial levels of underfunding put them under the "deficit reduction contribution" rules in 2007. These firms face a 100% funding target beginning in 2008.

Firms generally have a seven-year period to eliminate underfunding existing at the effective date. They must do so at least as fast as one-seventh per year. This key provision was already in both bills and the original Administration proposal. Airlines, as noted earlier, are given an even longer grace period.

The "at risk" test contains a great number of transition provisions, with the result that the full weight of the more conservative liability calculations would not hit some companies until 2015. First, there is a four year phase-in of the 80% funding threshold for determining whether a plan is "at risk". The level begins at 65% in 2008 and rises by 5 percentage points a year, until it hits 80% in 2011. Second, the additional liability calculation is phased in at 20% per year once a plan becomes "at risk." Third, the "PBGC load" factor only applies once a plan has been "at risk" in two of the previous four years, not counting years prior to 2008.

Benefit limitations on plans which are heavily underfunded are generally effective in 2008, but are delayed for unionized workers until the earlier of the expiration of the applicable labor contract or 2010. (This accomodates the three-year bargaining cycle traditional in many industries.)

There are many other transition rules, which are omitted here in the interests of simplicity.

Transparency

H.R. 4 specifies that pension plans that are less than 80% funded will have to make Section 4010 filings with PBGC. These filings contain considerably more timely and detailed actuarial and financial information than other required filings do, including an estimate of the termination liabilities that PBGC would take on if a plan were to experience a distress termination. These filings are confidential, but will be provided in an aggregate summary form annually to the committees of jurisdiction of the two Houses.

An interesting provision that was added to the original bills would require PBGC to disclose more information about the assumptions used in its "PIMS" model. This model provides an estimate of PBGC's claims and financial position over the succeeding 10 years, based on a great number of assumptions. Results of runs of the PIMS model are included in PBGC's Annual Report each year. PBGC does not claim any predictive power for the PIMS model, but it usually provides the only modelling results publicly released by PBGC that explore its future financial condition.

Variable PBGC Premiums

Both Houses had a same provision to increase variable premium receipts by eliminating the exception for firms which had reached their full funding limitation. This provision is also included in H.R. 4.

Defined Contribution and "Cash Balance" Issues

Consistent with our earlier paper, we will not address the many important provisions in the bill relating to defined contribution plans and to "cash balance" defined benefit plans.

