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S. 219: The National Employee Savings and Trust Equity Guarantee Act

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Summary

On July 26, 2005, the Senate Finance Committee approved S. 219, the “National Employee Savings and Trust Equity Guarantee (NESTEG) Act of 2005,” a bill to reform federal pension laws. This report summarizes the major provisions of the bill, as approved by the Committee. It will be updated as legislative developments occur.

Funding Requirements for Single-Employer Pension Plans. Federal law requires the sponsors of defined benefit pension plans to fund in advance the benefits earned by participants. The minimum required contribution to the plan is the sum of the benefits accrued by plan participants during the year (the plan’s “normal cost”) and amortization of any unfunded accrued liability from prior years. If a plan is underfunded, the plan sponsor must amortize (pay off with interest) the unfunded liability and also may be required to make an additional contribution called a deficit reduction contribution. The maximum period for amortizing a plan’s unfunded liability varies, but it can extend up to 30 years. A plan is considered to be underfunded if the ratio of assets to current liability is below 80% in a single year or is consistently below 90%. Under S. 219, pension plans would be required to amortize unfunded liabilities over no more than seven years, but deficit reduction contributions would no longer be required. In general, the plan sponsor would be required to contribute to the plan each year the sum of the plan’s normal cost plus an amount sufficient to amortize any unfunded liability over seven years.

S. 219 would require all benefits accrued by plan participants up to the beginning of the current plan year — the plan’s “accrued liability” — to be 100% funded. The bill would phase-in the 100% funding target over the period from 2007 to 2009. In 2007, the funding target would be 93% of the plan’s accrued liability and in 2008 it would be 96% of accrued liability. Beginning in 2009, the funding target would be 100% of the plan’s accrued liability. For small plans with 100 or fewer participants, the funding target would be phased in over five years. The funding target for small plans would be 92% of the plan’s accrued liability in 2007, 94% in 2008, 96% in 2009, 98% in 2010 and 100% in 2011 and later years.

Financial Condition of the Plan Sponsor. Funding requirements for pension plans reflect the assumption that the plan will continue to operate. If a plan terminates, the assets required to pay off its obligations all at once usually are more than the assets that it is required to have on hand as an ongoing plan. In other words, the “termination liability” of a defined benefit plan often exceeds its “ongoing liability.” Under S. 219, underfunded plans sponsored by firms classified as financially weak would be considered to be at risk of terminating. When determining their required contribution, sponsors of these plans would be required to assume that participants would retire at the earliest possible date and elect the form of benefit from the plan that has the highest present value.

A plan sponsor would be considered financially weak if for three consecutive years, (1) its debt has been rated below investment grade by all of the credit rating agencies that have issued a credit rating; or (2) the plan sponsor has no debt that has been rated, but all of the rating agencies that have issued ratings of the plan sponsor have rated it as below investment grade. If a plan sponsor is rated below investment grade in the current year but receives a higher credit rating than it received in the previous year, the current year would not be taken into account in determining if the plan sponsor is financially weak, and the years immediately before and after the current year would be treated as consecutive years. If there is no further improvement the following year, the sponsor would be treated as below investment grade and would be considered financially-weak. The Treasury Secretary would issue rules for determining if a plan sponsor is financially weak if a sponsor with 500 or more participants has not been rated by a credit rating agency. If the plan’s assets are at least equal to the funding target (determined under the assumptions applicable to financially strong firms), the plan would not be considered at risk, even if the sponsor’s debt is rated as below investment grade. Sponsors of plans with fewer than 500 participants would not be considered financially weak.

Valuation of Assets and Liabilities. The present value of a pension plan’s liabilities is determined by discounting future benefit payments at a specific rate of interest. The present value is inversely related to the discount rate: lower interest rates increase the present value of plan liabilities and the amount of money that must be put into the pension fund to pay those liabilities. Under current law, in determining their current liability, plans must use an interest rate that is no higher than the weighted average rate on long-term corporate bonds during the four-year period ending on the last day before the beginning of the plan year. Using a four-year average rate “smooths” the volatility that would occur if plan liabilities were discounted using the current interest rate as of the date of the calculation. The value of a plan’s assets also may be smoothed (over five years), but cannot be more than 120% or less than 80% of their market value.

S. 219 would require plan sponsors to discount plan liabilities according to the year that the liabilities are scheduled to be paid, using a different interest rate for each year. A payment due in 10 years, for example, would be discounted using a 10-year interest rate, while a payment due in five years would be discounted at a five-year interest rate. Taken together, the interest rates associated with each year are called the interest rate “yield curve.” In most cases, short-term interest rates are lower than long-term rates because the money that has been lent is at risk of default and of erosion by inflation over a shorter period of time. Pension payments owed to older plan participants and to current retirees are short-term liabilities because they will come due sooner than the benefits owed to younger workers. By using a yield curve to discount liabilities, plan sponsors with older workers or higher ratios of retirees to participants would have to contribute

more to their plans than sponsors of plans with younger workers or fewer current retirees because more of the plan's liabilities would be discounted at shorter-term interest rates.

Under S. 219, the present value of plan liabilities would change as interest rates change from year to year, but the bill would limit the amount by which contributions would be required to go up in response to falling interest rates. Regardless of the change in interest rates from year to year, the required contribution to a plan would not go up by more than the greater of (1) 30% of the plan's normal cost for the preceding plan year (i.e., the cost of benefits accruing in that year) or, (2) 2% of the plan's total liabilities for the preceding plan year. Plan assets would be valued at their fair market value as of the valuation date or at their average value for the three preceding months. The 80% to 120% range for valuing assets under current law (called a "corridor") would be repealed.

Contribution Limits and Credit Balances. Under current law, plan sponsors that contribute more than the minimum required amount to a plan build up "credit balances" that can be used to reduce future contributions. For example, if the minimum required contribution this year is \$1 million and the sponsor contributes \$1.1 million to the plan, a \$100,000 credit balance is created. If the minimum required contribution next year also is \$1 million, the sponsor would have to contribute only \$900,000 due to having a credit balance of \$100,000. Moreover, credit balances from prior years increase at the interest rate assumed by the plan, regardless of the actual investment gains or losses of the plan's assets. Under S. 219, credit balances would continue to be allowed, but they would be "marked to market." Credits would be adjusted to their market value, based on investment gains or losses since the date they were contributed to the plan. A credit balance could be used to satisfy part or all of the sponsor's minimum required contribution to the plan; however, in determining the amount of the minimum required contribution, credit balances would have to be subtracted from the plan's assets.

Under current law, employer contributions to defined benefit pensions are tax-deductible up to certain limits. S. 219 would allow plan sponsors to make additional tax-deductible contributions in excess of a plan's minimum funding requirements in order to build up the plan's assets. In 2006, the deductible contribution would increase to an amount equal to the difference between 180% of the plan's current liability and the value of the plan's assets. For years after 2006, the maximum deductible contribution would be the greater of (1) the excess of the sum of the plan's funding target, the plan's normal cost, and a "cushion amount," over the plan's assets and, (2) the minimum required contribution for the year. For plans that are not in the "at-risk" category, this calculation could be performed as if the plan was in at-risk status, thus allowing a larger contribution. The cushion amount would be equal to the sum of 80% of the plan's funding target for the plan year and the amount by which the funding target would increase, based on future compensation increases. For plans with "flat dollar" benefits (i.e., benefits that are not based on past compensation), the cushion would be based on expected increases in benefits, as calculated from the average benefit increase in the previous six years.

PBGC Premiums for Single-Employer Plans. Under current law, defined benefit plan sponsors pay an annual premium of \$19 per participant to the Pension Benefit Guaranty Corporation (PBGC). Sponsors of underfunded plans also pay a variable premium of \$9 per \$1,000 of underfunding. Only vested benefits are counted for the purpose of calculating the variable premium. Under S. 219, the annual per-capita PBGC premium would increase to \$30 in 2006, and would be indexed to the rate of growth of

the average national wage starting in 2007. The amount of the variable rate premium would not be changed, but the calculation of underfunding would be changed to reflect the new funding rules. Plans that are at the full funding limit would not have to pay variable premiums, but the bill would repeal the provision of current law under which no variable rate premium is required if contributions for the prior year were at least equal to the full funding limit. The amount of benefits guaranteed by the PBGC would be frozen if the plan sponsor enters bankruptcy, and the plan sponsor would be required to notify plan participants and beneficiaries of the bankruptcy and its effect on the PBGC benefit guarantee. For new plans sponsored by employers with 100 or fewer employees, the base PBGC premium would be \$5 per plan participant for the first five years of the plan's existence. The variable rate premium for new plans would be phased in over the first six years of the plan. The variable rate premium for plans with less than 25 employees would be no more than \$5 per participant.

Lump-Sum Distributions and Limitations on Benefits. Under current law, a defined benefit plan that allows benefits to be paid as a lump sum must use the interest rate on 30-year Treasury bonds to convert the annuity that otherwise would be paid to the participant into a lump sum. S. 219 would require plans to use a "yield curve" of interest rates to determine the amount of lump-sum payments. The interest rates used to calculate a lump sum payment would be based on the participant's age when the lump-sum is paid and the number of years until he or she would reach the plan's normal retirement age. Other things being equal, lump-sum payments would be greater for older participants. The new interest rate rules for lump sums would be phased in from 2007 to 2011.

Under current law, if a plan with a funding ratio under 60% adopts an amendment that increases benefits under the plan, the sponsor must bring the plan's funding ratio up to at least 60%. Under S. 219, benefits could not be increased if a plan's funding ratio is under 80%, lump sums could not be paid from a plan with a funding ratio under 60%, and benefit accruals would cease if a plan's funding ratio was under 60% in the prior year. Benefit increases would be permitted if the plan sponsor made contributions (in addition to the minimum required contribution) that would result in the plan being at least 80% funded. Amendments that would increase benefits and the payment of lump-sum distributions both would be prohibited if the plan sponsor is in bankruptcy, unless the plan's funding ratio is at least 100%. The plan administrator would be required to notify plan participants of these limitations before they take effect and also in advance of the date the restrictions would end. In order for the benefit restrictions to end, the plan actuary would have to certify that the plan is at the required funding ratio. The bill would provide three exceptions to the limitations on amendments that increase benefits, payment of lump sums, and accrual of new benefits in collectively bargained plans:

- If a collective bargaining agreement provides for a future benefit increase while a plan's funding ratio is above 80%, and the ratio later drops below 80%, the amendment could take effect, provided that it does so before the collective bargaining agreement ends or (if sooner) three years from the date that the funding ratio falls below 80%;
- If a collective bargaining agreement is ratified before the plan's funding ratio drops below 60%, benefit accruals could continue during the period of the collective bargaining agreement or (if less) for three years from the date that the funding ratio falls below 60%;

- Benefits in collectively-bargained plans that are not based on pay (e.g., “flat dollar” benefits per month of service) could increase at the concurrent rate of increase of the average wage of plan participants.

The provisions limiting benefit increases, lump-sum payments, and additional benefit accruals in underfunded plans would be effective in 2007 or on the termination of a collective bargaining agreement (or 2009 if earlier).

“Shut-Down” Benefits. The bill would continue to permit benefits triggered by a plant shutdown or other contingent event, but it would limit PBGC guarantees for these benefits. The PBGC benefit guarantee would apply as if the plan amendment adding the contingent benefit had been adopted at the time the shutdown or other event occurred. Therefore, the current law five-year phase-in of the PBGC benefit guarantee would apply.

Disclosure Requirements. Under current law, plan sponsors must provide participants with a summary annual report and, on request, with a copy of the Form 5500 that they filed with the IRS and Department of Labor. S. 219 would require information filed with the PBGC by plans that are underfunded by \$50 million or more (called “4010 notices”) to be made available to plan participants. Defined benefit plans would be required to provide benefit statements to participants every three years or to provide a notice of the availability of statements annually. Defined contribution plans that allow participant-directed investments would have to provide quarterly benefit statements. Other defined contribution plans would have to provide annual benefit statements.

Funding of Deferred Compensation Plans. S. 219 would prohibit, in certain circumstances, funding of non-qualified deferred compensation plans for a plan sponsor’s chief executive officer and four most highly compensated officers. The funding restrictions would apply if (1) a plan sponsor is financially weak and maintains a plan that is less than 80% funded, (2) the plan sponsor is in bankruptcy, or (3) during the 12-month period beginning six months before the distress termination of an underfunded plan.

Airline Pension Plans. Under the Senate bill, airlines would be permitted to amortize their unfunded liabilities over 14 years, rather than the seven-year period applicable to other firms. Benefits under these plans and the PBGC benefit guarantee both would be frozen as of the first plan year to which the special funding rules apply. The PBGC benefit guarantee would be applied as if the plan terminated on the first day of the year in which this special airline funding rule was adopted by the plan.

Cash Balance Plans and Other Hybrid Pensions. The bill would provide that “cash balance plans” do not discriminate against older workers merely because interest accrues to younger workers’ accounts for longer periods than to older workers’ accounts, provided that neither pay credits nor interest credits decrease as workers age. The bill would permit plan sponsors to use a market interest rate instead of the 30-year Treasury rate to discount lump-sum distributions, thus allowing them to pay a lump sum benefit equal to the participant’s notional account balance. Treasury regulations would define a “market interest rate,” but the bill specifies that a plan’s interest credit generally cannot be less than the Federal mid-term interest rate. Benefits under cash balance plans would be required to vest after no more than three years of service. The bill would require plans that convert to a cash balance design to include one of three provisions:

- The conversion cannot result in a period of no new benefits accruals (called a “wear-away” period) and the plan must either (1) provide all participants covered by the plan before the conversion with the greater of accruals under the old formula or new formula for at least five years after the conversion, or (2) provide participants who were at least age 40 at the time of the conversion and had combined age and service of at least 55 years with (1) the greater of the benefit under the old formula or new formula, or (2) a choice between the old formula or new formula;
- The plan must provide all participants who were covered at the time of conversion with (1) the greater of the benefit determined under the old formula or new formula, or (2) a choice between the benefit determined under the old formula or new formula; or
- The plan sponsor must provide additional pay credits or additional opening account balances so as to provide benefits that would be substantially equal to either of the prior two alternatives, as determined under Treasury Department regulations.

Mortality Assumptions. The Treasury Secretary would prescribe a mortality table to be used by all plans. The table would be based on the experience of plans and projected trends in such experience. It would be reviewed at least every five years.

Investment Advice. Plan sponsors would be protected from fiduciary liability for investment advice provided by qualified advisors not affiliated with funds offered under the plan, provided that the investment advisor meets certain disclosure requirements.

Diversification from Employer Stock. The bill would require that after three years of service, plan participants must be allowed to diversify out of employer contributions to a defined contribution plan that are invested in company stock.

Rules for Multiemployer Plans. The bill would increase the limit on tax-deductible contributions to multiemployer plans to an amount equal to the difference between 130% of the plan’s current liability and the value of plan assets. The bill would repeal the combined limit on deductions for contributions to combinations of multiemployer defined benefit and defined contribution plans. The bill also would add to the Internal Revenue Code the multiemployer plan funding notice requirement that was added to ERISA as part of the *Pension Funding Equity Act of 2004*. It would impose an excise tax of \$100 per day per participant for failure to meet the notice requirement.

“DB/K” Plans. The bill would authorize a new type of plan — the “DB/K Plan” — that would combine the features of a defined benefit plan and a §401(k) plan. The defined benefit portion of the plan would provide a minimum benefit of 1% of final average compensation per year of service up to 20 years, regardless of whether the participant contributes to the 401(k) portion of the plan. It would be fully vested in three years or less, and would be deemed to meet certain nondiscrimination requirements. The 401(k) portion of the plan would provide for automatic enrollment at a rate of at least 4% of pay and a fully-vested matching contribution equal to at least 50% of the employee’s contribution up to 4% of pay. The nondiscrimination rules for 401(k) plans would be deemed to be satisfied for these amounts. Contributions to the 401(k) plan (either higher matching contributions or after-tax contributions) and defined benefit accruals higher than the minimum benefit would be permitted, subject to the nondiscrimination rules.