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STRENGTHEN FUNDING FOR SINGLE-EMPLOYER PENSION PLANS

Introduction and Summary

This Administration believes that promises made to workers and retirees must be kept. The retirement security of the 34 million Americans participating in single-employer defined benefit plans depends on employers keeping the pension promises they make.

However, the current system does not ensure that pension plans are adequately funded. When underfunded plans terminate, workers' retirement security is threatened. Underfunded plan terminations are placing an increasing strain on the pension insurance system and impose an increasing burden on employers who sponsor healthy pension plans.

Increased claims from terminations of significantly underfunded pension plans have resulted in a record deficit in the single-employer insurance fund of the Pension Benefit Guaranty Corporation (PBGC). For the fiscal year ending September 30, 2004, the deficit in that fund has increased from $11.2 billion to $23.3 billion. The increasing PBGC deficit and high levels of plan underfunding are themselves a cause for concern. More importantly, they are symptomatic of serious structural problems in the private defined benefit system. It is important to shore up this structure and strengthen the financial health of defined benefit plans now. If significantly underfunded pension plans continue to terminate, not only will some workers lose benefits, but other plan sponsors (including those that are healthy and have funded their plans in a responsible manner) may have to pay even higher PBGC premiums and more severe steps will be needed in order to protect plan participants and maintain the solvency of the pension insurance program. Underfunding in the pension system must be corrected to protect worker benefits and to ensure taxpayers don't risk paying for broken promises.

This document outlines the technical specifications of the President's proposal to strengthen funding for single-employer pension plans. The proposal has three main elements, each of which is described in detail in a separate section describing current law, the reasons for change, and the proposal.

The following summarizes the main elements of the proposal and lists the key provisions for each element:

- **Reforming the funding rules to ensure sponsors keep pension promises**. The current system is complex and ineffective. The proposal would:
    - Base funding rules on meaningful and accurate asset and liability measures.

    - Require plans to make up shortfalls in a reasonable period.Provide employers with the opportunity to make additional tax-deductible contributions in good times, when plans are fully funded.

    - Apply reasonable restrictions on new benefit promises and lump sum payments of plans that are severely underfunded.

- **Improving disclosure to workers, investors and regulators about pension plan status.** Workers need to have good information about the funding status of their pension plans to make informed decisions about their retirement needs and financial futures. Similarly, investors and regulators need timely information about the status of pension plans to evaluate plan sponsors' financial obligations and to ensure compliance with the law. The proposal would:

    - Improve disclosure of plan funding status and funding trends.

    - Make publicly available certain information filed with the PBGC by underfunded plans.

    - Provide for more timely reporting of information in plan annual reports.

- **Reforming premiums to better reflect a plan's risk and restoring the PBGC to financial health.** Under the current premium structure the PBGC will not have enough resources to meet its obligations. Worse, the current premium structure encourages irresponsible behavior by not reflecting a plan's true level of risk. In addition, plan sponsor bankruptcies and plant shutdown benefits increase plan terminations and impose unreasonable costs on the PBGC. The proposal would:

    - Immediately increase the flat per-participant premium from $19 to $30 and index it thereafter.

    - Charge a risk-based premium based on the gap between a plan's funding target under the Administration's funding reform proposal and its assets.

    - Enable the PBGC Board to adjust the risk-based premium to a level that improves the PBGC's financial position in a reasonable amount of time.

    - Freeze the PBGC guarantee limit when a company enters bankruptcy and allow creation of liens, and perfection by the PBGC in bankruptcy for missed required pension contributions.

    - Prohibit shutdown benefits under pension plans and eliminate the guarantee of shutdown benefits.

While changes in the current law funding rules may also be needed for multiemployer pension plans, there are other factors involved that relate to the funded status of multiemployer plans. The funding rules applicable to multiemployer plans are not being addressed at this time.

Strengthen Minimum Funding Rules

Current Law

Defined benefit pension plans are subject to minimum funding requirements imposed under both the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 (ERISA). In the case of a qualified plan, the Internal Revenue Code excludes contributions to defined benefit pension plans from the gross income of participants and allows the plan sponsor a deduction for the contributions, subject to certain limits on the maximum deductible amount. The calculation of the minimum funding requirements and the limits on deductible contributions are based on the plan's funding method, supplemented by calculations based on a comparison between the plan's assets and a more standardized measure of the plan's liability, known as current liability. These rules for defined benefit pension plans do not apply to governmental plans, church plans that have not made an election to be covered by ERISA and certain fully insured plans.

Calculations based on the plan's funding method

Selection and use of plan's funding method.
A plan's funding method (selected from a number of acceptable actuarial cost methods) is used to determine the normal cost and, in some funding methods, an accrued liability. The normal cost is defined as the portion of the plan's liability that is attributable to the current year's service, as determined under the actuarial cost method. Depending on the actuarial cost method, the normal cost can be based on the benefits that accrue during the year (adjusted upwards for expected future pay increases in the case of a plan that provides for benefits based on final average pay) or can be a specified portion of the present value of the total benefits expected to be paid under the plan. The accrued liability is based on the portion of the present value of the total benefits that is associated with the past under the actuarial cost method. For example, the actuarial cost method that determines the normal cost as the present value of the benefits that accrue during the year determines the accrued liability as the present value of the benefits that accrued in prior years. However, some actuarial cost methods (such as the aggregate cost method) do not determine an accrued liability.

Actuarial value of plan assets.
A plan's funding method also includes a method of determining the actuarial value of plan assets. The actuarial value of plan assets may differ from the fair market value of plan assets (e.g., it may be determined under a formula that "smooths" fluctuations in market value by averaging the value over a number of years), but must be between 80 and 120 percent of the fair market value of plan assets.

Actuarial assumptions.
The actuarial assumptions that are used to determine liabilities under the plan's funding method are based on the actuary's best estimate of anticipated experience in the plan. For example, the interest rate must be the actuary's best estimate of the future earnings on plan assets. The actuarial valuation generally must be prepared by disregarding the

possibility of future changes in the plan's benefit formula, the maximum benefit levels under section 415 or the section 401(a)(17) limit on the maximum compensation that can be taken into account under a qualified plan. However, if the plan is a single-employer collectively bargained plan, benefit increases must be taken into account if they are scheduled to take effect during the term of the current collective bargaining agreement.

Actuarial valuations.

Each year, an actuarial valuation is prepared as of the valuation date for the year. The valuation entails the determination of the normal cost for the year, the determination of the accrued liability (in the case of a funding method that calculates an accrued liability) and a comparison of assets with liabilities as of the valuation date. The valuation date for a plan year is generally a date within the plan year or within the month preceding the beginning of the plan year. However, the valuation for a plan year may be made as of an earlier date within the prior plan year, provided that the value of the plan assets exceeded the current liability described below as of that earlier date and that adjustments are made for significant differences in participants.

Calculation of minimum funding requirement.

As part of the valuation, the accrued liability is compared with the actuarial value of plan assets. If the actuarial value of plan assets is less than the accrued liability, the shortfall must be amortized in level payments over a number of years. The amortization period that applies depends on the source of the unfunded accrued liability. For example, to the extent the unfunded accrued liability is attributable to an actuarial loss, the amortization period is 5 years; but if it is attributable to a plan amendment adopted after 1976, the amortization period is 30 years. The minimum contribution for the year based on the plan's funding method (and subject to override as described below) is generally equal to the sum of the normal cost and the amortization payments for the year, adjusted by the funding standard account credit balance, as discussed below. If there have been actuarial gains or there have been changes in plan provisions or actuarial methods or assumptions that reduce the unfunded accrued liability, the amount of those gains or the reduction in unfunded accrued liability as a result of those changes is amortized over the same amortization periods that apply to the corresponding sources of unfunded accrued liability and each year's amortization credits are applied to offset the amortization charges with respect to actuarial losses or other increases in unfunded accrued liability.

Amortization extensions.

A plan sponsor may apply for an extension of the amortization periods for a period of up to 10 years. The Internal Revenue Service may approve the extension only if it determines that the extension would carry out the purposes of ERISA and provide adequate protection for participants under the plan and that failure to permit the extension would be adverse to the interests of plan participants and would result in either a substantial risk that the plan would terminate or in a substantial curtailment of pension benefits or compensation levels. If an extension of the amortization periods is approved, a special interest rate is used to determine the amortization schedules.

Funding standard account.
Compliance with the minimum funding requirements is monitored using a "funding standard account" that is credited with each year's contributions and charged with each year's minimum funding requirements. If a sponsor contributes more than the minimum required contribution for a plan year, the excess is maintained as a credit balance in the funding standard account. The excess contribution, together with interest at the valuation interest rate, may be applied as an offset to the next year's minimum funding requirements. If the credit balance is not used to offset the next year's requirements, the credit balance is carried forward, with interest at the valuation interest rate, to subsequent years.

Maximum deductible contribution and full funding limit under the plan's funding method

The maximum deductible contribution determined under the plan's funding method (subject to override as described below) is generally equal to the normal cost plus a 10-year amortization of any unfunded accrued liability. If an employer that sponsors a plan with an unfunded accrued liability contributes additional amounts in order to amortize the unfunded accrued liability more quickly (i.e., over a shorter period) than the schedule of amortization payments used to determine the minimum required contribution, the additional contributions are reflected in a credit balance in the funding standard account, as described above.

Full funding limit.
To the extent the plan's assets (valued at the lesser of fair market value and actuarial value) exceed the plan's accrued liability (or the accrued liability under the entry age normal cost method if the plan's funding method does not determine an accrued liability), then the plan's deductible contribution determined under the plan's funding method (subject to the override described below) is equal to the normal cost minus that excess. In such a case, where the plan is at its "full funding limit," the required minimum contributions are also reduced. Thus, if the plan's assets (valued at the lesser of fair market value and actuarial value) exceed the plan's accrued liability by more than the normal cost for the year, unless one of the overrides described below applies, no deductible contribution is permitted and there is no minimum required contribution for the year. This is the case even if the plan is not adequately funded under a more accurate measure of liability.

Current liability and deficit reduction contributions

Current liability.
The minimum required contribution and maximum deductible contribution calculated under the plan's funding method are subject to an override that is based on the plan's current liability. Current liability is calculated as the present value of the plan's benefits that have accrued as of the valuation date (other than benefits that will arise as a result of a future unpredictable contingent event, such as a plant shutdown), determined using certain standardized actuarial assumptions. For plan years beginning in 2004 or 2005, the

interest rate used to determine current liability must be within the corridor of 90-100 percent of the weighted average of the rate of interest on long-term corporate bonds (as set forth in guidance issued by the IRS), where the average is determined for the 48 months preceding the first day of the plan year. For plan years beginning in 2006 and thereafter, current liability must be determined using an interest rate within the corridor of 90-105 percent of the weighted average of the rate of interest on 30-year Treasury bonds, with the same 48-month averaging period and weightings. The statute specifies that a standardized mortality table must be used in determining current liability, and IRS guidance provides that current liability is generally determined without recognizing the value of lump sum options under a plan.

Deficit reduction contribution requirement.

The minimum funding requirements are supplemented by a requirement to make deficit reduction contributions in the case of a single employer plan sponsored by an employer that has more than 100 employees participating in defined benefit plans maintained by that employer. The deficit reduction contribution applies only when the actuarial value of the plan's assets is less than 90 percent of current liability. In addition, the deficit reduction contribution rules do not apply if the actuarial value of the plan's assets is between 80 and 90 percent of current liability, provided that the plan's assets were at least 90 percent of current liability in 2 consecutive years out of the last 3 years.

Deficit reduction contribution amount.

If the plan is subject to the deficit reduction contribution rules, the minimum required contribution for the year is the greater of the minimum determined under the plan's funding method, as described above, and the sum of (1) the expected increase in current liability attributable to benefits accruing during the year, (2) an 18-year amortization of the unfunded current liability as of the first plan year beginning in 1988, (3) a specified percentage of the unfunded current liability (other than the unfunded current liability attributable to pre-1988 service and the current liability attributable to benefits arising as a result of the occurrence of an unpredictable contingent event, such as a plant shutdown), and (4) a specified contribution related to the current liability attributable to benefits arising from an unpredictable contingent event that has occurred. The specified percentage depends on the funded status of the plan (varying from 30 percent for a plan with a funded current percentage of 60, down to 18 percent for a plan with a funded current percentage of at least 90), generally corresponding to an amortization period of 4 to 7 years. Under the Pension Funding Equity Act of 2004, commercial airlines, steel manufacturers and certain other employers may elect to use special rules to reduce significantly the deficit reduction contribution for plan years beginning between December 28, 2003 and December 27, 2005.

Maximum deductible overrides.

An employer may deduct amounts contributed to the plan that are not in excess of the amount necessary to bring the plan's assets up to the current liability, without regard to whether the plan assets exceed the accrued liability under the plan's funding method. For this purpose, current liability may, at the employer's election, be determined using an interest rate as low as 90 percent of the weighted average of the rate of interest on 30-year Treasury bonds. However, if the plan has fewer than 100 participants, the current

liability is determined without regard to plan amendments increasing liabilities for highly compensated employees that are made in the last 2 years. If a single-employer plan that is insured by the Pension Benefit Guaranty Corporation (PBGC) terminates, the deductible contribution limit is increased to equal the amount required to make the plan sufficient for benefit liabilities.

Full funding limit override.

Current liability also is used as an override to the otherwise applicable full funding limit for a plan. Under this rule, the full funding limit cannot be less than the excess of 90 percent of current liability (including the current liability normal cost) over the actuarial value of assets. Thus, a plan may not be treated as being at the full funding limit if the actuarial value of plan assets is less than 90 percent of the plan's current liability.

Alternative minimum funding standard.

As an alternative to applying the rules described above, a plan which uses the entry age normal cost method may satisfy an alternative minimum funding standard. Under the alternative minimum funding standard, the minimum required contribution for the year is generally based on the amount necessary to bring the plan's assets up to the present value of the accrued benefits, determined using actuarial assumptions that apply when a plan terminates. The alternative minimum funding standard has been rarely used.

Minimum funding waivers

If a plan sponsor of a single-employer plan is unable to satisfy the minimum funding requirements for a year without incurring temporary substantial business hardship, the plan sponsor may apply for a waiver of the funding requirements for that year. The Internal Revenue Service may approve the waiver application if it determines that the application of the minimum funding rules would be adverse to the interests of plan participants in the aggregate, but only if the plan has not obtained a waiver more than 3 times in a 15-year period. If the amount of the waiver is more than $1,000,000, the Internal Revenue Service must consult with the PBGC, and a waiver will generally be granted only if the employer provides adequate security. Once the minimum funding requirement for a year has been waived, the missed contributions must be amortized over a 5-year period, using a statutorily specified interest rate.

Failure to contribute minimum required funding

If a plan sponsor is a member of a controlled group of trades or businesses (generally based on 80 percent ownership) or an affiliated service group, all members of the group are joint and severally liable for satisfying the minimum funding requirements. A 10 percent excise tax applies if the plan sponsor fails to contribute the minimum required funding for a plan year (i.e., the plan has an accumulated funding deficiency). In addition, if the accumulated funding deficiency exceeds $1 million, a lien arises in favor of the PBGC. If the funding deficiency is not corrected before the Internal Revenue Service issues a notice of deficiency, the excise tax increases to 100 percent.

Timing rules for contributions

Minimum required contributions.
If contributions are made on a date other than the date used in the actuarial valuation, the amount of the minimum contribution is adjusted with interest at the valuation interest rate, but not beyond the end of the plan year. If a single-employer plan had assets that were less than the current liability for the prior plan year, the minimum funding requirement for the current year must be substantially satisfied through quarterly contributions during the year. In addition, an employer sponsoring such a plan must make sufficient contributions during a year to ensure that the plan maintains sufficient liquid assets to pay 3 years' worth of benefits. Failure to maintain this balance as of the end of a quarter is known as a "liquidity shortfall" and is treated as a failure to meet the quarterly contribution requirements. Regardless of whether the quarterly contribution requirements apply, the period for making minimum contributions for a plan year extends to 8 ½ months after the end of the plan year. A contribution for the plan year that is made during this 8 ½ month period is included in the plan assets (as a contribution receivable) for the following plan year's actuarial valuation.

Failure to meet quarterly contributions.
The sanction for failing to make the quarterly contributions is a requirement to increase the contributions using a statutorily specified interest rate that was intended to be higher than the otherwise applicable rate. In addition, if the missed contributions total more than $1 million, a lien arises in favor of the PBGC. If a plan has a liquidity shortfall, the amount of the shortfall is treated as a failure to meet minimum funding requirements, giving rise to the excise tax described above.

Deduction rules.
An employer sponsoring a defined benefit pension plan generally may deduct amounts contributed to the plan that do not exceed the maximum deductible contribution, provided that the contributions are made prior to the tax filing deadline for the tax year. Contributions for a tax year that exceed the greater of the maximum deductible contribution and the full funding limit are subject to an excise tax if the employer is a taxable entity (including a tax-exempt employer that has ever paid unrelated business income tax).

Grandfathered floor-offset plans

ERISA prohibits a defined benefit plan from acquiring employer securities or employer real property if immediately after such acquisition such assets would exceed 10 percent of the fair market value of the assets in the plan. Under a floor-offset arrangement, the defined benefit plan provides the floor, or minimum benefit. That benefit is then offset, or reduced, by the annuitized benefit the defined contribution plan could provide.

The Pension Protection Act of 1987 (PPA 1987) amended ERISA to take assets under a defined contribution plan that is part of a floor-offset arrangement into account for purposes of the 10 percent limit. Thus, the limit applies on an aggregated basis to affected floor-offset arrangements, aggregating the separate but associated defined

benefit and defined contribution plans. However, the PPA 1987 amendment only applies to floor-offset arrangements established after December 17, 1987, so that defined contribution plans that are part of floor-offset arrangements established on or before December 17, 1987 (so-called "grandfathered floor-offset arrangements") are not subject to this limit.

Benefit limitations

Plan amendments increasing benefits in severely underfunded plans.
If an employer with more than 100 participants in defined benefit plans amends the plan to increase benefits, the employer is required to post security before the plan amendment can take effect if, after the plan amendment, the actuarial value of the plan's assets would be less than 60 percent of current liability (determined without regard to the unamortized portion of pre-1988 unfunded current liability). The amount of the required security is the amount by which the assets are less than 60 percent of current liability after the amendment (or, if smaller, the aggregate increase in current liability attributable to all post-1988 benefit increase amendments), but only to the extent this amount exceeds $10 million.

Other limitations on benefit increases.
In the case of a defined benefit plan sponsored by an employer in bankruptcy, an amendment improving the plan's benefits generally may not be made effective until the reorganization is complete. Similarly, if an employer has an outstanding minimum funding waiver for a defined benefit plan or has had the amortization period extended, the plan generally may not be amended to improve benefits.

Limitations on lump sums for plans experiencing liquidity shortfalls.
Under section 206(e) of ERISA, a plan that has a liquidity shortfall may not make lump sum payments (or other similar benefit payments that deplete plan assets on an accelerated basis) during the period of the shortfall. The limitation on payments during the period of a liquidity shortfall extends to lump sum payments and any other payment that is larger than a single life annuity (plus any social security supplements) and to the purchase of an annuity from an insurer. Under the Internal Revenue Code, a plan will not be disqualified merely because benefit payments are not made in accordance with this limitation during the period of liquidity shortfall.

Executive funding for nonqualified deferred compensation.
Companies can fund nonqualified deferred compensation arrangements for executives through a variety of mechanisms that secure benefits by segregating assets in a funding vehicle that is not fully available to creditors, such as rabbi trusts and insurance policies, without regard to the funded status of the company's pension plans for employees generally.

Reasons for Change

The pension funding rules should ensure that pension promises made by businesses to workers and retirees will be honored. The recent economic climate has exposed severe weaknesses in the pension funding rules. These weaknesses have resulted in serious plan underfunding, and terminations of underfunded plans have led to benefit losses for plan participants and record deficits for the PBGC. The fact that there have been successive and worsening pension funding crises over time demonstrates that fundamental reform is needed.

One reason for this problem is the Byzantine and often ineffectual set of funding rules under current law. They are needlessly complex and fail to ensure that many pension plans become and remain adequately funded. Current rules give employers too much discretion in setting their funding targets and provide insufficient opportunity for plans to become well funded. Current rules also do not provide enough incentive to be well funded because there are few significant consequences that arise from a plan being poorly funded, especially for a plan sponsor in poor financial health.

Current measures of plan funding are not based on measures of assets and liabilities that are meaningful and accurate

Funding targets should not be manipulable.
Because a plan's apparent funded status is a function of its chosen actuarial cost method, there is no uniformity in liability measures under current law. Furthermore, a plan actuary has substantial discretion in selecting an interest rate and the interest rates chosen commonly reflect the high rate of return that is anticipated from investing in equities. As a result, companies can report that their pension plans are fully funded, when in fact they are substantially underfunded using a more meaningful and accurate measure of liability.

Liabilities should be measured accurately using current interest rates.
Current law attempts to address the manipulability of the funding target by overlaying the requirement to make a deficit reduction contribution, which is based on a more standardized measurement of current liability. The deficit reduction contribution override to the minimum funding requirements has not been wholly effective, as a number of employers have adopted a funding policy that just keeps the plan's assets at 90 percent of current liability in order to avoid application of the deficit reduction contribution. Moreover, current liability has a number of structural flaws that result in that value having no obvious relationship to the amount of assets needed to pay all of the plan's benefit liabilities if the plan were to terminate.

One such flaw is that the interest rate used in determining current liability can be selected from an interest rate corridor that is based on an average of interest rates over the prior 48 months. As a result, during periods of rapidly changing interest rates, the current liability interest rate can be significantly out-of-date. For example, in November 2004, the weighted average of the long-term corporate bond rates used to determine current liability was 6.17 percent, while the actual rate for that month was 5.59 percent -- such an interest rate difference (.58 percent) can by itself materially understate plan liabilities.

Even if the current liability interest rate reflected current market conditions, it would produce an inaccurate measure of the plan's true liability because it is based on a long-term interest rate and fails to take into account the actual timing of when benefit payments will be due under the plan, which might be -- and often is -- considerably sooner. As evidenced by the difference between the interest rates on a 15-year and a 30-year mortgage, market interest rates are sensitive to the timing of the relevant cash flows.

Assets also *should be measured accurately.*
The use of a smoothed actuarial value of assets distorts the funded status of the plan. Using fair market value for purposes of the funding rules would give a clearer picture of a plan's funded status.

The risk of termination must be recognized for plan sponsors in poor financial health.
In addition to other flaws, the funding targets under current law fail to reflect the additional costs that an insurer would charge in providing annuities for a terminating plan. Pension plans sponsored by firms in poor financial health pose substantial risk of termination and losses to plan participants and the pension insurance fund. Under current rules, such plans are not required to fund to a target that adequately reflects the final costs of terminating the plan. While it is not necessary for all plans to fund to such a high standard, the pension funding target for a plan should not be based on the assumption that the plan will survive indefinitely, particularly if there is a substantial risk that the plan will terminate. Accordingly, the pension funding rules should not be based on the fundamental assumption that plan assets will always be able to earn an equity premium or that plans will be able to earn a long-term interest rate to meet short-term obligations. In addition, in the case of a plan with a substantial risk of terminating, the pension funding target should reflect the additional cost of terminating the plan and that plan participants are increasingly likely to retire early and to take their benefits in lump sum form.

Because of these flaws in measurements of liabilities and the permitted smoothing of assets, funding ratios based on current law measures of assets and liabilities often provide an inaccurate picture of a pension plan's true financial status. This is especially true when the smoothed current liability is compared with a smoothed actuarial value of assets which can be substantially above market value. Inaccurate asset and liability measures can contribute to unpleasant surprises about a plan's funded status for participants if their pension plan terminates. Recent well-known plan terminations include a case in which the plan appeared to be 84 percent funded on a current liability basis in the year before the plan termination, but when the plan actually terminated it turned out to be only 45 percent funded on a termination basis, with a total shortfall of $4.3 billion. In another case, the plan appeared to be 94 percent funded on a current liability basis in the year before the plan terminated, but when it terminated, the plan was only 33 percent funded on a termination basis, with a $2.5 billion shortfall. Had these plans been required to use a liability measure that reflected current market interest rates, the timing and form of benefit payments, and the cost associated with an actual plan termination, and had that liability been compared to the market value of assets, the stated funded status of the plan prior to termination would not have been so misleading.

Underfunded plans should make up their shortfalls over a reasonable period and without funding holidays until the shortfall is eliminated

Amortization periods are too long.

The current law 30-year amortization period for plan amendments is too long, as there is too much risk that the plan will be terminated before the 30 years is completed. Furthermore, collectively bargained plans often have a series of benefit increases every few years. As a result, these plans are perennially underfunded. While the deficit reduction contribution override was designed to address this problem (as well as the discretion in setting funding targets under the plan's funding method), its effectiveness has been limited by the ability of a plan sponsor to avoid the application of the deficit reduction contribution by keeping a plan funded just above 90 percent of current liability, as noted above.

Funding standard account credit balances should be eliminated.

One flaw in the current funding rules worth highlighting is the treatment of funding standard account credit balances. The credit balance rules allow an employer to apply their additional contributions from an earlier year -- with assumed interest -- as an offset to the minimum funding requirement for the current year without restriction. This allows a plan to have a contribution holiday without regard to whether the additional contributions have earned the assumed rate of interest or have instead lost money in a down market -- and, more importantly, regardless of the current funded status of the plan. In the two dramatic plan termination cases cited above, the credit balance in the funding standard accounts served to fully offset otherwise required contributions. As a result, no contributions were made to either plan during the three or four years leading up to plan termination. The law needs to provide an incentive to adequately fund plans at an appropriate level, without the volatility inherent in a credit balance system.

The rules should provide employers with the opportunity for additional funding

Additional tax-deductible contributions should be permitted.

The rules should provide greater flexibility for employers to make additional contributions in good economic times. The current funding rules can conceivably place a pension plan sponsor in the position of being unable to make deductible contributions in one year and then being subject to accelerated deficit reduction contributions in a subsequent year. This problem is caused by the interaction of the minimum funding requirements, which are designed to ensure the pension plan's financial integrity, the rules governing maximum deductible contributions, which are designed to limit excessive tax deductions, and the excise tax on nondeductible contributions. Prohibiting tax-deductible contributions whenever the plan's assets exceed the greater of the plan's accrued liability and the plan's current liability restricts the ability to build up a cushion that employers can use to protect themselves from the risk that contributions will have to be severely increased in poor economic times. The law should be revised to allow higher tax-deductible contributions during good economic times that would minimize precipitous funding increases during tough economic times, and thereby allow a plan sponsor to guard against future periods of low sponsor earnings and/or periods of poor plan asset returns.

Eliminate grandfather for pre-1988 floor-offset plans

The PPA 1987 grandfather for pre-1988 floor-offset plans means that participants in such an arrangement are at significant risk. If a company with a grandfathered floor-offset arrangement goes out of business, the employer stock held in the related defined contribution plan typically becomes worthless, with the result that the defined benefit plan is left with a large unfunded liability. This problem has been highlighted by the recent events surrounding the financial difficulties of the Enron Corporation, which had maintained a grandfathered floor-offset plan.

Stronger consequences should apply for persistently underfunded plans

Restraining liability increases in significantly underfunded plans.

Companies should be held accountable to make good on the pension promises they have made to their workers and retirees. The consequence of not honoring these commitments is that the retirement security of millions of current and future retirees is put at risk. Under current law, sponsors of underfunded plans can continue to provide for additional accruals and, in some situations even make benefit improvements, while pushing the cost of paying for those benefits off into the future. For this reason, companies have an incentive to provide generous pension benefits, rather than increase current wages, and employees may go along because of the PBGC guarantee. If a company's plan is poorly funded, the company should be precluded from adopting further benefit increases unless it fully funds them, especially if it is in a weak financial position.

Lump sums should be restricted in severely underfunded plans.

If a plan is severely underfunded, retiring employees should not be able to elect lump sums and similar accelerated benefits because the payment of those benefits allows those participants to receive the full value of their benefits while depleting the plan assets for the remaining participants. A similar concern applies when a severely underfunded plan purchases annuities.

Additional risk from plan sponsors in poor financial health.

Recent history has demonstrated that pension funding risk is greatest for employers in poor financial health. Furthermore, financial discipline from plan sponsors cannot be expected if there are no consequences associated with the lack of such discipline. Thus, if an employer is recognizably in financial difficulty and its pension plan is significantly underfunded, even more serious measures are called for. Such a plan should be frozen until the funding improves.

Other changes are needed

Executive funding for nonqualified deferred compensation.

Executives of companies in financial difficulty should not be able to benefit by having their nonqualified deferred compensation arrangements funded and made more secure, without addressing the risk to the retirement income of rank and file employees caused by severely underfunded pension plans. Rules also are needed that would preclude funding

executive compensation arrangements at a time close to termination of an underfunded pension plan covering rank and file employees.

Plant shutdown benefits should not be permitted.
A recurring problem in pension funding is that a plan may have special benefits that are only payable in the event that the location at which workers are employed ceases operations. Such events are inherently unpredictable, so that it is difficult to recognize the costs of these benefits in advance and current law does not include the cost of benefits arising from future unpredictable contingent events in current liability. Yet these benefits can dramatically increase the level of underfunding in a plan and by themselves have been a considerable source of pension funding problems. Allowing – and guaranteeing – plant shutdown benefits raises fairness issues since other participants and plan sponsors may bear the burden of paying for these unfunded benefits.

Proposal

The multiple sets of funding rules applicable to single-employer defined benefit plans would be rationalized and replaced with a single set of rules that provide for: (1) funding targets that are based on meaningful, accurate measures of liabilities that reflect the financial health of the employer; (2) the use of market values of assets; (3) a 7-year amortization period for funding shortfalls; (4) the opportunity for an employer to make additional deductible contributions in good years, even when the plan's assets are above the funding target; and (5) meaningful consequences for employers and plans whose funded status does not improve. Governmental plans, non-electing church plans and fully insured plans would continue to be excluded from the minimum funding rules.

These funding rule changes, the addition of meaningful consequences for employers and plans whose funded status does not improve, and improved disclosure to plan participants, investors and regulators, are part of an overall package of reforms that will improve the health of defined benefit pensions and the PBGC guarantee system.

Funding targets that are based on measures of liabilities that are meaningful and accurate and that reflect the financial health of the employer

Funding targets that depend on the plan sponsor's financial health.
The minimum required contribution to a single-employer defined benefit pension plan would be based on funding targets that vary depending on the financial health of the plan sponsor. For a plan sponsor that is healthy (i.e., the plan sponsor is not financially weak, as defined below), the funding target is the plan's ongoing liability. For a plan sponsor that is financially weak, the funding target generally is the plan's at-risk liability. However, if the plan sponsor has become financially weak within the past 5 years, there is a phase-in of the target liability, as described below.

Definition of financially weak.
A plan sponsor is financially weak for a plan year if, as of the valuation date, any plan sponsor for the plan has senior unsecured debt that is rated as not being investment grade

by each of the nationally recognized statistical rating organizations that has issued a credit rating for the debt (or, if no plan sponsor has senior unsecured debt that is rated, all of the nationally recognized statistical rating organizations that have made an issuer credit rating for any plan sponsor have rated the sponsor as less than investment grade). However, a plan sponsor would not be treated as financially weak if any significant member of the controlled group (whether or not a plan sponsor) has senior unsecured debt that is rated as being investment grade.

In addition, a plan sponsor is automatically treated as not being financially weak if it has neither senior unsecured debt that is rated nor an issuer credit rating and the employer does not maintain defined benefit plans covering at least 500 participants. In the case where no plan sponsor has either senior unsecured debt that is rated or an issuer credit rating and the employer maintains defined benefit plans covering at least 500 participants, the determination of whether the sponsor is financially weak would be made under regulations. It is expected that the regulations would generally determine whether the sponsor is financially weak based on financial measures, such as whether the long-term debt to equity ratio of the controlled group is 1.5 or more, with debt to include the unfunded pension liability (at-risk liability) and equity to be based on fair market value for a privately held company or market capitalization for a company whose stock is publicly traded.

Changes in financial health.

If a sponsor’s financial health worsens (i.e., the plan sponsor becomes financially weak) during a plan year (including having become financially weak before enactment), the change in the applicable funding target (and the associated normal cost) is phased in ratably over a 5-year period following the year the plan sponsor becomes financially weak (without regard to whether any of those years were prior to enactment). However, if a sponsor’s financial health improves so that it becomes healthy during a plan year, the funding target changes to ongoing liability for the next plan year.

Ongoing liability.

Ongoing liability is equal to the present value of all benefits that the plan is expected to pay in the future, based on benefits earned through the beginning of the plan year (including early retirement and similar benefits that the participant will grow into with future service to the extent of the benefits earned as of the beginning of the plan year). Present value is determined by discounting the future expected payments under the plan for the time value of money using the corporate bond yield curve described below, where the expected payments are determined using a mortality table prescribed by the Secretary of Treasury. Each other assumption, including the plan’s turnover and retirement assumption, is required to be actuarially reasonable based on the plan’s experience (or other relevant historical experience if the plan has no experience). The probability that future payments will be made in the form of a lump sum payment is among the factors that are required to be taken into account. Ongoing normal cost is the present value of all benefits that the plan is expected to pay that accrue during the plan year (including any increase in benefits earned in prior years attributable to compensation increases), calculated using the same assumptions as are used for determining ongoing liability.

At-risk liability.
At-risk liability would be based on the same benefits and assumptions as ongoing liability, except that the valuation of those benefits would require the use of certain actuarial assumptions that would take into account the fact that a plan maintained by a financially weak plan sponsor has a greater likelihood to pay benefits on an accelerated basis or to terminate its plan. The modified actuarial assumptions are: acceleration in retirement rates using the earliest early retirement age; and benefits being distributed in a lump sum payment (or in whatever other form of distribution results in the largest liability for the plan). These assumptions are designed to reflect behavior that typically occurs prior to plan termination when the financial health of the employer deteriorates. In addition, at-risk liability includes a loading factor to reflect the additional administrative cost of purchasing a group annuity if the plan were to terminate: the loading factor is $700 per participant plus 4 percent of the at-risk liability before the loading factor. In no event would the at-risk liability for the plan be less than ongoing liability for the plan plus the loading factor (which could occur, for example, if the earliest retirement age assumption were to result in less valuable benefits). At-risk normal cost is the same as ongoing normal cost, except that at-risk normal cost is generally calculated using the assumptions that are used for determining at-risk liability (but does not include the $700 per participant loading factor).

Interest rates used for present value calculations to be based on a yield curve.
The applicable funding target and normal cost would be determined using a series of interest rates drawn from a yield curve for high-quality zero-coupon corporate bonds. This corporate bond yield curve would be issued monthly by the Secretary of Treasury and would be based on the interest rates (averaged over 90 business days) for high quality corporate bonds (i.e., bonds rated AA) with varying maturities. Thus, the interest rates that are used in calculating ongoing liability and at-risk liability would vary, depending on how many years in the future a participant's benefit payment will be made. In the usual situation of an upwardly sloping yield curve, higher interest rates would be used to discount benefit payments expected to be made further in the future, with lower interest rates applying for benefit payments made in the near term.

Transition rules.
For plan years beginning in 2006 and 2007, the funding target would be determined as the weighted average of the value of the applicable funding target liability and normal cost for the plan, determined using the methodology described above, and that same liability and normal cost determined using the transition interest rate. The transition interest rate is the interest rate that would have been used to determine current liability if the law applicable to current liability for 2005 were to continue to apply for 2006 and 2007. For 2006, the weighting factor would be 2/3 for the calculation using the transition interest rate and 1/3 for the calculation using the corporate bond yield curve; and for 2007, the weighting factors would be reversed.

Valuation dates.
A plan's funding target (based on ongoing liability or at-risk liability, as applicable) and the market value of its assets for any plan year would be determined as of the valuation date for that year. A plan's valuation date may be any day of the plan year if the plan has

100 or fewer participants, and must be the first day of the plan year if the plan has more than 100 participants. If the valuation date is after the first day of the plan year, the funding target excludes the present value of benefits accrued between the first day of the year and the valuation date. For purposes of determining plan assets at the valuation date, any contribution that has been made for the current plan year is disregarded and any contribution to be made for the prior plan year that has not yet been paid is included in the plan assets as a contribution receivable. However, for plan years beginning in 2007 and later, only the present value of that contribution receivable is included in plan assets, with the present value to be determined using the average effective interest rate that applied in determining the prior year's funding target.

Minimum contributions for plans with market value of assets below funding target

If, as of the valuation date for a plan year, the market value of plan assets is less than the applicable funding target for the year, the minimum required contribution for the year would be equal to the sum of the applicable normal cost for the year and the required amortization payments for the shortfall, as described below. The alternate minimum funding standard account would be eliminated, but current law permitting waivers of minimum funding requirements would continue to apply.

Amortization payments.
Amortization payments would be required in amounts that amortize each amortization base over a 7-year period. The initial amortization base is established as of the valuation date for the first plan year beginning in 2006 and is equal to the excess, if any, of the funding target over the market value of assets as of the valuation date. The shortfall is amortized in 7 payments, beginning with a payment as of the valuation date for that plan year and continuing on a level basis at each valuation date for the next 6 plan years, where the level amortization payments are determined based on the applicable interest rates under the corporate bond yield curve.

For each subsequent plan year, if, at a valuation date, the sum of the market value of assets and the present value of future amortization payments (with the present value determined using the corporation bond yield curve as of the current valuation date) is less than the funding target, an additional amortization base equal to that shortfall is established. That shortfall is similarly amortized in 7 equal payments. The current law rules regarding extension of amortization periods would no longer be available to reduce the minimum funding requirements for a single-employer plan.

This process (i.e., comparing the funding target to the sum of the market value of assets and the present value of future amortization payments for past amortization bases, and establishing a new amortization base if there is a shortfall) is repeated each year on the valuation date. If, at any valuation date, the sum of the market value of assets and the present value of future amortization payments exceeds the funding target, no new amortization base would be established for that year and the total amortization payments for the next year would be the same as in the prior year (except to the extent amortization payments for a prior amortization base cease because that base has completed its 7-year amortization period). The amortization payments for each amortization base would

continue unchanged for 7 years (or until the market value of the plan's assets on a valuation date equals or exceeds the funding target if earlier). If, on a valuation date, the market value of the plan's assets equals or exceeds the funding target, then the amortization charges would cease and all existing amortization bases would be eliminated.

Timing rules.
The quarterly contribution rules would apply to all plans that have assets less than the funding target as of the prior valuation date, and the deadline for the final contribution for the year would continue to be 8 ½ months after the end of the plan year. A contribution made after the valuation date for the year would be credited against the minimum required contribution for the year based on its present value as of the valuation date, discounted from the date actually contributed and determined using the average effective interest rate that applied in the determination of the funding target under the actuarial valuation.

Required funding and opportunity to increase funding in good years

If, as of the valuation date, the market value of plan assets exceeds the funding target by more than the applicable normal cost, there would be no required funding for the year. If the market value of plan assets exceeds the funding target, but by an amount that is less than the normal cost for the year, the required funding for the plan would be equal to the normal cost minus the excess of the plan assets over the funding target. However, any plan sponsor would be permitted to make additional deductible contributions up to the maximum deductible amount.

Maximum deductible amount.
Funding would be permitted on a tax deductible basis to the extent the plan's assets on the valuation date are less than the sum of the plan's funding target for the plan year, the applicable normal cost and a specified cushion. The cushion amount is defined as the sum of (1) 30 percent of the plan's funding target and (2) an increase to reflect how much larger the funding target and applicable normal cost would be if they were to take into account anticipated future salary increases, or future benefit increases (based on the average for the past 6 years) in the case of plans under which the benefits for service to date are not based on compensation. To determine how much larger the funding target and applicable normal cost would be if they were to take into account anticipated future salary or benefit increases, the salary or benefit increase is applied to increase benefits under the plan formula based on service as of the valuation date, but limited, as under current law, to the then applicable tax law limitations on benefits and compensation. In no event would the maximum deductible contribution for any plan year be less than the plan's unfunded at-risk liability plus the at-risk normal cost.

Effect of contributing more than the minimum.
If a plan sponsor contributes more than the minimum required contribution for the year, the employer will receive a deduction for the year that the contribution is credited for funding purposes, but no adjustment is made to the required contributions under the payment schedules that amortize funding shortfalls. Because contributing more than the

minimum amount (and actual earnings thereon) will increase plan assets at the next valuation date, a contribution in excess of the minimum for a year will accelerate the date on which the plan's assets equal or exceed the funding target, after which the only required contributions would be the normal cost.

Further, to the extent that the plan sponsor makes additional contributions for a year so that the market value of the plan's assets at the next valuation date exceed the funding target by more than the normal cost for the next year, the plan sponsor will have the flexibility for that next year to make contributions up to the maximum level and the sponsor will not be required to make any minimum contribution for that year. The flexibility to not make a contribution for a year will continue as long as the plan's assets continue to equal or exceed the sum of the funding target and the applicable normal cost.

The potential for a sponsor to make additional contributions during good economic times (even when the plan's assets exceed its funding target) provides a plan sponsor with the opportunity to build up a cushion that can minimize future minimum contributions in bad years. The sponsor will also have incentives to choose to make contributions to the plan when it has the cash (even if the plan's assets exceed its funding target) in order to obtain a tax deduction and to minimize the risk of having to impose the benefit limitations described below. If an employer makes additional contributions, not only will plan participants have greater funding security, but the employer will have received an early deduction as well as tax shelter for the earnings on the early contribution.

A contribution made within the time for filing tax returns for a taxable year (which is generally not later than 8 ½ months after the end of the taxable year) may be deducted for that taxable year, provided that it does not exceed the maximum deductible amount and is treated as a plan contribution made for the plan year that contains the last day of the taxable year. No other changes would be made in the current law rules relating to the timing of contributions under the minimum funding rules and under the maximum deductible limits, or the coordination of taxable years and plan years.

Eliminate grandfather for pre-1988 floor-offset plans

The PPA 1987 exception for floor-offset arrangements in effect on or before December 17, 1987 would be eliminated. Floor-offset arrangements would be required to reduce their holdings of qualifying employer securities and qualifying employer real property to no more than 10 percent of the total combined assets of the defined benefit plan and the related individual account plan over a period of no more than 7 years. This requirement to dispose of such property would apply on a graduated basis pursuant to regulations.

Meaningful limitations on plans funded below target levels

Revision of current limitations on benefits.

The current law limitations prohibiting amendments improving benefits for a plan sponsor in bankruptcy would be retained. The generally applicable prohibition against large benefit increases in plans that are less than 60 percent funded would be replaced by the new rules below. The current law prohibition against lump sum payments (and other

forms of accelerated benefit payments, including the purchase of annuities) in the case of a plan with a liquidity shortfall would be retained. These rules would be supplemented by the additional limitations on benefits described below.

Limitation on benefit increases.

For a plan where the market value of the plan's assets is less than or equal to 80 percent of the funding target as of the valuation date, no amendment increasing benefits would be permitted, unless the sponsor contributes the sum of the minimum required contribution and the increase in the funding target attributable to the amendment. If the market value of the plan's assets is above 80 percent of the funding target, but was less than 100 percent for the prior plan year, then no benefit increase amendment that would cause the market value of the plan's assets to be less than 80 percent of the funding target would be permitted, unless the sponsor contributes the minimum required contribution plus the increase in the funding target attributable to the amendment (or, if less, the minimum required contribution plus the amount necessary to increase the plan's assets to equal 80 percent of the funding target). For a plan where the market value of the plan's assets was at least 100 percent of the funding target as of the prior year, no limit on benefit increases would apply.

Limitations on accelerated benefit distributions.

If either the market value of a plan's assets is less than or equal to 60 percent of the funding target as of the valuation date or the plan sponsor is financially weak and the market value of the plan's assets is less than or equal to 80 percent of the funding target as of the valuation date, no lump sum distributions or other accelerated benefit forms would be permitted.

Limitations on accruals for plans with severe funding shortfalls or sponsors in bankruptcy.

If the plan sponsor is financially weak and the market value of the plan's assets is less than or equal to 60 percent of the funding target as of the valuation date (i.e., the plan is "severely underfunded"), or for a plan whose sponsor is in bankruptcy and whose assets are less than the funding target as of the valuation date, the plan would be required to be frozen.

Prohibition on funding executive compensation for severely underfunded plans sponsored by financially weak employers and for insufficient plan terminations.

If a financially weak employer has a severely underfunded plan, special rules would apply under ERISA that would prohibit the funding of nonqualified deferred compensation for executives. These special rules would also apply to prohibit any funding of executive compensation that occurs less than 6 months before or 6 months after the termination of a plan whose assets are not sufficient to provide all benefits due under the plan.

Under the special rules, a company would not be permitted to devote its resources to fund an executive's nonqualified deferred compensation arrangements through a rabbi trust, insurance policy or other funding mechanism that limits immediate access to such resources by the company or by creditors. The rules would apply to any top executive in

any company in the controlled group (or former employee who was a top executive at the time of termination of employment).

Accordingly, a plan would have a right of action under ERISA against any top executive whose nonqualified deferred compensation arrangement was funded during the period of the prohibition. The right would permit recovery of the total amount that was funded, together with attorney's fees. The sponsor of any plan to which these rules apply would be required to notify the plan fiduciaries of its funded deferred compensation arrangements when any funding of deferred compensation arrangements for executives occurs in the case of a plan that is severely underfunded or when the plan terminates. The plan fiduciaries would have access to the company's books to ascertain whether the company met its obligation in this regard. Plan fiduciaries would be obligated, under existing law, to take reasonable steps to pursue the cause of action afforded by this new provision.

New plans.

Except for the prohibitions against lump sums and other accelerated benefit forms, the various limitations on benefits and the prohibition on securing executive compensation would not apply for the first five years after a plan is established.

Timing rules to implement limitations.

A series of special timing rules apply for determining whether a plan's funding percentage is below one of the thresholds for applying the benefit limitation thresholds described above, based on annual certifications that are to be provided by the plan actuary. If a plan was subject to a benefit limitation in the prior year, then the funding percentage is presumed not to have improved in the current year until the enrolled actuary certifies that the funded status at the valuation date for the current plan year has improved sufficiently so that the benefit limitation does not apply for the current year. If a benefit limitation did not apply in the prior year, but the funding percentage for that year was no more than 10 percentage points above the threshold for applying that benefit limitation, then the plan's funding percentage is automatically presumed to have been reduced by 10 percentage points for the current plan year as of the first day of the 4th month of the plan year (so that the benefit limitation applies for the current year beginning on that day) unless and until the enrolled actuary certifies that the funded status is such that the benefit limitation does not apply for the current year. In any other case, if an actuarial certification fails to be completed by the first day of the 10th month of the plan year, then the plan's funding percentage for the plan year is presumed to not exceed 60 percent for the current year beginning on that day for purposes of the benefit limitations.

With respect to the requirement that a plan be frozen when the sponsor is in bankruptcy if the plan assets are less than the funding target as of the valuation date, an automatic freeze would occur at the time of entering bankruptcy during a plan year unless and until the enrolled actuary certifies that plan assets are at least equal to the funding target as of the valuation date for the plan year. If such a certification is made during the plan year, then the freeze is released retroactively to the valuation date.

For the purpose of these timing rules, the actuary's certification is to be based on information available to the actuary at the time of the certification regarding the market value of plan assets and the actuary's best estimate of the plan's funding target on the valuation date for the current plan year. If the actuary determines that the funded percentage using the actual funding target would result in a change in the application of the benefit limitations, the actuary must notify the plan administrator of the change.

Participant notice of benefit or guarantee limitation.
Plans that become subject to benefit limitations or to special limitations on the PBGC guarantee (including plans of sponsors that enter bankruptcy) would be required under ERISA to furnish a related notice to affected participants and beneficiaries. The notice would be required to be furnished within a reasonable time after the date the limitation applies (or, to the extent set forth by the Secretary of Labor, a reasonable period before the limitation applies). A notice also would be required to be furnished within a reasonable time of the date a limitation ceases to apply. A penalty would be imposed under Title I of ERISA for a plan administrator's failure to furnish the required notice. The Secretary of Labor would be authorized to issue regulations describing the form, content, and timing of the notice.

Restoration of plan benefits.
Plans that are frozen or for which lump sums or other accelerated benefit forms are prohibited would be permitted to resume accruals and accelerated benefit forms in a subsequent plan year only by a plan amendment. The plan amendment may be adopted at any time after the first valuation date on which the plan's assets exceed the applicable threshold percentage. The plan amendment would be subject to the limitations on benefit increases and also would result in a phase-in of the PBGC guarantee.

Prohibition on plant shutdown benefits

Plans would not be permitted to provide benefits that are payable upon a plant shutdown or any similar unpredictable contingent event as determined under regulations. A plan that contains such a benefit would be required to eliminate the benefit, but only with respect to an event that occurs after the effective date, and such a plan amendment would not violate the anti-cutback rules. If a benefit becomes payable as a result of such a plant shutdown event that occurs after February 1, 2005, and before the effective date for the prohibition, the benefit would not be covered by the PBGC guarantee.

Effective dates

The proposal generally would be effective for plan years beginning in 2006. The new benefit limitations (including the prohibition on shutdown benefits) would be effective for plan years beginning in 2007. In the case of a collective bargaining agreement in effect on the date of enactment, the benefit limitations (other than the prohibition on shutdown benefits) would not be effective before the end of the term of that agreement (without regard to extensions) or, if earlier, the first plan year beginning in 2009. In the case of a collective bargaining agreement that provided for an shutdown benefit on

February 1, 2005, the prohibition on shutdown benefits would not be effective before the end of the term of that agreement (without regard to extension) or, if earlier, the first plan year beginning in 2008.

Revenue Estimate

Fiscal Years							
2005	2006	2007	2008	2009	2010	2006-10	2006-15
($'s in millions)							
--	151	1,432	-869	-2,699	-1,762	-3,747	-12,735

Improve Disclosure

Current Law

Section 4010

Section 4010 of ERISA requires the reporting of plan actuarial and company financial information by employers with plans that have (i) aggregate unfunded vested benefits in excess of $50 million (determined on a variable-rate premium basis), (ii) missed required contributions in excess of $1 million, or (iii) outstanding minimum funding waivers in excess of $1 million. Filing is on a controlled group basis.

The information required to be filed includes: (a) identifying information about members of the controlled group and the plans maintained by any members of the controlled group; (b) actuarial information regarding the plan's fair market value of assets and the value of benefit liabilities on a PBGC termination liability basis; and (c) financial information for each controlled group member such as financial statements on an individual or consolidated basis. Controlled groups must provide this information within 105 days after the end of their "information year." This is April 15th for most controlled groups.

Section 4010(c) prohibits disclosure of 4010 information, except for information that is otherwise public (e.g., public filings of financial information with the Securities and Exchange Commission). This is a specific override of the standards under the Freedom of Information Act (FOIA). There are also narrow exceptions for information formally requested by authorized committees of Congress and for litigation. The PBGC may disclose aggregate data for a group of filers as long as the aggregation is large enough so that no one can identify the information of specific filers.

Form 5500 and Schedule B actuarial statement

Pension plans generally are required to file an annual report and annual return under ERISA and the Internal Revenue Code. The Department of Labor, Internal Revenue Service and PBGC have consolidated these requirements into the Form 5500. Defined benefit pension plans subject to minimum funding standards generally are required to file an actuarial statement (Schedule B) each year with their Form 5500. The Schedule B must be certified by an enrolled actuary and must report information on the plan's assets, liabilities and compliance with funding requirements.

The Form 5500 is due 7 months after the end of the plan year (the end of July for a calendar year plan). However, a 2 ½ month extension is available (to October 15 for a calendar year plan). Copies of the plan's Form 5500, including the Schedule B actuarial statement and funding information, must be made available upon request to plan participants and beneficiaries receiving benefits under the plan. The Form 5500 also may be obtained by participants, beneficiaries, and the general public from a public document room at the Department of Labor.

Summary annual report (SAR)

Under ERISA, pension plans are required to furnish a summary of the Form 5500 to participants and beneficiaries receiving benefits under the plan. Plans must use a format set forth in Labor regulations to disclose basic financial information about the plan reported on the Form 5500. The SAR also must include a statement that enough money was contributed to the plan to keep it funded in accordance with the minimum funding standards, or that not enough money was contributed to the plan to keep it funded in accordance with the minimum funding standards and the amount of the deficit. If the current value of the assets of a plan is less than 70 percent of the current liability under the plan, the SAR also must include the percentage of such current value of the plan's assets. The SAR must be furnished within 9 months after the end of the plan year (or, if an extension applies for the filing of the Form 5500, 2 months after the extended due date).

Participant notice of underfunding

Under section 4011 of ERISA, plan administrators of certain underfunded single-employer defined benefit plans covered by the PBGC benefit guarantee program are required to notify participants, beneficiaries, alternate payees under qualified domestic relations orders, and collective bargaining representatives, if any, of the plan's funding status and the limits of the PBGC's guarantee. The notice must be furnished no later than 2 months after the filing deadline for the Form 5500 for the previous plan year and may be distributed with the plan's SAR. Generally, plans that are less than 90 percent funded and required to pay a variable rate premium to the PBGC under its guarantee program are required to issue such notices. However, in recent years, most plans have been exempt from paying variable rate premiums as a result of being at the "full funding limit."

Reason for Change

Accurate information about a plan's funding status is needed earlier

Wider dissemination of information for certain underfunded plans.
Participants are entitled to have timely and accurate information regarding the funded status of their pension plan and the financial condition of the plan sponsor. In particular, participants should know when their plan is underfunded and when the sponsor's financial condition may impair the ability of the company to fund or maintain the plan.

Making information regarding the financial condition of the pension plan publicly available would also benefit investors and other stakeholders and is consistent with federal securities laws requiring the disclosure of information material to the financial condition of a publicly-traded company. The funded status of a pension plan is clearly material information, because significantly underfunded plans may be a claim on future earnings, as well as affecting a sponsor's cost of capital and creditworthiness.

PBGC confidentiality procedures (at 29 CFR Part 4901) are generally subject to the requirements of the FOIA, except for the special rules at section 4010(c) prohibiting disclosure. Under exemption 4 of the FOIA, commercial or financial information that is required to be submitted to the Government is protected from disclosure if it is "privileged or confidential," i.e., if disclosure would (1) impair the government's ability to obtain necessary information in the future or (2) cause substantial competitive harm to the filer. For purposes of government disclosure, the commercial and financial information exceptions in the FOIA provide adequate protection for confidential business information.

More accurate and timely plan funding information.
As indicated above, asset and liability measures under current law are often not accurate and meaningful measures of the plan's funding status. As a result, participants who have lost benefits when their badly underfunded plan was terminated have often had no advance warning, or were led to believe that the level of underfunding was not significant. Information on a plan's funding target and a comparison of that liability to the market value of assets would provide more accurate disclosure of a plan's funded status. Providing the participants and beneficiaries with information on the funded status of a plan on a more timely basis would also make this information more useful to them.

The current deadline for filing Form 5500 means that the regulatory agencies are not notified of the plan's funded status for almost 2 years after the actual valuation date. If the market value of a plan's assets is less than its funding target, the relevant regulatory agencies need to monitor whether the plan is complying with the funding requirements on a more current basis.

Proposal

Section 4010

The special nondisclosure rules of section 4010(c) of ERISA overriding the FOIA standards would be eliminated. As a result, all information filed with the PBGC pursuant to section 4010 would be disclosable, except for confidential "trade secrets and commercial or financial information" under the FOIA. The requirements for reporting under section 4010 of ERISA would also be revised to be consistent with other elements of the pension reform proposal.

Effective date. The amendments made by the proposal would be effective with respect to filings made under section 4010 of ERISA on or after 30 days after enactment.

Form 5500, Schedule B actuarial statement and summary annual report (SAR)

All PBGC-covered, single-employer defined benefit plans would be required to disclose the plan's ongoing liability and at-risk liability in the annual Form 5500 (whether or not the sponsor is financially weak). The Schedule B actuarial statement would show the market value of the plan's assets, its ongoing liability and its at-risk liability.

The SAR would include a presentation of the funding status of the plan for each of the last three years. The funding status would be shown as a percentage based on the ratio of the plan's assets to its funding target. In addition, the SAR would include information on the company's financial health and on the PBGC guarantee.

The due date for furnishing the SAR to participants and beneficiaries for all plans would be accelerated to 15 days after the filing date for the Form 5500. A penalty would be imposed for a plan administrator's failure to furnish a SAR in a timely manner. The participant notice requirement under section 4011 of ERISA would be eliminated and the SAR disclosure used in its place.

In the case of a plan that covers more than 100 participants and that is subject to the requirement to make quarterly contributions for a plan year (i.e., a plan that had assets less than the funding target as of the prior valuation date), the deadline for the Schedule B report of the actuarial statement would be shortened. The due date would be the 15th day of the second month following the close of the plan year (February 15 for a calendar year plan). If any contribution is subsequently made for the plan year, the additional contribution would be reflected in an amended Schedule B that would be filed with the Form 5500.

Effective date. The proposal would be effective for plan years beginning in 2006.

Reform Premiums to Accurately Reflect Risk and Restore the PBGC to Financial Health

Current Law

Premiums

The PBGC provides mandatory pension insurance to most tax-qualified defined benefit pension plans. (Exceptions include government plans, church plans and plans of small professional corporations.) These plans or their sponsors pay premiums to the PBGC. Premium collections and investment earnings are PBGC's primary sources of revenue to pay guaranteed unfunded benefits of terminated plans. Premium rates are set by Congress and are adjusted infrequently. The PBGC receives no Federal revenue and is not backed by the full faith and credit of the Federal government. As of September 30, 2004, the PBGC had a deficit of over $23 billion.

In the single-employer program, the premium structure is composed of two components, a flat-rate premium and a variable-rate premium. The annual flat-rate premium for the single-employer insurance program is currently $19 per participant in a covered plan and has not been increased since 1991.

Certain underfunded plans must also pay a variable-rate premium (VRP). The VRP, which was added in 1987 and modified in 1994, is set at $9 per $1,000 of underfunding. Underfunding for the VRP is measured on the basis of a plan's "vested current liability."

Historically, the PBGC has received about $650 million annually in flat-rate premium revenue. The VRP revenue has varied. It was around $300 million in 2003, but increased to over $800 million in 2004. Since 1991, flat-rate premiums have made up approximately 67 percent of all PBGC premium revenues.

A plan at the "full-funding limit" under section 412 of the Internal Revenue Code and section 302 of ERISA is exempt from paying any variable-rate premium even if that plan has significant unfunded vested current liability.

Although the PBGC charges premium payers interest on premium underpayments, the PBGC is not authorized to pay interest to premium payers on refunds of premium overpayments.

Guarantee Limitations

Under title IV, crediting of service for purposes of benefit accrual, vesting and entitlement to retirement subsidies ceases when an underfunded plan terminates. Participants and beneficiaries become entitled to the portion of their benefits that is

guaranteed under title IV of ERISA and to non-guaranteed benefits to the extent non-guaranteed benefits are funded by allocable plan assets or recoveries from employers.

Guarantee limitations are determined as of the date of plan termination. In addition, when an underfunded plan applies to the PBGC for a distress termination, current law also imposes limitations on payment of benefits as lump sums and the purchase of annuities. These limitations prevent assets from being drained and diverted from payment of guaranteed benefits.

The PBGC's only means of protecting the insurance fund from growing liabilities and asset drains during bankruptcy is to terminate the plan.

Liens

Under both ERISA and the Internal Revenue Code, a lien automatically arises against the assets of a plan sponsor and members of its controlled group if required pension contributions of $1 million or more are missed. Currently, these liens can be perfected by the PBGC to provide the plan with a secured claim for missed contributions, but only against a sponsor or controlled group member that is operating outside of bankruptcy. Once a petition for bankruptcy has been filed, the automatic stay provision of the federal Bankruptcy Code prevents the PBGC from perfecting a lien against the debtor. In addition, the avoidance provisions of the Bankruptcy Code negate statutory liens that arise with respect to contributions that become due during bankruptcy but are not paid.

Shutdown Benefits

Certain pension plans provide early retirement benefits and other payments that are commonly referred to as "shutdown benefits." These are benefits that become payable under special circumstances relating to the closure of a plant, division or facility, or to layoffs of employees of a certain group or class, and they may trigger significantly disproportionate increases in plan liabilities.

Plant shutdown benefits increase the affected workers' retirement benefits in order to make up for the early retirement or layoff. Generally, shutdown benefits are partly paid as a subsidy to decrease or eliminate the actuarial reduction for early retirement and partly paid as a monthly flat-dollar supplement payable until age 62 when Social Security benefits begin. For example: an unreduced early retirement benefit (*i.e.*, the same monthly benefit that a worker would receive at normal retirement age) and a $400-per-month supplement payable until age 62. Shutdown benefits can have the effect of doubling or even tripling the value of the pension benefit owed by the plan.

The PBGC guarantees "all nonforfeitable benefits (other than benefits becoming nonforfeitable solely on account of the termination of a plan) . . . ." Shutdown benefits become nonforfeitable when the shutdown or layoff occurs, not when the plan terminates. Thus, shutdown benefits may be guaranteed if the shutdown occurs before the termination date, but they are not guaranteed if the shutdown occurs after plan termination. For purposes of applying the "phase-in" rules, the PBGC has treated the

date that the shutdown provision was added to the plan rather than the shutdown as the triggering event. Thus, the phase-in rules do not generally impact shutdown benefits.

The PBGC may initiate termination of a plan if "the possible long-run loss of the corporation with respect to the plan may reasonably be expected to increase unreasonably if the plan is not terminated." The additional liability for shutdown benefits is a long-run loss.

Reasons for Change

Premium Structure and Revenues

There are two basic problems with PBGC premiums. First, the premium structure does not meet basic insurance principles. Second, the premiums do not raise sufficient revenue to meet expected claims, much less improve the PBGC's financial condition.

Premium Structure

As noted above the current structure relies heavily on flat-rate premiums which, since they are unrelated to risk, results in large cost shifting from financially troubled companies with underfunded plans to healthy companies with well-funded plans. The fact that 70 percent of total historic claims come from the steel and airline industries is evidence of such cost shifting.

A properly designed pension insurance system should provide sponsors with incentives to fund their plans prudently and disincentives for undertaking risky behaviors that increase the likelihood of losses to the insurance fund. The current system largely lacks such a structure. The absence of proper incentives creates a system subject to "moral hazard" in which the PBGC, as a third party insurer, bears the risks of underfunding in pension plans whose terms are negotiated between employers and employees. For example, a weak company has incentives to make generous pension promises rather than increase wages because the premium structure fails to recognize the increased claims risk that such a company poses to the insurance fund.

The current premium structure does not reflect the risk of plan termination. In addition, the VRP reflects only a portion of the PBGC's "exposure" because the current exposure measure – vested current liability – is not a true measure of the plan's underfunding. In fact, even "current liability," the basis of the deficit reduction contribution funding target, is not a good measure of pension liabilities. Current liability uses an inappropriate discount rate – one that does not appropriately account for the timing of benefit payments – and does not reflect the risk of plan termination.

The weakness of the current premium structure is exacerbated by rules that exempt plans from paying the VRP if they are at the full-funding limit, which can be less than 90 percent of current liability. As a result a plan can be substantially underfunded on a termination basis and still pay no VRP. Despite substantial underfunding, in 2003 only about 10 percent of participants were in plans that paid the VRP.

Premium Revenues

Premium revenue remains inadequate to cover annual claims, which were $5.4 billion in 2003, and $14.7 billion in 2004. Nor is current revenue sufficient to reduce the 2004 deficit of over $23 billion. The PBGC's future financial health is threatened.

In addition, the current rate-setting mechanism is inflexible and does not allow the PBGC to respond to changing conditions in the defined benefit plan universe, in the financial markets in which pension plans invest, or in its own financial condition. Under current law, only Congress can change pension insurance rates and it has not done so since 1991.

Further, premium payers should receive interest on monies that are owed to them and not paid within a reasonable time, e.g., 60 days.

Payment of lump sums and annuity purchases can drain assets from the plan

Many plan sponsors continue to operate their plans until late in the bankruptcy proceeding, terminating the plan prior to emerging from bankruptcy or prior to liquidating. During the time the sponsor is in bankruptcy, payment of lump sums and annuity purchases can drain assets from the plan, which reduces assets available for payment of non-guaranteed benefits to other participants in the event the plan terminates. Bankruptcy also increases the pension insurance program's losses for unfunded guaranteed benefits. In addition, guarantees continue to increase as a result of inflation adjustments in the maximum guarantee limitation and the passage of time under the phase-in guarantee limitation. The increases in guarantees also increase the pension insurance system's losses in the event the plan terminates.

The longer a company is in bankruptcy, the more participants earn a higher priority claim under the plan to share in limited plan assets and recoveries for payment of non-guaranteed benefits. This increase in the number of participants with higher priority claims dilutes the potential payments to those who have been retired or eligible to retire for the longest time.

Companies can avoid contributions without consequence

Because the automatic stay and avoidance provisions of the Bankruptcy Code prevent PBGC from perfecting liens for missed required contributions in bankruptcy, companies are able to avoid making contributions to the plan as otherwise required by federal law, and to do so without consequence. As a result, plan participants and the PBGC insurance program both suffer losses if an underfunded plan terminates while the plan sponsor or members of its controlled group are in a bankruptcy proceeding. These losses can be substantial.

The automatic lien provisions of ERISA and the Internal Revenue Code are intended to ensure that unpaid contributions are not treated the same way as normal loans and this special lien should not be made ineffective by entering bankruptcy. Although not covered by the Bankruptcy Code, the Federal Home Loan Banks have a similar priority

under the functional equivalent to bankruptcy for banks, when the Federal Deposit Insurance Corporation acts as receiver or conservator for an insolvent institution.

Shutdown benefits are inappropriate for a pension plan

Shutdown benefits are a type of contingent benefit, i.e., a benefit triggered by satisfying a certain condition. In general, plans must fund a contingent benefit based on the probability of occurrence. In the case of a shutdown benefit, however, an employer typically would not be able to predict a shutdown ahead of time, and even in those circumstances where it is predictable, it generally would be predictable only shortly before the shutdown, which would not be enough time to have the benefit fully funded. For purposes of the special deficit reduction contribution applicable to underfunded plans, a shutdown benefit is classified as an "unpredictable contingent event benefit" and may not be funded until the shutdown occurs.

The PBGC is often faced with the decision of whether to terminate a plan prior to a plant shutdown in order to protect the program against further losses. This often results in a race to the courthouse to terminate the plan before the shutdown occurs to prevent the shutdown benefits from becoming guaranteed.

Shutdown benefits are generally severance-type benefits that are inappropriate for a pension plan. Shutdown benefits are frequently found in plans of financially troubled companies with underfunded plans. When paid, shutdown benefits drain the plan of assets that would otherwise go to pay pension benefits and account for a substantial percentage of the PBGC losses that other premium payers must make up.

Proposal

Premiums That Reflect Plan Risk

Under the proposal, premiums would better reflect the risk a plan poses to the system. The flat-rate premium would be adjusted based on the wage index used to adjust Social Security benefits. The risk-related premium would be based directly on a meaningful measure of underfunding and reflect the health of the sponsor's controlled group. Under current conditions (significant underfunding), a greater percentage of premium income would come from the new risk-based premium than from the flat-rate premium.

The current flat-rate premium of $19 per participant would be updated immediately to reflect wage growth since 1991 and would be updated annually in future years using the Social Security Administration's Average Wage Index. Had this index been in effect for 2005, the flat-rate premium for 2005 would be $30 per participant.

Risk-based premiums would be charged to all plans with assets less than their funding target under the Administration's funding reform proposal. The premium rate per dollar of underfunding will be identical for all plans. The role of risk-based premiums is to provide PBGC with the revenue – above and beyond that derived from flat-rate premiums

and investment income – necessary to meet expected future claims and to retire PBGC's deficit over a reasonable time period. The premium rate per dollar of underfunding will be reviewed and revised periodically by the PBGC Board consistent with meeting these goals. Risk-based rate adjustments will be computed based on forecasts of the PBGC's expected claims and of its future financial condition.

Under the proposal, two plans that are identical in all respects except for the sponsor's financial health will be charged different risk-based premiums. A plan with a financially weak sponsor will pay premiums for each dollar of unfunded at-risk liability, while a financially healthy sponsor will pay premiums for each dollar of unfunded ongoing liability.

The full-funding limit exception would be eliminated so that all underfunded plans would be required to pay risk-based premiums.

The PBGC would be authorized to pay interest on premium overpayments.

Effective date. The proposal would be effective for plan years beginning on or after January 1, 2006.

Guarantee Freeze When Contributing Sponsor Enters Bankruptcy

The proposal would amend title IV of ERISA to require that when a contributing sponsor enters a bankruptcy or similar proceeding, Title IV guarantees are frozen. The freeze on guarantees would continue for two years after the sponsor emerges from bankruptcy. In the event the plan terminates during the bankruptcy proceeding or within two years after the company emerges from bankruptcy, benefit guarantees would be determined based on provisions of the plan, salary and service, and guarantee limitations as of the date the company entered bankruptcy. The priority among participants for purposes of allocating plan assets and employer recoveries to non-guaranteed benefits in the event of plan termination would also be determined as of the date the sponsor enters the federal bankruptcy or similar proceeding.

The plan administrator would be required to issue a notice to plan participants explaining the limitations that apply to benefit guarantees, and potential receipt of non-guaranteed benefits in a termination, on account of the bankruptcy. Regulations would prescribe the form, content, and timing of the notice. The notice requirement would be coordinated with other notice requirements related to the pension reforms.

Effective date. The amendments made by the proposal would be effective with respect to initiations of federal bankruptcy or similar proceedings or arrangements for the benefit of creditors on or after the date 30 days after enactment.

Allow PBGC to Perfect Liens in Bankruptcy for Missed Required Pension Contributions

The proposal would amend section 362 of the federal Bankruptcy Code to create an exemption from the automatic stay to allow creation of liens, and perfection of those liens by the PBGC, against a plan sponsor and controlled group members for missed pension contributions under ERISA section 302 and Internal Revenue Code section 412. The amendment would also exempt liens for missed contributions from the lien avoidance provisions of chapter 5 of the Bankruptcy Code.

Effective date. The amendments made by the proposal would be effective with respect to initiations of federal bankruptcy proceedings on or after the date 30 days after enactment.

Elimination of Guarantee of Shutdown Benefits

The guarantee provisions of Title IV of ERISA would be amended so that the guarantee would not apply to benefits that are payable upon a plant shutdown or any similar contingent event.

Effective date. The proposal would be effective for benefits that become payable as a result of a plant shutdown or similar contingent event that occurs after February 1, 2005.