THE ERISA INDUSTRY COMMITTEE

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Advocating the Benefit and Compensation Interests of America's Major Employers

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ERIC PENSION POINTERS

Issue briefs providing information about the pension funding debate

PLAIN ENGLISH EXPLANATION OF FUNDING REQUIREMENTS FOR SINGLE-EMPLOYER PENSION PLANS

Under a single-employer defined benefit pension plan, benefits are paid according to a formula set out in the plan and are paid from a pension trust that is funded by the sponsoring employer. In order to ensure the plan has sufficient assets to pay benefits as they come due, the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code (IRC) require the sponsoring employer to calculate annually whether additional contributions should be made to the plan, and, if contributions are needed, to make them.

1974 Funding Rules

The funding rules established by ERISA and the IRC in 1974 require the employer to calculate, using reasonable assumptions, (1) the present value of the future benefit payments the plan currently owes plus (2) the present value of the benefit payments the plan is likely to owe in the future. The sponsor compares this amount to (1) the value of the assets currently held by the plan and (2) the expected future return on those assets. If present value of the liabilities exceeds the value of the assets, a contribution must be made.

Under the 1974 rules, long-term assumptions are used – that is, the interest rate used to calculate the present value of plan liabilities and the expected return on plan assets reflect long-term trends rather than short-term gyrations. In this way, the 1974 rules impose steady and predictable requirements on an employer – a key consideration when a business decides whether to sponsor a defined benefit plan.

[Detail Note: The following factors are taken into account each year in computing the present value of the plan's future liabilities: (a) benefits accrued by participants during the past year (called the "normal cost"), (b) benefit increases that apply to prior service (called "past service liabilities"), (c) benefit increases that apply to future service, (d) experience gains and losses, (e) any previous funding requirements that have been waived by the IRS, and (f) changes in actuarial assumptions such as mortality, expected age of retirement, or increases or decreases in the discount rate used to calculate the present value of future benefits.

These amounts are amortized over specified periods and the results are then compared to the value of the plan's assets to determine the amount of any contribution that is due for that year.]

1987/1994 Funding Rules

In laws enacted in 1987 and modified in 1994, Congress required employers to accelerate their contributions to plans deemed to be either significantly or persistently underfunded based on calculations that track current market conditions more closely than the 1974 rules. The 1987/1994 rules -- sometimes called the "current liability" or "deficit reduction contribution (DRC)" funding rules -- look at whether a plan is likely to be able to purchase annuities from a private sector insurance company to cover benefits already accrued by participants and due to be paid in the future. If not, the rules require the employer to make a current contribution to the plan, thereby accelerating the pace at which that plan is funded.

Thus, the 1987/1994 rules "backstop" the 1974 rules, ensuring that, while a plan is being funded to meet long-term obligations, its funded status is also being measured on a basis that reflects current market conditions. However, because asset returns and interest rates can fluctuate dramatically over short periods of time, any funding requirements that were tied rigidly to current asset values and interest rates would result in sharp gyrations in an employer's required contributions and would subject the employer to volatile and unpredictable cash calls that would impede sound business planning and could even endanger the employer's existence.

The 1987/1994 rules mitigate this danger by basing the interest rate assumption on a four-year average and by allowing fluctuations in the value of the plan's assets to be smoothed by averaging asset values, within certain limits, over five years. Averaging and smoothing also delay the impact of lower interest rates or lower asset values (which often accompany an economic downturn) on the pension funding requirements. In this way, extra contributions required by the 1987/1994 rules typically are due when the economy is recovering from a downturn, not when it is entering one.

[Detail Note: Under the 1987/1994 rules, liabilities are calculated using a mortality table specified in the law and an interest rate that is between 90% and 100% of the four-year weighted average of certain long-term bond rates. Asset values, which are calculated at market value, may be smoothed over five years, but must be within 80% to 120% of current fair market value.

The 1987/1994 rules apply if, using the assumptions outlined above, (1) the value of the plan's assets is less than 80% of the present value of its liabilities or (2) the value of the plan's assets is less than 90% of the present value of its liabilities for two of the last three years. Moreover, whenever the value of the plan's assets is less than 100% of the present value of its liabilities, the employer must make quarterly contributions during the current plan year. Normally, the employer makes a single contribution to the plan 9 months after the end of each plan year – so the quarterly contribution requirement typically requires an employer to make a double contribution in the first year quarterly contributions are required.]

Mandated Interest Rate

The 1987/1994 rules require all plans to use the same interest rate. In recent years, there have been several changes to the required interest rate.

The 1987 law mandated use of the 30-year Treasury bond rate. However, Treasury bond rates reflect the government's fiscal situation – not the amounts needed to fund pension liabilities. This became obvious in the late 1990s when the yield on the 30-year bond began to drop dramatically in response to the federal budget surplus and Treasury buy-backs of the 30-year bond. The yield on the 30-year bond dropped even more after October 31, 2001, when the Treasury ceased issuing these bonds.

As the bond rate dropped, the present value of pension liabilities increased sharply and artificially. Congress responded by allowing plans to use an interest rate that was 120% of the 30-year bond rate for 2002 and 2003. For 2004 and 2005, Congress adopted a new, market-based rate that more accurately reflects the amounts needed to fund a pension plan's liabilities than does any government rate. This rate is based on a composite of indices of high-quality, long-term corporate bond rates.

Unless Congress enacts another law, however, the mandated interest rate for the 1987/1994 funding rules will revert to the defunct 30-year Treasury bond rate in 2006. Forcing plans to use this rate will result once again in inaccurate and inflated measurements of pension liabilities.

The ERISA Industry Committee
July 25, 2005

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