THE ERISA INDUSTRY COMMITTEE

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

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CREDIT BALANCES IN DEFINED BENEFIT PENSION PLANS

PART 1: INTRODUCTION TO CREDIT BALANCES

The credit balance for a defined benefit pension plan keeps track of contributions that the sponsor has made in excess of the minimum required contributions. These excess contributions can then be used in a future year to decrease the contribution requirement, but they are not otherwise treated differently from other assets in the plan trust.

A useful analogy is a fare card for a public transportation system. If you spend $5 per day to take the train into work and back home and there are 20 working days in a month, you need to put a total of $100 ($20 times 5) on your card over the course of a month. Putting $5 on the card every day would be like contributing the minimum. Alternatively, you could put $25 on the card the first day and then use the "credit balance" on your card to pay for the trip each remaining day of the week, or you could put the full $100 on your card on the first day and just use "credit balance" to pay for the rest of the month. Like a pension plan's credit balance, the $25 or $100 on the card is a real asset that can be used to pay future fares.

The use of credit balances for pensions is best illustrated with an example (see attachment). Let's assume there are no normal costs, asset returns, or interest. In this example, the target liability for the plan is $100, the assets are $86, and there is currently no credit balance. To reach a goal of funding 100% of the liability, the sponsor would need to contribute $14 ($100 minus $86). If the law requires this shortfall to be made up over 7 years, then the sponsor must contribute $2 per year ($14 divided by 7).

In the first year of the seven, the sponsor's business does very well and it decides to contribute $6 instead of the required $2. These are real assets, generally cash, which is then invested in stocks and bonds and held in a trust that is only available to pay benefits. The assets of the plan are now $86 + $6 = $92, rather then the $86 + $2 = $88 that the plan would have had if the sponsor only contributed the minimum. Because the sponsor has contributed more than was required, it now has a credit balance of $6 (actual) - $2 (required) = $4. Note that this $4 credit balance is just a method of keeping track of the extra contributions. The $4 arises due to real contributions to the plan, and it is part of the $92 in the trust.

In the second year, the funding laws would require another $2 contribution. If the sponsor's profits are much lower that year, the sponsor may decide to use some of the $4 credit balance to offset the $2 required contribution, leaving a credit balance of $2.

In this case, the sponsor would make no additional contributions in year 2 and the assets would remain at $92. The sponsor is essentially allocating $2 of the $6 contribution to year 1, another $2 to year 2, and keeping another $2 to allocate to a future year.

In summary, credit balances are:

- Contributions made above and beyond those required by law
- Real assets already in the pension fund
- Available to pay benefits and not refundable

Credit balances are NOT:

- A separate account outside of the plan
- Phantom assets

Credit Balance Example:

		Contribute Minimum	**Contribute More than Minimum**
a.	Target liability	$ 100	$ 100
b.	Assets at beginning of year 1	86	86
c.	Shortfall (a. - b.)	14	14
d.	Required annual contribution (c. / 7)	2	2
e.	Contribution in year 1	2	6
f.	Assets at end of year 1 (b. + e.)	88	92
g.	Credit balance at end of year 1 (e. - d.)	0	4
h.	Contribution in year 2	2	0
i.	Assets at end of year 2 (f. + h.)	90	92
j.	Credit balance at end of year 2 (g. + h. - d.)	0	2

Assumes no normal cost, initial credit balance, asset return, or interest.

PART 2: CREDIT BALANCE ISSUES

The Pension Protection Act of 2005 (H.R. 2830) preserves the credit balance system, which is very important. However, for many purposes, the bill reduces actual plan assets by the amount of the plan's credit balance and thus treats the plan as much less funded than it is.

This reduction forces companies to retroactively waive vast amounts of existing credit balances, as explained below. This is unfair; such a retroactive legislative change will definitely undermine employers' commitment to the defined benefit plan system.

The reduction in the bill is explained as a means to prevent double counting the credit balance. The double counting argument is not correct, as explained below.

RETROACTIVITY

Example:

Plan liability: $100
Plan assets: $105
Existing credit balance: $60

Under the bill, the company has two choices. First, it could treat the plan as 45% funded, even though the plan actually has $105 of assets. If a plan is 45% funded, the plan is at-risk and benefits must be frozen.

Under the bill, if the company does not want to freeze benefit accruals and does not want the plan to be treated as at-risk, the company must permanently waive part of its credit balance. The company in the above example would have to waive at least $15 of its credit; if the plan is a flat dollar union plan, the company would have to waive well over $35 of its credit balance (more than half of its credit balance).

In brief, if a company does not want to freeze benefits, it will be forced to retroactively waive large amounts of its existing credit balance.

DOUBLE COUNTING

The justification for the bill's treatment is that an alternative approach would be double counting the credit balance. That is not correct. Double counting only exists when a credit balance is used two different ways to satisfy the same rule.

For example, in determining the minimum contribution of an underfunded plan, the credit balance should be subtracted from assets (as it is under current law). The reason is that credit balances can be treated as a contribution to the plan for purposes of satisfying the minimum contribution rules. It would be double counting if a credit balance could be treated as both a contribution to the plan and part of the plan's assets.

In determining whether a plan is at-risk or subject to the benefit restrictions, credit balances are not treated as contributions. Therefore, there is no reason to reduce the plan's actual assets by the credit balance.

Every funding rule needs to be analyzed separately in determining if there is double counting. For example, if the double counting argument were applied for deduction purposes, it would lead to results that make no sense and that no one favors. Where a credit balance is treated as a contribution to satisfy a rule, the credit balance should not be treated as a plan asset for purposes of that rule. Where a credit balance is not treated as contribution to satisfy a rule, there is no reason to reduce actual plan assets by the credit balance.

Congress has looked at this double counting issue before. In 1989, Congress looked at this issue and squarely resolved it in the legislative history, stating clearly that credit balances should not be subtracted from actual plan assets for purposes of several rules, including the benefit restriction rule then in place.

This credit issue is a critical one for the "good guys" who have pre-funded their plans. Eliminating their credit balances retroactively is unfair and will drive companies out of the defined benefit plan system.

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