International Body Promotes Stricter Funding Requirements for Public and Private Pension Plans

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In the United States, pension plans traditionally pay attention only to domestic entities such as the Congress, Department of Labor, Internal Revenue Service and Pension Benefit Guaranty Corporation as the source for potential rules on funding their pension plans. However, at least one international body has chosen to enter the debate over pension funding, and U.S. employers may wish to observe its activities for possible future impact on U.S. pension plans.

The Organization for Economic Cooperation and Development (OECD) is an organization founded in 1960 and comprised of approximately 30 countries, including the U.S., U.K. and a number of European countries, that seeks to foster good governance in market economies. For some years, the OECD has been issuing guidelines relating to pensions. Past guidelines have dealt with the protection of the rights of member and beneficiaries, pension fund governance, and managing pension fund assets. The OECD was also instrumental in encouraging the expensing of stock options.

Most recently, the Working Party on Private Pensions of the Directorate for Financial, Fiscal, and Enterprise Affairs and the Insurance and Private Pensions Committee of the OECD, have promulgated a set of Guidelines on Funding and Benefit Security. These guidelines (which will be referred to in the article as the "Guidelines") are expected to be available at the OECD website (www.oecd.org\daf).

The Guidelines reflect many concepts familiar to U.S. plan sponsors, but suggest several views not currently in line with common U.S. plan practices, at least not yet. It is these concepts that will be the focus of this article.

Funding requirements may be imposed on public sector pension plans.

The guidelines state that they "may" also be applicable to the funded occupational plans of public sector employees. In the U.S., of course, plans of states, local governments, and their instrumentalities and political subdivisions are generally exempt from federal regulations, other than selected portions of the federal tax rules. They are, in particular, not subject to the funding requirements of ERISA or the Internal Revenue Code. Governmental plans in the U.S. are generally funded in the manner determined by the applicable jurisdiction's governing body, or not funded at all. It is also common for funded public plans in the U.S. to be funded as a percentage of employee compensation, and not an amount determined in relation to costs, experience or other actuarial factors,

other than indirectly. These common practices would not be permitted if rules similar to the Guidelines were to be applied to public pension plans (which are much closer to the current ERISA funding requirements), as discussed below.

Unfunded private occupational plans should be prohibited.

The Guidelines state that they do not cover unfunded occupational plans, but that is because prior guidance (the Occupational Pensions Core Principles issued in 2001) recommends that such financing arrangements be prohibited. This recommendation appears to include unfunded SERPs and top hat plans for executives and excess benefit plans in the U.S. The annotations to the Guidelines acknowledge that defined benefit plans offered to senior executives (so-called "top hat" schemes) may be permitted, "but should not benefit from tax advantages." Specific reference is made to tax deductibility as such a tax advantage, but it is not clear whether this is intended to refer to the advantage of tax deferral or to deductibility when paid. The application of the principles of the Guidelines to either defined contribution plans or excess plans covering all employees affected by the qualified plan limits (which may cover non-executives) is not specifically addressed.

Funding standards that may apply.

The goal of the Guidelines is best summed up as that the legal requirements of the country should require the identification and maintenance of a level of assets sufficient to meet accrued benefit obligations. In this, the Guidelines do not appear to go as far as the approach taken by the European Union in its 2003 Directive for Institution for Occupational Retirement Provisions (IORP) which call for "in cases of cross-border activity…that the technical provisions be fully funded at all times", though the IORP also contemplates that a member state may allow temporary underfunding in plans that do not cross borders. (Some EU member states, though, require overfunding.) A number of other interesting points appear in the Guidelines:

1. Among the factors that should be taken into account is "the possibility of benefit adjustments." Though not clear, this could be read to include the possibility of voluntary early retirement window benefits, shutdown benefits and other future benefit increases.

2. Legal requirements should not prevent funding methods that seek to dampen the short-term volatility of funding contributions.

3. Funding rules should be counter-cyclical, providing incentives to build reserves against market downturn. Tax regulations should not discourage the build-up of sufficient reserves to withstand market conditions. The guidelines do not, however, address the impact of confiscatory taxes on pension reversions.

4. In the case of "autonomous pension funds" operating without a guarantee from the sponsor, a term which would appear to include (but not be limited to) Taft-Hartley funds in the U.S., the fund should be required to hold additional assets over an above necessary to fully fund the pension liabilities on a termination basis.

5. The Guidelines do not clearly address the reversion of excess pension assets, other than to say that in the event that assets exceed promised benefits upon termination, there should be rules in place as to the allocation of the funding excess or surplus between the plan sponsor and plan members and beneficiaries. In the U.S., of course, plans may allocate surplus assets to plan members on plan termination, through additional benefits, but generally strive to avoid having any such excess assets or a reversion to the employer due to the punitive taxes on such reversions.

Other provisions of the Guidelines.

The Guidelines provide a number of recommendations regarding the measurement of pension liabilities, including that legal requirements on the use of reasonable actuarial assumptions which may take into account liabilities both on ongoing and a termination basis. Insolvency guaranty schemes (e.g., PBGC insurance) should be provided.

What is the current status of the Guidelines and what effect may they have on the U.S.?

The Guidelines on Funding and Benefit Security are to be sent to the Insurance and Private Pensions Committee and then to the OECD Council for approval as a recommendation. It is not of binding force on the OECD member states. Rather, the Guidelines are intended to guide regulations of pension plans of the member states. The precise manner of implementation is up to each country, and Guidelines recognize that the manner of implementation may vary from country to country. While the Guidelines refer to themselves at one point as "best practices", they also state that the aim is to meet the underlying objectives of each guideline.

A letter from the Chairman of the Insurance and Private Pension Committee and the Working Party on Private Pensions notes that, because of the importance of the funding issue, it has been proposed that a public consultation on the Guidelines will be held and comments on the funding Guidelines will be taken until June 23. For more information, see www.oecd.org/daf/pensions.

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