

## What's a Credit Balance? How Does It Affect Pension Funding?

The American Academy of Actuaries<sup>1</sup> Pension Committee provides this educational fact sheet on elements of funding reform for defined benefit pension plans with respect to the concept of the *credit balance* and the concerns associated with the practice.

**Credit balances are an outgrowth of minimum funding requirements:** If an employer sponsors a defined benefit pension plan, it is obligated to make at least the minimum required contribution each year, as defined in Internal Revenue Code (IRC) Sec. 412. Employers can choose to make more than the minimum contribution, up to the maximum tax-deductible amount, as defined in IRC 404.

Each dollar contributed for a given year, in excess of the minimum, is recognized as a credit and can be used to meet the minimum contribution requirements in a future year. These credits are accumulated with interest to build the *credit balance*. These credits are not segregated in the assets, but are tracked and reported each year with the annual filing of the Form 5500 that goes to the Department of Labor.

If the credit balance is not used in the next year, it grows with interest to the end of the next plan year. Under current law, the interest rate used is the same one the actuary uses to value liabilities under the plan.

### Examples:

The following are examples that highlight both the mechanics of maintaining the *credit balance*, as well as an explanation of concerns with the practice.

*Illustration Facts* (we make the following assumptions):

- the pension plan has \$100 million in assets;
- the minimum required contribution is \$10 million;
- the maximum tax deductible contribution is \$20 million;
- the pension plan's expected long-term rate of return is 8 percent; and
- up until now only the minimum has been contributed, so the credit balance is zero.

**Example 1:** The company has had a good prior year and wants to contribute the maximum, because by doing so the company will have credits that can be used in difficult times in the future. So, the company contributes \$20 million at the beginning of the year.

At the end of the year, assuming the plan's assets grow at the assumed 8 percent interest rate, the plan will have assets of \$129.6 million (the \$100 million in assets plus the \$20 million contribution, all with interest at 8 percent). The plan will also have a *credit balance* of \$10.8 million (the excess contribution in the prior year of \$10 million plus 8 percent interest).

Plan assets (BOY)	\$ 100.0
Max Contribution	+ 20.0
	120.0
Interest (at 8%)	+ 9.6
<b>Plan assets (EOY)</b>	<b>129.6</b>
Credit Balance (BOY)	\$ 0.0
Actual Contribution	20.0
Min Contribution	- 10.0
	10.0
Interest (at 8%)	+ .8
<b>Credit Balance (EOY)</b>	<b>10.8</b>

<sup>1</sup> The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States. In addition to setting qualification standards and standards of actuarial practice, a major purpose of the Academy is to act as the public information organization for the profession. The Academy is nonpartisan and assists the public policy process through the presentation of clear, objective analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials and congressional staff, comments on proposed federal regulations, and works closely with state officials on issues related to insurance.

## ACADEMY FACT SHEET – What is a Credit Balance?

2 <sup>nd</sup> Year	
Min Contribution <sup>2</sup>	\$ 11.0
<b>Credit Balance</b>	- <u>10.8</u>
Actual contribution	.2
Prior plan assets	+ <u>129.6</u>
	<b>129.8</b>
Interest (at 8%)	+ <u>10.4</u>
<b>Assets</b>	<b>140.2</b>

In the next year, if the minimum and maximum contribution amounts are \$11 million<sup>2</sup> and \$22 million respectively, the company's minimum required contribution would be \$11 million minus the \$10.8 million credit or \$0.2 million. If times are difficult, the company might take full advantage of that option and only contribute \$0.2 million. If assets grew at the 8 percent rate again in the second year, they would be \$140.2 million (\$129.6 million plus \$0.2 million, all with 8 percent interest).

Alternatively, the company could also make the maximum contribution at the beginning of the second year, and by year-end, the *credit balance* will equal \$23.5 million (the \$10.8 million credit balance from the prior year plus another \$11 million, all increased by the assumed rate of 8 percent).

Thus, the company actually has the option to contribute in the second year anything from \$0.2 to \$22 million.

The *credit balance* is important because it allows employers to manage their cash flow and business cycle by contributing more funds in good years and drawing from the *credit balance* in tight years. Removing the credit balance would be perhaps the single most powerful disincentive for employers to contribute more than the minimum required funding amount each year.

**Example 2:** Let's assume the same facts as in Example 1, except that your company only contributed the minimum \$10 million in the first year. At the end of the first year, the credit balance would be zero and your pension plan's assets would be \$118.8 million (\$100 million in assets plus \$10 million contribution, all with 8 percent interest). The second year your company would have to contribute at least the full minimum of \$11 million. If you contribute just the minimum, your pension plan's assets would be \$140.2 million (\$118.8 million in assets plus \$11 million, all with 8 percent interest) at the end of the second year.

There are two interesting points to make here:

(1) The pension plan's assets are exactly the same as they were in Example 1 at the end of year two for the employer that used up the credit balance in the second year. This is true only because the plan assets increased at the same rate as was used to discount actuarial liabilities under the plan. If assets increase by a different amount (as in example 3), then it will not happen.

(2) When the employer did not contribute an excess contribution in the first year (i.e. did not create a credit balance), the range of possible contributions in the second year was greatly reduced (i.e., they had to contribute between \$11 million and \$22 million, whereas the employer in Example 1 could choose to contribute any amount between \$0.2 million and \$22 million).

### So why are there concerns with the use of the credit balance?

**Example 3:** The following example assumes the same initial facts as the first one. In the first year the company contributes the maximum deductible amount of \$20 million, which results in a *credit balance* for the next year of \$10.8 million. However, in this example we assume the assets actually fall to \$0. This is an extreme example, to make a point. Even though assets are now \$0, and the plan is completely unfunded, the plan would still have a credit balance of \$10.8 billion that could reduce or eliminate the next year's minimum contribution.

2 <sup>nd</sup> Year	
Actual Contribution	\$ 22.0
Min Contribution	- <u>11.0</u>
	11.0
Credit Balance (prior year)	+ <u>10.8</u>
	21.8
Interest (at 8%)	+ <u>1.7</u>
<b>Credit Balance</b>	<b>23.5</b>

Plan assets (BOY)	\$ 100.0
Actual Contribution	+ <u>10.0</u>
	110.0
Interest (at 8%)	+ <u>8.8</u>
<b>Plan assets (EOY)</b>	<b>118.8</b>
<b>Credit Balance (EOY)</b>	<b>0.0</b>

2 <sup>nd</sup> Year	
Actual Contribution	\$ 11.0
Prior plan assets	+ <u>118.8</u>
	<b>129.8</b>
Interest (at 8%)	+ <u>10.4</u>
<b>Assets</b>	<b>140.2</b>

<sup>2</sup> That is, before subtracting the credit balance.

## ACADEMY FACT SHEET – What is a Credit Balance?

Plan assets (BOY)	\$ 100.0
Max Contribution	+ <u>20.0</u>
	120.0
Asset decline (at 25%)	- <u>30.0</u>
<b>Plan assets (EOY)</b>	<b>90.0</b>
Credit Balance (BOY)	\$ 0.0
Actual Contribution	20.0
Min Contribution	- <u>10.0</u>
	10.0
Interest (at 8%)	+ <u>.8</u>
<b>Credit Balance (EOY)</b>	<b>10.8</b>

A more reasonable example could have assets decline by 25 percent. While even this may seem like an impossibly bad result, during the period from 2000 through 2002 declining equity markets resulted in many firms facing these types of losses.

Under this scenario, at the beginning of the second year, the plan has a *credit balance* of \$10.8 million, but only \$90 million in assets, and the minimum contribution requirement increased to \$19 million to begin to make up the asset losses. To meet the minimum funding requirement, the company only needs to contribute \$8.2 million (\$19 million minimum less the credit balance of \$10.8).

Comparing the two scenarios, you can see how the *credit balance* can help an employer manage a dramatic increase in contributions (from \$10 million to \$19 million). But you can also see that increasing the credit balance by an *assumed* rate of return can mask the need for funding. While the credit balance grows at 8 percent from \$10 million to \$10.8 million, the extra \$10 million in contributions that created the credit balance dropped by 25 percent during the year. By the end of the year they, are worth only \$7.5 million. So in a sense, the employer is getting credit for \$3.3 million (\$10.8 - \$7.5) that no longer exists.

For more information on the credit balance issues, please see the attached excerpt from the Academy's issue analysis, *Pension Funding Reform for Single Employer Plans*, or contact Heather Jerbi, the Academy's senior pension analyst (202.785.7869; Jerbi@actuary.org)

2 <sup>nd</sup> Year	
Min Contribution	\$ 19.0
<b>Credit Balance</b>	- <u>10.8</u>
Actual contribution	8.2
Prior plan assets	+ <u>90.0</u>
	<b>98.2</b>
Interest (at 8%)	+ <u>7.9</u>
<b>Assets</b>	<b>106.1</b>



## AMERICAN ACADEMY *of* ACTUARIES

The following is an excerpt on alternatives for the modification of credit balance rules from the Academy's paper, *Pension Funding Reform for Single Employer Plans*:

**Modify credit balance rules:** The PBGC has expressed its concern that plan sponsors can avoid a contribution by using a credit balance, even when their plans are very underfunded. The credit balance is the excess of contributions made in the past over required minimum contributions (with interest). It was created to encourage employers to contribute more in good years, so they can reduce contributions in difficult times. The credit balance allows plan sponsors to manage their cash flow. It helps contributions coincide with the employer's business cycles; they can contribute more during good years, less in difficult times.

The theory behind the credit balance is that the plan is no worse off than if the employer had just contributed the minimum. However, this theoretical basis of the credit balance does not fully work in practice because the credit balance grows at the assumed interest rate, even when plan assets plummet. The rules do this for simplicity. To make the theory work, the credit balance should increase or decrease at the same rate as plan assets.<sup>1</sup>

Other ideas would be to not credit any interest on the credit balance, though the balance could still be too large if asset values declined. Credit balances could expire at the same time as tax carry-forwards. This would force sponsors to use it quickly, and discourage employers from making additional contributions.

The current administration has proposed eliminating the credit balance, but plan sponsors (particularly those who built up large credit balances recently) would see this as an unfair change to rules on which they relied. Such a proposal would discourage plan sponsors from contributing excess contributions in good years. In fact, the credit balance, with actual returns, does not hurt funding levels. Assets will always be better, or at least as good, if the employer had never contributed more than the minimum.

Thus, many note that the problem is not with the credit balance; the minimum contribution rules are too weak. If these rules were stronger, underfunded plans would not be able to build up such a large credit balance. For example, we could shorten the amortization periods for paying off new liabilities without eliminating the credit balance idea.

If necessary, a compromise would keep the credit balance, and restrict its use only for very underfunded plans. Congress could apply this prohibition to plans subject to the DRC,<sup>2</sup> but that would make the contribution even more volatile in the year a plan becomes subject to the DRC rules. Unfortunately, wherever the threshold is set for this rule, it will make the funding rules more volatile and cyclical. To be responsive to this concern, policy-makers could gradually downgrade the ability to use the credit balance as the plan becomes more poorly funded. Alternatively, and preferably, it could be prohibited from offsetting just the normal annual contribution if the plan is underfunded. This alternative is not only simpler, it would eliminate the volatility concern, and it would encourage funding discipline (i.e., the normal cost would be payable to the plan in every year). If the plan sponsor found it could not make any contribution in the current year, they could still be permitted to apply for a minimum-funding waiver from the IRS (which could be automatic if the employer were willing to freeze benefits or provide security).

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<sup>1</sup> The determination of the experience gain and loss would then have to reflect that. Because of its complexity, this rule should be implemented prospectively so it doesn't change the rules of the game in midstream. In addition, sponsors won't know the return on plan assets until they know the minimum required contribution at year-end. This could be remedied by reflecting the different return in the following year.

<sup>2</sup> If the credit balance cannot be used to offset the DRC, then IRC Sec. 412(1)(8)(A) should be changed so it does not increase the unfunded CL by the credit balance.