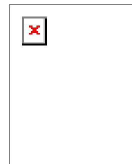
Examining Pension Security and Defined Benefit Plans: The Bush Administration's Proposal to Replace the 30-Year Treasury Rate



American Society of Pension Actuaries (ASPPA)
Statement for the Record In connection with Joint Hearing Committee on Ways & Means, Subcommittee on Select Revenue Measures Committee on Education and the Workforce, Subcommittee on Employer-Employee Relations

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The American Society of Pension Actuaries (ASPPA) appreciates this opportunity to submit its views in connection with this joint hearing that has been called to examine pension security and defined benefit plans, with special focus on the Bush Administration's proposal to replace the 30-year Treasury rate as the benchmark for calculating required contributions to defined benefit plans and lump sum payouts from defined benefit plans.

ASPPA is a national organization of over 5,000 retirement plan professionals who provide consulting and administrative services for qualified retirement plans covering millions of American workers. The vast majority of these plans are maintained by small businesses. ASPPA members are retirement plan professionals of all types, including consultants, administrators, actuaries, and attorneys. ASPPA's membership is diverse, but united by a common dedication to the private pension system.

We applaud the Subcommittees and the full Committees for their leadership in exploring these important issues. We also commend the Subcommittees and the full Committees for their demonstrated commitment to maintaining the framework of laws upon which is built a strong, employer-based system of providing retirement income benefits to our nation's workers.

The Yield Curve: Further Details, Further Study, Comprehensive Review Required

On July 7, the Bush Administration's Treasury Department announced significant proposals to change some of the rules for funding single-employer defined benefit plans. The proposals as they are currently available are summarized below; it is important to note that at this stage, Treasury is still working on some important details. The centerpiece of the plan is a proposal to replace the 30-year Treasury bond rate as an interest rate benchmark for purposes of calculating the deficit reduction contribution and lump sum distributions with a corporate bond interest rate based on a yield curve (i.e., a duration-matched discount rate).

ASPPA congratulates the Bush Administration for its willingness to address these important issues. Specifically, ASPPA welcomes the Bush Administration's acknowledgement of a corporate bond rate as conceptually an appropriate replacement for the 30-year Treasury bond rate.

ASPPA is currently studying these proposals. Until all of the details are revealed, it is difficult to reach ultimate conclusions. After further review, ASPPA may very well conclude that a yield curve approach, appropriately refined, is a reasonable approach to replacing the 30-year Treasury bond rate. However, ASPPA strongly believes that a significant change to the funding rules, such as the yield curve proposal, should only be considered in the context of a complete review and possible additional revisions respecting the overall funding rules.

ASPPA's initial conclusion is that while perhaps a yield curve approach may be more theoretically correct, as the Bush Administration asserts, there are other aspects of the funding rules that likely could also be more

refined to be more theoretically correct. ASPPA believes all these elements should be examined together, comprehensively.

For example, mortality rules could certainly be updated. It may be appropriate to allow plans to use mortality tables that are better tailored to the specific demographics of the plan. For example, H.R. 1776, the new pension reform bill introduced by Representatives Rob Portman (R-OH) and Ben Cardin (D-MD), would permit the use of “blue collar/white collar” mortality tables in certain circumstances. Further, duration matching concepts might be appropriate for purposes of asset valuation. Similarly, asset smoothing techniques and amortization periods for experience gains and losses probably should be reconsidered. Additionally, there is a need to discuss rules that would allow plan sponsors to better fund their plans in advance, when they have the resources to do so. ASPPA is in the process of examining these and other issues.

A critically important aspect of any overall review of the funding rules must also include consideration of any change’s potential impact on defined benefit plan coverage. Defined benefit plan coverage in this nation is threatened. Some three quarters—75 percent—of our nation’s workforce is not covered by a defined benefit plan. Although some of these workers, if they are fortunate enough, are at least covered by a defined contribution plan like a 401(k) plan, most of the nation’s workforce does not enjoy the security of a guaranteed level of post-retirement income.

Recent stock market declines clearly highlight the difference between a defined benefit plan and a defined contribution plan, in which participants bear the risk of investment losses. According to a recent study by the Employee Benefit Research Institute, a three-year bear market immediately prior to retirement can significantly reduce income replacement rates generated by 401(k) plan accounts. This is not an issue for defined benefit plans, which provide a guaranteed monthly retirement benefit for employees. A defined benefit plan’s guarantee of a specific level of post-retirement monthly income provides a strong retirement policy justification for encouraging defined benefit plan coverage. Consequently, any defined benefit plan funding reform and related proposals must carefully balance potentially expected burdens against perceived benefits. In fact, given the importance of promoting defined benefit plan coverage ASPPA believes that any proposed increased burden on defined benefit plans must be justified by a compelling policy rationale.

Interim Benchmark Should Replace 30-Year Treasury Rate until Completion of a Comprehensive Review of Funding Rules

In the July 7 proposal, the Bush Administration indicates that it supports comprehensive funding reform. The Administration is currently reviewing the appropriateness of current mortality tables. It is also considering possible incentives for more consistent annual funding requirements. However, Treasury says it views these issues as follow-up issues, a second step to follow enactment of the yield curve proposal. By contrast, ASPPA believes these issues should be considered together, so that the potential for their combined effect on defined benefit plan coverage can be examined. Consequently, ASPPA believes the yield curve rules should not be instituted before consideration of other possible changes to the funding rules.

Thus, it is ASPPA’s view that a 4-year weighted average corporate bond rate should be enacted as a substitute for the 30-year Treasury bond rate. This interim approach should endure for several years, until a formal study can be conducted to develop proposals for comprehensive funding reform. In fact, ASPPA would suggest a joint Administration/Congressional commission, with private sector input, to study all pension funding reform issues.

ASPPA believes the interim 4-year weighted average corporate bond rate measure should be based on the provision included in H.R.1776, the Portman-Cardin pension reform legislation. The relevant provision in H.R. 1776 would replace the four-year weighted average 30-year Treasury bond rate with a four-year weighted average corporate bond rate. Treasury would determine the rate, using a blend of indices reflecting high-quality long-term corporate bonds. The Portman-Cardin provision would also apply a spot corporate bond rate to lump sum distributions. The spot corporate bond rate would begin in the third year after enactment, and would be fully phased in over the subsequent five years. ASPPA supports this provision and would suggest applying a similar provision to any short-term measure in advance of comprehensive funding reform.

Further, ASPPA supports the Portman-Cardin provision to fix the interest rate at 5.5 percent for calculating the lump sum Internal Revenue Code section 415 defined benefit limit. ASPPA encourages Congress to

enact this provision immediately. This provision is particularly important to ensure sounder funding of small business defined benefit plans. ASPPA strongly urges that the fixed 5.5 percent rate for calculating the lump sum 415 defined benefit limit be included in any defined benefit plan funding legislation enacted by Congress this year.

Congress has been considering a replacement for the 30-year Treasury bond rate for some time. Presently, for purposes of the deficit reduction contribution, plans can use up to 120 percent of the 4-year weighted average of 30-year Treasuries. However, this rate is scheduled to revert to 105 percent after the 2003 plan year. Thus, it is critical that Congress act to address this issue this year.

Summary of Bush Administration Proposals

Funding and Lump Sum Changes

For purposes of calculating the deficit reduction contribution (DRC) under section 412(l) the 4-year weighted average 30-year Treasury bond interest rate would be replaced with a "yield curve discount rate" which would be fully phased in after years. Beginning with the 2004 plan year and ending with the 2005 plan year, a 4-year weighted average of a corporate bond rate would be used. Treasury would determine the rate by blending various high-quality corporate bond indices reflecting bonds of maturities of at least 20 years. Beginning with the 2006 plan year, two-thirds of current liability for purposes of the DRC would be determined using this corporate bond rate and one-third would be determined using a yield curve. For purposes of the 2007 plan year, these percentages would flip. For the 2008 and later plan years, the current liability would be determined entirely based on the yield curve. It is important to note that the yield curve would not reflect 4-year weighted averages, and would be to some degree a spot rate.

Although the technical details of the proposal have not been released, it is our understanding that the yield curve would be applied to projected future cash flows, which would then be discounted using an interest rate based on the yield curve. In other words, each year’s projected future cash flows would be discounted using a different interest rate. The actual mechanics of this have not yet been ironed out. The Administration is asking for broad regulatory authority to address the details. ASPPA believes that it would be overly burdensome, if not impossible, to value every participant’s benefit individually and thus some averaging techniques must be allowed.

Calculation of lump sums would be done using the same rules as under current law for the 2004 and 2005 plan years (i.e., the spot 30-year Treasury bond rate). For the 2006 and 2007 plan years, a phase-in between the 30-year Treasury bond rate and a yield curve approach similar to the one described above for purposes of calculating current liability would apply. For the 2008 and later plan years, lump sums would be calculated entirely under a yield curve approach. Thus, the interest rates for workers electing lump sum distributions closer to normal retirement age will be lower (and thus more valuable) than for younger workers.

The Administration proposal does not address the issue of the interest rate used for purposes of determining the defined benefit plan limit under Internal Revenue Code section 415 for a lump sum distribution. ASPPA urges both Congress and Treasury to establish a fixed rate—5.5 percent would be appropriate—for this purpose.

Increased Disclosures

Beginning with the 2004 plan year, all plans would have to disclose the value of plan assets and liabilities on a termination liability basis in their summary annual report. It is unclear under what basis termination liability would be measured for this purpose.

ASPPA has concerns about this termination liability disclosure proposal, particularly the burden it would place on plans that are otherwise well funded. It is further unclear what is accomplished by this proposal, given that such disclosure and notices are already required to be given to plan participants in the case of under funded plans under Title IV of ERISA. ASPPA believes the very real burden that would be imposed on plan sponsors by such a disclosure rule would substantially outweigh any perceived benefit of such a rule, in terms of

additional information to participants.

Beginning with the 2004 plan year, plans required to submit financial data to the PBGC under ERISA section 4010 would have to make available to the public, upon request, a certain amount of such information respecting the plan. The specific information that would be required has not yet been specified.

Beginning with the 2006 plan year, plans would have to disclose in the summary annual report their current liability (for purposes of the deficit reduction contribution) determined entirely based on the yield curve.

Benefit Restrictions for Severely Underfunded Plans with a Threatened Plan Sponsor

Where (1) a plan's funding ratio falls below 50 percent of termination liability (probably using a Title IV standard) and (2) where the plan sponsor has a junk bond or similar credit rating or the plan sponsor has declared bankruptcy, the plan would no longer be able to accrue additional benefits (no accruals from additional service, age, or salary growth plus any benefit improvements) and would no longer be able to pay lump sums unless the plan sponsor contributes cash or provides security to fully fund the added benefits or lump sums. This is a restrictive rule—perhaps overly restrictive—for those plans subject to it, although it is unclear how many plans would be affected. The restriction on lump sums can be seen as punitive from the standpoint of innocent participants who suddenly lose the ability to elect a lump sum distribution, particularly from a threatened plan. In addition, ASPPA believes that there are tens of thousands of defined benefit plans maintained by plan sponsors who have not issued bonds and thus do not have a bond credit rating. ASPPA encourages both the Administration and Congress to consider alternative credit standards for such plans. ASPPA would be pleased to further discuss this issue and our accompanying concerns with the key policymakers in this process.

Other Funding Reforms

Finally, the Administration indicates that it is also reviewing other possible defined benefit plan funding reforms. The July 7 proposal states that Administration personnel are considering "the proper establishment of funding targets, appropriate assumptions for mortality and retirement age, and incentives for more consistent annual funding." ASPPA concurs that these issues merit further study and recommendations for modification, and believes such study and recommendations should come before the establishment of a yield curve to replace the 30-year Treasury rate as the benchmark rate for important defined benefit plan calculations. ASPPA disagrees with the Administration's insistence that its yield curve proposals should be enacted immediately, before consideration of these other possible reforms. ASPPA strongly urges Congress to undertake the necessary comprehensive review of all pension funding rules before enactment of significant reforms.

Summary and Conclusion

ASPPA believes the Administration's yield curve proposal for establishing a new and better benchmark interest rate for purposes of calculating the deficit reduction contribution and lump sum distributions holds some promise as the best way to solve the current pension funding crisis confronting defined benefit plan sponsors. However, ASPPA strongly believes that pension funding issues are crucial to an employer's decision to establish a defined benefit plan—and that defined benefit plans are superior mechanisms for providing retirement income security to our nation's workers. Consequently, ASPPA believes it is necessary to conduct a comprehensive review of all pension funding issues prior to the enactment of a permanent change to the benchmark interest rate.

At the same time, however, ASPPA knows it is imperative to establish a new benchmark interest rate to replace the 30-year Treasury bond rate. Because Treasury has stopped issuing 30-year bonds, the 30-year bond interest rate no longer works as a viable measure for calculating pension funding issues. Any failure to establish a stable replacement rate threatens employers' ability and willingness to continue their defined benefit plans.

Accordingly, ASPPA urges Congress to enact an interim replacement benchmark rate. ASPPA supports the long-term corporate bond rate mechanism contained in H.R.1776 as the appropriate interim rate. Further,

ASPPA supports the formation of a Congressional-Administration-Private Sector commission to study and make recommendations on overall pension funding issues, prior to the enactment of a permanent replacement benchmark rate. ASPPA believes there is potential for the Administration's yield curve proposal, but that further study—both with respect to still-undetermined and important details of how it would work, and with respect to its interaction with other pension funding rules—is necessary before the yield curve can be definitively judged.

ASPPA would be pleased to provide further input and/or to answer any questions lawmakers may have as they grapple with this important and complex issue. ASPPA also thanks the Committees for this opportunity to provide input.

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