



August 26, 2002

PENSION FUNDING PROPOSAL

OVERVIEW:

Targeted Reforms: ERIC proposes targeted improvements to the current law funding standards. These reforms are essential to restoring the health of the voluntary employer-sponsored defined benefit system and to securing the benefits of millions of U.S. workers and their families. Specifically, ERIC proposes to

- replace the current mandated 30-year Treasury bond rate with a new composite corporate bond rate,
- phase in the new rate for lump sum calculations,
- coordinate the new rate with related mortality assumptions, and
- reduce the frequency with which employers bounce in and out of current liability funding and quarterly contribution requirements.

Need for Reform: Employers are required to use 30-year Treasury bond rates to make a variety of pension calculations, including funding requirements designed to ensure that a plan has assets sufficient to pay benefits owed to date using assumptions consistent with those that would be used by insurance companies to satisfy the liabilities under the plan. When the 30-year Treasury bond rate was selected as the basis for the new funding rules established in OBRA '87, Treasury rates were much closer to corporate bond rates than they are today. The Treasury Department's buyback program and its subsequent discontinuation of the 30-year bond have driven the rates on 30-year bonds to an artificially low level that is significantly below prevailing long-term corporate bond rates. Treasury rates reflect the government's cost of borrowing, while corporate bond rates are indicative of the rate of return on an insurance company's investment portfolio. Thus, any future convergence of Treasury rates and corporate bond rates would be accidental.

The artificially low rate of return on 30-year Treasury bonds has distorted and exaggerated employers' pension funding obligations as well as their obligations to pay variable-rate premiums to the Pension Benefit Guaranty Corporation. This has weakened employees' retirement security. It has encouraged employers to curtail or terminate their plans and has weakened employer interest in continuing to maintain pension plans.

Congress recognized the severity of the problems caused by mandating an artificially low interest rate by temporarily increasing the range of permissible interest rates for use in funding and PBGC premium calculations [sec. 405 of the Job Creation and Worker Assistance Act, P.L.107-147, enacted March 9, 2002]. *However, this temporary relief will*

expire at the end of 2003. Without additional action, employers will be faced with even more severe funding spikes.

The artificially low 30-year rate has also distorted plans' benefit payments by inflating the size of lump-sum payments from traditional defined benefit plans, which are based on the 30-year Treasury rate. These artificially inflated lump sums have discouraged employees from electing to take their benefits as annuities -- contrary to federal retirement policy -- and have imposed substantial and largely unanticipated cash demands on pension plans. At the same time, the low 30-year rate has restricted the interest crediting rate on employees' accounts in the many cash balance plans that base their interest crediting rate on the 30-year Treasury rate. These results are not in the interest of employees, employers, or the nation as a whole.

Although voluntary employer-sponsored defined benefit pension plans provide valuable retirement security benefits to the millions of employees who participate in them, the coverage of these plans is declining. Since the enactment of ERISA in 1974, the percentage of private sector U.S. workers covered by defined benefit pension plans has dropped from 39% in 1975 to 23% in 1995. Between 1988 and 1999, the number of active participants in PBGC-insured defined benefit plans fell by 18%, from 27.3 million to 22.4 million -- notwithstanding the expansion of the total workforce during this period.

Short-sighted funding standards have been a major reason for the decline of defined benefit plans. Current rules subject employers to highly volatile funding requirements that are difficult, if not impossible, for employers to predict, thus making it less attractive for employers to maintain defined benefit plans. While there are many changes that ERIC and others might propose to make pension funding standards more compatible with the objective of providing retirement security, ERIC's proposal is restricted to key issues that must be settled before the expiration of the temporary relief provided in P.L.107-147.

ERIC PROPOSAL

Replace the 30-Year Treasury Rate with a Composite Rate: For funding, variable rate premium, and lump-sum purposes, the 30-year Treasury bond rate should be replaced by a composite corporate bond rate (the "Composite Rate"). Under the proposal, the Composite Rate is the unweighted arithmetic average of several indices that consist of high quality bonds with maturities of ten years or more. The Composite Rate is designed to be indicative of the rate of return on an insurance company's investment portfolio -- as contrasted with a rate that, like the 30-year Treasury rate, is indicative of the federal government's cost of borrowing.

Initially, the following indices should be used to establish the Composite Rate:

1. Moody's Aa Long Term Corporate Bond Index;
2. Merrill Lynch 10+ High Quality Index;
3. Salomon Smith Barney High Grade Credit Index; and
4. Lehman Brothers Aa Long Credit Index.

Under the proposal, the Treasury (1) may issue regulations replacing any index that ceases to be published or that becomes unrepresentative of the rate of return on an insurance company's investment portfolio and (2) is required to publish the Composite Rate daily. The Composite Rate on any date is the unweighted arithmetic average of the rates for the designated indices.

The Composite Rate replaces the 30-year Treasury rate wherever the latter terms appears in current law. For purposes of the minimum funding standards, the Composite Rates on the applicable dates will be averaged in accordance with the weighted average rules of current law.

For example, the current funding standards under IRC § 412(l) are based on liabilities calculated using an interest rate within a permissible range of not more than 5% above, and not more than 10% below, the weighted average of the rates of interest on 30-year Treasury securities during the four-year period ending on the last day before the start of the plan year. Under the proposal, the calculation is the same, except that the Composite Rate is used instead of the 30-year Treasury rate.

Similarly, the variable rate premium should be based on the plan's unfunded vested benefits based on 100% of the Composite Rate, rather than the 30-year Treasury rate, for the month preceding the beginning of the plan year.

Under the proposal, the minimum lump-sum payment from a pension plan is likewise based on 100% of the Composite Rate, rather than the 30-year Treasury rate. The current regulatory provisions regarding lump-sum payments will remain in place under the proposal, however. For example, the proposal does not change the rules regarding the stability period for lump-sum calculations, except that the Composite Rate is used instead of the 30-year Treasury rate. Under the proposal, changing from the 30-year rate to the Composite Rate will not cause a plan to violate the anti-cutback rule.

Phase-in of New Interest Rate for Lump-Sum Purposes: The new interest rate should be phased in over a three-year period for purposes of calculating the minimum lump-sum payment under a pension plan. The three-year phase-in will moderate the effect on lump sums of shifting from the 30-year rate to the Composite Rate. However, the three-year phase-in will not apply for purposes of the minimum funding standards or the variable rate premium.

The three-year phase-in will operate as follows. In the first year, the interest rate will be the weighted average of the two rates, giving one-third weight to the Composite Rate and two-thirds weight to the 30-year Treasury rate. In the second year, the interest rate also will be the weighted average of the two rates, except that two-thirds weight will be given to the Composite Rate and one-third to the 30-year Treasury rate. In the third year (as well as subsequent years), the rate will be based entirely on the Composite Rate.

Mortality Table: At the time the Composite Rate becomes effective, the use of the RP 2000 Combined Mortality Table will be required for funding and variable rate premium purposes. Consistent with current law, the Treasury will be required periodically (and at least every five years) to review the mortality table and to update the table as appropriate to reflect the

actual experience of pension plans (including permitting plan-specific adjustment factors such as employment classification, lifetime income, and other relevant demographic factors) and projected trends in such experience. Mortality assumptions for lump-sum purposes will be updated according to current law.

Volatility Rule: Under IRC § 412(l)(9), a plan is exempt from the funding requirements of IRC § 412(l) if the plan is at least 80% funded and is at least 90% funded for each of the two preceding plan years (or for each of the second and third immediately preceding plan years). Under the proposal, the rule in § 412(l)(9) will be changed so that a plan will be exempt from the additional funding requirements of § 412(l) if the plan is at least 80% funded and *is at least 90% funded for at least two of the immediately preceding four plan years*.

Quarterly Contribution Requirement: Under current law, an employer must make minimum funding contributions on a quarterly basis if the plan is less than 100% funded. The 100% standard can operate as a “hair trigger” for plans even in the general vicinity of 100% funding, since a relatively small change in interest rates or asset values can easily subject such a plan to, or exempt it from, the quarterly contribution requirement. In order to reduce the frequency with which plans bounce in and out of the quarterly contribution requirement, the proposal changes the trigger for the quarterly contribution requirement to mirror the volatility requirement in § 412(l)(9), as modified in accordance with the preceding paragraph. Thus, under the proposal, a plan will be exempt from the quarterly contribution requirement if the plan is at least 80% funded and is at least 90% funded for at least two of the immediately preceding four plan years.

Replacing the 30-Year Treasury Rate in Pension Regulation

Under current law, the yield on the 30-year Treasury bond is used to regulate pension plan operations in a variety of ways. Now that the Treasury Department is no longer issuing 30-year Treasury bonds, a permanent replacement for the 30-year Treasury rate must be found.

This paper and the attached charts present a proposed replacement for pension regulatory purposes. A new metric would replace the yield on the 30-year Treasury bond with a composite yield on high quality, long duration corporate bonds. The yield is intended to be representative of rates of return that underlie the price of annuities sold by insurers active in the group annuity marketplace. The composite incorporates several private sector indices, to allay concerns that a specific index could be subject to change or manipulation that would affect pension regulation.

The composite index is the average of four indices:

- Moody's Aa Long Term Corporate Bond Index
- Merrill Lynch 10+ High Quality Index
- Salomon Smith Barney High Grade Credit Index
- Lehman Brothers Aa Long Credit Index

The underlying index rates reflect yields to maturity on corporate bonds with the two highest quality designations. All have modified durations in the range of 10-12, which is a common range for pension plan liabilities.

It is anticipated that the Treasury would be given regulatory authority, by legislation, to replace items in the composite index should a given index cease to be published, or if it becomes unrepresentative of rates underlying annuity pricing for some other reason.

In choosing a corporate bond yield index as a replacement for the 30-year Treasury rate, the resulting regulatory interest rate is expected to increase somewhat. This is appropriate, given that, when the 30-year Treasury was initially implemented into law for pension regulation, an outdated mortality table was specified. Since the outdated mortality table understated life expectancy and so understated resulting liabilities, it was appropriately paired with the 30-year Treasury rate, which understated insurer financing opportunities and so overstated liabilities. The pension regulatory rules have since been amended to provide for routine updates in mortality tables; this mitigates the effect of shifting from a government to a corporate bond index. The attached Exhibit D shows a decreasing difference between PBGC's estimates of the marketplace annuity interest rates and the proposed new metric. We believe this is due primarily to updates in mortality assumptions.

The components of the proposed index have been issued for varying periods of time. The attached charts that illustrate the proposed metric on a historical basis add components to the index as of the date that the component index was established. Thus the historical proposed rate as illustrated is initially based solely on the Moody's and Merrill Lynch

Detailed Technical Information Regarding Charts

The charts are based on monthly averages of the rates; this is the same basis used to reflect 30-year Treasury yields under current pension regulation. In some instances, due to data limitations, we have graphed the monthly averages based on an average of daily data.

The series used are as follows:

- ***Moody's Aa Long Term Corporate Bond Index.*** The minimum maturity for the bonds in this index is 20 years, with an average of 30 years. Average yield of corporate bonds rated AA by Moody's. Moody's Long-Term Corporate Bond Yield Averages are derived from pricing data on a regularly replenished population of nearly 100 seasoned corporate bonds in the U.S. market, each with current outstandings over \$100 million. The bonds have maturities as close as possible to 30 years; they are dropped from the list if their remaining life falls below 20 years, if they are susceptible to redemption, or if their ratings change. All yields are yield-to-maturity calculated on a semi-annual basis. Each observation is an unweighted average, with Average Corporate yields representing the unweighted average of the corresponding Average Industrial and Average Public Utility observations. This index is included in the charts for the entire period.
- ***Merrill Lynch 10+ High Quality Index*** is a subset of the US Corporate Master index using AAA-AA Rated bonds with maturities 10 years and higher. The Corporate Master Index tracks the performance of US dollar-denominated investment grade Corporate public debt issued in the US domestic bond market. Qualifying bonds must have at least one year remaining term on maturity, a fixed coupon schedule and a minimum amount outstanding of \$150 million. Bonds must be rated investment grade based on a composite of Moody's and S&P. "Yankee" bonds (debt of foreign issuers issued in the US domestic market) are included in the Index provided the issuer is domiciled in a country having an investment grade foreign currency long-term debt rating (based on a composite of Moody's and S&P). Medium term notes qualify for inclusion. All non-Corporate debt, including Foreign Governments and Supernationals, are excluded from the Index. "Global" bonds (debt issued simultaneously in the eurobond and US domestic markets) also qualify for inclusion. 144a issues are not included in the Index until they are exchanged for registered securities. The Index is rebalanced on the last calendar day of the month. Issues that meet the qualifying criteria are included in the index for the following month. Issues that no longer meet the criteria during the course of the month remain in the index until the next month-end re-balancing at which point they are dropped from the index. The inception date of the Index is December 31, 1972. It is included in the chart for the entire period.

- ***Salomon Smith Barney High Grade Credit Index.*** The High-Grade Credit Index includes those issues from the Credit Index that have at least ten years to maturity (long-term) and a minimum credit rating of AA-/Aa3. The Credit Index includes US and non-US corporate securities and non-US sovereign and provincial securities. The index is included in the attached charts from January 1995.
- ***Lehman Brothers Aa Long Credit Index.*** The overall Credit Index includes investment-grade bonds issued by corporations and non-corporate entities. The Credit Index is subdivided into industrial, finance, utility, and non-corporate sectors and had a total market value of \$1.84 trillion, or 26.8% of the Aggregate Index, as of December 31, 2001. All bonds must be SEC-registered (144A's can be included but must be issued with registration rights). Credit Index results are also available on the basis of credit quality (Aaa, Aa, A, and Baa) since 1973. The Credit Index includes publicly issued U.S. corporate and non-corporate debentures and secured notes that meet the maturity, liquidity, and quality guidelines. Subordinated issues are included provided other criteria are met. Securities with normal call and put provisions and sinking funds are included, but structured notes with embedded swaps or other special features are excluded. Medium-term notes are excluded unless they are publicly underwritten. Private placements, 144As without registration rights, floating-rate securities, and Eurobonds are also excluded, but global issues that are SEC registered are included. Bond issues included in the Long Credit Index must have 10+ years left until maturity. The index is included in the attached charts from September 2000 based on availability to us of monthly average rates from that point (the index was established at a prior point).

The Exhibits compare the proposed composite rate over the past 12 years with:

- each of the indices
- 30-year Treasury yields
- PBGC rates

PBGC rates are based on a monthly survey which is then adjusted by PBGC and announced in advance of the month to which the rates will apply; this generates a "lag" in PBGC interest rates compared to market rates. PBGC rates displayed in the chart have been adjusted 2 months to account for the timing difference. PBGC rates are typically issued as an initial and an ultimate rate – the ultimate rate is typically adjusted annually while the initial rate is adjusted monthly with a lag as described above. The rates shown are based on the initial (monthly-adjusted) PBGC rate.

Exhibit A : Composite Rate Index
Composite of Corporate Bond Yield Indices
1990 - 2002

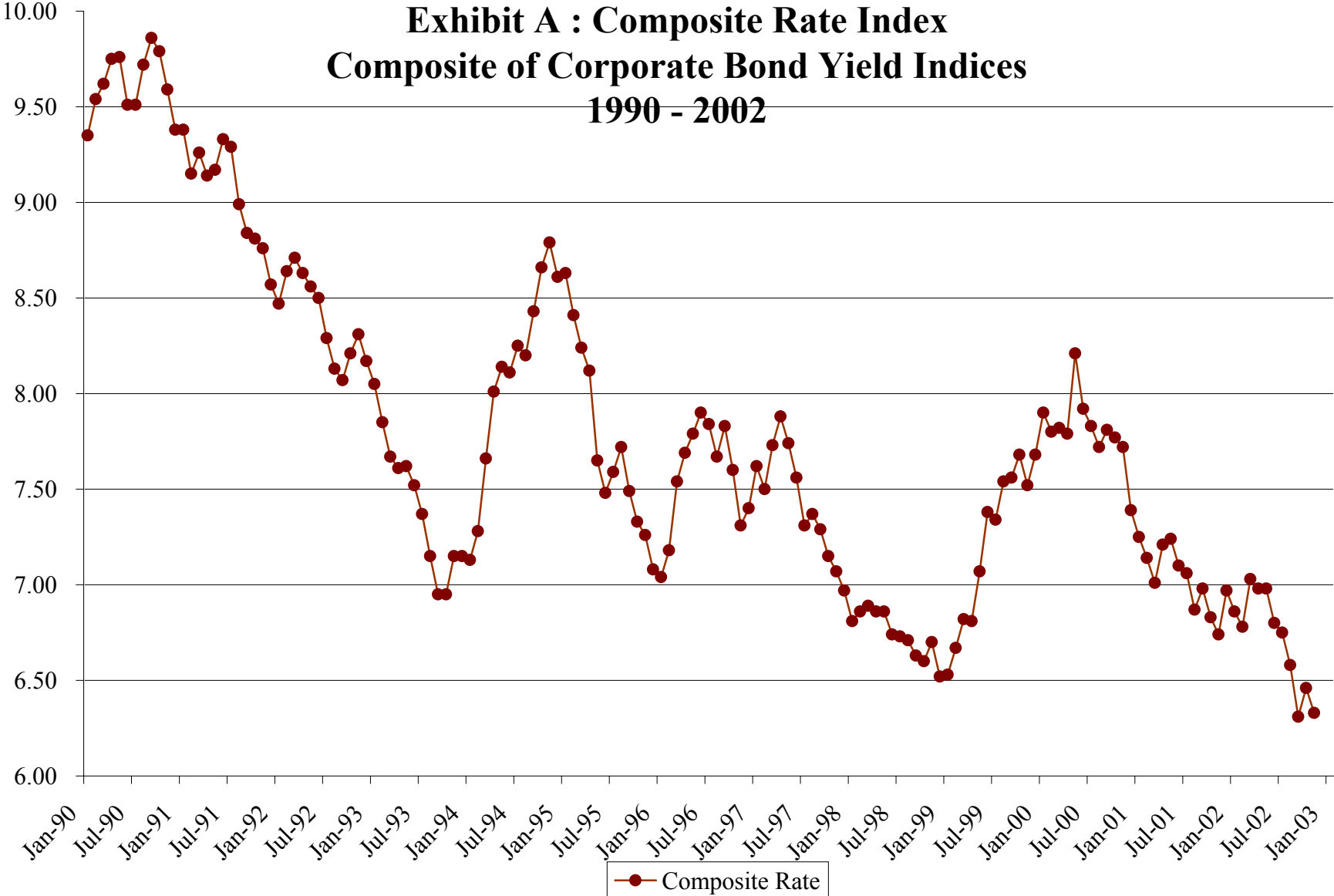


Exhibit B: Composite Rate Index with Underlying Yields from Moody's, Merrill Lynch, Salomon Bros. And Lehman Bros. 1990 - 2002

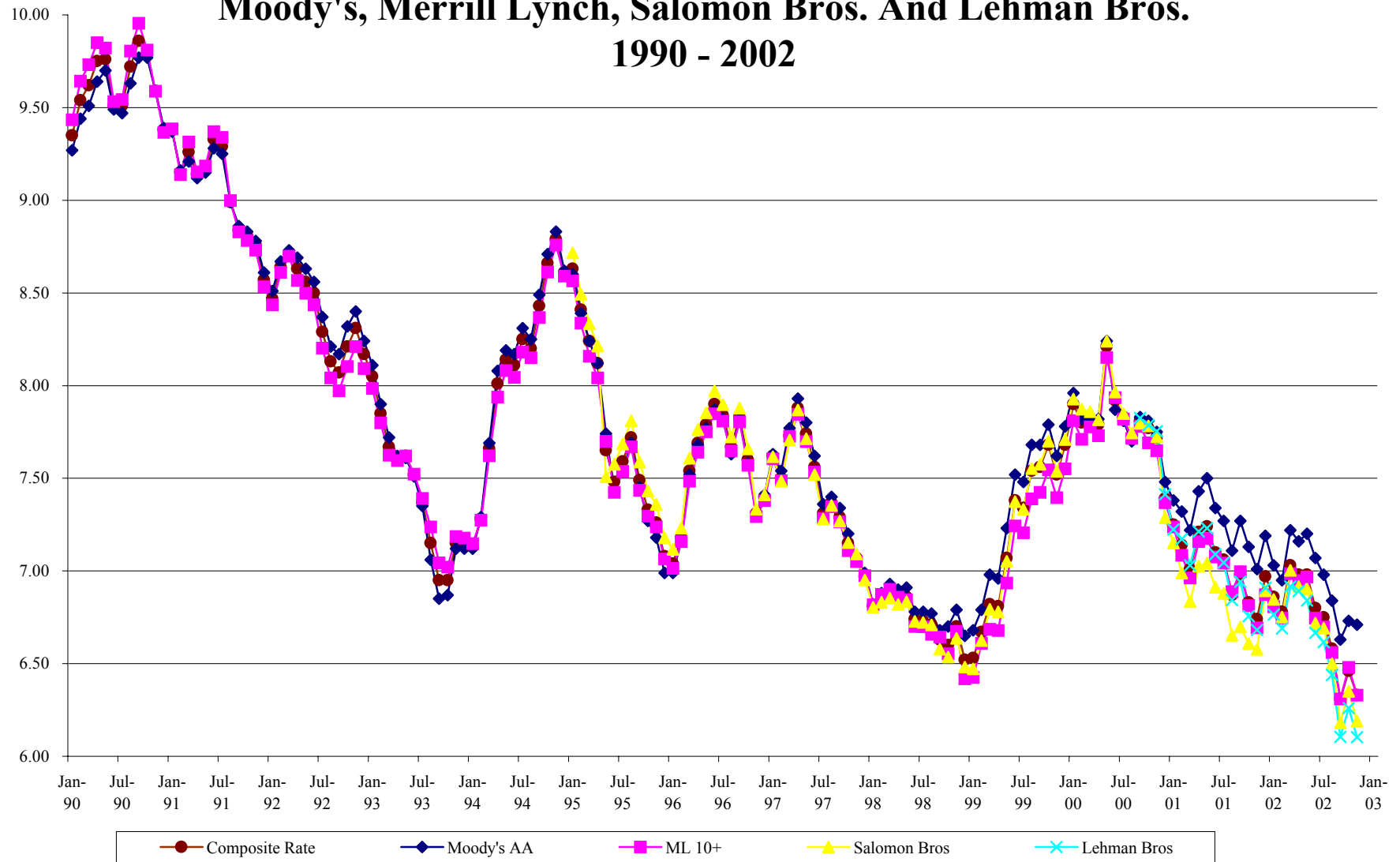


Exhibit C: Composite Rate Index vs. 30-Year Treasury Bond Yield and PBGC rate (adjusted 2 months) 1990 - 2002

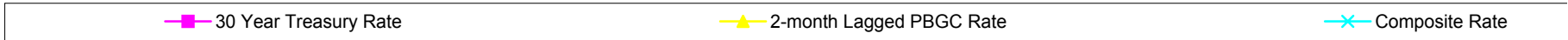
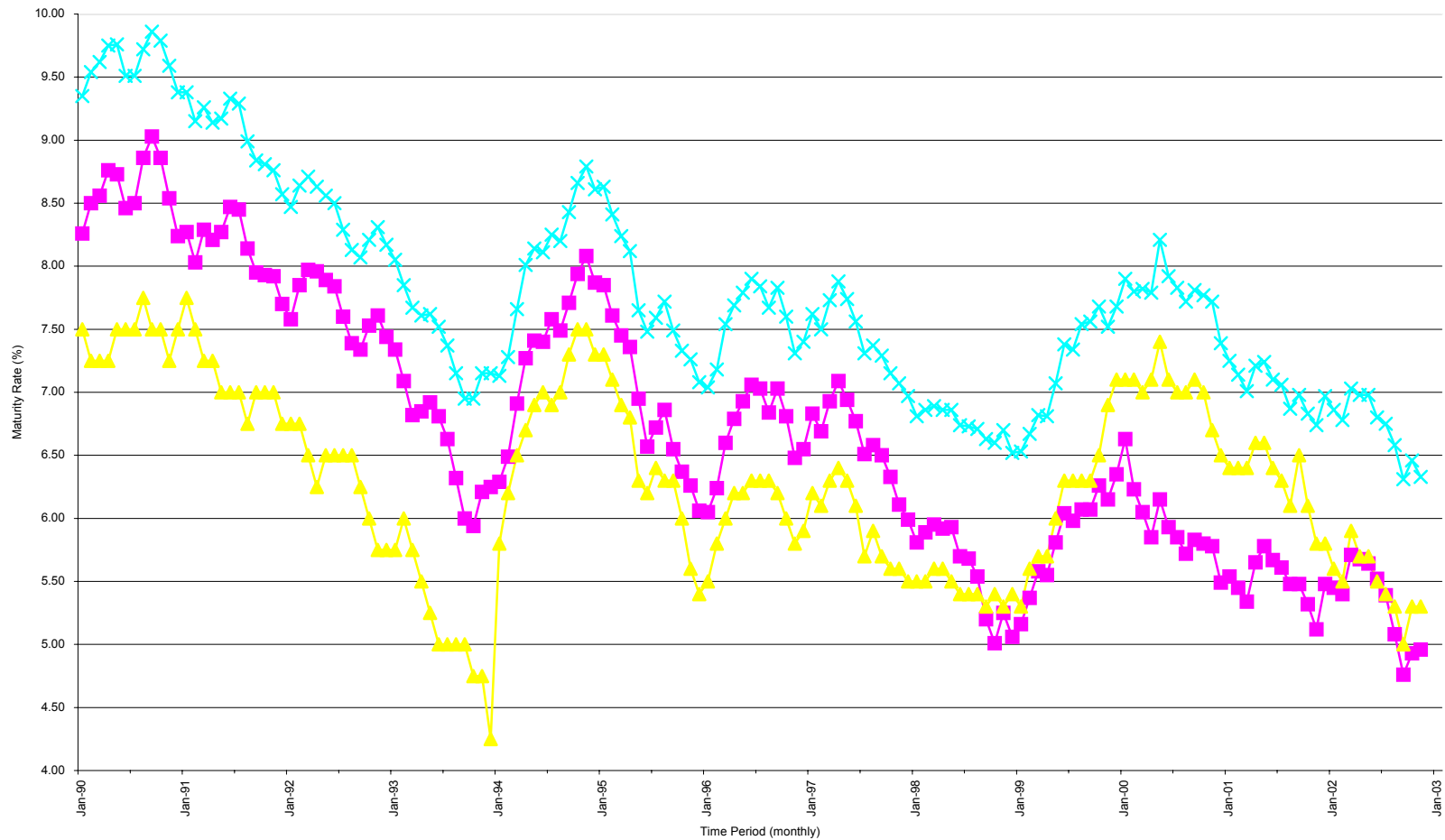


Exhibit D: Differences between Composite Rate Index and 30-Year Treasury Bond Yield and PBGC rate (adjusted 2 months) 1990 - 2002

