



The ERISA Industry Committee
Representing the Employee Benefits Interests of America's Largest Employers
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Mr. William Sweetnam
Benefits Tax Counsel
U.S. Department of the Treasury
Washington, D.C.

RE: Guidance Regarding Corporate Bond Rate for Pension Regulation

Dear Bill:

Thank you and the other members of the Treasury staff for taking the time November 13 to discuss with ERIC staff and members technical aspects of the guidance Treasury must produce once legislation replacing the defunct 30-year Treasury bond with a corporate bond rate is enacted. Although the final statutory language may vary somewhat from versions currently available, we wanted to follow up now to outline key matters that we believe Treasury should take into account in formulating guidance. When final statutory language is available, we may make additional comments.

As you know, ERIC's members have been examining the use of high-quality, long-term corporate bond indices as a potential discount rate for pension regulation purposes for approximately two years. With the time for computing next year's contribution requirements already upon us, we will be pleased to work with you to achieve the goal of rapidly issuing guidance that plan sponsors will need immediately and that they can readily and effectively implement. At any time, if there is any information we can provide that will assist you meeting your responsibilities, please let us know.

Subject to reviewing the final statutory language, we believe that, in order to determine an interest rate that reasonably approximates an employer's ability to defease its pension obligations, the Treasury should :

- (1) Publish the methodology for computing the rate. It is important that both plan sponsors and the financial community have a clear understanding of the derivation of a discount rate that can have a dramatic impact on a company's cash flow.
- (2) Select indices of high-quality long-term bonds. We recommend indices with bonds generally in the top two quality levels with average maturities of 20 years or more. While valid arguments can be made to include indices of other grades and durations, these criteria ensure a conservative rate that tracks average pension durations and is reasonably aligned with annuity prices.

(3) Select only indices that are published by established financial services firms and that are based on publicly disclosed methodologies. Again, transparency is critically important to ensuring the confidence of all stakeholders in the required discount rate. The Treasury should not deconstruct a rate and alter it internally.

(4) Calculate the rate by computing the arithmetic average of the selected indices and by including a larger rather than a smaller number of indices when possible. Each index can be seen as a professionally derived view of the current market. Applying equal weight to each index and including a larger rather than a smaller number of indices in the calculation provides both the Treasury and other stakeholders with maximum protection and stability if one index moves out of line with the others for a short or extended period.

(5) Use the yield to maturity rate. The rates used need to be well understood and appropriate for the purpose. This issue is discussed in more detail below.

Yield to maturity is by far the most commonly used reference for current interest rates on long-term corporate bonds. It is also the rate used under the current law (although that rate is based on the 30-year Treasury bond). Yield to maturity, sometimes also stated as a bond-equivalent yield, reflects the percentage rate of return to maturity date, determined on the basis of the bond's coupon rate and current market price.

Other published rates include the effective yield and yield to worst. Effective yield is generally higher than yield to maturity. The effective yield calculation essentially annualizes the semi-annual coupon rates. While this produces an acceptable result, it is not the most commonly used rate.

Yield to worst is generally lower than yield to maturity. Yield to worst is an approximate calculation that reflects yields determined as of all the potential exercise dates. To the extent that the yield to worst calculation differs from yield to maturity it may be inconsistent with the typical duration of pension liabilities. Moreover, yield to worst provides only a crude approximation of the potential effect of call provisions within long-term bonds, and it ignores the offsetting effects of put options that may also be included in the bond portfolios. Thus, it does not provide a technically sound appraisal of the option effects.

In order to (a) ensure that the rate produced is constructed in a manner that will be familiar to and rapidly understood by pension professionals, (b) avoid creating concerns regarding manipulation of the new rate, and (c) avoid burdening the Treasury staff with complex and unnecessary analysis of call and put options, the yield calculation should be based on the yield to maturity.

If you have any questions or comments, please give me a call.

Sincerely,

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