

Testimony of Peter Kelly  
On Behalf of  
The U.S. Chamber of Commerce

Before the Working Group on  
Defined Benefit Funding and Discount Rate Issues  
ERISA Advisory Council  
US Department of Labor

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Mr. Chairman, members of the Council, thank you for the opportunity to present the views of the United States Chamber of Commerce. I am Peter Kelly, a shareholder in the law firm of Ogletree, Deakins and a member of the Employee Benefits Policy Committee of the U.S. Chamber of Commerce on whose behalf I speak today.

The U.S. Chamber is the world's largest business federation representing more than three million businesses and organizations of every size, sector, and region, with substantial membership in all 50 states.

The funding requirements and other discount rate requirements applicable to defined benefit plans are a significant concern for many of our members. We appreciate the Council's work in furthering discussion and resolution of unique structural burdens imposed on plans and plan sponsors by the confluence of the decline in the market for the vanishing supply of 30-year Treasury bonds, recent adverse economic trends and related declines in plan asset values.

## **I. Introduction**

The defined benefit plan system is in a state of crisis. The most pressing issue facing defined benefit plans is the need to replace the 30-year Treasury bond interest rate. However, broader issues of pension reform also require review and consideration. After a prosperous period of constant profit and high investment returns, many companies are suffering from erratic profits, declining asset values, and low investment returns. At the same time, many companies that were previously prohibited from making contributions to their defined benefit plans are now required to make significant contributions to those same plans.

In addition, corporate bankruptcies have forced the Pension Benefit Guaranty Corporation ("PBGC") to assume responsibility for 783,000 pensioners in more than 3,100 plans by the end of 2002. The surplus established by the PBGC in the late 1990s has quickly reverted to a budget deficit.

These events have created concern for all involved in the defined benefit pension system. The U.S. Chamber has been actively involved in discussing these issues with the Administration and with members of Congress. Below, we discuss the Administration's Proposal for funding reform, including the replacement of the 30-year Treasury rate, as well as other relevant funding issues.

## **II. Urgent Need for Replacement of the 30-year Treasury Interest Rate**

The U.S. Chamber must stress the paramount and urgent need to approve a permanent replacement for the obsolete 30-year Treasury bond. We certainly appreciate the Administration's attention to this issue and its support for the composite corporate bond rate proposed by Representatives Portman and Cardin, even though only as another temporary solution. By limiting its support for the composite corporate bond rate to only two years, the Administration has raised unwarranted doubts about the appropriateness of that methodology as a permanent solution. Pension plans do not have more time. A law must be enacted immediately to provide a rational and appropriate replacement to the 30-year Treasury rate. For the reasons outlined below, we believe that a composite corporate bond rate is the appropriate permanent replacement for the 30-year Treasury rate.

### ***A. The 30-year Treasury Bond Interest Rate is Obsolete***

The Internal Revenue Code ("Code") and ERISA require plan sponsors to use interest rates based upon 30-year Treasury bond interest rates in determining pension liabilities for certain funding purposes and for determining lump sum distributions. When these requirements were enacted there was a robust market in 30-year Treasury bonds and the interest rate on such bonds was considered an appropriate benchmark for pension funding and benefit distribution purposes.

On October 31, 2001, following a three-year program of buying back 30-year bonds, the Treasury Department announced that it would cease issuing the bonds. This decision led to a gradual decline in the availability of existing 30-year bonds and the elimination of a flow of new bonds replacing them. The result was an artificial decrease in the 30-year Treasury bond interest rate that created a corresponding artificial increase in pension liabilities and lump sum valuations.

As a temporary fix, the Job Creation and Worker Assistance Act of 2002 (PL 107-147) increased the range of permissible interest rates for determining contributions, lump sum distributions and PBGC premiums for under-funded pension plans to 120% of the current 30-year Treasury bond interest rate. The temporary remedy will expire on December 31, 2003. If the temporary fix expires without appropriate action to resolve this issue, there will be an even greater artificial increase in pension liabilities. Such a result would devastate the defined benefit pension system.

Representatives Portman and Cardin have introduced a bill (H.R. 1776) that offers a resolution to the 30-year Treasury bond rate issue. The bill would replace the 30-year Treasury bond rate with a composite corporate bond rate to calculate pension liabilities

and the present value of lump-sum benefits. On July 18, 2003, the House Ways and Means Committee reported out H.R. 1776. As reported, the Ways and Means Committee version of H.R. 1776 adopts the Portman and Cardin corporate bond rate approach only through 2006, leaving the rate issue unresolved for 2007 and later years.

On July 7, 2003 (prior to the recent Ways and Means Committee action), the Administration offered a proposal that varies from the Portman and Cardin approach. As explained by the Treasury Department, this Proposal would follow the Portman and Cardin corporate bond rate approach for an initial period of two years and would thereafter shift pension funding, financial disclosures and distributions onto a new system of financial liability estimation based upon a yield curve model.

The Administration has taken a positive step in accepting a corporate bond rate as the most appropriate in measuring plan liabilities. However, they acknowledge there are many issues to resolve and additional funding reforms to develop. Therefore, under the Administration's Proposal, plan sponsors' ability to forecast and budget cash contributions beyond the next two years will not improve.

***B. The Yield Curve Concept Will Change Current Funding Calculations in a Fundamental Way***

In 2002, Congress recognized that the 30-year Treasury bond interest rate was not an appropriate factor for measuring pension liabilities. In testimony before Congress in April 2003, Treasury also acknowledged that the 30-year Treasury bond interest rate is an inappropriate measure. The Administration's Proposal does not, however, simply replace the inappropriate 30-year Treasury rate. The yield curve concept introduces a new funding structure that cannot be easily implemented.

The few details released about the proposed yield curve approach suggest that defined benefit plan actuarial calculations will have to change significantly. Moreover the changes will be administratively burdensome and difficult to implement cost effectively. To accurately calculate a liability using a yield curve, the plan actuary will have to calculate an aggregate stream of individual future benefit payouts that must then be individually discounted based on each year's rate from the yield curve. Such a payout stream is not currently calculated as part of the annual valuations or for other purposes. In some situations, actuaries do calculate a payout stream of total projected retirement benefits, but the Administration's Proposal requires an additional payout stream calculation for all participants based on benefits that have accrued to date. This is a type of calculation not ordinarily calculated prior to retirement, unless requested by an individual participant.

Moreover, there are additional actuarial considerations in producing a detailed payout stream. For example, many retirees elect a joint & survivor payment form. If these forms are actuarially equivalent to a single life annuity, the plan actuary typically only reflects the single life annuity in the valuation of benefits since payment form does not affect the present value of the benefit. However, the joint & survivor payments are

smaller and paid over a longer period of time. Consequently, these forms increase the plan's duration and would need to be reflected under a duration-matching approach, such as the yield curve. This complexity applies to all forms of payment, including even more complicated payouts such as level income options where a significant amount of the benefit is paid in the initial years.

In addition, it is rare to complete the sort of duration-related calculation contemplated by the Proposal. Despite the Administration's claims, our members disagree that this approach is a well-established financial accounting "best practice."

Along with additional complexity comes additional cost. Since a yield curve approach is generally not used for any other purpose, the Proposal requires more calculations than current law imposes. Moreover, the individual calculations involved will require an enormous expenditure of resources to perform plan data testing on an individual by individual basis and to repeat that labor intensive process often.

Consequently, plan sponsors cannot implement a yield curve rate without substantially modifying the method used to calculate the pension liability.

#### ***C. The Proposal Adds Volatility to the Pension Funding Requirements***

The Administration's Proposal eliminates 4-year averaging. Therefore, changes in current spot rates as well as the shape of the yield curve will affect the calculation of liability. Thus, it will be more difficult to forecast funding requirements.

The Administration has subsequently suggested a 90-day smoothing of the yield curve rate. This is not enough time to create predictability. Over a 90-day period, market rates remain fairly volatile. Plan sponsors generally project their funding requirements over several years and would like to have certainty about their funding requirements over that period of time.

#### ***D. A Yield Curve for Lump Sums Benefits is Confusing***

Participants will not understand their lump sum calculation or be able to predict the amount to be paid at separation because different rates would apply to different participants. The interest rate for determining a lump sum payment (or annuity from an account based plan) will move up or down with the market as well as with the shape of the shifting yield curve. Many participants are not familiar with a yield curve and will not understand the changes from year to year.

Furthermore, different lump sum factors already apply at different ages due to mortality differences. The yield curve will add another factor making the differences between ages even larger. We have estimated the impact of the proposals on lump sum benefit payments (after a phase-in period) using the Administration's Proposal, and the June 30, 2003 Salomon Brothers Pension Discount Curve and 30-year Treasury benchmark rate. As shown in the following table, lump sum benefits for retirees may decrease modestly, while lump sums for deferred vested participants would decrease more substantially.

Age	Retirees (Immediate Annuities)				Deferred Vesteds (Deferred Annuities)			
	65	62	60	55	50	45	40	35
Ratio of Yield Curve Approach to Current 30-year Treasury Rate Method	98%	97%	97%	95%	76%	70%	66%	62%

The U.S. Chamber strongly supports the permanent resolution in H.R. 1776, as it was introduced, but we recognize that compromise was necessary in the context of the Ways and Means Committee mark-up. We will continue to work with the Administration and the Hill to resolve this issue before the temporary remedy expires.

### III. The Yield Curve Approach Requires Further Study

#### A. *Advantages of Modeling Pension Liabilities Using a Yield Curve Are Unproven and Subject to Question*

The Administration's yield curve proposal seeks to require all plans, no matter how dissimilar, to report liabilities based upon the aggregate present value of all individual liabilities over the projected individual benefit distribution periods using an index, the yield curve, that changes virtually every day and differs based upon the expected duration of each individual's expected payments. This burdensome new approach is justified as providing the PBGC, investors in the financial markets and others with a consistent and up-to-date measure of the present value of the plan liabilities that have been assumed by the plan sponsor as of any date.

An unstated assumption behind this proposal is that the benefits of a standardized view of plan liabilities will be worth the enormous effort and cost of complying with the new record keeping and reporting required to produce this data. It is assumed that it is self evident that the PBGC and participants in the financial markets will make good use of this new information in modeling the impact of plan obligations on the financial condition of plan sponsors.

Some financial models currently use yield curves to measure various non-pension liabilities. We do not question that there have been recent expressions of interest in the use of yield curve data to improve liability modeling. In fact, some ground breaking theoretical studies have been performed in the United Kingdom in the last decade<sup>1</sup> that suggest that the modeling process that is being suggested for use in measuring pension obligations (usually referred to under the general Dynamic Financial Analysis of “DFA”) will benefit greatly from more objective data to reduce the dependence of the calculations involved in the modeling process on other unknown or random factors. These theoreticians have offered models that they claim improve on DFA models by bringing to bearing the approaches to random event predictions that were developed early in the past century by the Russian theorist Markov and were brought to development in Eastern Europe in the last half of the 20th century (generally referred to as Stochastic models, based upon the Greek word that mathematicians use to refer to “randomness,” but is literally translated as “pertaining to chance”).

One problem with the wholesale legislative imposition of the use of the yield curve as a technique for improving these sophisticated modeling approaches is that there is a serious unresolved debate whether existing yield curve data can adequately fulfill this function. For example, one critic has reported that yield curves offer only a “Band Aid” approach that could conceivably make liability estimation models more reliable, but that yield curve data that is not carefully constructed will make estimates less, not more, reliable.<sup>2</sup> This critic has also suggested that even the most well constructed yield curve data sets will only address a symptom of an otherwise internally inconsistent model.<sup>3</sup> These criticisms are particularly apt since the literature about the currently available yield curve data sets suggests that the data that would be used under the Administration’s Proposal may suffer from some of the inadequacy that sparked these expressions of concern.<sup>4</sup>

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<sup>1</sup> E.g., Andrew J.G. Cairns, *Pension Funding in a Stochastic Environment: The Role of Objectives in Selecting An Asset Allocation Strategy*, 1 Proceedings of the 5<sup>th</sup> AFIR International Symposium 429-53 (Brussels 1995), available at [www.ma.hw.ac.uk/~andrewc/papers/ajgc2.pdf](http://www.ma.hw.ac.uk/~andrewc/papers/ajgc2.pdf).

<sup>2</sup> Don Mango, *Structural Dependence and Stochastic Processes*, American Re-Insurance 2001 Casualty Actuarial Society DFA Seminar, available at [www.casact.org/coneduc/dfa/2001/handouts/mango1.ppt](http://www.casact.org/coneduc/dfa/2001/handouts/mango1.ppt) [hereinafter *Mango*]. For a similar criticism of the use of yield curves in certain liability models, see Peter Blum, Michel Dacorogna & Paul Embrechts, *Putting the Power of Modern Applied Stochastics into DFA*, 2001 Casualty Actuarial Society DFA Seminar, available at [www.casact.org/coneduc/dfa/2001/handouts/blum1.ppt](http://www.casact.org/coneduc/dfa/2001/handouts/blum1.ppt).

<sup>3</sup> *Mango*, *supra* note 2.

<sup>4</sup> The Society of Actuaries sponsored a study that included a critical assessment of yield curve and other alternative indices. Victor Modugno, *30-Year Treasury Rates and defined Benefit Pension Plans* (SOA 2001), available at [www.soa.org/sections/dbpp.pdf](http://www.soa.org/sections/dbpp.pdf).

In light of the enormous and costly new burdens of the yield curve methodology recommended by the Administration, the U.S. Chamber believes prudence dictates that the approach be thoroughly studied before any effort is made to impose such a methodology. Moreover, the study should evaluate the burdens and costs of the proposed methodology and examine critically the assertions that the PBGC and the financial markets will be able to make meaningful use of the data generated by all these new proposed efforts and expenditures and should offer conclusions about the balancing of the benefits and burdens.

***B. There is not a Single “Right” Interest Rate.***

We do not believe there is a single right interest rate for measuring plan liabilities. There is a range of acceptable interest rates that should be considered in the context of other assumptions such as mortality, terminations and retirement rates. If plan sponsors were purchasing annuities to settle the liabilities in their plans, there would not be a single quoted amount. Rather, each insurer asked would have its own pricing structure and produce a different liability.

***C. Cash Balance Plans Require Further Consideration.***

Many plan sponsors have account-based plans where interest is credited at the lump sum rate (or deemed equivalent rate in accordance with Notice 90-11). It is not clear how a yield curve would interact with these plans – particularly with regard to whipsaw issues. The Administration has not yet addressed how the yield curve rate would apply to cash balance plans. It makes no sense to adopt a yield curve approach now when its application is uncertain, is subject to future reform proposals and is known to be incompatible with other Code provisions. In the meantime, we can not accept a delay in interest rate relief while these issues are decided.

The Administration has suggested that additional changes will be forthcoming that will add “incentives for more consistent annual funding requirements.” A representative from the PBGC suggested it is most appropriate to measure the liability accurately, eliminating smoothing techniques at the front-end, and then develop appropriate smoothing in the required funding calculation. We suggest the yield curve portion of the proposal should be deferred until these smoothing approaches are discussed, evaluated and agreed to by all parties.

**IV. The Current Contribution Deduction Rules are a Detriment to the Defined Benefit Plan System**

Currently, plans sponsors are limited by the Code as to the amount of contributions that they may make to a plan in any single year. A plan sponsor may not contribute more than the full funding limit to the plan. If a plan sponsor does make a

contribution that exceeds the full funding limit, the sponsor is subject to an excise tax. The excise tax is equal to 10 percent of the nondeductible contribution. Thus, when employers are profitable and have the means to make additional contributions, they are not only discouraged but also penalized for doing so. Obviously, such a policy contravenes the vitality of the defined benefit plan system. The U.S. Chamber strongly believes that any future pension reform must consider an increase to the deduction limitations.

## **V. New Pension Plan Disclosure Obligations**

### ***A. ERISA Section 4044 Termination Liability Calculations***

The Administration's approach would require the annual preparation of ERISA Section 4044 allocation calculations. There would be significant additional cost in developing annual calculations of plan liabilities in the event of a hypothetical plan termination. These calculations involve layered tiers of calculations that require careful allocations among different, ever-changing groups of employees based upon their service, their age and numerous other benefit formula related factors. These calculations are among the most burdensome and costly procedures a plan can ever endure. Moreover, in addition to enormous costs for outside services, the calculation is labor-intensive and time-consuming for the plan administrator who will be required to perform annual exhaustive record keeping regarding all of the information that goes into the calculation.

Currently, such calculations are usually required only in the event of a plan termination. Because the burdens of such calculations are so great, Treasury regulations expressly permit plan spin-offs or mergers without the actual performance of such calculations as long as the plan sponsor maintains the capability to perform such calculations for a period of years after the spin-off or merger.

Annual termination calculations would not provide relevant information in the majority of cases. In addition, this information would unduly alarm plan participants. A well-funded plan is not expected to be 100% funded on a termination liability basis. Should participants be concerned if the plan is "only" 80% funded or even 60% funded on a plan termination basis? Participants would be provided an implied funding target that plan sponsors are not expected to meet and may not be able to make deductible contributions up to since ongoing plans are not funded on a termination basis.

Furthermore, this information may not reflect a current picture because it will be difficult to provide these calculations on a timely basis to participants. If the termination liability is presented in the Summary Annual Report, it will likely be representative of the plan's funded status almost two years previously. That is, a Summary Annual Report issued in October 2003 would most commonly report liabilities as of January 1, 2002. Due to interest rate and asset swings, termination liability estimates become "stale" very quickly.

***B. Public Release of ERISA Section 4010 Information***

The value of public disclosure of ERISA Section 4010 filing information is not readily apparent. Private companies are already very concerned under the current rules that information that they supply to the PBGC will become public. As applied to private companies, this proposal will seem to them as a first step towards their private financial information becoming public.

Moreover, the Section 4010 filing requirement is currently flawed in that it uses a fixed dollar threshold of \$50 million underfunding. In the current low interest rate environment, most every large employer plan has a good chance of being required to make this filing even if it is nearly fully funded. This proposal perpetuates and magnifies this anomaly.

**V. PBGC Funding Issues**

***A. Reform of the Rules for PBGC Premium Calculations***

The state of the PBGC is a concern to all parties involved in the defined benefit plan system. The U.S. Chamber has a proven track record supporting termination insurance rules (including variable rate premiums) that combat the unreasonable shifting of defined benefit sponsorship obligations from troubled companies to the PBGC and other termination insurance premium payers. However, it is important that plan sponsors that maintain healthy and viable plans are not penalized unnecessarily.

The PBGC has alluded to further changes to the existing risk-based premium schedules. Without the details of such a proposal, we cannot determine the impact of such a change. We are concerned, however, about the definition of “risk” particularly as it applies to small businesses and privately-held companies. Such companies do not easily fit into the credit rating system used for publicly-traded companies and, thus, may be unduly biased if premiums depend upon that system.

***B. Restrictions on Benefit Improvements in Troubled Plans***

While the criterion offered in the Administration’s Proposal for determining which companies may pose a threat to the termination insurance program seems reasonable, as with any cliff type threshold, it may trigger overly harsh consequences for plans that are close to or just over the threshold. Although additional restrictions on the ability of troubled companies to create insured benefit accruals may be appropriate, the proposal would accomplish this through a direct restraint on the ability of companies to freely contract with their employees and their representatives. Although it is certainly appropriate to deny termination insurance protection to irresponsible pre-bankruptcy benefit accruals, directly restraining the ability of private parties to make contract arrangements is troubling. Moreover, troubled companies may not always present a

financial risk to the termination insurance system. Whatever restrictions are imposed, the PBGC should permit retroactive benefit accruals when the company regains its financial health.

In addition, this part of the Administration's Proposal is likely to create timing issues. For example, if a plan's funding level falls below 50% for the January 1, 2004 valuation, it is not clear when benefit accruals should be frozen. Should accruals be frozen as of January 1, 2004, which is likely to be at least 6 months before the plan sponsor discovered that the plan's funding level was below 50%? Or, should accruals be frozen as of January 1, 2005 when (1) the 2004 funding calculations may still not be completed or (2) the plans funded status may have increased significantly to a percentage greater than 50?

## **VI. Conclusion**

At this time, the defined benefit system needs an immediate, rational replacement to the 30-year Treasury rate. The yield curve is not an immediate fix and there are not enough details to determine if it is rational. The composite corporate bond rate is a rational replacement that can be implemented immediately.

The U.S. Chamber is committed to the continued dialogue on all funding issues and looks forward to the continued participation of the Council in these discussions.