

IMPROVE THE ACCURACY OF PENSION LIABILITY MEASURES

Current Law

Defined benefit pension plans are subject to minimum funding requirements and limits on maximum deductible contributions. In the case of a single-employer defined benefit plan maintained by an employer who has more than 100 employees participating under defined benefit plans sponsored by that employer, the minimum funding requirements established under ERISA are supplemented by a deficit reduction contribution.

The deficit reduction contribution is based on the plan's current liability. For plan years beginning in 2004, current liability is required to be calculated using an interest rate that is within 90-105 percent of the weighted average of the rate of interest on 30-year Treasury securities, where the average is determined for the 48 months ending with the month preceding the first day of the plan year. Current liability is calculated using a statutorily specified mortality table.

Current liability is also relevant in determining the maximum deductible contribution to a defined benefit pension plan. Under section 401(a)(1)(D), an employer's contributions to a defined benefit plan do not exceed the maximum deductible amount so long as they are less than the amount necessary to bring the plan's assets up to the current liability (determined without regard to plan amendments made in the last 2 years in the case of a plan which has 100 or fewer participants for the plan year).

Under section 401(a)(29), an employer sponsoring a single employer plan with assets less than 60 percent of current liability (determined without regard to the unamortized portion of pre-1989 unfunded current liability) that amends the plan to increase benefits is required to post security before the plan amendment can take effect. The amount of the security is the excess of the assets needed to increase the plan's funded current liability percentage to 60 percent (or, if less, the amount of increases in current liability attributable to all post-1988 benefit increases) over \$10 million.

Under section 401(a)(33), an amendment to a defined benefit plan sponsored by an employer in bankruptcy improving the benefits under the plan generally may not be made effective until the reorganization is complete. Under section 412(f), if an employer has an outstanding minimum funding waiver for a defined benefit plan, the plan generally may not be amended to improve benefits until the waiver is fully amortized.

In the case of a distribution of a lump sum (and certain other benefit forms that do not provide for lifetime payments), the amount of the distribution must be no less than the amount determined using a statutorily specified interest rate and mortality table. The interest rate is the average of the rate of interest on 30-year Treasury securities for the month preceding the distribution or, in accordance with regulations, at some earlier time as established under the plan.

Reasons for Change

Interest rates used for determining an employer's pension funding obligations should accurately

reflect the cost of settling its pension liability. Changes in the financial markets have fundamentally altered the relationship between the interest rate on the 30-year Treasury bond and interest rates on other fixed income securities. As a result of those changes, while 105 percent of the interest rate on 30-year Treasury securities may have been an appropriate interest rate to be used in discounting pension liabilities in the past, this is no longer the case today. The continued use of 105 percent of the interest rate on 30-year Treasury securities overstates the cost of settling an employer's pension liability. This in turn dramatically increases the funding requirements for sponsors of many plans at a critical phase in the economic expansion.

The interest rates used for current liability purposes should be based on market-determined interest rates for similar obligations. An employer's pension promise need not be quite as secure as the full faith and credit guaranty of the Treasury security, but should be as safe as a high-quality corporate bond. Accordingly, the interest rates for determining current liability should be based on interest rates on high-quality corporate bonds.

The interest rates used to determine current liability should also reflect the timing of future benefit payments under the plan. To the extent that a plan will be making the bulk of its benefit payments in the next few years, the interest rates used to discount those payments should be the market yields for shorter-term bonds. Conversely, to the extent a plan will be making most of its payments far into the future, it is appropriate to use longer-term yields to discount those payments. These steps would improve the accuracy of the liability measurement.

The interest rates used to determine pension liabilities should reflect current market conditions, rather than the potentially stale interest rates of 2 years ago. Any smoothing in interest rates should be just sufficient to reduce short term market volatility without reducing measurement accuracy. Calculations of pension liability using current market conditions would enable plan sponsors to make a realistic assessment of their plans' funded status.

The current use of the rate of interest on 30-year Treasury securities for purposes of determining lump sums creates a mismatch between the amount of an employee's lump sum and the value of the annuity that the employee would otherwise receive. This mismatch may create an incentive for retirees to select one form of benefit payment (a lump sum) rather than an annuity. Changing the interest rate used to determine lump sums to market-determined interest rates that reflect the timing of expected benefit payments would remove this bias and ensure that the amount of the lump sum is the same as the value of the annuity. Any such change should provide a transition period, so that employees who are expecting to retire in the near future are not subject to an abrupt change in the amount of their lump sums as a result of changes in law.

Proposal

For plan years beginning in 2004 and 2005, current liability would be determined using a weighted average of the yields on high-quality long-term corporate bonds. The average would be determined for the 48 months ending with the month preceding the first day of the plan year.

Beginning in 2008, current liability would be determined using a series of interest rates drawn from a yield curve of high-quality zero-coupon bonds with various maturities. The maturities would be selected to match the amounts and timing of when benefit payments are expected to be

made from the plan. The yield curve would be issued monthly by the Secretary of Treasury and would be based on the 90-day average of interest rates for high quality corporate bonds.

For plan years beginning in 2006 and 2007, current liability would be determined as the weighted average of the value of the current liability determined using the methodology applicable to 2004 and 2005 and the value of the current liability determined using the methodology applicable to 2008 and beyond. For 2006, the weighting factor would be 2/3 for the “old” methodology and 1/3 for the new methodology; and for 2007, the weighting factors would be reversed.

For plan years beginning in 2004 and 2005, there would be no change in the law relating to determination of lump sums from defined benefit plans. However, beginning in 2008, lump sum calculations would also be calculated using rates drawn from the zero-coupon corporate bond yield curve. Thus, the interest rate that would apply would depend on how many years in the future a participant’s annuity payment will be made. Typically, a higher interest rate would apply for payments made further out in the future.

For distributions in 2006 and 2007, lump sum calculations would be determined as the weighted average of the value of the lump sum determined using current law and the value of the current liability determined using the methodology applicable to 2008 and beyond. For 2006, the weighting factor would be 2/3 for the “old” methodology and 1/3 for the new methodology; and for 2007, the weighting factors would be reversed.

If a plan sponsored by an employer with a below investment grade credit rating has assets less than 50 percent of termination liability, the plan would be required to be frozen (i.e., no additional accruals would be permitted), but service would continue to be earned for purposes of vesting and eligibility for benefits. In addition, such a plan would be required to suspend lump sums (and other forms of accelerated benefit payments, including the purchase of annuities).

The proposal generally would be effective for plan years beginning in 2004. The requirement for a freeze of accruals and the suspension of lump sums for a plan that is funded less than 50 percent of termination liability that is sponsored by an employer with a below investment grade credit rating would be effective for plan years beginning in 2005.

Revenue Estimate

Fiscal Years							
2004	2005	2006	2007	2008	2009	2005-09	2005-14
(\$'s in millions)							
8,537	12,297	7,340	3,042	-1,586	-5,467	15,626	-15,869