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CONCERNS REGARDING SPOT VALUATIONS AND BACK–END SMOOTHING

This paper discusses the critical need for predictability with respect to the application of the defined benefit funding rules and why proposals to use spot valuations of interest rates and assets lead to unmanageable unpredictability. The paper then discusses why "back-end smoothing" proposals will not adequately address the need for predictability. The paper also includes a section that shows, based on historical data, that spot valuations are not accurate.

Background

One of the major defined benefit plan funding issues is the need for predictability with respect to the sponsoring employers' costs and obligations. Businesses need to be able to plan ahead. A company that can foresee significant pension plan expenses can budget for those expenses. On the other hand, if a company might face large unpredictable pension plan expenses, it is difficult for the company to commit scarce resources to the non-plan investments necessary to grow the company's business and create jobs.

There are features of current law that are helpful in improving the predictability of defined benefit plan expenses. These features are often referred to as "smoothing" rules. Two particular smoothing rules have been highlighted in the recent discussions of defined benefit plan funding.

Asset smoothing. The law permits the valuation of a defined benefit plan's assets to be "smoothed." See Treasury Regulation §1.412(c)(2)-1. Generally, the regulation permits a plan to use any asset valuation method that is based on fair market value (or average value, which is generally based on historical fair market values) and that meets the following requirements. In general, the method (1) must be consistently applied, (2) must not be designed so as to result in an artificially high or low valuation, and (3) must result in a value that is between 80% and 120% of fair market value (or within a smaller corridor around average value). As stated in the Treasury Regulations, the purpose of this rule:

> is to permit use of reasonable actuarial valuation methods designed to mitigate short-run changes in the fair market value of plan assets. The funding [rules]… are generally based on the assumption that the defined benefit plan will be continued by the employer. Thus, short-run changes in the value of plan assets presumably will offset one another in the long term. Accordingly, … it is generally not necessary to recognize fully each change in fair market value of the assets in the period in which it occurs.

Liability smoothing. Very generally, there are two sets of liability valuations performed with respect to defined benefit plans. One is the determination of current liability. For this purpose, there is a prescribed interest rate rule; in 2005, the interest rate must be at least 90% but not more than 100% of the four-year weighted average of the high-quality long-term corporate bond rate. The four-year averaging smoothes out interest rate fluctuations and allows significant predictability.

Liability valuations are also required with respect to the "ERISA funding rules" (i.e., the rules other than the deficit reduction contribution rules). For this purpose, the plan's actuary is required to use a reasonable interest rate; the actuary is not required to adjust this rate in response to fluctuations in current conditions as long as the rate continues to be reasonable and reflect the best estimate of anticipated experience under the plan. Thus, the rules permit plans to avoid volatility for this purpose.

Administration's proposal.

The Administration has proposed eliminating all smoothing with respect to asset valuation. The Administration's proposal would eliminate substantially all interest rate smoothing by reducing the four-year averaging period to 90 business days (and by repealing the ERISA funding rules).

The proposal would make funding obligations extremely unpredictable. Under the proposal, it would not be uncommon for a plan's funded status to change by, for example, 10% during the last few months of a year, creating huge unexpected changes in funding obligations. Thus, a plan that has been 100% funded for an extended period can become 90% in a short period of time, triggering a very substantial funding obligation.

This type of unpredictability would drive large numbers of companies out of the defined benefit plan system, which would not only severely hurt PBGC, but would also undermine retirement security.

Back-end smoothing.

Some commentators have suggested following the Administration's proposal with respect to spot valuations but addressing the unpredictability issue by smoothing contribution obligations ("back-end smoothing"). The primary purpose of this paper is to discuss why such suggestions should not be followed.

Predictability versus volatility. Some of the back-end smoothing proposals have confused predictability and volatility. These proposals would limit the amount by which a contribution can change from one year to another year. The maximum change would be a large but manageable number.

These proposals address volatility, i.e., the extent to which contributions can vary from one year to the next. They do not address predictability. For example, assume that a company made a $9 million required contribution for year 1, but reasonably projects that it will have to make no more than a \$6 million contribution for year 2. In the last few months before the valuation date for year 2, interest rates and asset values fall. Under the Administration's spot valuation approach, the company's funding obligation could increase enormously to, for example, \$15 million. Assume further that the back-end smoothing proposals would limit that obligation to \$12 million (a 33% increase over the prior year). A \$12 million contribution requirement would arguably not be volatile because it is only 33% above the prior year's required contribution, but it would be very unexpected. And it would be a 100% increase over the projected obligation. That is exactly the type of unpredictability that is driving companies out of the defined benefit plan system.

Spot valuations are not accurate. The reason given for favoring back-end smoothing is that it is important to have accurate upfront measurements of funded status. The argument is made that spot valuations are accurate. This is not true, as shown by historical data.

The accuracy argument is that the 90-business-day average of interest rates at the end of year 1 is "the" accurate measure of interest rates for the following 12 months. This makes very little sense. Interest rates change from month to month. The chances that 90-day period will be an accurate predictor of the following 12 months are actually very low.

Historically out of the last 20 years, there has not been a single instance where the Administration's 90-business-day average would have accurately predicted the average of the next calendar year's interest rates within 10 basis points. In fact, there have only been three instances where the proposal would have predicted the average of the next year's rates within 25 basis points. Moreover, in half of the last 20 years, the prediction would have been wrong by more than 50 basis points. Thus, based on empirical evidence, it is overwhelmingly likely that the Administration's proposal will not result in accurate valuations in any sense.

Effective predictability. Even though spot valuations are not accurate and thus there is no reason to use them, this paper assumes for purposes of discussion that spot valuations are to be used, creating a need for back-end smoothing. The next question is whether one could design a back-end smoothing rule that provides the same level of predictability as the front-end smoothing rules under current law.

Assume for simplicity that as of August 31, 2010, the applicable discount rate used for funding purposes to determine plan liabilities has been 6% for 3 years and 8 months. For the last 4 months of 2010, the rate is 5.6% (a drop of .4% being a not uncommon change). Assume further that a plan has been 100% funded based on the 6% interest rate. Based on a 5.6% interest rate, the plan would be 94% funded, which would trigger a substantial funding obligation.

Under the present law smoothing rules, the .4% fall in interest rates would be gradually recognized. Thus, as of January 1, 2011, the four-year weighted average of the interest rate would be 5.95%, resulting in a funded level of approximately 99.25%. Accordingly, under current law, a company in this situation would be able to foresee that for 2011 the company can devote significant resources to creating jobs and growing the business, because any pension funding obligation will be very small. Accordingly, any effective back-end smoothing rule would need to provide that company with the same assurance by ensuring that contribution obligations are determined as if the plan were above 99% funded.

We are not aware of any back-end smoothing proposal that would systematically provide plans with that same level of predictability. It is certainly theoretically possible to design such a rule, but it would likely be very complex and would end up simply duplicating the current-law smoothing rules in an indirect and much more complicated way. Our fear is that a much simpler and less effective back-end smoothing rule will be suggested. <u>Accordingly, we believe that it is critical that any suggested back-end smoothing idea be tested in a very specific way – based on facts like those described above - to ensure that it fully addresses the critical need for predictability.</u>

<u>Need to smooth many rules.</u> The current law front-end smoothing rules provide much-needed predictability with respect to a broad array of rules. Numerous important rules turn on a plan's funded status and it is critical that the effect of each of these rules be at least as predictable as under current law.

For example, under both current law and the Administration's proposal, the deduction limit with respect to plan contributions turns on a plan's funded status. If a plan's funded status is unpredictable, a company will not be able to predict what contributions can be made on a deductible basis, again undermining a significant planning need. Accordingly, a separate back-end smoothing rule will be needed to address the deduction rules and will need to be carefully crafted to ensure the same level of predictability as under current law.

All of the benefit restrictions under both current law and the Administration's proposal (such as the restriction on benefit increases for plans that are 80% or less funded) turn on a plan's funded status. It is critical that the application of these restrictions be foreseeable, yet there has been no proposal to apply back-end smoothing to these rules.

Without being comprehensive, other important rules that turn on funded status and that need to be predictable include (1) the application of the quarterly contribution rules, (2) the ability to make section 420 transfers to pay for retiree health expenses, and (3) as discussed in more detail below, application of the variable rate premium.

Under current law, the application of the variable rate premium ("VRP") is based on a spot interest rate and is scheduled to become based on a spot asset valuation. This creates some problems today, but it is manageable because of an appropriate exception from the application of the VRP. The Administration would apparently eliminate that exception and greatly expand the application of the VRP. This would dramatically increase the need for a smoothing rule for this purpose.

For example, today, many large companies fund at whatever level is necessary to avoid the VRP (using the VRP exception); the companies do that because the VRP is, from a company perspective, wasted money that should be used for participants. If the VRP exception is eliminated and the companies want to avoid the VRP, they will need a predictable target. The spot valuation system, under which a plan can go from 100% funded to 90% funded in a very short period, does not provide that needed predictability. In fact, for plans that fund to avoid the VRP, the spot valuation system can create enormous and unpredictable funding needs since those companies would have to fund the entire shortfall (10% in the above example), not just an amortized portion of it.

In short, the need for a back-end smoothing rule with respect to the application of the VRP is acute.

Conclusion. For companies, the need for predictability related to funding is critical. Thus, it is imperative that any back-end smoothing proposal be carefully evaluated in the context of every relevant rule, not just contribution obligations. It is also important that the predictability achieved by any such proposal be specifically compared to the predictability under current law. It is theoretically possible to design an extremely long and complicated set of rules that would satisfy these criteria. But in the end one would be left with inaccurate spot valuations and exceedingly complex rules, with no policy progress at all. And the far greater threat is that the back-end smoothing rules would create less predictability than under present law and that accordingly, companies would leave the defined benefit plan system in droves.