October 4, 2005

RE: PBGC’s Interest Rate Assumptions

Dear Senator:

As the Senate moves toward consideration of pension funding legislation, it is crucial to keep in mind how different assumptions about interest rates and other factors can dramatically skew the perspective of the funded status of the Pension Benefit Guaranty Corporation (PBGC) and employer-sponsored pension plans.

Yesterday, in a communication to you, the American Benefits Council cited a study1 we commissioned, prepared by former officials of the Joint Committee on Taxation, that examines how the PBGC’s use of abnormally low interest rates in calculating the pension obligations for the plans it has taken over artificially inflates the size of its own deficit. Along the very same lines, an October 3, 2005 New York Times article exposes how the PBGC’s choice of interest rate assumptions also inflates the supposed underfunding of plans that the PBGC has not taken over, such as the plans sponsored by General Motors and other companies.

According to the article, PBGC asserts that GM would have a $31 billion shortfall if the company terminated its plans today. However, the PBGC did not reveal any of the assumptions underlying its estimates. These assumptions are critical to understanding how and why the PBGC reached its conclusion. The calculation of the present value of defined benefit pension plan liabilities is extremely sensitive to the assumptions used, including the interest rates. Even small changes in the interest rate can have huge effects on the plan’s perceived liabilities.

The PBGC’s generally accepted termination assumptions – which presumably were applied to the GM plans – greatly and inappropriately inflate liabilities in ways that portray an unrealistic picture of a plan’s funded status and, regrettably, reduce retirees’ benefits when the agency takes over a plan. Yet

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PBGC makes its calculations about the ongoing plans sponsored by GM and other companies based on termination assumptions.

All of the stakeholders in the current pension reform debate, including the Bush Administration, acknowledge that the interest rate derived from 30-year Treasury bills, is an inappropriately low rate and must be replaced. Nonetheless, the PBGC’s termination interest rate is a full percentage point lower than even the discredited 30-year Treasury rate. Some have defended the PBGC’s use of a termination interest rate by asserting that it approximates the interest rate used by insurance companies in pricing annuities to satisfy the liabilities of terminating pension plans. A major flaw in that argument, however, is that the PBGC does not buy annuities to pay its obligations. Rather, the agency invests assets turned over to it and pays benefits from the assets as they come due.

The table at the bottom of this communication shows the dramatic change in apparent funded status when a plan is measured at PBGC termination interest rates. The illustrative plan is fully funded when measured using a spot corporate bond rate similar to that used in current and proposed funding legislation. Even using the 30-year Treasury rate, the plan is still 90 percent funded. However, using the PBGC termination interest rates, the plan appears to be only 83 percent funded. These results would be typical of many mature plans with a significant retiree population.

General Motors and the vast majority of other companies sponsoring defined benefit pension plans have done a tremendous job of keeping their plans well-funded during the difficult economic times of the last five years. As even the New York Times article noted, GM has contributed $56 billion to its plan over the past dozen years.

If Congress is to engage in a thoughtful and balanced discussion of pension funding reform, it is essential that lawmakers subject the PBGC to the same scrutiny about the assumptions the agency uses in making calculations – whether it is estimating its own deficit or the funded status of employer-sponsored plans – as it applies to the assumptions made by the companies that voluntarily sponsor America’s defined benefit pension plans.

Sincerely,

James A. Klein
President
Effect of PBGC Termination Interest Rates

The following table shows the dramatic change in apparent funded status when a plan is measured at PBGC termination interest rates. The illustrative plan is fully funded when measured using a corporate bond rate similar to that used in current and proposed funding legislation. However, using PBGC termination interest rates, the plan appears to be only 83 percent funded. These results would be typical of most mature plans with a significant inactive population.

<table>
<thead>
<tr>
<th>Basis</th>
<th>Date</th>
<th>Rate</th>
<th>Liability (hypothetical)</th>
<th>Assets (hypothetical)</th>
<th>Funded %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spot Corporate Bond Rate</td>
<td>08/01/2005</td>
<td>5.37%</td>
<td>$100</td>
<td>$100</td>
<td>100%</td>
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<tr>
<td>30-Year Treasury Rate</td>
<td>08/01/2005</td>
<td>4.41%</td>
<td>$111</td>
<td>$100</td>
<td>90%</td>
</tr>
<tr>
<td>PBGC Termination Rates</td>
<td>08/01/2005</td>
<td>3.4% for first 20 years, then 4.75%</td>
<td>$120</td>
<td>$100</td>
<td>83%</td>
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</tbody>
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