

PENSION POINTERS.....

PLEASE FORWARD TO THE LA FOR PENSIONS:

In the near future your office again will be asked to take a position on pension reform. The currently pending bills are the most significant reform bills since ERISA passed in 1974. The choices made in crafting a final bill will encourage employers to establish and maintain defined benefit pension plans – or will encourage them to avoid those plans. The bills also make significant changes to rules governing defined contribution plans.

To assist you in understanding this critical legislation, we will be sending you briefs on key issues in the bills. This brief examines whether the interest rate and asset values used to determine a plan's funded status should be averaged over time. Put it in a special folder so you will have it readily available when the time comes for your office to determine whether the bill will help, or hinder, pension coverage in the future.

AVERAGING & SMOOTHING AND THE MYTH OF ACCURACY

Pension funding reforms proposed by the Administration and included in the Senate bill (S. 1783) rely on an assessment of a pension plan's funded status that is based on a discount rate (interest rate) and asset values measured over a very short period of time. Reliance on short-term measuring periods raises five key questions:

- Does it provide a meaningful assessment of a pension plan's funded status?
- Will the plan sponsor be able to plan for upcoming contributions?
- Will required contributions follow a steady pattern over time or vary widely year-to-year?
- What will be the impact of the proposal during economic upturns and downturns?
- What will be the impact of the proposal on pension plan funding?

Present Law:

The current liability funding rules (which apply only when a plan is significantly or persistently underfunded) require calculation of a plan's liability using an interest rate that is between 90% and 100% of the average of the prescribed interest rate¹ for the previous four years, weighted 40%, 30%, 20% and 10% beginning with the most recent year. The value of the plan's assets may be smoothed over a period of up to five years so long as the resulting value is between 80% and 120% of the fair market value on the valuation date.

In the case of plans that are not significantly or persistently underfunded, present law permits use of reasonable long-term interest rate assumptions that reflect the plan's experience and reasonable expectations.

¹ The interest rate prescribed in the law has varied over the past several years. Through 2001 it was the 30-year Treasury bond rate. For 2002 and 2003 a rate up to 120% of the 30-year Treasury rate was allowed. For 2004 and 2005 a composite rate of long-term, high quality corporate bonds applied. In 2006, the law reverted to the 30-year Treasury bond. The bills would re-institute the corporate bond rate for 2006 and phase in a corporate bond yield curve in the future.

Pending Proposals:

- Administration: Calculate a pension plan's liability using the prescribed interest rate averaged over 90 days. Plan assets would be their market value as of a single day – the plan's valuation date.
 - House bill (H.R.2830): Calculate a pension plan's liability using an interest rate that represents the three-year average of the prescribed interest rate for the previous three years, weighted 50%, 35%, and 15% beginning with the most recent year. The value of plan assets may be smoothed over a period of up to three years so long as the resulting value is between 90% and 110% of the fair market value on the valuation date.
 - Senate bill (S.1783): Calculate a pension plan's liability using the prescribed interest rate averaged over the preceding 12 months. The value of plan assets could be smoothed over the preceding 12 months.
- These rules would apply to all plans, not just those that are significantly or persistently underfunded.

Discussion of the Key Questions:

- Meaningful Assessment: ALL of the pending proposals significantly reduce the averaging and smoothing available under present law. First, they completely eliminate long term, plan-specific assumptions from the law. Second, they reduce the time over which a short-term measure of the plan is taken. Third, they more closely tie asset values to point-in-time market values by reducing or eliminating the permissible corridor from this calculation. The Administration's proposal takes the most extreme approach.
 - A spot (or one-day) measure will reflect the liabilities and assets for that day only. But generally no actual plan transaction occurs on that date. By the time an actual plan transaction occurs, spot valuations are very out-of-date and, based on historical data, very inaccurate.
 - In a pension plan, benefits accrue gradually, and benefit payments, including lump sums, are spread out over long periods of time. Short-term measures are precise for the short periods involved – but do not provide a meaningful assessment of the plan, which exists for a much longer period.
- Planning for contributions: An employer must be able to include expected future contributions to the pension plan in its business plan in order also to manage the essential aspects of the business such as research and development, capital investment, hiring, and marketing. Under present law, an employer has some ability to predict future contributions because the employer will have much of the data that determines those contributions well in advance.
 - The only way to preserve predictability is to continue to provide advance data to employers through averaging and smoothing mechanisms.
- Stable contributions: A business cannot tolerate required contributions that vary widely from year to year, locking up too much of the employer's available cash "just in case." Short-term measures produce wide differences in calculations – and wide differences in funding requirements.
 - Providing generous averaging and smoothing provisions and allowing flexibility within corridors assist in maintaining stability in contributions year-to-year.
- Economic impact: During a recession, monetary authorities typically lower short-term interest rates causing bond yields to decline. Lower bond yields increase the calculation of pension liabilities. Under present law, these increases are phased in so that they do not have their primary impact just as a recession is deepening. Similarly, under present law, as the economy improves interest rates typically are increased and the resulting

lower calculations of pension liabilities also are phased in so that increased contributions continue as employers gain more cash. Without averaging and smoothing, companies would face cash calls from the pension plan just as they were struggling with the effects of the recession – deepening economic woes.

- For each extra dollar of pension contribution, business investment is reduced by 60-70 cents.² Lower investment spending has a multiplier effect on the GDP.
- If the Administration’s interest rate and asset proposals had been in effect from 2001-2003, in 2003 the economy would have lost 237,000 jobs. Instead, under present law, it added 93,000 jobs. Over the 2001-2003 period there would have been 585,000 fewer jobs.³
- **Plan funding:** If a pension plan has \$10 billion in assets and receives \$100 million contributions each year, at the end of five years the plan will have \$10.5 billion plus asset returns (setting aside distributions to keep the example simple). If a different \$10 billion plan receives contributions of \$200 million the first year, nothing the second year, \$300 million the third year, and nothing the fourth and fifth years, at the end of the five years it, too, will have \$1.5 billion plus asset returns – but the employer’s ability to run its business will have been impaired.
- A plan is more likely to meet a funding target through steady and stable contributions. Sharp gyrations in contributions due to the computation of a plan’s status though short-term, volatile measures produce nothing useful and can do great harm.

Conclusion:

It is clear from the above discussion that the averaging and smoothing provisions of the Administration proposal and the Senate bill produce negative answers to the five key questions.

- They do not provide a meaningful assessment of the funded status of a long-term obligation such as a pension plan.
- They do not allow employers to predict future contributions.
- They will inflict sharply gyrating cash calls on a sponsoring employer.
- They will worsen economic downturns and cost jobs at companies that sponsor pension plans.
- They will have no real impact, in the end, on pension funding.

But they could have a substantial impact on the ability of an employer to sponsor a pension plan.

Conferees should, at a minimum, provide three years’ averaging and smoothing as in the House bill. Here’s why:

Companies making business plans need to be able to make reasonable predictions regarding their funding obligations. Funding projections can be rendered inaccurate not merely because of unanticipated changes in interest rates but also because of unanticipated changes in asset values. Several analyses provided to date have focused exclusively on interest rates; these analyses only provide half of the needed information. Asset values must also be taken into account since they have a material impact on the minimum required contribution level; in fact, in certain cases, asset smoothing can be even more important than interest rate smoothing.

Picking a mid-point between the bills (e.g., two years) is not sufficient to overcome the problems outlined above.

² Joshua Rauh of the Graduate School of Business at the University of Chicago, “Investment and Financing Constraints: Evidence from Funding Corporate Pension Plans,” quoted in February 28, 2005, study for the Business Roundtable “Pension Smoothing Changes Would Worsen Job Losses in Recession.”

³ “Pension Smoothing Changes Would Worsen Job Losses in Recessions: An Analysis for the Business Roundtable Pension Reform Study Group.” Robert F. Wescott, Principal Investigator. Feb. 25, 2005.

It can be shown mathematically that two-year smoothing provides significantly less predictability than three-year smoothing, especially with respect to asset smoothing. Perversely, the most dramatic unpredicted swings in required contributions due to shortened averaging and smoothing periods occur in better funded plans that are just below their funding targets. This type of marked unpredictability results in a strong incentive for employers with well-funded plans to freeze or terminate those plans.

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