



AMERICAN BENEFITS COUNCIL

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RAISING REVENUE, REDUCING GOVERNMENT SPENDING AND SAVING JOBS BY RESOLVING A CONFLICT BETWEEN PENSION POLICY AND ECONOMIC POLICY

As discussed in more detail below, our national economic policy to keep interest rates low has resulted in artificially high pension plan funding obligations. This is putting unjustified pressures on American businesses. We propose to address this issue by permitting companies to use more stable and historically accurate interest rates in determining funding obligations.

Similarly, the current-law requirements to amortize long-term liabilities over seven years have created unmanageable volatility in funding requirements since the requirements have taken effect. It is critical that we benefit from the lessons of the past few years and modify the amortization rules to reflect the long-term nature of pension plan liabilities.

The proposal set forth below saves jobs and raises revenue, which makes its inclusion appropriate in either a jobs bill or a debt-reduction bill. Moreover, as explained at the end of this paper, the proposal would reduce billions of dollars in unnecessary government spending.

BACKGROUND

Interest rates. In order to address the critical challenges facing our economy, the government has made great efforts to keep interest rates at historically low levels. This is creating extraordinary pressures on pension plans and thus will not have the intended helpful effect on pension plan sponsors.

For pension funding purposes, plan liabilities are calculated by discounting projected future payments to a present value by using legally required interest rates based on corporate bonds: the lower the rate, the greater the liability. Thus, today's artificially low rates are triggering artificially high pension liabilities.

For example, in the case of a typical pension plan, the effective interest rate required by law has dropped by approximately 70 basis points from 2011 to 2012, which increases liabilities by approximately 10%. Thus, a plan with \$7 billion of liabilities a year ago would have \$7.7 billion of liabilities today. That translates into an additional funding shortfall of \$700 million. That in turn triggers a company obligation to make an additional contribution of approximately \$119 million per year for seven years. That \$119 million is not needed to pay benefits; that obligation is simply the result of artificially low interest rates that have no relationship to the plan's ability to pay long-term benefits.

On a national basis, preliminary indications are that, in large part due to the interest rate decline, required pension funding contributions for 2012 will be far greater than the amount required for prior years, unnecessarily diverting billions of dollars away from job retention and creation and from business investments. As discussed further below, reducing those pension contributions not only saves jobs, but increases tax revenue and decreases government spending by many billions of dollars.

Amortization periods. Under the Pension Protection Act of 2006 (the "PPA"), funding shortfalls are required to be amortized over seven years. In 2006, that appeared to be an appropriate amortization period. But the last few years have opened everyone's eyes to the dramatic volatility that is possible with respect to funding obligations and the markets. Seven-year amortization created unmanageable obligations following the 2008 downturn and is threatening to create even more unmanageable obligations for 2012 and subsequent years. If the PPA's amortization period has created multiple severe problems in just a few years, we need to learn from that. An increase in that amortization period is clearly warranted.

PROPOSAL

The proposal has two parts: an interest rate component and a modification of the current-law amortization period rules.

Interest rates. With respect to interest rates, we also need to learn from the lessons of the last few years. Economic conditions can change quickly, and interest rates are often maintained at very low levels during difficult economic periods. Under the current funding rules, that will mean that when we encounter a downturn in the economy, interest rates may well fall, exacerbating the problems for pension plan sponsors and undermining any economic recovery by unnecessarily diverting assets away from business investments. This does not make sense, especially since pension plan obligations are long-term obligations.

We need to move to a sounder system for setting interest rates. Why should obligations due over 50 years be calculated based on interest rate movements that may

be aberrational and/or attributable to governmental economic policy? It would make far more sense to base interest rates on a long-term period that is consistent with the long-term nature of pension liabilities. Accordingly, for all purposes other than PBGC premiums and valuing lump sum distributions payable to participants, we propose that beginning in 2012, plan liabilities would continue to be determined based on segment rates, which are based on the average interest rates over the preceding two years. However, under the proposal, any segment rate must be within 10% of the average of such segment rates for the 25-year period preceding the current year, thus ensuring that temporary interest rate fluctuations do not have an unjustified effect on funding obligations.

Amortization periods. Under the proposal, funding shortfalls would be amortized in two steps. First, the amount necessary to bring a plan to 80% funded would be amortized over the current-law seven-year period. Second, any other shortfalls would be amortized over 15 years. For example, assume that a plan has liabilities of \$100 million and assets valued at \$70 million. The \$10 million amount needed to bring the plan to the 80% funded level would be amortized over seven years. The remaining \$20 million shortfall would be amortized over 15 years. Subject to a narrow exception, this proposal would eliminate existing amortization bases and apply the new amortization system to plans' total shortfall in 2012.

We believe that this proposal strikes the right balance between (1) ensuring that plans that are less well funded improve their funded status quickly, and (2) reducing the funding volatility that has been created by the current seven-year amortization period.

BUDGET EFFECTS

As noted, this proposal would have very positive budget effects in the billions of dollars. First, during this period of low interest rates, basing funding interest rates on historical averages will reduce funding. (Correspondingly, during periods of high interest rates, this will increase funding.) Decreasing funding has, over the years, had two positive budget effects. First, it increases tax revenues by decreasing deductible contributions to a tax-exempt trust. Second, decreasing funding creates negative outlays on the spending side by increasing the variable rate premiums paid to the PBGC.

The proposal would also decrease government spending in a very significant manner. Generally, government contractors in the energy area are reimbursed for their pension contributions. In the defense area, new rules have just been adopted under which defense contractors will, subject to a phase-in period, generally be reimbursed for their full pension contributions. Thus, since the proposal reduces required funding contributions during this period of low interest rates, federal government spending would appear to be correspondingly reduced, likely by billions of dollars. The proposal

has been submitted for scoring by the Joint Tax Committee and the Congressional Budget Office.

Moreover, the government spending being reduced appears to be spending that is completely unnecessary in economic terms. There is widespread agreement that interest rates are being held artificially low to stimulate the economy. In this context, if contributions are made to pension plans based on the artificially low interest rates, and the plans become fully funded or close to fully funded based on such rates, those same plans will be vastly overfunded when interest rates return to normal levels. In fact, it is distinctly possible that many of the plans will be overfunded indefinitely, which means that the required contributions were wasteful.

The solution to the government spending issue is not to reduce government reimbursements. That would simply mean the government would be requiring government contractors to make completely unnecessary contributions. The solution is to correct the interest rates being used so that no one has to make completely unnecessary payments.

CONCLUSION

To maintain the current funding rules would be to ignore the painful lessons of the last few years. Interest rates are susceptible to artificial fluctuations that can hide the true value of pension liabilities. This can result in unnecessary expenditures by businesses and the government, slowing economic growth and leading to government waste. The proposal would address this conflict by preventing artificially low interest rates from slowing any economic recovery or creating unnecessary spending. In addition, short amortization periods for long-term liabilities can impose artificial pressures on businesses to divert assets away from productive use. It is critical that we solve these problems. Our proposal would do exactly that, as well as give American businesses the predictability they desperately need to make business plans.

The proposal set forth below has the dual appeal of saving jobs and raising revenue, which makes its inclusion appropriate in either a jobs bill or a debt-reduction bill.