



THE COMMITTEE ON INVESTMENT OF EMPLOYEE BENEFIT ASSETS

CIEBA of AFP Supports Changes to Pension Funding Discount Rate

ISSUE. Current law requires pension plan sponsors to use an interest rate based on the 30-year Treasury bond to calculate liabilities for minimum funding purposes, determine Pension Benefit Guaranty Corporation (PBGC) premiums and calculate lump sum distributions to retirees. For a variety of reasons, including the fact that the U.S. Government stopped issuing 30-year bonds in 2001, the longest Treasury bond rate is significantly lower than high-grade corporate bond rates. Currently, the spread between the longest Treasury bond and corporate bond rates is wider than historical market levels. As a result, many plan sponsors are required to make funding contributions in excess of what is needed to maintain retirement security for plan participants, to pay higher variable rate premiums to the Pension Benefit Guaranty Corporation (PBGC) and to pay out artificially inflated lump sums.

In recognition of the problems caused by the artificially low Treasury interest rate, Congress in 2002 enacted a *temporary* measure allowing plan sponsors to use a higher interest rate for calculating their funding obligations and PBGC premiums. This temporary measure is still based on the 30-year Treasury rate, but allows plan sponsors to use a broader range around that rate to calculate minimum funding requirements. The temporary provision expires at the end of 2003. If the temporary relief is allowed to expire without additional congressional action, plan sponsors will be forced to use the base 30-year Treasury rate creating even more distortion in funding and premium requirements. (While no new 30-year Treasury bonds are being issued, the Department of Treasury continues to publish a rate based on the remaining 30-year bonds.)

CIEBA POSITION. The Committee on Investment of Employee Benefit Assets (CIEBA) is the voice of the Association for Financial Professionals (AFP) on employee benefit plan asset management and investment issues. CIEBA members represent more than 115 of the country's largest pension plans. Members manage \$711 billion in defined benefit assets and \$441 billion in defined contribution plan assets on behalf of 16 million participants and beneficiaries.

CIEBA supports the ERISA Industry Committee's (ERIC) proposal to replace the 30-year Treasury bond rate with a composite corporate bond rate for funding and PBGC premium calculations. CIEBA also supports the ERIC proposal to phase-in use of the new interest rate for lump sum payouts. The ERIC proposal calls for using an average of four indices that consist of high quality, longer-term corporate bonds. While the proposal specifies the four indices to be used initially in establishing the composite rate, it also provides a procedure for replacing indices as necessary.



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RATIONALE/DISCOUNT RATE. CIEBA believes that public policy should foster the long-term viability of private sector defined benefit plans. These plans are a mainstay of retirement security for millions of American workers. Employers who offer defined benefit plans assume responsibility for funding those plans and bear the investment risks associated with providing guaranteed benefits to their workforce. Forcing plan sponsors to make unnecessarily large contributions or pay higher than necessary PBGC premiums significantly weakens employer support for these plans.

As the investment managers and fiduciaries for many of the nation's largest pension plans, CIEBA members support designating an interest rate for calculating pension plan liabilities that neither underestimates nor overestimates the minimum funding needed to assure retirement security for plan participants. The appropriate rate should mirror the rate of return on insurance company investment portfolios that are the basis for annuity pricing. The composite corporate bond rate proposed by ERIC is a practical way to approximate the returns on insurance company investment portfolios. Using a composite rate based on four broad, widely available corporate bond indices virtually eliminates any possibility of manipulation and fosters transparency.

Some would argue that using a rate based on corporate bonds is too conservative. They point out that, over time, equities have consistently outperformed bonds and that most pension plans have exposure to equities in their portfolios. However, using a rate based on stock indices alone or combined stock and bond indices could result in discount rates that are too high to assure adequate funding and/or increase volatility in funding requirements.

Others argue for continued use of the longest Treasury rate or other government bond rate. Interest rates on the longest Treasury bond are artificially low, for a variety of reasons, including scarcity. This scarcity was caused largely by the Treasury's decision to stop issuing 30-year bonds and the Treasury buyback of bonds in recent years. But, even if the Treasury were to resume issuing 30-year bonds, they should not be used to determine pension plan liabilities. The government will always have some advantage in borrowing because Treasury bonds enjoy the full faith and credit of the U. S. government. In addition, during the down legs of economic cycles, investors shift their exposure to "flight to quality" investments, including Treasury bonds. As a result, spreads between Treasuries and corporate bonds widen.

Over time, Treasury issues do not track the rate of return of a typical insurance company investment portfolio. According to the Academy of Actuaries' Pension Practice Council, "...regardless of how high or low Congress sets the current liability interest rate, the rate should be *determined* using a high quality, long-term corporate bond index...By contrast, any non-corporate-bond measure, such as a Treasury rate, would cease to accurately reflect corporate bond rates or annuity prices once the economic climate changes, even if the rate were appropriate when originally enacted."

RATIONALE/LUMP SUM INTEREST RATE. The interest rate used to calculate minimum lump sum payments and the rate used for minimum funding should be the same. Public policy should, at a minimum, promote a level playing field between lump sum payments and annuities that protect workers (and spouses) for their lifetimes. But, the use of a lower interest rate for lump sum calculations is a subsidy that makes lump sums more valuable than annuities. As such, workers are encouraged to take lump sum payouts, foregoing any spousal protection and leaving them vulnerable to the risk of outliving their resources.

The interest rate used for calculating lump sums also has implications for plan funding. If plans are required to use a lower interest rate for lump sums than the rate they use for funding calculations, plans will become less well funded over time.

CIEBA recognizes, however, that an abrupt change in the interest rate used to calculate lump sum payments could create a hardship for those closest to retirement who have planned on receiving a lump sum based on the 30-year Treasury rate. Therefore, CIEBA supports the proposal to phase-in the use of the composite rate for lump sum calculations over three years.

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The Committee on Investment of Employee Benefit Assets, better known as CIEBA, is the voice of the Association for Financial Professionals (AFP) on employee benefit plan asset management and investment issues. CIEBA is a nationally recognized forum for ERISA-governed corporate pension plan sponsors on fiduciary and investment matters. CIEBA members represent 115 of the nation's largest corporate pension funds, managing more than one trillion dollars in assets on behalf of sixteen million plan participants and beneficiaries. The Association for Financial Professionals in Bethesda, Maryland supports more than 14,000 individual members from a wide range of industries throughout all stages of their careers in various aspects of treasury and financial management. AFP is the preferred resource for financial professionals for continuing education, financial tools and publications, career development, certifications, research, representation to legislators and regulators, and the development of industry standards.

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