AMERICAN BENEFITS COUNCIL

PENSION INTEREST RATE REPLACEMENT:
A YIELD CURVE APPROACH RAISES MORE QUESTIONS THAN IT WOULD SOLVE

An alternative approach to replacing the 30-year rate that has been proposed by the Bush Administration would be to use a corporate bond yield curve as the new interest rate benchmark for valuing pension plan liabilities. Under this yield curve concept, the interest rate used for measuring the liability associated with a particular pension plan participant would be the interest rate on a bond with a duration equal to the period prior to the retirement date of that participant. The Council has a number of very significant concerns about a yield curve approach.

- **A Yield Curve Approach Raises More Questions Than It Would Solve.** The most serious threshold problem is that a yield curve concept is just that – a concept, an idea – and one that is highly controversial at that. It is not a formulated proposal for replacing the 30-year Treasury bond rate. For example, it is unclear how such a concept would apply to issues such as the determination of PBGC premium obligations, the precise calculation of lump sums, the payment of interest credits under hybrid pension plans and the valuation of contingent forms of distribution.

- **Increased Volatility Threatens Plan Sponsorship**. A yield curve approach to measuring pension plan liabilities would increase the volatility of these liabilities. Liabilities would become dependent not only on fluctuations in interest rates but also on changes in the shape of the yield curve (which occur when the rates on bonds of different durations move independent of one another) and on changes in the duration of plan liabilities (which can occur as a result of layoffs, acquisitions, divestitures, etc.). In addition, the Bush Administration would eliminate the so-called interest rate averaging technique embodied in present law, which allow employers to use the average of the relevant interest rate over several years in valuing liabilities. Elimination of averaging would further increase volatility. Yet volatility in pension obligations undermines employers' ability to predict and budget their costs and has already been one significant deterrent under current law to remaining in the defined benefit system. Clearly it would be counterproductive to aggravate this deterrent in a proposal designed to improve the health of the defined benefit system.

- **Technical Flaws Are Present In The Yield Curve Structure**. The markets for bonds of certain durations that would be utilized under a yield curve concept are very thin, with few such bonds being issued. As a result, single events – the bankruptcy of a single company unrelated to the plan sponsor, for example – can affect the rate of a given bond index dramatically and further aggravate the volatility of pension liability measurements.

- **The Yield Curve Presents Significant Complexity**. The yield curve approach would be significantly more complex than the current system. As a result, it will be much more difficult to explain to employer sponsors of plans, many of which already see the complexity of the system as a reason to abandon their defined benefit programs. For large employers with multiple defined benefit plans, complexity will be further increased since each plan will be required to use a different set of rates for measurement of its liabilities (since the duration of liabilities in each plan will differ). The complexity of the approach will also mean that employers must rely more heavily on sophisticated actuarial and software services, driving up the costs in an already expensive pension system. Such increased costs are detrimental to all employers but can be particularly daunting to small and mid-size employers where pension coverage rates are the lowest.

Some may wish to debate the theoretical merits of the yield curve concept and/or explore the many unanswered questions such a concept presents -- indeed the Council would be happy to be a part of such discussions. But the urgent need to replace the 30-year rate cannot await such academic deliberations. Plans and benefits are being frozen <u>today</u> and a replacement for the obsolete 30-year rate must likewise be enacted <u>today</u>.