FYI

Volume 26 / Issue 71 / October 20, 2003

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For Your Information

CONGRESS WORKING TO REPLACE 30-YEAR TREASURY RATE

Bills have been introduced in both the House and the Senate that would create a new benchmark rate for determining pension funding, PBGC premiums and lump sum benefit payments. The new temporary rate would be used in place of the interest rate on 30-year Treasury bonds until a permanent benchmark rate could be developed. The House passed its version, H.R. 3108, on October 8 and the focus now turns to the Senate.

BACKGROUND

Under current law, defined benefit pension plans must use a rate reflecting the yield on 30-year Treasury bonds for certain pension calculations. In February 2002, the Treasury announced that it would no longer issue 30-year bonds. The lack of new bonds, among other reasons, rendered the rate on 30-year Treasury bonds an inappropriate measure for pension purposes. As an interim substitute, the IRS mandated the use of a rate based on the yield on the 30-year Treasury bond maturing in February 2031 (the 30-year interim Treasury rate). The use of this substitute measure is slated to expire at the end of 2003.

In recent years, interest rates have hit historic lows. The low rates coupled with the fact that 30-year Treasury bonds are no longer being issued exaggerated the decline of the 30-year interim Treasury rate. This has led to inflated lump sum pension payments, and increased PBGC premiums and contributions to fund pension obligations. Also, the low interest rates along with depressed earnings on assets have created an underfunding crisis in employer-sponsored pension plans.

The Bush administration earlier this year proposed as a replacement for the 30-year interim Treasury rate, a yield curve based on highly-rated corporate bonds. A yield curve approach would result in different rates for plan sponsors based on the average number of years over which their benefit liabilities would be paid. Thus, in today's economic environment where discount rates are higher at longer durations, an employer with an older workforce would be required to make greater contributions to meet funding requirements. In addition to the administration's proposal, several bills have been introduced in Congress that include provisions for replacing the 30-year interim Treasury rate.

LEGISLATION

There are currently three key pieces of legislation in the House and Senate from which a replacement rate will likely emerge. A House bill (H.R. 3108) and two Senate bills (S. 1550 and S. 1971) all include provisions for replacing the 30-year interim Treasury rate. Note that S. 1971 was introduced during the prior session of Congress but only recently considered by the Senate Finance Committee. The number refers to the 107th Congress and the legislation has not yet been assigned a number in the current 108th session of Congress.

House Bill

H.R. 3108. On September 17, Representative John Boehner (R-OH), the Chairman of the House Education and Workforce Committee, along with a bipartisan group of supporters introduced H.R. 3108 – the Pension Funding Equity Act of 2003. H.R. 3108 would provide a temporary two-year replacement for the 30-year interim Treasury rate until Congress can evaluate and enact permanent and comprehensive funding reforms.

Under H.R. 3108, the temporary replacement rate would be a blend of corporate bond index rates to be determined by Treasury. Current liability would be calculated using an interest rate within a 90% – 100% corridor of the four-year weighted average of the replacement rate. PBGC variable premiums would be calculated by using the new corporate bond rate for the month preceding the start of the plan year. The bill does not indicate that there would be any change in using 85% of that rate for this purpose. However, lump sums would continue to be calculated as under current law (i.e., using the 30-year interim Treasury rate) for at least the next two years. The bill's provisions would expire on December 31, 2005. At that time, the interest rate would revert to a 90% – 105% corridor of the four-year weighted average of the 30-year interim Treasury rate.

On October 8, the House passed H.R. 3108 by an overwhelming majority (397-2). The action now turns to the Senate. The Senate may consider the bill as passed by the House, amend it or substitute one of the Senate bills discussed below.

Senate Bills

S. 1550. In July, Senator Judd Gregg (R-NH), the Chairman of the Senate Health, Education, Labor and Pensions (HELP) Committee, introduced S. 1550 – the Pension Stability Act. This bill would replace the 30-year interim Treasury rate with a composite corporate bond rate for five years starting in 2004. During this five-year period, a commission would be established to develop a permanent long-term solution to the pension funding crisis. Under the bill, for 2004 and 2005, plan sponsors would be able to determine their current

liability using an interest rate within a permissible range of 90% – 105% of the four-year weighted average of the composite corporate bond rate. The upper limit of the permissible range would drop to 100% for 2006 through 2008.

With respect to lump sum payments, the required interest rate would be the lower of the corporate bond rate or the 30-year interim Treasury rate, plus an applicable percentage of the excess of the corporate bond rate over the 30-year interim Treasury rate. The applicable percentage for 2004 and 2005 would be zero, increasing to 20% in 2006, 40% in 2007 and 60% in 2008. If no action is taken by Congress by the end of 2008, the rate for lump sums would revert to the 30-year interim Treasury rate.

S. 1971. On September 17, the Senate Finance Committee unanimously approved the Chairman's modification to S. 1971 – the National Employer Savings Trust Equity Guarantee Act (NESTEG) – sponsored by the committee's Chairman, Senator Charles Grassley (R-IA). Among its numerous pension reforms, NESTEG includes a provision that would temporarily replace the 30-year interim Treasury rate with a long-term corporate bond rate, as determined by Treasury, followed by a transition to a yield curve approach beginning in 2007.

According to the Finance Committee's description of NESTEG, in determining a plan's current liability for plan years beginning after December 31, 2003 and before January 1, 2007, the permissible range of the four-year weighted average of rates on corporate bonds would be 90% – 100%.

Also, the bill would require the use of the corporate bond rate for determining PBGC variable premiums for plan years beginning in 2004 through 2006. The bill does not indicate whether 85% of the corporate bond rate would continue to be used. Lump sum payments would continue to be calculated using the 30-year interim Treasury rate through 2006. However, beginning in 2007, the interest rate for funding pension plans, determining PBGC variable premiums and calculating lump sum distribution payments would be based on a yield curve reflecting interest rates on corporate bonds of various durations.

The use of the yield curve would be phased in at a rate of 20% per year beginning in 2007. During the phase-in period, the interest rate would be based on a combination of the yield curve and the previously "applicable rate." For funding and PBGC premium purposes, the applicable rate would be the corporate bond rate and for lump sum purposes, the applicable rate would be the 30-year interim Treasury rate. In addition, for years beginning after 2006, the bill directs Treasury to publish a single composite rate based on the yield curve, which plan sponsors may use for paying PBGC variable premiums and lump sum distributions. The composite rate could also be used to calculate current liability by plans with 100 or fewer participants.

> ***COMMENT***. *Mellon and other members of the employee benefits community believe a yield curve approach would create problems. For example, it would exacerbate funding volatility by making liabilities dependent not only on fluctuations in interest rates but also on changes in the yield curve caused when rates on bonds of different durations move independently of one another.*

Deficit Reduction Contribution. NESTEG provides that if a deficit reduction contribution was not required for any plan year beginning after December 31, 1999 and before January 1, 2001, no such contribution would be required to be made after 2003 through the end of 2006. In essence, this provision would provide a three-year deficit reduction holiday.

Benefit Limitations for Certain Underfunded Plans. Under NESTEG, benefit improvements would be prohibited if a plan is sponsored by a company that has a below-investment grade rating in two of the last five years and the fair market value of the plan's assets is less than 50% of current liability for vested benefits. Further, the plan would be frozen and lump sum payments would be prohibited. These provisions would take effect in 2004.

> ***COMMENT***. *Senator Gregg has stated that he is not opposed to the use of a yield curve and is willing to work with Senator Grassley to create legislation that would permit smoothing techniques to limit volatility. However, Senator Grassley, a major player in these negotiations, is firmly committed to not diluting a yield curve approach.*

CONCLUSION

The end of the year is fast approaching which leaves Congress very little time to enact comprehensive pension legislation. A stand-alone bill, such as H.R. 3108 or S. 1550, has the best chance of enactment. We are providing input and supporting efforts by employee benefit organizations to ensure that an appropriate replacement for the yield on the 30-year interim Treasury rate is enacted.

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