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CONCERNS WITH THE FUNDING RULES IN THE CHAIRMAN'S MARK OF THE "NATIONAL EMPLOYEE SAVINGS AND TRUST EQUITY GUARANTEE ACT OF 2005"

The Chairman's Mark of the "National Employee Savings and Trust Equity Guarantee Act of 2005" includes very significant modifications of the funding rules applicable to defined benefit plans. We thank Chairman Grassley and Ranking Member Baucus for their leadership on these critical issues. Many of the provisions contained in this Mark are important improvements in the funding rules. The proposed reform of the deduction rules relating to pension contributions would allow companies to build up a funding cushion that will help their plans weather difficult economic times. And very importantly, the Mark preserves the basic credit balance structure; if this structure were undermined, pre-funding would be discouraged, leading to less benefit security for participants. Also, the Mark generally provides some helpful transition rules to mitigate compliance burdens. However, with significantly more costly new rules, it is our expectation that companies will need more time to transition than is provided under the bill.

We do, however, have concerns regarding the Mark, which are set forth below. Of course, because there has not been time to model the proposed new rules, we anticipate identifying more issues in the coming weeks.

Predictability. It is critically important to businesses that pension plan funding obligations be predictable. Without funding predictability, companies cannot make business plans regarding new investments, new products, and new jobs. The Mark eliminates the "front-end smoothing" of asset values and interest rates that currently provides funding predictability and relies instead on "back-end smoothing." Specifically, the Mark limits the amount that the required contribution to a plan can increase or decrease from one year to the next year. The limit is the greater of (1) 30% of the prior year's normal cost for the plan, or (2) 2% of the prior year's total liability for the plan.

We believe that the near-spot valuations of assets and interest rates required by the Mark do not provide the desired accuracy nor are they predictable. Spot valuations are accurate on the day or days they are made, but no related plan transaction occurs on that day or days. By the time the related plan transaction occurs many months later, the

spot valuations are inaccurate. Since spot valuations are both inaccurate and unpredictable, there is no reason to require them. So we urge that present-law front-end smoothing be retained.

If the Committee retains back-end smoothing, we urge the Committee to address two major problems in the back-end smoothing rules. The first problem is best explained as follows. Assume two companies - - A and B - - are identical in all respects, including their plan, with one exception. Company A's plan offers lump sums and thus has very few retirees receiving annuity payments. For such a company, the Mark's limit on increases in required contributions generally appears to work relatively well (subject to the problem discussed below); the limit permits a large but manageable increase in contributions.

Company B's plan, on the other hand, does not have lump sums and has many retirees receiving annuity payments. Thus, the 2% component of the back-end smoothing rule is a very large number for Company B. That means, in turn, that the limit on contribution increases for Company B will be far higher than the limit on Company A's increases. Based on Form 5500 data for 737 plans with over 10,000 participants, we estimate that in 20% of the cases, the limit on contribution increases for a company with a plan that does not pay lump sums would be at least 4 times than the limit applicable to the company if its plan did provide lumps sums. In other words, if Company A's contribution can go up by $100 million, Company B's contribution can go up by at least $400 million. Since Company A and Company B are exactly the same size and have the same need for predictability, this system clearly fails to address this need for Company B. Company B will certainly feel pressure to freeze benefits to control costs and achieve better predictability.

This first problem in the back-end smoothing rule can be corrected by basing the 2% component of the rule on the plan liability attributable to active participants (subject to a special rule for frozen plans that have no active participants).

The second problem with the proposed back-end smoothing rule arises at the end of a 7-year amortization period. Because of the limit on decreases in the required contribution, losses occurring at the end of a 7-year amortization period could have to be funded immediately. This type of sudden funding obligation is completely unpredictable and is a good illustration of the very significant difference between volatility and predictability.

This second problem can be corrected by making the back-end smoothing rule only apply to increases in required contributions. The basic amortization rule is structured to avoid significant decreases in required contributions except in cases where such a decrease is warranted.

Credit rating. Under the Mark, if a company is rated below investment grade, a plan sponsored by the company would be treated as at-risk (subject to a 7-year phase-in). In determining the liability of an at-risk plan, the company is required to assume that all employees retire at the earliest retirement age and choose the most valuable benefit available. This proposal will generally increase liabilities very significantly for at-risk plans. Contribution requirements can correspondingly be increased by a far greater percentage.

This proposal raises very serious concerns in two respects. First, it is a very frightening precedent for the Federal government to rate the viability of companies, either directly (in the case of private companies) or indirectly (in the case of public companies). Second, this proposal can plan enormous additional liabilities on struggling companies. It is clear that the proposal would cause more struggling companies to go bankrupt. That is against the interests of the company, the employees, the economy, and the PBGC (which inherits liabilities only from failed companies).

We understand the need to identify high-risk plans. But the question is what to do to those plans once they have been identified. The answer is not to increase their costs and potentially force them out of business. The credit rating proposal should be deleted.

Transition to new lump sum rule. The Mark requires that lump sum distributions be taken into account in determining a plan's funding target, effective in 2007. This new rule would cause a significant increase in liabilities for many plans and thus should be phased in over 5 years.

Yield curve. The Mark provides that the yield curve should reflect interest rates on "high quality" corporate bonds. The legislative history should provide that all investment grade quality levels should be taken into account for this purpose, with additional weight given to the second and third quality levels. The second and third quality levels reflect conservative rates and, unlike the top quality level, the market for such bonds is relatively substantial.

VRP. The most significant issue that has no back-end smoothing is the variable rate premium ("VRP"). Under current law, the application of the VRP is based on a spot interest rate and is scheduled to become based on a spot asset valuation. This creates some problems today, but it is manageable because of an exception from the application of the VRP. The Mark would eliminate that exception and thus greatly expand the application of the VRP. This would dramatically increase the need for a smoothing rule for purposes of determining applicability of the VRP.

Yield curve transparency. The Mark requires the Secretary of the Treasury to publish its yield curve, but does not require the Secretary to publish the methodology used in determining the yield curve. It is critical that the methodology be published so

that companies can make their own projections about future yield curve interest rates. These types of projections are common today and are critical in business planning.

Multiple lump sum interest rates. The Mark does not fix the whipsaw issue for cash balance plans. Accordingly, applying the yield curve interest rates to determine lump sums will create major problems for cash balance plans. Under whipsaw, a cash balance plan's interest crediting rate generally must match its discount rate. If older workers have a lower discount rate, then either they will have to receive a lower interest crediting rating (which will not happen and could not happen legally) or all interest crediting rates will have to be reduced. Reducing interest crediting rates would not only be extremely unpopular but would also be prohibited by the anti-cutback rules, leaving employers in a situation where they are forced to create a large whipsaw problem or to violate one law or another.

At-risk liability. The at-risk actuarial assumptions in the Mark are a "worse than worst case". The point of the at-risk assumptions is to simulate a company bankruptcy with all participants terminating and taking available subsidized benefits. But the Mark assumes each participant terminates at the earliest retirement age. That age could be, for example, a year away for some employees and 15 years away for other employees. Since a company cannot go bankrupt at different times with respect to different employees, this assumption does not make sense. The Mark should be modified to assume, for example, that all participants terminate within two years and take all available subsidies.

Multiple employer plans. The Mark states that generally for purposes of the funding rules, multiple employer plans will be treated as separate plans with respect to each participating employer. Under current law, many longstanding multiple employer plans are treated as a single plan for purposes of the funding rules. If such plans were forced to do separate funding calculations for each employer, it would require hundreds of additional calculations at great expense and burden. The current law treatment of longstanding multiple employer plans as a single plan should be preserved.