

Pending Legislation and Pension Issues

BACKGROUND

Three separate legislative proposals are currently before Congress that may have a significant impact on the way pension plans are funded and how lump benefits are calculated. Two of the bills primarily address interest rate calculations for all pension plans, while one bill focuses exclusively on underfunded pension plans in the airline industry. The current legislation is being driven by three primary factors: 1) the impending expiration of a current law that allows the use a more favorable rate to calculate pension liabilities; 2) the Federal Government's discontinuance of issuing 30-year Treasury Notes which currently acts as a benchmark for various pension calculations; and 3) the distressed status of many pension plans as a result of historically low interest rates and poor investment returns. As a side note, the Administration made its own proposal regarding these pension issues, but it was not well received and has so far been withdrawn from consideration.

The most important concept to understand in discussing this legislation is the impact of interest rates on calculating both lump sum benefits and current pension liabilities. Simply put, the *lower* the interest rate used, the *higher* the lump sum and the *greater* the current pension liability. The interest rate for lump sum benefit calculations should generally reflect the investment performance that a retiree could reasonably expect over his remaining lifetime. The interest rate for calculating current pension liability should generally reflect the investment expectations of the pension fund.

As you might imagine, corporations that oversee defined benefit pension plans (DBP's) would generally like to use the *highest* interest rate they reasonably could in both calculations since this would decrease lump sum payouts and decrease pension funding requirements. However, these rates must also be realistic in order to protect both the rightful retirement expectations of the beneficiary as well as the solvency of the pension plan. The Federal Government, through legislation, sets the *maximum* rate that managers of DBP's can use for both funding and lump sum calculations. Pension fund managers are free to use lower rates, but typically do not do so. Currently the maximum rate for calculation lump sum benefits is the current

yield on 30-year Treasury notes. *The AA pilots' A-Plan document is specifically tied to this federally defined rate for lump sum calculations.* The current maximum rate for calculating current liabilities (and hence funding requirements) is 120% of the 30-year Treasury yield.

The maximum rate for calculating current pension liabilities was last set by the "Job Creation and Worker's Assistance Act of 2002" in part to ease funding burdens on pension plans in a historically low interest rate environment. That provision is set to expire on December 31, 2003. In the absence of any legislative action, this funding rate will revert to the previous benchmark of 105% of the 30-year Treasury note, which will in turn create significant underfunding issues overnight for many pension plans. Many businesses see themselves at risk for being forced to make large deficit reduction payments to pension plans at a time when they cannot afford it. As a result, the impending expiration of the current rate is the primary motivation for corporate lobbying for legislative action, and it is highly likely that Congress will act on this specific issue in some fashion.

As a related matter, the Federal Government no longer issues 30-year Treasury Bills, and in time this benchmark will become less relevant for pension calculations. Therefore, some of the pending legislation attempts to deal with this problem by, at least temporarily, creating a new benchmark interest rate for pension fund calculations.

Finally, the current pension problems in the airline industry is providing motivation for one bill that specifically targets airline pension underfunding issues by allowing airlines to defer some payments in the short term in exchange for accelerated payments later.

KEY ISSUES

Interest rate for calculating lump sum benefits. This interest rate should reflect the investment expectations for a retiree. The consensus among financial advisors is that retirees emphasize *capital preservation* which demands a lower risk investment strategy. Thus, the interest rate used in this calculation should be reasonably conservative, and this conservative rate is currently represented by the yield of 30-year Treasuries.

Interest rate for determining future pension liabilities. This interest rate should reflect the investment expectations for the entire pension

plan. Pension plans have a longer time horizon and invest for *capital appreciation* with a conservative mix of equities and fixed-income assets. Thus a somewhat higher rate is more appropriate for calculating future pension liabilities, but that rate must still be reasonably conservative to protect the pension plans' solvency.

Deficit Reduction Contributions. When a DBP reaches a funding level of 90% of current liabilities, IRS regulations require that the pension fund manager make deficit reduction contributions to return the funding level above 90% of current liabilities. The drop in funding levels may be the result of poor investment returns, a decrease in the interest rate used to calculate current liabilities, or an unexpected increase in fund payouts. Depending on the exact circumstances, these deficit reduction contributions can be significant. Two of the pending bills attempt to provide relief by setting a more favorable interest rate for calculating current liabilities (H.R.1776, S.1550) while the other bill provides a longer grace period for making deficit reduction contributions (H.R.2719).

PENDING LEGISLATION

The three bills current under consideration are:

- In the House, H.R. 1776, the "Pension Preservation and Savings Expansion Act of 2003", also know as the Portman/Cardin bill;
- In the Senate, S.1550 the "Pension Stability Act", also known as the Gregg Bill; and
- In the House, H.R. 2719, the "Airline Pension Act of 2003", also known as the Camp bill.

H.R. 1776

The "Pension Preservation and Savings Expansion Act" is the furthest along of the three bills having been reported out of the House Ways and Means Committee just prior to the summer recess. This bill will now go before the full House, and if passed must still be acted on by the Senate. While H.R. 1776 contains a number of provisions regarding pensions and retirement savings accounts, the primary issues affecting AA pilots are the changes in the interest rates used in for lump sum calculations. Specifically, H.R. 1776 would set the interest rate for lump sum calculations as the 30-Year Treasury note yield for the first two years and then stepwise elevate the

figure to a rate tied to long-term corporate bonds which have historically been higher than the 30-year Treasury note rate. The Secretary of the Treasury would be charged with establishing this corporate bond rate on a periodic basis. This legislation has a sunset provision which will cause it to expire in 2006 and provides no mechanism for creating a permanent rate for pension calculations. In addition, H.R. 1776 would *immediately* establish a new rate for calculating future pension liabilities at the same long-term bond rate which should have the effect of immediately reducing current pension liabilities for DBP's.

H.R. 1776 received a great deal of public attention when the Chairman of the Ways and Means Committee forced a vote in a very partisan fashion which resulted in a call to the Capitol Police to eject Democratic committee members from the Committee Library. It is currently unclear whether the acrimony surrounding this bill will hamper its consideration before the full House.

The primary concern with H.R. 1776 is that it eventually sets an interest rate for lump sum calculations that is unreasonably high for the investment expectations of a retiree. Additionally, the exact mechanism for determining the appropriate corporate bond benchmark leaves too much discretionary power in the hands of the Secretary of the Treasury.

S.1550

The "Pension Stability Act" has not yet been reported out of the Senate Finance Committee and it does not yet have a companion bill in the House. S.1550 is best termed a "rifle shot" approach to addressing pension interest rate issues. Lacking any of the other extra provisions of H.R. 1776, S.1550 addresses only the interest rate issues and in a similar fashion as H.R. 1776. The primary difference is that it maintains this rate structure until 2008, and it specifically provides for a Blue Ribbon Panel to study the issue and recommend a permanent solution. Due to its targeted approach and the lack of controversy associated with H.R.1776, S.1550 is deemed to have better chance for passage this year.

S.1550 also shares the same problem with inappropriate interest rates for lump sum calculations as H.R.1776.

H.R.2719

The “Airline Pension Act of 2003” has yet been reported on by the House Ways and Means Committee. This bill is specifically targeted at ailing airline pension funds and does not address interest rate issues. As such, it is given little chance of passing in its current form, though its sponsors may attempt to attach some of its provisions to another piece of legislation. H.R.2719 provides a mechanism to relax deficit reduction contribution requirements for underfunded pension plans and allows for a longer repayment period. Unfortunately, this mechanism as currently written actually creates a disincentive for managers of DBP’s to fully fund their plans in certain cases.

SUMMARY

The recent crisis facing many pension plans has captured the attention of Congress, and they appear highly motivated to address some of issues as they rate to underfunded plans. While each of the bills before Congress have some pluses and minuses, none of them are considered acceptable to APA in their present form. APA is currently attempting to address our primary concerns through legislative contacts as well as direct discussions with American Airlines management. Depending on the outcome of these initiatives, APA may be requesting the assistance of the membership in the near future for direct lobbying of your Congressmen and Senators.