THE COMMITTEE ON INVESTMENT OF EMPLOYEE BENEFIT ASSETS

PENSION CONFERENCE AGREEMENT SHOULD SET PARAMETERS FOR YIELD CURVE AND GUARANTEE TRANSPARENCY AND PUBLIC INPUT

It is critical that final pension legislation spell out the basic parameters of the yield curve and create a process for ensuring that the yield curve is transparent and reflective of investment-grade corporate bond yields. The interest rates that will be derived from the yield curve are arguably the most important assumption in the calculation of pension liabilities. The yield curve, however, is not a market instrument like a bond. It is a tool that must be estimated from market behavior and its creation is as much art as science. Final legislation should not provide Treasury with unfettered discretion to build the yield curve. It should only delegate responsibility for constructing the yield curve within statutory guidelines and procedural safeguards.

PARAMETERS. Final legislation will almost certainly increase the volatility of liability calculations. This means that plans will need to manage the risk that interest rate movements will increase minimum contributions. To manage interest rate risk, some plans invest a portion of their assets in the bonds that are used to measure their liability. How plans "hedge" their liabilities against interest rate fluctuations may also be affected by the availability of bonds that underlie the rates used to measure that liability. Final legislation needs to ensure that the yield curve reflects an "investable" universe of bonds to allow plans to manage their interest rate risk.

There are three basic parameters that are essential to this concept of investability and that should be incorporated in final legislation.

- First, final legislation should direct Treasury to include all investment-grade corporate bonds in the yield curve. It is particularly important that the yield curve include A and BBB-rated bonds. These two classes represent over 75 percent of the market value of all investment-grade corporate bonds and more than 80 percent of the total number of investment-grade corporate bond issues.
- Second, final legislation should provide that the bonds included in the yield curve are weighted based on market value. Market value captures the bonds that are available for investment. It is also the standard methodology used among major corporate bond indices.
- Third, final legislation should spell out that the yield curve segment rates should be reflective of all points within each segment of the curve. This will ensure that the segments do not distort the yield curve.

TRANSPARENCY. The final legislation should also ensure that the yield curve is transparent and capable of replication in the marketplace. It is absolutely essential that financial experts have the opportunity to analyze and comment on the myriad complex decisions that will ultimately produce the yield curve. To this end, final legislation should require Treasury to disclose the methodology by which bonds are selected and rejected, the universe of bonds that were considered, the bonds that are reflected in the yield curve, the mathematical formulas for converting bond yields into the yield curve, the methodology for estimating the slope of the yield curve, and the methodology for developing rates to be used for the third segment of the yield curve. It should also provide for an extended notice and comment period to ensure that stakeholders have adequate time to consider and comment on the Treasury methodology.

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