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Multiemployer Plan Actuarial Certifications under the Pension Protection Act of 2006

Practice Note
December 2007

Introduction

This practice note has been prepared by the Multiemployer Plans Subcommittee of the Pension Committee of the American Academy of Actuaries. Its primary purpose is to provide guidance to actuaries preparing actuarial certifications for multiemployer pension plans under the Pension Protection Act of 2006 (PPA). This statute applies, for the first time, an actuarial "best-estimate" standard to projections of the funding-standard account credit balance many years into the future.

The guidance provided in this practice note is intended to assist actuaries in the selection of procedures for preparing actuarial certifications and communicating the results of the actuarial projections. This guidance is also intended to assist actuaries in consulting with boards of trustees in developing, monitoring, and updating funding improvement plans and rehabilitation plans now required for certain pension plans under the PPA. The actuary should have a thorough understanding of the multiemployer provisions of the PPA before preparing the actuarial certifications specified in the legislation.

For consistency purposes, references are made in this practice note to sections of the Internal Revenue Code (IRC), as amended by the PPA. However, note that the PPA also amended parallel sections of the Employee Retirement Income Security Act (ERISA).

It should be recognized that the information contained in this practice notes provides advisory, non-binding guidance. This practice note is not promulgated by the Actuarial Standards Board, and it is not binding on any actuary.

The Subcommittee welcomes comments and suggestions on this draft practice note. Comments and suggestions may be sent to Samuel Genson (genson@actuary.org), pension policy analyst of the American Academy of Actuaries.

The members of the Multiemployer Plans Subcommittee responsible for this draft practice note are as follows: Eli Greenblum, FSA, FCA, MAAA, EA,, Chairperson; James Dexter, FSA, FCA, MAAA, EA; Doug Holden, FSA, MAAA, EA; James McKeogh, FSA, FCA, MAAA, EA, ; Brian O'Konski, ASA, MAAA; EA, and James Shake FCA, MAAA, EA.

<u>Question and Answer #1</u>

Q 1: How would the market value of plan assets, as of the certification date, ordinarily be determined, given that audited financial statements will generally not be available by the 90th day of the plan year? To project future-year results from that initial value, would the assumed rate of return on assets used in projections be applied to the market value of assets or the actuarial value?

A 1: IRC Section 432(b)(3)(B) requires the actuary to make projections based upon reasonable actuarial estimates, assumptions, and methods that offer the actuary's best estimate of anticipated experience under the plan in connection with the annual actuarial certification of the plan's funded status.

The initial asset value should be determined using the best information available at the time the certification is prepared. Sources could include:

- Unaudited financial statements;
- Actual cash flow items supplemented by the investment consultant's estimate of the actual rate of investment return;
- A roll-forward of partial year (e.g., third quarter or 10-month) financial statements, supplemented by actual cash flow items and index returns based on the portfolio mix for the remainder of the year.

When an actuarial method of valuing plan assets is used, the prudent actuary will exercise care in projecting assets forward using the assumed rate of return on plan assets.

The funded percentage as defined in IRC Section 432(i)(2) is calculated using the actuarial value of assets (as determined in IRC Section 431(c)(2)). However, the actuary will ordinarily want to determine whether there are any factors that might cause applying the assumed rate to the <u>actuarial</u> value of assets not to be a best estimate. Such factors might include recent large gains or losses that have not been fully recognized or other recent or current market conditions that could significantly affect the mechanics of the asset-valuation method in the short-to-intermediate term.

The actuary may feel that applying the assumed rate to the most recent market value of assets (estimated as of the certification date) is a more appropriate best estimate, given the short-to-intermediate term horizon of the projections as opposed to the long-term basis used for the regular funding valuation. In that case, the actuary would project the market value forward and derive the actuarial value for each year from the result, so that a gain or loss on investment experience would be recognized.

Question and Answer #2

Q 2: Under the PPA, one method for assuming future contributions in funding projections is to use "reasonably anticipated employer contributions for the current and succeeding plan years, assuming that the terms of the one or more collective bargaining agreements pursuant to which the plan is maintained for the current plan year continue in effect for succeeding plan years."[1] Under this method, how would projected contributions reflect any plan-sponsor policy that new collective-bargaining agreements increase the contribution rate in some manner, such as on each anniversary of the agreement?

A 2: For purposes of preparing the annual certification of the plan's status, anticipated increases in contribution rates beyond those in current collective bargaining agreements that would occur under the policy would not be reflected.

However, plans in endangered or critical status are subject to formal PPA benchmarks for improving their funded status. Actions to improve funded status can include contribution increases in future collective bargaining agreements. The actuary will typically participate in the process to develop, update, and monitor funding improvement plans and rehabilitation plans. The anticipation of increased contributions in future bargaining agreements generally would be reflected for calculating expected future benchmarks if such increases were included as part of the formal funding improvement or rehabilitation plan.

Question and Answer #3

Q 3: What issues regarding consistency normally would be considered when projecting or rolling forward contributions and normal costs?

A 3: Projections and roll-forwards involve assumptions, whether explicit or implicit, about future contributions and future normal costs. Unless the plan uses the unit credit cost method for minimum funding, the actuary ordinarily will project two streams of normal costs: one under the actuarial valuation method, so that future credit balances can be determined, and one under unit credit to project future funded percentages.

Projection assumptions typically are consistent. For example, if each active participant is assumed to earn a full year of service in each future plan year and 1,500 hours of service are needed to be credited with a year of service, then it would be inconsistent to assume future contributions at a rate of less than 1,500 hours of service for each active participant. Similarly, if a plan bases accruals on the dollar amount of contributions on behalf of a given participant, the work level required to generate the assumed contributions should be consistent with the level of employment assumed in the projected benefits. Customarily, the normal cost

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[1] 29 U.S.C.A. § 1085(b)(3)(B)(ii)(I) (Thomson/West 2007).

appropriately reflects any changes in the contribution levels projected for future years based on industry-activity information provided by the plan trustees (this would generally include consideration of both future contribution base units per active participant and the number of active participants).

Question and Answer #4

Q 4: Projections of the funding standard account are required. To develop a funding improvement plan, projections of the funded percentage are also required. Are these projections commonly completed using an open group forecast valuation? Or can assets and liabilities simply be rolled forward from year to year?

A 4: In general, either approach is acceptable. For many plans, a roll forward will be sufficient. However, the actuary may consider whether the values in the roll forward (e.g., normal costs, contributions, and benefit payments) require adjustment for future periods. For instance, normal costs will require adjustment to maintain consistency with any projected industry activity that affects future contributions. For funded-percentage projections, the benefit payments could be adjusted for future periods, based on past trends in annual benefit payments, the demographics of the plan participants, and past and projected future benefit changes.

In some cases, a forecast valuation may be appropriate to capture a given plan's demographic progression and to reflect significant changes that would not be captured in a simple roll-forward projection. The actuary ordinarily would consider the nature of the actuarial cost method being used in the funding standard account projection and whether it would be appropriate to roll costs forward, with the implication that the normal cost per active employee will remain constant. Under the entry age normal cost method this is generally true, although under the unit credit cost method (the basis for the funded percentage) the actuary typically will take into consideration the fact that the normal cost for any given individual will increase over time and that new entrants will have lower normal costs. In addition, benefit provisions or contribution rates may differ for some plans, depending on when a participant entered the plan or the plan year during which that service is performed. Finally, differences in early retirement provisions, trends in entry ages, or different wage scales could be expected to affect the overall demographic profile of plan and, hence, the normal cost and other values used in the projection.

Question & Answer #5

Q 5: For purposes of annual actuarial certifications under the PPA, projections of future contributions are made. For these projections, one method of estimating future contributions is by using contribution rates in the collective bargaining agreements under which the plan is maintained. Under this method, how would

increases occurring during the term of an agreement, but after the year for which the certification is made, be reflected?

A 5: The projections would reflect the contribution rates in the agreement for the year of the certification, as well as increases scheduled to take effect in future years.

For example, an employer with a calendar-year plan has a collective bargaining agreement for a term of July 1, 2007, to June 30, 2010, that has been adopted prior to the certification date for 2008. The initial pension contribution rate for the agreement is $5/hour, increasing to $6/hour on January 1, 2009. When preparing the 2008 certification, the projected contributions would be based on the $5/hour rate for 2008 contributions, and on the $6/hour rate for 2009 and later contributions.

For plans in which contributions are negotiated as a percentage of wages, the actuary customarily would consider whether to apply a payroll growth assumption (excluding individual merit/seniority increases).

Note that, instead of using the contribution rates in collective bargaining agreements which are discussed in this Q & A, the projections can assume that contributions equal to those for the most recent plan year will be continued, if the actuary determines there have been no significant demographic changes that would make such an assumption unreasonable. The actuary might also consider whether non-demographic factors, such as significant employer contribution decreases, might make this assumption unreasonable.

Question & Answer #6

Q 6: Under the PPA, the plan sponsor provides alternative benefit and contribution schedules to the bargaining parties for endangered and critical status plans. For example, a default or alternative schedule could state that, if the current contribution rate is continued in the next contract, benefits would decrease. As agreements expire, one of the alternative schedules is selected. For purposes of the annual actuarial certifications under the PPA, how would this situation be reflected?

A 6: When preparing an annual certification, the minimum funding standard account is projected for future years. For these projections, even if a benefit reduction is not reflected in the minimum funding standard account for the current year, it can be reflected in a future year. The benefits valued are normally consistent with the bargained contributions and schedules as they are adopted.

Question & Answer #7

Q 7: If a change to benefits that was not included in the base valuation used to determine PPA certification is adopted before the actuarial certification is submitted for a given year, how might the actuary reflect this change in the certification?

A 7: For ERISA funding purposes, benefit changes that go into effect on or before the first day of the plan year generally are taken into account in the certification for that year. Any change to benefits that is adopted after the first day of the plan year and prior to the certification may be taken into account in the actuarial certification. The funding standard account projection for the current year and for future years typically is based on existing IRS guidance, such as Revenue Ruling 77-2, when reflecting the change in the current year's funding standard account. For purposes of projecting the funding standard account for the second and subsequent years of the period, these benefit changes are normally included.

Example

Plan year is a calendar year. The plan's trustees meet on February 15, 2008, to review the plan's investment return for 2007 and how it affects the plan's funded status. At the meeting, it is decided to reduce the plan's future accrual rate by 50 percent, effective April 1, 2008. This change may be reflected in the projection of the funding standard account for 2008 and future years. For 2008, the impact is prorated in accordance with Revenue Ruling 77-2. For the projection into 2009 and beyond, the change is fully recognized. If this change had occurred on January 1, 2008, it ordinarily would be fully taken into account for 2008 and all subsequent years in the 2008 certification.

Question & Answer #8

Q 8: If a change to the contribution rate occurs during the plan year but before the actuarial certification is submitted for that year, how might the actuary reflect this change in the certification?

A 8: IRC Section 432(b)(3)(B)(ii)(I) allows the actuary to assume that the terms of the collective bargaining agreements for the current year remain in effect. Thus, if a change to the collective bargaining agreement occurs during the plan year but prior to the actuarial certification, it customarily would be reflected in the projections, if the actuary chooses to use Section 432(b)(3)(B)(ii)(I). This includes new rates for any future period that are contained in a new agreement which is ratified before the certification is prepared.

Example

The plan year is a calendar year. The collective bargaining agreement expires February 29, 2008, and the new agreement is effective March 1, 2008. The new collective bargaining agreement provides for an increase in the hourly

contribution rate, from $1 per hour to $1.50 per hour, effective March 2008, and $2 per hour, effective March 2009. These increases typically are taken into account in the 2008 certification, if Section 432(b)(3)(B)(ii)(I) is being used to project contributions.

The actuary may also consider whether it is necessary to reflect other significant events that were not included in the base actuarial valuation used for the PPA status certification, such as a significant employer withdrawal.

Question and Answer #9

Q 9: When increases to the total wage/benefit package are negotiated, without specifying the allocation to the pension plan, what documentation actuaries would need, to be able to assume contribution increases for the PPA certification?

A 9: If a future increase in the total wage/benefit package has been negotiated, but without specific reference as to how much will be allocated to the pension plan, the actuary generally would not assume any increase to the pension contribution rate. Usually there is a specific commitment to the pension plan before the increase can be reflected. It is not sufficient to simply rely on past history or a stated intention in determining how much of the total increase will go to the pension plan.

To assume an increase in the pension contribution rate, the actuary commonly receives written documentation as to any specific action taken to allocate contribution increases. This would generally be obtained from the plan trustees, but might also be provided by those bargaining parties that control the allocation, if the actuary is completely satisfied that they have appropriate authority to do so.

Example

The plan year is a calendar year and the plan covers a construction industry craft. As of January 1, 2008, $3 per hour is being contributed to the pension plan. The bargaining agreement provides for increases to the total wage/benefit package of $1 per hour on January 1, 2009, and another $1 per hour on January 1, 2010. The bargaining parties have stated that each December, before the increase goes into effect, the union will allocate the increase for each year among the health plan, pension plan, and wages. Because the bargaining agreement does not specify the allocation of the future increases, when making the projections for the 2008 certification, the actuary typically will not make an assumption that an increase to the pension contribution rate will occur on January 1, 2009, and January 1, 2010.

To assume that a portion of each increase will be allocated to the pension plan, there must be direction from the trustees specifying the amount of each increase to be allocated to the pension plan. For example, the allocation may (in the trustees' view), be completely at the discretion of the union. The trustees might

rely on minutes, documenting a union meeting, in which the contributions were specifically allocated, including the amount or percentage allocated to the pension plan, and the time period for which that allocation is valid. If the union decides to put 50 cents per hour, of both the January 1, 2009 and January 1, 2010 increases, into the pension plan at its December 2007 meeting, and the trustees direct the actuary to include those increases, then they would be reflected in the 2008 certification.

Question and Answer #10

Q 10: What documentation should be included as part of the certification of critical/endangered status? (What lists of things should be included in documentation of the certification—assumptions, reliance on others, etc.?)

A 10: IRC Section 432(b)(3) requires that the certification disclose the following:

- Whether the plan is in endangered or critical status for the plan year being certified;
- If the plan is in a funding improvement or rehabilitation period, whether the plan is making the scheduled progress in meeting the requirements of the funding improvement or rehabilitation plan.

If the plan is in endangered or critical status, the certification commonly would include the specification of its status (i.e., endangered, critical, or neither) as of the beginning of the plan year, as well as the funded percentage and other relevant metrics (e.g., credit balance expiration), if the plan is endangered or critical.

Section 432(b)(3) also requires that the actuary make projections based upon reasonable actuarial estimates, assumptions, and methods that offer the actuary's best estimate of anticipated experience under the plan. The projections of liabilities are based on the most recent of either the actuarial valuation completed for minimum funding purposes for the preceding plan year, or the most recently filed Schedule B (Form 5500). This means that the actuary would generally use the regular valuation assumptions and cost methods for the projections (including experience over the projection period) and disclose these assumptions as part of the certification.

Other items that normally are disclosed or documented would include the following:

- For determining whether the plan is in critical or endangered status, as the case may be, a description of how both plan liabilities and assets are projected to the certification date and for subsequent years (examples of factors to be documented would be any projected growth or decline in normal costs, benefit payments, or expenses);

- The date that the plan assets were valued, the source of plan assets (e.g., unaudited financial statements, bank statements), whether the assets have been adjusted from a date prior to the end of the year (including assumed amounts of contributions and benefit payments, and the basis for the actual investment rate of return used during the roll-forward period), and the actuarial valuation method (if not described as part of the assumptions);

- Anticipated employer contributions (described in Section 432(b)(3)(B)(ii)) for each year and the basis used to project contributions;

- The projected amount of the credit balance during the forecast period;

- Any projected industry activity (described in Section 432(b)(3)(B)(iii)), including covered employment and contribution levels, and the source of that information (generally, the trustees);

- Any other anticipated changes during the forecast period that deviate from the original actuarial valuation or Schedule B used as the basis for the certification, including adopted changes in plan provisions, and, if the plan sponsor adopts it, a change in funding method, etc. While typically the assumptions in the base valuation would be used for the projection period, special circumstances (e.g., merger, plan change, significant demographic changes) may also dictate the need for an assumption change. The prudent actuary will justify any deviation from the base valuation assumptions, and document why the original assumptions no longer meet the best estimate standard.

Question and Answer #11

Q 11: How do the projections for the actuarial certification required under IRC Section 431(d) (dealing with amortization extensions) differ from other projections?

A 11: To obtain an automatic five-year extension of amortization periods under IRC 431(d), the actuary is required to certify that four conditions exist, based on reasonable assumptions. First, the actuary must certify that the plan is expected to have a funding deficiency within 10 years, absent allowance of the extension being requested. For these projections, the actuary might use the same projections he or she used in the annual certification to test for critical or endangered status. Second, the actuary must certify that "the plan sponsor has adopted a plan to improve the plan's funding status." While the plan's funding status is not defined in this context, the statute does not appear to refer to the formal funding improvement plan required for endangered plans. In addition to any formal plan that may be developed, the actuary might consider recent actions implemented by plan trustees that are projected to improve the funding status, or recent

contribution increases adopted by the bargaining parties, as well as the impact of policies or plans adopted by the plan sponsor to improve the funding status of the plan. Third, the actuary has to certify that the plan has sufficient assets to pay benefits and expenses in a timely fashion over the extended amortization period. For this certification, the actuary could do a cash flow projection over the requisite period. Again, policies or plans adopted by the plan sponsor could be reflected in the assessment. In some situations, the actuary may be able to demonstrate that the last condition is satisfied without performing a detailed projection. Lastly, the actuary must be able to certify that the required notice under IRC Section 431(d)(3)(A) has been provided to the required stakeholders.