VOLUME 27 ■ NUMBER 3 FALL 2002

EAR
ENROLLED ACTUARIES REPORT

ABCD CASH BALANCE LETTER

Rephrasing the Question

LAST FALL, WE PUBLISHED A LETTER from a group of pension actuaries seeking guidance from the Actuarial Board for Counseling and Discipline (ABCD) on consulting issues related to cash balance conversions. In drafting the original letter, the authors stuck to simple facts. As it happens, greater detail would have facilitated greater specificity in the ABCD's response. Consequently, the authors this summer revised their letter to provide additional facts.

The revised letter, and the ABCD's response, are printed on Pages 4-8 with permission from the signers of the letter—Donald Segal, chairperson of the Academy's Pension Committee; Dennis Polisner, chairperson of the Academy's Committee on Pension Accounting; Vince Amoroso, a member of the Academy's Pension Practice Council; and David Flagg, a member of the Academy's Council on Professionalism—and from Robert Sturgis, chairperson of the ABCD.

As happened with last year's letter, the topics raised in this letter will be discussed at the annual meeting of the Conference of Consulting Actuaries (CCA) Nov.3-6 in Amelia Island, Fla. Panelists in the session, "ABCD Cash Balance Letter Revisited," will be Amoroso, Flagg, Academy President Dan McCarthy, and Ed Burrows, a member of the ABCD and the Academy's Pension Practice Council. For more information, go to the CCA's website, www.ccactuaries.com/meetings/am2002/program1.html. To read the original letter, go to www.actuary.org/pdf/fall_2001.pdf.

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The *Enrolled Actuaries Report* is a quarterly publication of the American Academy of Actuaries (www.actuary.org).

EA Enrollment Renewal

The Joint Board for the Enrollment of Actuaries has asked the Academy to share the following information with its members who are enrolled actuaries:

The Joint Board is currently processing applications for renewal of enrollment. Some questions have been raised as to what is the enrollment number for the current cycle, which began on April 1. The renewal notices that the Joint Board has been issuing are computer-generated and a zero precedes every four-digit enrollment number. In completing the 2001 schedule B, or any prior year, you should ignore this zero and continue to use your four-digit enrollment number, preceded by the prefix "02".

You may begin using the "02" prefix as soon as you receive the letter from the Joint Board approving the renewal of your enrollment, and it must be used by Sept. 1, 2002.

Questions? Contact the Joint Board at 202-694-1891.

Message From the EA Meeting Committee

WE WOULD LIKE TO THANK ALL THOSE that made the 2002 Enrolled Actuaries Meeting, held March 10-13 in Washington, a success. We are grateful to the speakers who volunteered their time, to the Conference of Consulting Actuaries staff that handled the countless logistical and organizational issues, and most importantly, to those of you who attended.

Of the nearly 1000 attendees at the 2002 meeting, about one-third returned our meeting survey. We want to assure you that the planning committee takes your feedback seriously. A great deal of our time is spent discussing your suggestions for ways to improve the meeting. We cannot please everyone, but we do review every comment submitted—the bad along with the good.

For example, most survey respondents indicated they liked the meeting location in Washington, but several suggested moving the meeting to other parts of the country (with one request for Hawaii). Our desire to encourage significant government participation, and the size of the meeting, restricts location options; however, we continue to consider other sites. Comments concerning specific sessions and speakers are discussed and analyzed. It will come as no surprise that actuaries seldom agree on anything. We received several comments that a particular presenter was the best speaker at the 2002 meeting, while another attendee complained that the same presentation was horrible.

It may help your critique of the EA Meeting if you better understand the objectives for this conference. Certainly we want to provide relevant information to enrolled actuaries in an understandable format and in a setting that is conducive to learning. A primary goal is to allow EAs the opportunity to earn all their required continuing education credit by attending two EA meetings during any three-year enrollment cycle—that's a lot of credit packed into two and a half days. Lastly, we are very conscious of your continuing education budget. Some actuaries want to get by on the lowest cost possible, while others want more amenities; we attempt to strike a reasonable balance.

A professionalism session at the EA Meeting.

We are hard at work planning the 2003 Enrolled Actuaries Meeting, to be held March 17-19. We hope you will attend and give us your comments!

Ken Hohman
Chairperson
Enrolled Actuaries Meeting Committee

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Projections and Truncations in 2002 Limitation Amounts

BY TOM SCHRYER

ACTUARIES NEED TO PROJECT both the EGTRRA and Pre-EGTRRA variants of each IRC limitation in 2002 FAS 87 accounting valuations of DB pension plans. The table below summarizes the information needed to make such projections. The pre-EGTRRA limitations shown are also needed for the minority of plans that continue to use the pre-EGTRRA (old law) limitations, and to amortize the change in liability due to the fundamental changes to the limitations.

The first step when projecting limitations is to calculate a series of purely "before truncation" figures increased for changes in the cost of living. Each of these is then truncated to get the projected limitation. A $5,000 truncation means the limitation is reduced to the next lower multiple of $5,000 if the unrounded amount is not already an exact multiple of $5,000.

The old law DB 415 Limitation for 2002 (shown in the graph below) illustrates projection and truncation. The $144,873 before truncation figure for 2002 equals the $141,075 before truncation figure for 2001 (not shown below) increased for inflation, and becomes the $140,000 old law limitation for 2002 after the applicable $5,000 truncation. Four different truncations are used. Note that future legislation is required to extend the EGTRRA levels beyond 2010. The sunset provision of EGTRRA (Section 901) states that limitations for 2011 and later will be "as if the provisions and amendments … had never been enacted."

Actuarial Complication

Paragraph 46 of FAS 87 uses the phrase "under existing law" to give guidance on projecting limitations. People at FASB have publicly advised actuaries to use EGTRRA limitations for limitation years through 2010 and projected old law limitations thereafter when calculating projected benefits in 2002 FAS 87 valuations. IAS 19 (the standard for international accounting) does not seem to address statutory limitations directly, but paragraph 86 says to look only to the stated terms of the plan. IRC 411(d)(6) generally prohibits any reduction in accrued benefits, and FASB suggests that actuaries get legal advice when they consider the likelihood that IRC 411(d)(6) will protect benefits accrued at the end of the 2010 limitation year from reductions due to any decrease in limitations in 2011. An influential person at the IRS has indicated privately and informally that 411(d)(6) would protect the EGTRRA accruals after 2010, but that was only one opinion.

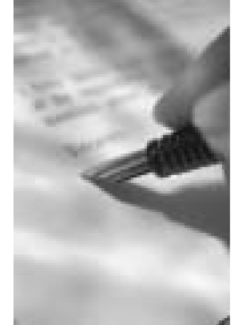
Actuarial calculations relating to 2002 contribution levels will generally be done using EGTRRA-only limitations, without projection, as the IRS explained in Q&A 17 of Revenue Ruling 2001-51. In other words, the sunset provision will be ignored. The IRS explanation only addressed IRC 415's limitation on benefits, but since the limitation on pay is subject to the same Section 901 of EGTRRA, a strong inference can be made that the same approach also applies to the limitation on pensionable pay.

TOM SCHRYER is a consulting actuary with Findley Davies Inc. in Cleveland.

	Limitation	Limitation Before Truncation	Truncation Level	Last Year's Limitation	Limitation Before All Inflation
Pay (EGTRRA)	$200,000	$200,000	$ 5,000	$170,000*	$200,000
Pay (old law)	180,000	182,925	10,000	170,000	150,000
DB 415 (EGTRRA)	160,000	160,000	5,000	140,000	160,000
DB 415 (old law)	140,000	144,873	5,000	140,000	90,000
DC 415 (EGTRRA)	40,000	40,000	1,000	35,000	40,000
DC 415 (old law)	35,000	36,585	5,000	35,000	30,000
401(k) (EGTRRA)	11,000**	11,000	500	10,500	Scheduled
401(k) (old law)	11,000	11,268	500	10,500	7,000

*Under EGTRRA, DB benefits can reflect pre-2002 pays up to $200,000.

**Before age 50



July 30, 2002

Actuarial Board for Counseling and Discipline
1100 Seventeenth Street NW
Seventh Floor
Washington, DC 20036

Re: Follow-up Questions to ABCD on Pension Actuarial Professionalism

Gentlemen:

Last year we wrote to the ABCD requesting guidance in connection with hypothetical scenarios related to consulting on cash balance pension plan conversions. It was our stated intention to make public our request and the ABCD's response in order to improve practitioners' understanding of the mechanics by which the ABCD provides guidance as well as to stimulate dialogue in this controversial area of practice. Your time and effort in responding was greatly appreciated by us. Judging by the many comments we have personally received or have become aware of, practitioners were indeed receptive to this approach for improving professionalism.

The scenarios we originally developed were, quite intentionally, not overly detailed. In reviewing the ABCD's response, however, it appears that in eliminating the "clutter" from our request we also omitted important facts that made your analyses more difficult to accomplish. We too found this to be an educational experience!

We have redeveloped our scenarios and again respectfully request guidance from the ABCD as to whether or not the actuaries have (or may have) violated any precepts in the Code of Professional Conduct.

As was the case before, we intend to seek publication of this letter and any guidance that the ABCD provides to us. The fact patterns are once again purely hypothetical, and any similarity to actual matters pending before the ABCD or individual practitioners is entirely coincidental.

First Scenario—Plan Design Work

A pension actuary is providing consulting advice to his/her plan sponsor client on plan design matters. The actuary also serves as the enrolled actuary for the client's ERISA defined benefit plan. The plan sponsor wants to change the current plan design to better achieve the following business objectives:

- Allow employees to earn benefits more evenly throughout their careers, and eliminate the financial "back loading" effect which exists in the current final-pay-related plan design,
- Reduce the existing plan's heavy inducements for early retirement, and
- Make the plan more understandable and a greater asset for recruitment purposes.

The actuary actively assists his/her client with the plan redesign project, and suggests approaches to achieve the sponsor's goals that the sponsor had not previously thought of, such as a cash balance plan design with a so-called benefit "wear away" feature. All of the approaches suggested by the actuary have been used by the actuary's other clients, and the actuary believes that all of the approaches are fully permissible under current laws. The actuary points out that under each of the design alternatives, expected benefits for individual employees will either increase or decrease (creating so-called "winners and losers"), but that under the cash balance design alternatives, this will be hard for employees to determine on their own.

The client is committed to changing the retirement program to better align it with his business objectives.

Second Scenario—Communicating Plan Design Changes

A plan sponsor has decided to convert a final-pay-related pension plan to a cash balance plan. Although the sponsor's expected costs are unchanged, the actuary has advised the client that there will be some losers, and that some of those individuals will experience very large reductions (for example, as large as 50 percent or more) in the value of their expected pensions. The plan sponsor indicates that he will "deal with" any negative fallout from the new design. The plan sponsor asks the actuary to send a series of examples on the actuary's letterhead that illustrate different classes of hypothetical employees who are winners, but specifies that no losers should be included in the examples. The plan sponsor has indicated that he is preparing an internal memo to employees describing the plan design change. The memo will reference the professional assistance provided by the actuary's firm, and the examples will be attached.

The actuary has worked with this client for many years, and has always found him to operate with the highest degree of integrity. To the best of the actuary's knowledge, the client has always followed through on the many instructions the actuary has provided. Nevertheless, the actuary is somewhat surprised

by the client's request, and is unsure what to do.

Actuary's Response A

The actuary speaks to the client again and raises the issue of informing employees that there will be both winners and losers. The client indicates that the letter to employees will make clear that there will be both winners and losers, and that any individual can request personalized benefit projections.

The actuary complies and sends only examples of winners. The actuary caveats the transmittal letter to the plan sponsor and each of the illustrative examples with a statement to the effect that the examples only show winners but that some participants may be losers.

Actuary's Response B

The actuary speaks to the client again and raises the issue of informing employees that there will be both winners and losers. The client indicates that the letter to employees will make clear that there will be both winners and losers, and that any individual can request personalized benefit projections.

The actuary provides examples that illustrate both winners and losers. The actuary's transmittal letter to the plan sponsor indicates that all of the examples should be provided to affected employees. None of the examples have caveats on them.

Actuary's Response C

The actuary makes no follow-up call to the client.

The actuary provides many examples that illustrate winners and one example that illustrates a loser with a 5 percent reduction in expected benefits. The actuary's transmittal letter to the plan sponsor indicates that all of the examples should be provided to affected employees. None of the examples have caveats on them.

Third Scenario—Communicating Plan Design Changes

Same facts as the second scenario, except that the actuary has never worked with the client before being hired to help with the cash balance project. The actuary has no reason to question the client's integrity. The actuary makes no follow-up call to the client.

The actuary complies and sends only examples of winners. The actuary caveats the transmittal letter to the plan sponsor to the effect that the examples are not a "fair" representation since no losers are shown. The examples do not include a caveat.

Thank you in advance for your participation.

Sincerely,

Vince Amoroso
David Flagg
Dennis Polisner
Donald Segal

cc: Daniel McCarthy, AAA

August 5, 2002

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Gentlemen:

In a letter dated April 3, 2001, you requested guidance on certain issues related, principally, to cash balance plans. The issues involve the conversion of traditional defined benefit plans to a cash balance format. They include questions related to transition provisions and participant disclosure. We responded in a letter dated June 29, 2001. Your inquiry and our response have received considerable attention within the pension actuarial community.

In follow-up conversations, we have agreed that it could be useful if you resubmitted your original inquiry, expanding certain of the scenario descriptions and requesting additional guidance. You submitted this revised inquiry on July 30, 2002.

This letter constitutes our response to your revised inquiry. We are attaching this revised inquiry and its attachments, asking that you consider these attachments as part of our response. Our references to scenarios are references to scenarios as set forth in these attachments.

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In our response to the first scenario, we focus exclusively on plan design consulting with the principal. The scenario does not address, other than tangentially, the issue of employee communication. Our response relative to the first scenario does not address this issue.

With this first scenario, the focus of your inquiry involves the question of compliance with Precept 1 of the Code of Professional Conduct as effective Jan. 1, 2001 (the Code). Precept 1 states that:

> An Actuary shall act honestly, with integrity and competence, and in a manner to fulfill the profession's responsibility to the public and to uphold the reputation of the actuarial profession.

We are mindful that cash balance conversions of the type described in the first scenario have been viewed with disfavor by many observers.

We are also mindful of the following legal and regulatory issues, some of which were recited in our June 29, 2001 letter:

- "Wear-away" features of the type you describe have been challenged as violations of the anti-backloading rules of ERISA and the Internal Revenue Code.
- These same "wear-away" features are considered by some to violate ADEA [Age Discrimination in Employment Act], to the extent they may reflect discriminatory intent or to the extent they may cause disparate impact detrimental to older workers.
- The very nature of the typical cash balance plan has been challenged as a violation of age discrimination rules found in ERISA, ADEA, and the Internal Revenue Code.

There is controversy over whether these recited legal and regulatory issues do involve violations. A sizeable body of the most experienced practitioners in the pension field believes that they do not. Some of these practitioners are actuaries who participate actively in maintaining practice standards of the consulting firms for which they work. Others are attorneys responsible for seeing that these same firms are intimately familiar with all relevant legal requirements.

On balance, based on the facts described in your inquiry, we believe that the plan design advice described in the first scenario does not violate Precept 1 of the Code.

We do believe the actuary should ascertain that the principal is aware of the legal and regulatory issues we have described.

Our conclusion is based on the current situation regarding these legal and regulatory issues. This conclusion could be changed by future events.

Suppose, for example, a controlling authority determined that the wear-away features you describe do violate anti-backloading rules, or that the typical cash balance plan does violate age discrimination rules. If the consulting advice described in the first scenario were rendered after any such determination, the actuary rendering the advice would probably be violating Precept 1 of the Code.

We must reemphasize that our response relative to the first scenario does not address the issue of employee communications. In our discussions with you, we have agreed that for educational purposes it would be useful to separate the issue of plan design and Precept 1 from the issue of employee communications and Precept 8. In actual practice, of course, it is generally difficult to separate the two issues. We want to make it very clear that our response on this first scenario does not consider the question of whether Precept 8 has been violated.

The second and third scenarios involve employee communication that makes use of calculations furnished by the actuary. Before we get into a detailed discussion of these scenarios, it might be well to examine Precept 8 of the Code in some detail. Precept 8 states that:

> An Actuary who performs Actuarial Services shall take reasonable steps to ensure that such services are not used to mislead other parties.

We call attention, in particular, to the words "reasonable steps."

Some observers appear to see a bright line method for assuring that reasonable steps were taken. This method involves a written caveat, directed at the principal, to the effect that the actuary's services must not be used to mislead other parties. This caveat would either be incorporated into the written work product or included in the transmittal document. Where appropriate, the caveat might indicate uses that could be misleading, requesting that these uses be avoided. In this view, it would never be necessary to take any additional step. In this view, an appropriate written caveat might not always be necessary, but it would always be sufficient.

We feel that such a caveat is unnecessary in some circumstances, adequate in others, and insufficient in still others. Facts and circumstances are always relevant.

Depending on the actuary's comfort level, we believe satisfaction of the reasonable-steps requirement might necessitate one or more of these steps:

1. A dialogue with the principal regarding the manner in which the principal proposes to use the calculations and the steps the principal will take to ensure against misleading employees;
2. A written caveat cautioning against uses that would mislead employees;
3. A request by the actuary that the actuary be permitted to review and suggest modifications in employee communication material before it is released; or
4. The actuary's resignation from the assignment if the actuary feels unable to prevent the misleading use.

If step 2 appears desirable, there are some cases where the actuary might find it acceptable to include a written caveat in the document transmitting illustrative information. There are other cases where the actuary might consider it necessary to embed a caveat in the body of each illustration.

We are not suggesting that reasonable steps will necessarily include any of the four steps we have recited. There may be steps not on this list that will more appropriately discharge the actuary's obligation. Our point is that step 2 on our list is not necessarily sufficient.

The actuary's comfort level would ordinarily be influenced by prior experience with the principal and the extent to which the actuary believes the principal or the principal's agents may design communications that leave participants with difficulty understanding the whole picture. For example, the actuary may conclude that a proposed plan change is likely to be viewed by participants as "unfair." The actuary may believe that the principal would prefer to counter this participant view by emphasizing those aspects of the change that participants may consider favorable and de-emphasizing those aspects that participants may consider unfavorable. In this circumstance, the actuary should be especially concerned over the danger of an incomplete or misleading communication.

Clearly, the Code could be changed to be more definitive on the meaning of "reasonable steps." However, at this point we are firm in our position that step 2 is not necessarily sufficient. Facts and circumstances are always relevant.

Turning to the second scenario, a final pay plan is being converted to a cash balance arrangement. Under the facts, "... there will be some losers and ... some of those individuals will experience very large reductions (for example, as large as 50 percent or more) in the value of their expected pensions." The disquieting aspect of the second scenario is that the sponsor has requested a series of examples on the actuary's letterhead, specifying that the examples should:

> ... illustrate different classes of hypothetical employees who are winners, but... no losers should be included...

It is part of the scenario that:

> The actuary has worked with this client for many years, and has always found them to operate with the highest degree of integrity. To the best of the actuary's knowledge, the client has always followed through on the many instructions the actuary has provided. Nevertheless, the actuary is somewhat surprised by the client's request, and is unsure what to do.

In response A to the second scenario:

> The actuary speaks to the client again and raises the issue of informing employees that there will be both winners and losers. The client indicates that the letter to employees will make clear that there will be both winners and losers, and that any individual can request personalized benefit projections.

Nevertheless, the actuary complies with the request and sends only examples of winners. The actuary does include a caveat in the transmittal letter and each of the illustrations, stating that "the examples only show winners but ... some participants may be losers."

We believe the actuary has come close to satisfying the "reasonable-steps" requirement. However, we believe the actuary should remain puzzled over the fact that the principal wants to distribute samples of winners but not losers. In response A, we do not believe the actuary has necessarily satisfied Precept 8. Indeed, it seems somewhat bizarre that the principal should promise to "make clear that there will be both winners and losers" while insisting that the general explanation should illustrate only winners. We might suggest that, despite a history of integrity and compliance with the actuary's recommendations, the principal may have in mind an employee communication that is less than candid. We note that in some cases the reductions in projected benefits will be as large as 50 percent or more. Reductions of this magnitude certainly should not be treated casually.

In response B, the actuary has the same discussion with the client as in response A. But, following this discussion, the actuary provides illustrations of both winners and losers. The actuary indicates that all the examples should be provided to affected employees.

With response B, we find it much easier to conclude that there has not been a violation of Precept 8.

Based on the hypothetical facts now set forth in response B, we do not believe there has been such a violation. In particular, we do not believe that under the facts it is necessary for the examples themselves to contain caveats. In this regard, we are mindful that the client has a history of integrity and compliance with the actuary's recommendations.

Response C does not involve a discussion with the client. The actuary provides many illustrations of winners and only one of a loser. The expected benefit reduction for the loser is only 5 percent. In response C, we do not find it impressive that the transmittal letter indicates that all of the examples should be provided to affected employees. We conclude that there is probably a violation of Precept 8.

We turn, finally, to the third scenario. Based on the hypothetical factors recited, we conclude that there is probably a violation of Precept 8. We would have reached this conclusion whether or not the examples had included caveats.

We should caution that this letter sets forth responses to hypothetical questions. A real situation could involve additional facts that might change our analysis.

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We should also caution that the preceding discussion examines only the question of compliance with the Code. The Internal Revenue Service has published proposed regulations governing "204(h) notices." In some cases, a plan sponsor must distribute these notices whenever a plan is amended to reduce benefit accruals significantly. The proposed regulations provide that under certain circumstances a 204(h) notice must include illustrative examples.

Based on your descriptions, it seems likely that the illustrations you describe in scenario 2, response A, would not meet these illustrative-example requirements. The same conclusion applies to scenario 3. The descriptions you have provided for scenario 2, responses B and C, are not sufficient to indicate whether the illustrative-example requirements would be satisfied.

We note that the proposed regulations appear to require a notice whenever it is reasonable to expect that the accrual in any future year will be reduced significantly. Apparently, this is true even if it is reasonable to expect that the cumulative accrued benefit at every future date will be unreduced.

Please be sure to contact us again if you believe that further clarification would be helpful.

ACTUARIAL BOARD FOR COUNSELING AND DISCIPLINE
Robert W. Sturgis, Chairperson

PBGC Amends Benefit Regs

THE PBGC RECENTLY ISSUED A FINAL RULE amending its regulations to reflect changes in how it pays benefits. Effective June 1, the new rule offers participants more choices of annuity benefit forms and clarifies the earliest date on which a participant is eligible to retire.

Traditionally, the PBGC decided the earliest date a participant could retire on a case-by-case basis. Given constantly evolving plan designs, the PBGC has decided to introduce the concept of an "earliest PBGC retirement date."

If the earliest annuity date is on or after the participant reaches age 55, the earliest PBGC retirement date will be the same as the earliest annuity date. If the earliest annuity date occurs prior to the date the participant reaches age 55, then the earliest PBGC retirement date will be the date the participant turns age 55. The PBGC will still determine retirement dates prior to age 55 on a case-by-case basis.

Under the new rule, PBGC will also provide participants whose benefits aren't yet in pay status the option of electing an annuity benefit form.

To read the PBGC's final rule, go to www.pbgc.gov/laws/lawsregs/federalreg/040802.pdf.

Pension Resource

THE PBGC HAS ISSUED A NEW EDITION of its annual statistical reference book, the Pension Insurance Data Book 2001, which tracks the experience of PBGC's two insurance programs and the defined benefit pension plans they protect.

The new edition contains a summary page presenting key information about PBGC operations and several additional data tables on the multiemployer program. It also features graphs that illustrate current data and trends, both in PBGC operations and in the universe of private pension plans insured by PBGC.

For each of the PBGC's insurance programs, the book includes data tables on the people receiving or eligible to receive benefits from PBGC and the agency's benefit payments, the financial condition of the program, the people and plans protected by the program and the overall funding level of the pension plans covered by the program.

The data book is available on the PBGC website at www.pbgc.gov/publications/databook/databook01.pdf. Single copies may be obtained by writing to: PBGC Data Book, Suite 240, 1200 K Street, NW, Washington, DC 20005-4026.

LOOKING FOR PALS

The Pension Assistance List (PAL), the Academy's nationwide referral service for actuaries interested in helping individuals understand their pension benefits, is looking for more volunteers.

By broadening participants' knowledge about their pension plans, as well as acquainting them with the valuable work that actuaries provide in plan development and management, PAL gives actuaries a chance to serve both the profession and the public good.

To take part, look for the enclosure in this month's mailing of the *EAR*. Or you can sign up online at www.actuary.org/palform.htm. If you need more information, contact Kasha Shelton, the Academy's administrative/legislative manager (shelton@actuary.org; 202-223-8196).