AMERICAN ACADEMY *of* ACTUARIES

Internal Revenue Service
CC:PA:LPD:PR (REG-139236-07), Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

March 31, 2008

Re: Regulations on Measurement of Assets and Liabilities for Pension Funding Purposes (REG-139236-07)

To Whom It May Concern:

On behalf of the American Academy of Actuaries[1] Pension Committee, I respectfully request your consideration of its comments regarding the Regulations on Measurement of Assets and Liabilities for Pension Funding Purposes (REG-139236-07). The proposed regulations provide much needed guidance regarding the new funding rules in the Pension Protection Act of 2006 (PPA). We are providing comments on certain items of concern to the actuarial profession.

Valuing Benefits Not Based on Service or Accrued Benefits

We are concerned about the method described in proposed regulation 1.430(d)-1(c)(1)(ii)(C) as it applies to certain benefits that are not based on service or accrued benefits. The proposed regulations require the value of the benefit be accrued over the service period ending when the age and service eligibility requirement are met. Example 3 clarifies, in the case of a disability benefit that is available upon disability after 15 years of service, that any expected benefit is accrued by year 15 and not over the entire service period until the disability.

This approach is not consistent with common actuarial practice. Such benefits are most commonly accrued over the period until assumed decrement, in effect recognizing that death or disability during employment are part of the eligibility condition, in addition to any age and service requirements. The common approach is the one outlined in Revenue Procedure 2000-40, Section 3, Approval .01:

[1] The American Academy of Actuaries is a national organization formed in 1965 to bring together, in a single entity, actuaries of all specializations within the United States. A major purpose of the Academy is to act as a public information organization for the profession. Academy committees, task forces and work groups regularly prepare testimony and provide information to Congress and senior federal policy-makers, comment on proposed federal and state regulations, and work closely with the National Association of Insurance Commissioners and state officials on issues related to insurance, pensions and other forms of risk financing. The Academy establishes qualification standards for the actuarial profession in the United States and supports two independent boards. The Actuarial Standards Board promulgates standards of practice for the profession, and the Actuarial Board for Counseling and Discipline helps to ensure high standards of professional conduct are met. The Academy also supports the Joint Committee for the Code of Professional Conduct, which develops standards of conduct for the U.S. actuarial profession

> (6) For active participants, when valuing ancillary benefits that are not directly related to the accrued retirement benefit, the projected benefit related to a particular separation date is the benefit determined for the participant under the plan's benefit formula(s) calculated using the projected compensation and the projection, under respective assumptions, of any other components that would be used in the calculation of the benefit on the expected separation date. The portion of the projected benefit allocated to the current plan year is the projected benefit at the expected separation date divided by the number of years of service the participant will have at such date. The portion of such projected benefit allocated to prior years of service is the projected benefit multiplied by a fraction, the numerator of which is the number of years of service at the beginning of the plan year, and *the denominator of which is the number of years of service the participant will have at the expected separation date.* [Emphasis added]

The impact of the change from past guidance within the proposed regulations is most readily apparent in the case of a death benefit, say $10,000, paid as a lump sum in the event of death of an active participant (regardless of service). The approach in the proposed regulations would require the full expected value of this "insurance" coverage to be fully accrued at date of hire. In contrast, prior IRS guidance recognized that such coverage was being provided over the working career, and spread the cost ratably over that period.

We would also like to note other current practices for possible consideration under the final regulations. Since death and disability benefits are ancillary benefits, again equating to insurance coverage, a reasonable attribution approach is to capture the "term cost"—the estimated cost of covering for the events of death or disability occurring during the year. As with the suggestion above, this would have the effect of spreading the cost of coverage over the period of coverage. Finally, in the case of a disability benefit that grants service for periods between the date of disability and normal retirement, since continued disability is often a requirement for the accrual of additional service, some actuaries include the effect of the additional year of service in the normal cost as it "accrues." The disabled employee is treated, in effect, as an active employee accruing benefits with a present value calculated using disabled-life assumptions.

Lastly, the regulations should identify any required difference in determining the target liability with respect to disability benefits (depending on whether the disability benefit provides for a continuing accrual of credited service during the period of disability) versus if it provides an immediate disability income benefit payable during the period of disability.

Yield Curve Election

Under Internal Revenue Code (IRC) Section 430(h)(2)(D)(ii) as amended by PPA, plan sponsors have the right to elect to use the yield curve. This election, once made, can only be revoked with IRS approval. This means, under the statute, that a plan sponsor who does not currently match their plan assets to their plan liabilities has the right to use smoothed, segment rates today. However, at some future date, if they decide to change their investment policy so that plan assets are invested to match plan liabilities, the statute allows them to elect to shift to using the yield curve to value their liabilities.

Proposed regulation 1.430(h)(2)-1(e) calls for more than what is contained in the statute by requiring IRS approval of not just a revocation of such an election, but also the election itself. For 2008, automatic approval for the initial yield curve election is granted. But in later years, the IRS is requiring approval of any election to move to the yield curve. Thus, plan sponsors have lost their right as described in the statute to shift to the yield curve at the point that makes sense for the plan.

Similarly, the statute provides for a transition between the PPA segment rates and prior law rates and allows the plan sponsor to elect to waive the transition. Under the statute, a time frame for such an election is not specified, nor does such an election require approval; only revocation of the election. The same holds true for the ability to elect a lookback month other than the default. Yet, the proposed regulations require more than the statute in these cases, requiring approval to make the elections themselves.

We believe the final regulations should not be more restrictive than the statute.

Yield Curve Measurement

By its structure, PPA recognizes (and arguably encourages) the practice of matching the investment of pension plan assets to the plan's liabilities. While a certain amount of smoothing was allowed via the segment interest rates, plan sponsors were also allowed the option to elect to value plan liabilities using the full yield curve. For a plan sponsor that does match pension plan assets and liabilities, the best "smoothing," from the perspective of the least funded ratio volatility, will occur when assets and liabilities are both valued at market rates at the same point in time. This happens naturally for assets by using market value on the valuation date. But to make this happen on the liability side, the plan actuary must use a yield curve developed from bond yields measured as of that same valuation date. Unfortunately, the method the IRS uses to determine the full yield curve does not allow this matching to occur because it uses a yield curve that is averaged over the prior month, instead of using the yield curve as of the last day of the month.

We don't believe this view is mandated by statute. When IRC Section 430(h)(2)(D)(i) says the yield curve "for such month," it does not necessarily mean the average for such month. This is similar to the recent issue the PBGC dealt with when it needed to reflect the FTAP "at the end of the preceding plan year" for ERISA Section 4010 reporting purposes. It recognized the FTAP is only calculated at the beginning of the plan year. The PBGC rightfully indicated in regulations that the FTAP for all points in the plan year, including the end of the year, is the FTAP as of the valuation date. In order to appropriately recognize and support the matching of plan assets and liabilities as recognized in the statute, the IRS should allow for the use of the yield curve as of the last day of the month.

Valuing Hybrid Plans Defined as Lump Sums

With regard to the valuation of lump sums and other IRC Section 417(e)(3) optional forms offered by traditional plans and determined solely by the use of Section 417(e)(3) assumptions, the proposed regulations call for valuing the annuity that corresponds to the Section 417(e)(3) distribution using special actuarial assumptions. These special actuarial assumptions essentially replace the Section 417(e)(3) interest rates that would have been used to determine the benefit under the optional form with the IRC Section 430(h)(2) funding rates used to value the annuity. In addition, the IRC Section 430(h)(3) mortality table after the annuity starting date is replaced with the current applicable mortality table under IRC Section 417(e)(3). The result of valuing the underlying annuity with these assumptions is that optional forms that are actuarially equivalent under IRC Section 417(e)(3) will produce consistent funding targets. The only difference between the funding target for the IRC Section 417(e)(3) distribution (e.g., lump sum) and the funding target for the underlying annuity flows appropriately from the difference between the IRC Section 430(h)(3) mortality table, which is gender-based, and the unisex IRC Section 417(e)(3) applicable mortality table. Without this approach, such consistency would not necessarily have been the case. We agree that this is the most logical and desired result and we applaud the IRS for including this provision and strongly recommend that it be retained.

Along these same lines, we recommend that a similar rule be established for hybrid plans. Many hybrid plans use the IRC Section 417(e)(3) assumptions as the basis to convert account balances into annuities. Under such plans, the annuity options and the account balance lump sum will be actuarially equivalent at the annuity starting date. Logic would suggest that these options should therefore produce consistent funding targets. However, without an analogous approach to the one contained in the proposed regulations for traditional plans (as described above), this consistency would not necessarily occur.

We recommend that the funding target for annuity options under a hybrid plan that converts accounts or lump sums to annuities using IRC Section 417(e)(3) assumptions be determined as the present value of the lump sum, with an adjustment to the resulting present value as of the valuation date. The adjustment would be needed to reflect the difference between IRC Section 430(h)(3) mortality, which is gender-based, and unisex IRC Section 417(e)(3) mortality. The present value would be adjusted by the ratio of 1) a life annuity factor at the valuation date for an annuity deferred to the projected annuity starting date —determined using the valuation interest rates and IRC Section 430(h)(3) mortality table— to 2) the similar factor determined using the valuation interest rates, the Section 430(h)(3) valuation mortality table for periods prior to the projected annuity starting date, and the current IRC Section 417(e)(3) applicable mortality table for periods after the projected annuity starting date. The result of this approach would be consistent funding targets for the lump sum and annuity in the valuation of a hybrid plan.

Hybrid Whipsaw

As mentioned under the Yield Curve Measurement section, PPA recognizes the matching of pension plan assets and liabilities. Further, PPA expanded the design of cash balance plans to allow interest to be credited at market rates. However, the IRS proposed funding regulations do not wed these two concepts together very well and have created “valuation whipsaw.”

Proposed regulation 1.430(d)-1(f)(4)(iii)(D) describes the projection of the assumed payment to the expected date of payment using a reasonable interest crediting assumption and then discounts it back like all other cash flows under PPA using the appropriate yield curve (full or three-segment). The project and discount method is a reasonable read of PPA; however, more thought should be given to the projection component.

Assume a cash balance plan is credited with some kind of “balanced fund” return that is available in the market and ultimately permitted under the final hybrid regulations. For a $100,000 cash balance account, the way to perfectly immunize the liability is to invest $100,000 of plan assets in the same balanced fund. Yet, to the extent we have to project today's $100,000 cash balance with anything greater than the yield curve, when we discount back with the yield curve we will end up funding something larger than the cash balance account, which will result in overfunding the plan benefits.

A solution to this problem is to refocus on the projection component. IRC Section 430(h)(1) requires assumptions to be both reasonable and to reflect anticipated experience. To the extent a plan’s investments mirror the basis for interest crediting, using market rates for the projection assumption (where the prescribed discount rates are recognized as an acceptable benchmark for market) should be considered reasonable under IRC Section 430(h)(1).

Similarly, if a cash balance plan is credited with a safe harbor market rate, it should be deemed reasonable to set the projection assumption equal to the prescribed discount rates. Thus, for example, if the cash balance plan credits the discount rate on three-month Treasury bills plus 175 basis points, there would be no valuation whipsaw.

Leaving At-Risk Status

The proposed regulations address the provisions of IRC Section 430(h)(5), which require the approval by the commissioner of large changes in actuarial assumptions. In general, this rule applies where changes in the actuarial assumptions (disregarding changes in the mandated interest and mortality) decrease the funding shortfall by more than the statutory threshold.

The preamble to the proposed regulations provide an example indicating that approval could be required when a plan leaves at-risk status and returns to its previously used actuarial assumptions. Note that the at-risk provisions are phased in over five years, so even if a plan is using the at-risk assumptions for the portion of the funding shortfall that is being phased in, the plan will probably continue to use the regular assumptions for the portion of the funding shortfall that is not yet phased in. Furthermore, even for a plan that is fully phased in, the regular assumptions are used for various purposes such as determining whether the credit balance can be used or whether IRC Section 436 benefit restrictions apply. Thus, if a plan leaves at-risk status and uses the actuarial assumptions that were previously used to determine the not-at-risk funding shortfall, this should not be considered a change in the actuarial assumptions that requires approval.

Defining What is a Plan's Actuarial Assumption

Certain economic assumptions are commonly expressed in relation to the interest rate used to determine the funding shortfall or to a published index. For example, the crediting rate assumption for a hybrid plan may be based on the third segment of the segmented yield curve under IRC Section 430(h)(2). A cost-of-living increase assumption might be based on the recent increase in a published cost-of-living index, or an average of recent increases. For an assumption that is expressed using such a methodology, as long as the methodology used to determine the assumption remains unchanged, a change in the assumed numerical rate should not be considered a change in the actuarial assumptions requiring approval of the commissioner under IRC Section 430(h)(5). Conversely, if the underlying methodology is changed, even if the assumed numerical rate remains the same, this should be considered a change in the actuarial assumptions that is subject to approval. The types of situations described in this paragraph, along with the need or lack thereof for approval, should be described in the final regulations.

I thank you for this opportunity to share our thoughts on these regulations. We would be interested in meeting with you to answer any questions or discuss any of the concerns expressed in this letter. If you have any specific questions or would like more information, please contact Samuel Genson, the American Academy of Actuaries' pension policy analyst, at 202-223-8196. Thank you for your consideration of this matter.

Sincerely,

James F. Verlautz, FSA, EA, MAAA, FCA
Chair, Pension Committee
American Academy of Actuaries