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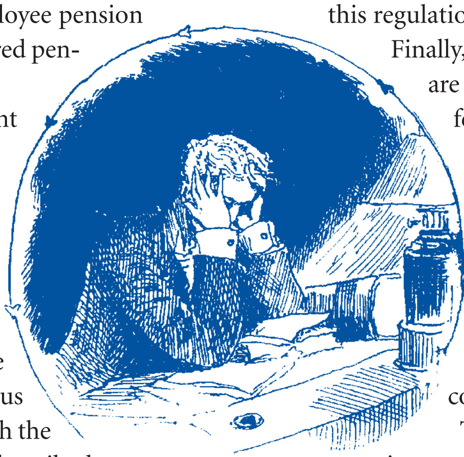
EAR
ENROLLED ACTUARIES REPORT

A Cautionary Tale

BY JUDY ANDERSON

AS PENSION ACTUARIES, we all know the importance of understanding the framework of the legislation and regulations that we work in. This fact can't be overemphasized. Techniques that are used in Canada may not be appropriate or even permissible in the United States. Similarly, an approach that may be viable for a public employee pension plan may not be allowed for a privately sponsored pension plan.

Why repeat these cautions? Because of recent confusion about using the Aggregate Entry Age Normal funding method. This funding method is discussed in the book *A Problem Solving Approach to Pension Funding and Valuation*, by W. H. Aitken. It is also discussed at length in an SOA study note, "Variation on Entry Age Normal Cost Methods." The study note points out that the method can produce spurious gains/losses. This means it does not comply with the definition of "reasonable funding methods" described in IRC Regulation 1.412(c)(3)-1, paragraph (c)(2). The method is inappropriate for meeting minimum funding standards for qualified plans in the United States.



Why discuss the method at all, then? Well, it represents an approach to stabilizing costs per employee on a plan-wide basis and was used before IRC Regulation 1.412(c)(3)-1 became effective in 1980. Also, not every U.S. pension plan is subject to this regulation—public plans, for instance, are not. Finally, it is important to remember that there are plans outside of this country where different funding methods may be allowed and appropriate.

Given the increasing globalization of plan sponsors and of the actuarial profession, along with rapidly changing regulations, the education and examination syllabus of the SOA has moved away from nation-specific considerations.

The lesson here is to know the regulations you work with. This method is on the syllabus because it can be used in certain situations and in certain countries. But don't assume that because it is in the study note, you can use it. Check the regulations.

JUDY ANDERSON is staff fellow for retirement systems at the SOA and a contributing editor of *EAR*.

Inside this issue

EAR
ENROLLED ACTUARIES REPORT

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

Academy's Social Security Game Featured in Online Forum

the Social Security game

PRINT AND ONLINE VERSIONS of the October *Consumer Reports* invited readers to play the Academy's Social Security game (**www.actuary.org/socialsecurity/**) to test out various proposals for ensuring the program's long-term solvency. The magazine also created an online forum inviting reader suggestions for protecting Social Security.

The response was impressive. In fact, the volume of comments persuaded *Consumer Reports* to keep the site up for several weeks longer than anticipated.

"In content, it's turning into one of the best online discussions we've had," a *Consumer Reports* editor told the Academy in mid-October.

Comments made during the forum ranged widely, as is evident from the sampling that follows. To read all the comments, go online to **www.consumerreports.org/Boards**.

SOCIAL SECURITY GAME continues on Page 2 ►

Social Security Game, *continued from Page 1*

"Politicians know that people do not want to hear hard messages, so they make proposals that minimize hardship and appeal to people's greed. Unfortunately, voters accept this pandering as truth. The Social Security Game replaces wishes and dreams with facts, and gives citizens the opportunity to join the debate in a meaningful way."

"Removing the cap on the amount of wages taxed for Social Security has to be the first step in reducing the shortfall. Having the cap in place creates a regressive tax, where lower income households are shouldering more of the burden."

"This is an excellent forum and game. The choices may not prove to be as tough as presented, however. Many believe that the actuaries of the Social Security Administration have been a tad conservative in their economic growth assumptions. The best security for Social Security is a rapidly growing economy (and wages). If the United States can continue to grow and improve productivity, then the painful choices now being presented to us will evaporate before our eyes. Go U.S. economy go!!"

"Social Security should be a social program (as the name suggests), not a government-run savings account—we put money in to serve the social good, we should not necessarily expect to get that money back if we have other financial resources. Simply exempting those who will earn more than $40,000 per year through private retirement plans would just about fix the system in one simple step."

"Too many of us seem to think that what we pay into Social Security is 'ours.' It is not. The payments into the program are there to eventually provide someone with a subsistence level of income when and if the need arises. The incentive to provide for one's own retirement standard of living should be that the Social Security program is essentially a poverty program, not a retirement program, unless you plan to live in poverty after retirement."

"Social Security can easily be fixed (but not politically possible) by eliminating Social Security taxes and increasing the present income tax rates by 8 percent and then paying out Social Security benefits from the General Fund. This would have no effect on the taxes of 90 percent of Americans. Benefits would cap at a $70,000 income rate. The present Social Security funds would be released to the general fund."

"The retirement savings component could be spun off in the form of mandatory retirement accounts, where you get out of it what you put into it. Singapore does this on a huge scale: the mandatory retirement funds then loan the money to the government, which pays a decent rate. Good return, low risk. Australia also has mandatory retirement where you can pick the (government-approved) fund to hold your money. It is only marginally successful because the government keeps changing (the) rules regarding payouts and tax credits."

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“The basic problem with the Social Security system started when President Johnson decided that it should be part of the ‘general fund’ instead of a separate entity, since it was such a big cash cow. Since that time, Congress has pilfered most of the funds for other programs. The problem could probably be solved if Congress would put it back the way it was originally designed, and not spend it. If it were to stay how it is now, I would opt to be able to invest *all* of what I pay into my own investment portfolio.”

“To those who so bitterly oppose and would abolish Social Security as we know it, I feel you are not old enough to remember what it was like before Social Security was enacted. ‘Poorhouse’ was not a figure of speech. Nearly every county in the nation had a public poorhouse, and that is where major numbers of the elderly finished out their lives. Does anyone know of a county poorhouse today? Before you throw out the baby with the bathwater and wind up in the same sort of situation, do a little research on this matter and learn just how much stability Social Security has wrought and why. Pity you or yours should (they) ever come to such an end. . .”

“The money taken out for Social Security is our money; it does not belong to the government. I understand the prudent need to have retirement and disability funds available to each person and do not object so much to the mandatory withdrawal, but I want to be able to designate where some of the funds, at least, can go to earn additional interest or investment money.”

“Social Security is a vast government Ponzi scheme not based on principles of limited government. It should be abolished, along with other transfer programs. The individual tax savings would allow people to take care of themselves.”

“Start with a ‘Day Certain’ that all newborns born after this date will not receive Social Security. Henceforth, those new people will contribute a minimum of 2 percent of working income to a private savings account of their own choosing. As long as it is a legal type of savings vehicle, it can be used for anything from a passbook savings account to individual stocks, to investment in a business. The choice should be up to the individual, and that person should be able to roll the money into different types of investments as he/she sees fit. The account should remain classified as a ‘retirement account’ until such time (as) this individual ‘declares’ retirement, whatever this age may be. The retirement age should be up to the individual. The money should not be taxed when removed, and if the individual uses up the money before they die, the person either goes back to work or goes on Medicare/Medicaid.”

“I believe that someone who works all their life should be ensured some level of dignity in their retirement. Social Security is there to provide that dignity.”

“I would drop *all* recipients over age 18 who are survivors of deceased Social Security payers, who receive benefits for college. Nobody’s birth certificate comes with a college education entitlement.”

Updated Social Security and IRS Amounts for 2001

Two of these tables list updated figures for Social Security amounts and covered compensation for 2001. The third table lists projected figures for IRS pension limits, based on the law in effect on Dec. 1. If legislation affecting these tables is enacted after Congress returns, we will publish updated information in the next issue of *EAR*.

The tables were compiled by Andrew Eisner of Buck Consultants, Inc., Research Department.

Covered Compensation, 2001

2001 Wage Base $80,400

YEAR OF BIRTH	AGE IN 2001	SSRA	YEAR OF SSRA	COVERED COMPENSATION ROUNDED TO: $1*	$12	$600**	$3,000
1934	67	65	1999	33,066	33,060	33,000	33,000
1935	66	65	2000	35,106	35,100	35,400	36,000
1936	65	65	2001	37,214	37,212	37,200	36,000
1937	64	65	2002	39,323	39,312	39,600	39,000
1938	63	66	2004	43,471	43,464	43,200	42,000
1939	62	66	2005	45,546	45,540	45,600	45,000
1940	61	66	2006	47,620	47,616	47,400	48,000
1941	60	66	2007	49,660	49,656	49,800	51,000
1942	59	66	2008	51,649	51,648	51,600	51,000
1943	58	66	2009	53,569	53,568	53,400	54,000
1944	57	66	2010	55,463	55,452	55,200	54,000
1945	56	66	2011	57,323	57,312	57,600	57,000
1946	55	66	2012	59,149	59,148	59,400	60,000
1947	54	66	2013	60,940	60,936	61,200	60,000
1948	53	66	2014	62,583	62,580	62,400	63,000
1949	52	66	2015	64,140	64,140	64,200	63,000
1950	51	66	2016	65,589	65,580	65,400	66,000
1951	50	66	2017	66,960	66,960	67,200	66,000
1952	49	66	2018	68,237	68,232	68,400	69,000
1953	48	66	2019	69,454	69,444	69,600	69,000
1954	47	66	2020	70,620	70,620	70,800	72,000
1955	46	67	2022	72,763	72,756	72,600	72,000
1956	45	67	2023	73,774	73,764	73,800	75,000
1957	44	67	2024	74,700	74,700	75,000	75,000
1958	43	67	2025	75,531	75,528	75,600	75,000
1959	42	67	2026	76,303	76,296	76,200	75,000
1960	41	67	2027	77,014	77,004	76,800	78,000
1961	40	67	2028	77,666	77,664	77,400	78,000
1962	39	67	2029	78,231	78,228	78,000	78,000
1963	38	67	2030	78,780	78,780	78,600	78,000
1964	37	67	2031	79,286	79,284	79,200	80,400
1965	36	67	2032	79,714	79,704	79,800	80,400
1966	35	67	2033	80,057	80,052	79,800	80,400
1967	34	67	2034	80,280	80,280	80,400	80,400
1968	33	67	2035	80,400	80,400	80,400	80,400

* Represents exact average of wage bases, as permitted by law and regulations.

** After 1993, IRS does not authorize the use of covered compensation tables rounded to $600 multiples under 401(l). Thus, integrated plans using this table are not safe-harbor plans.

Social Security—2001 Factors

On Oct. 18 the Social Security Administration announced updated factors for 2001.

Wage Base	The maximum amount of earnings taxable in 2001 is $80,400 for Social Security purposes.
COLA	The cost-of-living increase in benefits is 3.5% payable for December 2000 benefits.
Wage Index	The average annual wage figure of $30,469.84 will be used in computing benefits for workers who become eligible in 2001. This figure is based on data for the last complete year (1999) and was used to determine other wage-indexed numbers given in the table below.

FACTOR	2000	2001
Wage base:		
for Social Security	$76,200	$80,400
for Medicare	No Limit	No Limit
old-law wage base, for indexing PBGC maximum, etc.	$56,700	$59,700
Cost-of-living increase (applies to Dec. 2000 benefits, payable in Jan. 2001)	2.4%	3.5%
Average annual wage (based on data 2 years earlier)	$28,861.44	$30,469.84
PIA formula, 1st bend point	$531	$561
PIA formula, 2nd bend point	$3,202	$3,381
Maximum family benefit, 1st bend point	$679	$717
Maximum family benefit, 2nd bend point	$980	$1,034
Maximum family benefit, 3rd bend point	$1,278	$1,349
Retirement test exempt amount (annual):		
below SSNRA	$10,080	$10,680
year of SSNRA	$17,000	$25,000
Wages needed for one quarter of coverage	$780	$830
FICA (employee) tax rate:		
Social Security (OASDI)	6.20%	6.20%
Medicare (HI)	1.45%	1.45%
Total	7.65%	7.65%
SECA (self-employed) tax rate, total	15.30%	15.30%

IRS Pension Limits for 2001

Here are the official 2001 pension limits. In its release, the IRS cautions that pension legislation awaiting action by Congress may affect some of the amounts.

Principal Limits

		LIMITS		TO PROJECT FUTURE VALUES		
IRC §	LIMIT	2000 ROUNDED	2001 ROUNDED	2001 UNROUNDED	NEXT INCREMENT	% INCREASE NEEDED
415(b)(1)	Defined benefit plan limit	$135,000	$140,000	$141,075	$145,000	2.8%
415(c)(1)	Defined contribution plan limit	30,000	35,000	35,625	40,000	12.3%
401(a)(17)	Limit on includible compensation*	170,000	170,000	178,125	180,000	1.1%
402(g)(1)	Limit on 401(k) elective deferrals	10,500	10,500	10,973	11,000	0.2%
414(q)	HCE definition	85,000	85,000	88,000	90,000	2.3%

Other Limits

		LIMITS		TO PROJECT FUTURE VALUES		
IRC §	LIMIT	2000 ROUNDED	2001 ROUNDED	2001 UNROUNDED	NEXT INCREMENT	% INCREASE NEEDED
402(g)(4)	Limit on 403(b) tax-deferred annuity	$ 10,500	$ 10,500	$ 10,973	$ 11,000	0.2%
457(b)	Limit on nonqualified deferrals	8,000	8,500	8,717	9,000	3.2%
409(o)(1)(C)	ESOP payouts, 5-year limit	755,000	780,000	783,750	785,000	0.2%
409(o)(1)(C)	ESOP payouts, additional 1-year limit	150,000	155,000	156,750	160,000	2.1%
408(k)(2)(C)	SEP pay threshold	450	450	470	500	6.4%

** Governmental plans have special rules for eligible participants as defined in OBRA '93.*

Cash Balance Pension Plans Revisited

If you were asked to name a crisis where swift, focused response resulted in a successful resolution, what crisis comes to mind? The Cuban missile crisis of the early 1960s? The Iran hostage crisis? The cash balance crisis of 1999?

Well, OK, maybe categorizing the public reaction to the cash balance plan disclosures in 1999 as a crisis of national proportions is a stretch, but for the credibility of the actuarial profession it had the elements of a potential crisis.

THE CHALLENGE

Our profession was broadly characterized by the news media as co-conspirators with corporate America to stealthily rob American workers of their expected pension benefits. Regardless of the veracity and accuracy of the accusations, we actuaries were publicly on trial for the first time in my 30-year career. Remaining silent was not an option.

So how did we respond? Were we swift and focused? I think the answer is a qualified "yes." Because actuaries are represented by more than one professional body, it is often hard for us to act swiftly. However, in this instance, the Academy, the ASPA, the CCA, and the SOA all issued public responses in short order after criticism of actuaries gained national attention in May of 1999.

By any measurement, our response was focused and most important, focused on the right issue: professionalism. One way we demonstrated our continued commitment to professionalism was the proposed new standard on benefit illustrations. It was a direct and, I think, appropriate response to the crisis.

By the summer of 1999, it became evident to many that the actuarial profession was under fire for its part in perceived abuses created by the conversion of some traditional pension plans to cash balance plans. Among the actions taken by the profession was a request from the Pension Practice Council of the Academy that the Actuarial Standards Board (ASB) consider developing a standard on cash balance plan illustrations.

It is not unusual for the board to receive a request for the development of a standard from another organization. For example, the actuarial standard of practice covering domestic relations orders for pension plans was first suggested by the Actuarial Board for Counseling and Discipline. The National Association of Insurance Commissioners has asked the board to consider the adoption of other standards.

So the board took the request under routine advisement—with one significant difference. We decided that because of the growing controversy surrounding cash balance plans, we would consider the development of the standard in an expedited, but still measured fashion.

The development of the standard was expedited in that its process was given priority in terms of resources and attention. However, in no way was the process cut short. The board's review of the proposed benefit illustration standard was as careful and deliberate as it is with any other developing standard. As Chairperson Bill Reimert and his Pension Operating Committee can attest, the board did not sacrifice any level of scrutiny.

August 1999

The Pension Operating Committee was assigned the task of initially considering the idea of a standard for cash balance plan benefit illustrations. The committee determined a standard was in its opinion doable, and valuable to the profession. It prepared a recommendation for the issuance of a proposed new standard.

September 1999

The ASB approved the committee's recommendation that a proposed standard on benefit illustrations be developed for exposure to the profession. What the committee proposed to the ASB was not a cash balance benefit illustration standard per se, but a standard applicable to all pension plan benefit illustrations.

This was the first of two key decision points in the development process. The committee recommended, and the ASB concurred, that if it was valuable to provide guidance to actuaries working on benefit illustrations for cash balance plans, it was equally valuable to provide guidance for actuaries working on illustrations for other pension plans. It reflected the committee's opinion that the standard should not be narrowly focused, nor should it be reactive. Any standard should serve a long-term, valuable purpose to the profession and the publics we serve. In other words, the Academy's request notwithstanding, if there was not a good reason for a standard absent the current hoopla about cash balance plans, there would be no new standard.

So how did we respond? Were we swift and focused? The answer is a qualified "yes."... By any measurement, our response was focused and most important, focused on the right issue: professionalism.

November 1999 through February 2000

The committee met monthly to develop the proposed standard. In addition to the meetings, there were conference calls and subcommittee activities, and much drafting and editing between meetings. Early in its deliberations, the committee reached a conclusion on a second key decision point.

The committee concluded that the proposed standard be limited to illustrations of changes in plan benefits, not to all benefit illustrations. For example, the proposed standard would not apply to routine annual statements. This was done for several reasons. One reason was the thought that guidance was most needed in situations where pension plan participants might be choosing between two alternative plan benefit formulae based on information developed with the help of the actuary. Another reason was the practical considerations of making the standard workable and not so broad as to provide no meaningful guidance.

March 2000

The committee presented a proposed standard to the ASB for issuance as an exposure draft. Reluctantly, and with much praise for the core of its effort, the ASB returned the proposed standard to the committee for further refinement. As was pointed out, expediting the process was never meant to compromise the thoroughness of the process.

There was much the ASB liked about the proposed standard. It contained an innovative approach to the difficult issue of applying an actuarial standard to a work product over which the actuary has limited, if any, control. But while we recognized that there was a sense of urgency associated with the cash balance crisis, we decided the proposed standard would be ready for exposure only after some fundamental refinements were made.

To the credit of the leaders of our profession, I never got one call challenging our decision to make changes before the proposed standard was released for exposure.

The committee went right back to work, and by the July 2000 board meeting, had a revised draft for us to consider. There were multiple conference calls and in-person meetings over the next two months.

MISSION ACCOMPLISHED

July 2000

The ASB unanimously approved the revised draft for release as an exposure draft.

In a period of about a year and two months, thanks in great part to the commitment and sacrifice of its Pension Operating Committee, the ASB released for public consumption a proposed standard in response to the great cash balance pension plan crisis of 1999.

Did we remedy the crisis? No, that was never our intent. What we have attempted to do is provide meaningful guidance to actuaries who are involved with the preparation of certain benefit illustrations including those related to the conversion of a traditional pension plan to a cash balance plan. And, in direct response to the crisis, the proposed standard creates a mechanism to help restore public confidence in the completeness and accuracy of the statements.

This article was written by Alan Stonewall, chairperson of the Actuarial Standards Board. It was published earlier in the SOA newsletter, *The Actuary*, and is reprinted here with permission.

Casting a Wide Net

The Pension Benefit Guaranty Corporation (PBGC) recently announced that it has located some 6,600 missing pension plan participants since launching its Pension Search Directory in December 1996. The search directory is located on the PBGC website at **www.pbgc.gov**.

The 6,600 people located to date were eligible for $21 million in pension benefits. This includes about 4,800 people owed $10 million who were found in the last year. They come from 48 states, the District of Columbia, and Puerto Rico. More than half are from just five states: 1,089 in New York, 969 in California, 399 in Ohio, 376 in Pennsylvania, and 374 in Texas. Benefits for those found averaged $4,200, ranging from $2 to $111,000.

The directory, which can be accessed by state, by individual name, or by the name of a company, contains the names of individuals who could not be located by the PBGC through regular mail or commercial locator services. Many of them are workers whose former employers closed pension plans and distributed benefits. Others are workers or retirees whose underfunded pension plans were taken over by PBGC.

Individuals who find their names on the directory are required to submit proof of age and other vital statistics to PBGC to verify their identity. After PBGC verifies a completed application, those eligible for benefits begin receiving checks within two months. Those entitled to future benefits will receive them at retirement age.

FRONT TO BACK?

Academy Says IRS Tests Produce Illogical Results

IN CERTAIN INSTANCES, IRS OFFICIALS recently have been interpreting the anti-backloading tests of Internal Revenue Code section 411(b)(1) in ways that produce illogical results, says the Academy's Pension Committee in a recent letter to the IRS.

"Such interpretations seem inconsistent with congressional intent and with longstanding practice in running the tests," the committee states in its letter, signed by Pension Committee Chairperson Donald J. Segal.

The anti-backloading rules were designed to assure that a pension plan could not be configured to delay too much of the benefit accruals to the later years of service. Under some recent interpretations, plans that are actually frontloaded could be found to be impermissibly backloaded. "There is ample evidence in the legislative history that Congress did not intend to restrict the frontloading of benefit accruals through the application of the anti-backloading rules," the letter states.

The committee recommends that the IRS allow or require a separate anti-backloading test for each benefit formula in a "greatest of" situation. If each formula satisfies one of the tests, the committee suggests, then the plan satisfies the anti-backloading rule. To read the full text of the letter, go to **www.actuary.org/pdf/statement00/pension/pStatement_91400.pdf**.

Academy Alert on Proposed Treasury Regulations

In late October the Academy issued an Academy Alert in the pension and employee benefit field discussing proposed regulations on testing new comparability plans for nondiscrimination.

The new rules, proposed by the Department of the Treasury, would be applied in addition to, not instead of, existing nondiscrimination requirements. Under the proposal, the new rules would apply in plan years beginning on or after Jan. 1, 2002. A hearing on the proposed rules is scheduled for Jan. 25, 2001.

Prepared by Ed Burrows and reviewed by James Durfee, the alert is one in a series of regular Academy updates on the latest developments in Congress, federal agencies, and the courts, tailored to each practice area. They are available to subscribers by mail, e-mail, or fax. The annual subscription fee for alerts on pension and employee benefit issues is $50. For more information, contact Academy Legislative Assistant Kasha Dumas at (202) 223-8196 or dumas@actuary.org.