AMERICAN ACADEMY *of* ACTUARIES

July 9, 2010

Office of Federal Procurement Policy
725 17th Street, N.W.
Room 9013
Washington, DC 20503
Attn: Raymond J. M. Wong

RE: CAS Pension Harmonization NPRM, CAS-2007-02S

Dear Mr. Wong:

The Pension Committee of the American Academy of Actuaries[1] respectfully requests your consideration of comments regarding the proposed rulemaking on the harmonization of Cost Accounting Standard (CAS) Nos. 412 and 413 with the Pension Protection Act of 2006 (PPA). The Pension Committee appreciates the opportunity to comment on this important effort.

The Pension Committee commends the CAS Board on its continued efforts to achieve "harmonization" as prescribed by the Pension Protection Act. It is clear that the Notice of Proposed Rulemaking (NPRM) has been developed based upon the feedback received from many sources after the release of the Advanced Notice of Proposed Rulemaking (ANPRM). However, there is a concern within the actuarial community that certain elements of the NPRM will produce results that may prevent plans from meeting the objective of harmonization. We feel there are certain key provisions in the NPRM that require further analysis, reconsideration, and perhaps revision prior to issuing a final rule.

While the CAS Board may philosophically disagree with the use of settlement liabilities similar to those applied under PPA to determine government contracting pension costs for an ongoing plan, it is nevertheless congressionally mandated as the required funding approach for pension plans and is inextricably linked to CAS costs through the requirement that cost accounting standards harmonize with the PPA funding rules. Modeling the provisions of the NPRM in simple PPA/CAS harmonization forecasts indicates that the NPRM does not effectively recognize PPA funding under CAS Nos. 412 and 413 (i.e., required contributions are not fully reimbursed over time under the terms of the NPRM as previously suggested under the ANPRM). We have identified certain areas in the NPRM, most notably the proposed addition of unnecessary triggers, the elimination of mandatory amortization of mandatory prepayment credits and the basis for settlement accounting, that we believe require revision so that the final rule achieves harmonization with consistent and equitable results. The remainder of this letter provides further commentary regarding these particular provisions of the NPRM that do not appear to support harmonization of CAS with PPA and offers suggested revisions for your consideration.

[1] The American Academy of Actuaries is a 16,000-member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

The Harmonization Threshold Test

The Harmonization Threshold Test compares the pre-harmonization CAS-assigned pension cost to the PPA minimum funding requirement for the plan as a whole. For purposes of this comparison, the assigned pension cost is not reduced by any prepayment credits and the PPA minimum funding requirement is not reduced by any funding balances.

We believe that the inclusion of this first threshold test does not aid in harmonization of the two sets of rules but instead creates unnecessary volatility, complexity and inconsistencies in the proposed calculations. Our understanding is that the rationale for this test is to ensure that the minimum accrued liability (MAL) calculations only apply when a plan's minimum funding requirement exceeds the unadjusted assignable pension cost. This logic presumes that harmonization is only needed in years when the PPA requirements for the pension plan as a whole exceeds the plan's CAS expense. This may be appropriate if both calculations use the same asset base and amortization period. However the NPRM utilizes assets after subtraction of the prepayment credit to determine the unadjusted assignable pension cost. As a result, the PPA requirements will likely reduce to zero while prepayment credits remain. When this occurs, there is little likelihood of fully assigning the remaining prepayment credits that have been developed in the course of solely satisfying a plan's minimum funding requirements.

One of the benefits stated in the NPRM is as follows:

> The proposed rule of this NPRM harmonizes the disparity between the PPA minimum contribution requirements and government contracting cost. The proposed rule should provide relief for contractors' concerns with indefinite delays in recovery of cash expenditures while mitigating the expected pension cost increases that will impact Government and contractor budgets.

By applying this test on a discrete basis, we do not believe that this threshold test achieves the benefit desired by the CAS Board stated above. By simply comparing the current PPA minimum required contribution with the existing CAS expense, the NPRM is not considering the fact that plans with prepayment credits significantly in excess of their PPA funding balances have historically not been able to assign those costs under current CAS rules. Because the Harmonization Threshold Test is based on contribution requirements before reduction for funding balances and prepayment credits, plan sponsors may be ineligible for harmonization adjustments due to previous historical funding requirements exceeding CAS assignable costs. This imbalance will continue to be exacerbated over the next five years of the NPRM transition period when only partial recognition of PPA liabilities will be permitted.

In addition to not taking into consideration past contributions made to pension plans, the comparison of current CAS expense with the current PPA minimum contribution does not recognize the timing difference inherent in the determination of the CAS expense and PPA's funding requirements. In particular, PPA requires all shortfall amortization to occur over seven years, whereas the CAS recognition occurs over longer periods of time (from 10 to 30 years). As a result, if this threshold is used, the comparison of the current year CAS expense with the current year PPA minimum contribution creates a timing mismatch that generally prevents the full amount of PPA required contributions to be recognized as assignable pension cost, if this threshold is used, due to the more rapid funding requirements under PPA. Effectively, this means that any recovery of prepayments can only happen in years where the minimum required contribution is greater than the unadjusted assignable cost; in addition to those years only partial recovery is permitted.

An additional difficulty with the Harmonization Threshold Test is that the NPRM does not explain how commercial segments that do not engage in government contracting are to be taken into account. Plans with commercial operations could potentially have a distinct advantage in obtaining harmonization adjustments for their governmental contracting segments simply due to having commercial operations within the same pension plan. This can occur when the CAS expense is determined solely for the government contracting portion of the plan, whereas the PPA minimum contribution is determined for the entire plan (including the commercial portion).

Our recommended approach to address all of these problems is to eliminate the first Harmonization Threshold Test entirely. The second and third threshold tests, which are applied to individual cost-accounting segments, sufficiently address the harmonization requirement.

Recovery of Prepayment Credits

The ANPRM listed reconciliation of minimum required contributions with contract cost recognition over a reasonable time period as one of the goals for harmonization. A key element of the ANPRM that was discarded in the NPRM was a mechanism designed to ensure systematic recovery of mandatory prepayment credits. The NPRM even stated, "The amortization of the mandatory prepayment credits was added to the ANPRM to guarantee that the contractor would recover all of its required contributions within a reasonable time period." While these proposed provisions added complexity to the rules (which could have been further refined as suggested by various parties in the ANPRM comment process to address the concerns, as noted in the NPRM), the proposed ANPRM harmonization provisions appeared to be a reasonable compromise between the conflicting objectives of CAS and PPA. However, the NPRM moved in the opposite direction not only by eliminating the provisions for amortization of mandatory prepayment credits but by also creating additional triggers for harmonization with PPA funding measurements.

As defined in the ANPRM, mandatory prepayment credits refer to the amount of the minimum required funding in excess of the pension cost assigned to a cost accounting period. Under the ANPRM, subject to phase-in, mandatory prepayment credits were amortized over five years as a separate component of assignable costs. Therefore under the ANPRM, they are assignable even if a plan was otherwise limited to zero contributions due to application of the assignable cost limit.

Under the NPRM, there is no mechanism present to ensure that contractors will be able to assign mandatory prepayment credits. One step that would help in this matter would be either to eliminate the first trigger based on a comparison of the PPA cost to the preliminary CAS cost, as mentioned above, or alternatively to base the trigger on the presence of remaining prepayment credits. However, even with elimination or modification of the trigger, situations could still arise in which recovery of accumulated mandatory prepayment credits may be indefinitely delayed.

For example, consider the situation that many contractors are currently experiencing. Due to the low corporate bond interest rate environment, their PPA liabilities are substantially higher than their long term CAS funding liabilities, resulting in current minimum required contributions that are generating prepayment credits under CAS. For purposes of this example, let's assume that a contractor is using a PPA effective interest rate of six percent and a long term funding rate of eight percent. Right now, since their PPA costs and liabilities are higher than their non-harmonized CAS costs, the NPRM rules would provide for some recovery of the minimum required contribution. But this recovery is limited to the period when the threshold tests provide for the use of the MAL in the CAS calculations. When the PPA threshold tests no longer provide for the use of the MAL, a negative amortization is then created to restore the use of the CAS liability. At this point the recovery of the existing prepayment credits may cease and additional prepayment credits could potentially begin to accumulate.

This situation could also be further exacerbated under scenarios when the corporate bond rate increases and/or future asset performance exceeds expectations after the mandatory prepayment credits have accumulated, effectively locking up the mandatory prepayments and limiting the recovery of these actual funding costs incurred with respect to the pension plan.

To eliminate these situations in which recovery of accumulated mandatory prepayment credits are indefinitely delayed, we ask the Board to reintroduce the mandatory prepayment credit mechanism that was contained in the ANPRM. Based on comments submitted on the ANPRM, this prior attempt was problematic in at least four areas:

1. The phased-in amortization period was unduly complicated.

   To remedy this, we would recommend using a 10-year amortization period without any phase-in.

2. There was uncertainty as to how to separate mandatory from voluntary prepayment credits.

   In order to provide for fair and consistent identification of these credits, a clear and easily applied set of rules for determining mandatory prepayment credits is necessary. Also such rules should be easy to audit and verify. For this purpose, information available on the Schedule SB can be used.

   We propose the following possible approach for developing and maintaining voluntary and mandatory prepayment credit accounts. The initial balance of the mandatory prepayment credit account would equal the excess, if any, of the contractor's prepayment credits as of the close of the plan year preceding when the PPA rules are first applicable (generally 2008 except for PPA Section 106 contractors) over the plan's prefunding balance as of the same day (before any portion of the prefunding balance is waived). In subsequent years the mandatory prepayment credit account would increase with minimum funding requirements, prefunding balances used to offset funding requirements, and investment return; and would decrease with assignable costs. The use of prefunding balances in this manner essentially allows a contractor to recharacterize, as a mandatory prepayment credit, contributions that previously have been considered voluntary contributions—but only to the extent that such contributions are being used to satisfy minimum funding requirements.

   At any time, the voluntary prepayment credit account would equal the excess, if any, of the contractor's prepayment credits over the current balance of the mandatory prepayment credit account.

3. It was unclear how the mandatory amortization charges affect future assignable CAS costs.

   We recognize that the mandatory amortization charges essentially represent an acceleration of otherwise assignable CAS costs. Accordingly, they should be recognized in a manner which will reduce otherwise assignable CAS costs in future periods. In order to accomplish this, we think simply treating them as gains subject to a 10-year amortization provides an appropriate method of recognition.

4. It was unclear how to allocate the mandatory amortization charges in a plan with multiple segments.

   We believe the most equitable manner to accomplish this is to first allocate such charges proportionately among segments that are underfunded based on their respective levels of underfunding on a harmonized basis. This would provide orderly progress toward a goal of bringing all segments up to full funding over time. If all charges have not been allocated at this stage any remaining amount would be allocated in proportion to its harmonized normal costs. Therefore, a segment that has been curtailed and has a zero normal cost would only share in funding needed to eliminate any underfunding but would not share in the allocation of excess assets.

Prepayment Credits
In addition to the concerns above regarding the elimination of the mandatory prepayment concept, we have identified certain technical areas with respect to prepayment credits which we believe require further attention:

1. Proposed Section 412-50(a)(4) states, “The accumulated value of such prepayment credits shall be adjusted for investment returns and administrative expenses in accordance with 9904.413-50(c)(7) until applied towards pension cost in a future accounting period.” We agree that the prepayment credit should be adjusted for investment returns and for a proportional share of investment-related expenses. However, we do not believe that the prepayment credit should be adjusted for non-investment related administrative expenses. We note that the existence of prepayment credits does not typically trigger additional fees for actuarial, audit and other administrative services. Therefore, there is no reason to allocate a portion of such administrative fees to the prepayment credits.

2. The example in proposed Section 412-60.1(b)(1)(i) is intended to illustrate the application of investment earnings to the prepayment credit. This example is worded such that the entire existing prepayment credit is applied to the assignable pension cost as of the first day of the plan year and a “new” prepayment credit is established for the amount contributed in excess of the remaining assignable pension cost. It is our understanding that the timing of the funding of pension costs is governed by section 31.205-6(j) of the Federal Acquisition Regulations which generally allows, without penalty, a delay in funding beyond the first day of the plan year, but not beyond 30 days after each quarter of the year. Accordingly, we believe that the example, as worded, may create a misimpression regarding the timing of when prepayment credits should be applied. To prevent the example from being misconstrued, we would suggest that the first sentence of Note 4 be changed to read as follows: “The contractor has decided to transfer and apply the prepayments credits on the first day of the plan year.” In addition, we think it would be helpful to show an illustration that demonstrates the creation of a completely new prepayment credit that illustrates how the prepayment credit grows in its first year, as well as a separate illustration that demonstrates the exhaustion of an existing prepayment credits illustrating how to determine the actual rates of return, since there doesn’t appear to be guidance on this issue. For example, under PPA any amounts added to the prefunding balance in the current year are credited with the effective interest rate for the remainder of that year. It is our understanding that this was intentionally done under PPA so as to avoid the complexities associated with determining actual rates of return from each contribution date to year end. It would seem that the analogous treatment for CAS purposes should therefore be to adjust with the long term interest

rate for newly created prepayment credits for the remainder of the year of creation and for remaining credits until exhaustion in the final year of existence.

3. Proposed Section 412-60.1(b)(1) illustrates how asset values are calculated for a hypothetical contractor. In this example, the assets are shown separately for the segments and the prepayment credit, each being rolled forward separately. We are aware that this is one of several ways currently used to calculate the market and actuarial values of assets where there are also accumulated prepayment credits. Therefore, clarification is needed as to whether this NPRM requires a change to this method. If it remains unclear whether a change to this method is voluntary or mandatory, the lack of clarity will lead to confusion on the part of both contractors and the government.

Alignment of Actuarial Value of Assets (AVA)
Both the ANPRM and the NPRM chose not to include pension asset smoothing as part of the mandatory harmonization provisions. However, the Pension Committee believes that since pension funded status and costs are developed taking into consideration the funded status that is ultimately derived using both liabilities and assets, it is appropriate to allow for the alignment of asset smoothing methods between the two sets of rules as part of the mandatory accounting changes required as part of CAS harmonization. PPA provides for use of an AVA that uses asset averaging (up to two years) and a corridor that bounds the AVA from 90 percent to 110 percent of market value. However, CAS continues to provide for asset smoothing up to five years and maintains the 80 percent to 120 percent corridor.

In our view, it is actuarially inconsistent to apply harmonization from a liability perspective only. Since the implementation of PPA required a fundamental change in the AVA methodology for pension plans, reducing the years of permissible smoothing and the market value of assets (MVA) corridor measurement, we believe it is only appropriate to include a provision allowing a one-time change in the AVA methodology for CAS as part of the harmonization rule. This would further align the approaches under the two rules and, therefore, further reduce the cash flow timing disparity that currently exists and would be exacerbated if the PPA AVA methodology is not incorporated into CAS harmonization.

Segment Closing Calculations
In the absence of a plan termination, the NPRM provides that segment closing calculations are to be made using the unadjusted actuarial accrued liability (AAL), which is based upon long-term actuarial assumptions. We believe that this result is not viable for the reasons described below.

As background, the NPRM provides for two measures of assets and for two measures of liabilities. The various asset and liability measures have different volatility attributes:

1. **Relatively stable measures:** Because the AAL "shall reflect long-term trends so as to avoid distortions caused by short-term fluctuations" (<u>see</u> CAS 412-50(b)(4)), AALs tend to be relatively stable. Similarly, the AVA (<u>see</u> CAS 412-30(a)(15) and CAS 413-50(b)) typically smoothes fluctuations in the market and therefore is relatively stable.

2. **Relatively volatile measures:** The MVA is, by its very nature, quite volatile. Similarly, the MAL is based upon the "rates at which the pension benefits could effectively be settled based on the current period rates of return on investment grade fixed-income investments" (<u>see</u> NPRM at 412-50(b)(7)(iv)(A)). As such, it reflects market volatility similar to that exhibited by the MVA; and under some liability driven investment strategies it may move nearly 100 percent in tandem with the MVA.

Because the NPRM compares the volatile MVA against the stable AAL, the amount of segment closing adjustment (i.e., the difference between the two amounts) will fluctuate considerably. Such a comparison is illogical and would reward one party and penalize the other in an arbitrary manner based on an "apples to oranges" determination of the funded status at segment closing. While the NPRM provides for the use of market-based liability measures (the MAL) in the ongoing calculations to achieve harmonization, it does not apply the MAL in the situation where it would be most applicable, the segment closing. We believe this creates a fundamental inconsistency in the application of actuarial liabilities and calculations within the NPRM.

More significantly, by basing the segment closing on the AAL rather than the MAL, the NPRM effectively reverses harmonization on a cumulative basis by retaining the present segment closing rules. This means that any increases in CAS pension cost recovery that result from harmonization would be refunded at the time of segment closing. Coincident with directing the harmonization of CAS with PPA, Congress established the funding target as the minimum level of appropriate pension funding. Because the funding target and the MAL are, for practical purposes, identical at segment closing, PPA essentially contemplates that assets equal to the MAL would have been accumulated at segment closing through required funding to that level. In effect, one government agency would penalize a contractor if its pension assets are below the MAL while another would demand a refund of any excess of the MAL over the AAL. Because the contributions required by PPA are irrevocably maintained within the pension trust, a contractor closing a segment would be required to refund to the government the cumulative amount of pension costs that it had recovered under the harmonization rule with funds outside of the pension trust.

Given these inconsistencies, we believe that the segment closing rule proposed in the NPRM would not achieve harmonization and could create the additional risk of government-contracting plan sponsors exiting the defined benefit system as a whole given the inherent financial risk and lack of financial flexibility.

In our view, the CAS Board should calculate segment closing adjustments based on the difference between the MVA and the MAL, where the MAL would be based upon the most recent set of PPA interest rates available as of the segment closing date without the averaging that is included as a part of the PPA funding segment rates. Both the MVA and the MAL represent independent market-based assessments of the value of the assets and obligations based upon then-prevailing market conditions, therefore volatility would be less than in the current proposal and the potentially wide-reaching problems resulting from the reversal of harmonization at segment closing would be eliminated.

Conclusion

The Pension Committee recognizes the efforts of the CAS Board to achieve harmonization as prescribed under PPA, especially considering that Congress did not provide any further guidance regarding how Cost Accounting Standards (CAS 412 and 413) should be harmonized with the PPA funding requirements. We also understand the difficulty in aligning the apparent conceptual differences between the ongoing entity perspective of CAS and the settlement funding perspective of PPA which has resulted in an increasing cash flow timing disparity for plan sponsors. The result of CAS harmonization with PPA should ensure agreement between the two sets of rules such that pension funding required under PPA is recognized for cost recovery in a timely manner, as previously stated in the Academy's response to the staff discussion paper in 2007. To achieve this, we believe that addressing the areas of concern noted in this letter are critical to meeting the objective of harmonization under PPA.

Finally, we feel that if the areas noted above are not addressed in the final rule, additional exposure will be introduced into the pension system for plan sponsors who are subject to the CAS rules. A final rule that contains provisions prohibiting the ultimate recovery of costs already incurred by sponsors could discourage the continuance of pension programs by affected plan sponsors which would be counter to the objective of the harmonization rule contained within the Pension Protection Act.

We would be happy to discuss any of these items with you at your convenience. Please contact Jessica M. Thomas, the Academy's pension policy analyst (202-785-7868, thomas@actuary.org) if you have any questions or would like to discuss these items further.

Sincerely,

John H. Moore, FSA, MAAA, EA, FCA
Chairperson, Pension Committee
American Academy of Actuaries