EAR
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Pension Protection Act of 2006: It's the Law

ON AUG. 17, before an enthusiastic White House audience, President Bush signed into law the Pension Protection Act of 2006.

The Academy hailed the legislation for bringing some much-needed clarity for defined benefit plans but warned that there is still a need for Congress to create a long-term national retirement policy framework that includes a guaranteed lifetime income.

"A national retirement income program must embrace and promote defined benefit pension plans," said Donald Segal, the Academy's vice president for pension issues. "An enduring national retirement framework must include a guaranteed retirement income for life for all Americans. Social Security, even if we were to solve its current funding shortfalls, does not provide an adequate retirement income, and defined contribution plans, such as 401(k) accounts, carry with them significant risks."

The legislation is the culmination of months of negotiation by House and Senate conferees who struggled to hammer out compromises between competing pension reform legislation passed by the House (H.R. 2830) and by the Senate (S. 1783). Just before going on summer recess on July 28, the House took the provisions agreed to in conference (except certain tax provisions) and passed them 279 to 4 in a new bill, H.R. 4. To avoid further delay, the Senate passed H.R. 4 without any amendments by a vote of 93 to 5 late in the evening of Aug. 3.

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Academy Task Force to Advise on Implementation

IN THE WAKE OF THE PASSAGE last month of the Pension Protection Act of 2006 (H.R. 4), what comes next? As protracted as it seemed at the time, the final passage of pension reform legislation was really just the beginning of a much longer process. Now it falls to government agencies to write and revise regulations to incorporate the new legislative provisions.

Acknowledging the importance of this next step, the Academy has brought together a group of pension professionals to form a Funding Reform Advisory Task Force that will assist federal agencies as they work to implement the new legislation.

"We recognized the need for appropriate, timely, workable, and easily administrable guidance to facilitate the change in funding rules," said Donald Segal, the Academy's vice president for pension issues. "So, we decided to create a task force with the expertise capable of assisting in that process."

The task force is composed of a cross-section of actuaries representing different areas—small plans, large plans, multi-employer plans—as well as a number of other interested parties working in the employee benefits arena. Meeting for the first time on Aug. 29, the task force identified issues that need to be addressed through regulation and discussed the necessary prioritization of those items. At the end of the meeting, various task force members were charged with providing input to the relevant federal agencies.

"As task force discussions occur," said Segal, "we will provide input to the appropriate government representatives. It will be an ongoing process with a completely open dialogue on both sides."

—HEATHER JERBI

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Academy Challenges *Wall Street Journal* on Pension Issues

ON TWO SUCCESSIVE DAYS in August, the Academy's Pension Practice Council sent dissenting letters to the editor of the *Wall Street Journal*.

In an Aug. 17 letter, the council pointed out several inaccuracies in an Aug. 15 *Journal* article, "What You Need to Know About Pension Changes," on likely pension plan conversions resulting from the passage of the Pension Protection Act of 2006.

The article stated that under cash balance plans, "workers get nothing if they leave before they are 'vested,' which usually takes five years." In its letter, the council pointed out that the vesting schedule for cash balance plans was changed from five to three years in the new legislation. Similarly, the article cited "wear-away" as a major problem when defined benefit pension plans are converted to cash balance plans. In fact, the new legislation bans wear-away for any cash balance conversion on or after June 29, 2005.

The council also disagreed with a suggestion in the article that companies could boost their profits by converting to cash balance plans. "Converting to a cash balance does not automatically reduce pension expenses," the council stated in its letter. "When a company decides to reduce pension expenses, it often considers a variety of changes. Cash-balance conversions have sometimes been implemented by organizations seeking to reduce their future pension costs; this plan is simply one way to achieve this objective. Alternative approaches available to plan sponsors—then and now—include reducing benefits under 'traditional' designs or freezing or terminating their plans altogether."

Responding to an editorial, "The Other Pension Crisis," that appeared the next day in the *Journal*, the council agreed that problems with public-sector defined benefit plans needed to be addressed but took issue with the editorial's conclusion that public-sector workers would be better served by moving to defined contribution plans.

"Defined benefit plans are not the problem," the council argued in an Aug. 18 letter that was published in the Aug. 28 issue of the paper. "Poorly written pension laws and regulations, combined with pension managers who have over promised benefits or under funded their pension obligations, have been the problem."

Both letters are available online at www.actuary.org/pension.asp.

PBGC Requires Electronic Filing

EFFECTIVE JULY 1, the Pension Benefit Guaranty Corp. (PBGC) is requiring the sponsors of large pension plans (those with 500 or more participants in the prior year) to file their premiums electronically for plan years beginning on or after Jan. 1, 2006. Sponsors of all pension plans are required to file electronically for plan years beginning on or after Jan. 1, 2007.

The PBGC is encouraging plan sponsors to sign up and file premiums electronically in advance of the deadline by filling out an online application on the PBGC's website. Go to www.pbgc.gov/practitioners/premium-filings/content/page13265.html and click on "My Plan Administration Account (My PAA)."

The PBGC website has lots of helpful information about electronic filing, including checklists to help get you started, online demos to see how "My PAA" works, and answers to frequently asked questions. There is also a "What's New" section for plan administrators and practitioners that highlights items of interest such as the implementation of mandatory electronic filing. Go to www.pbgc.gov, select the practitioner page, and click on the "What's New" link.

The Value of Defined Benefit Plans

Editor's Note: *The following is the executive summary of a new issue brief published in August by the Pension Committee of the Academy's Pension Practice Council.*

DEFINED BENEFIT (DB) and defined contribution (DC) plans are both components of a broad examination of retirement security. However, there are a number of distinct differences between these types of retirement plans. The American Academy of Actuaries' Pension Committee has created an issue brief to discuss these differences, what they mean to long-term retirement goals, and ways to achieve parity between DB and DC plans.

- **DB** plans specify the benefit employees will receive when they retire from employment.
- **DC** plans specify the contribution the employer pays into the plan each year for the employee.
- **HYBRID PLANS**, such as cash balance plans, are DB plans that have DC elements.

Advantages of DB Plans Versus DC Plans for Employees

DB plans provide retirement security through predictable lifetime incomes for retirees, no matter how long they live. The issue brief discusses, in detail, how DB plans are effective at reducing the different types of risk for employees, including investment risk, longevity risk, inflation risk, contribution risk, leakage risk, disability risk, survivor risk, early retirement risk, and company solvency risk.

DB plans also have been more efficient at investing one large pot of funds, which means they can fund larger benefits with the same contribution, or the same benefit with a smaller contribution.

Advantages of DB Plans Versus DC Plans for Employers

DB plans can be as flexible and creative as their designers want them to be. Employers have some flexibility in the amount of contributions they make to DB plans each year—in good years they can put more in so that in tough years they can put in less. They also have more flexibility with investments and design of the DB formulas.

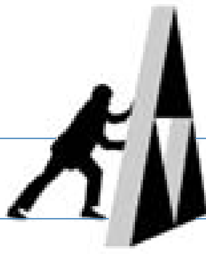
In addition, DB plans can help employers better manage their workforce. Incentives, such as early retirement windows, can assist in mitigation of the negative financial effects of workforce reductions on employees. And DB plans can provide incentives that allow employers to better recruit and retain employees. When communicated well, DB plans are more effective in reducing retirement fears among older employees because DB pension benefits can be more predictable.

Advantages of DB Plans Versus DC Plans for the Nation

There are several advantages, in general, of DB plans as compared to DC plans: A higher percentage of an employer's workforce is covered in a DB plan than in a 401(k), where the employee's contribution is voluntary; the trillions in DB assets promote national saving, economic efficiency, and can reach certain investment markets that 401(k)s cannot; DB plans reduce the nation's dependence on Social Security and other government assistance programs; and lifetime pension benefits from DB plans are more likely to help reduce poverty rates for the elderly.

Achieving Parity Between DB and DC Plans

At one time, DB plans covered 40 percent of the workers in the United States. Now they cover less than half that percentage. The disparity in treatment of DB versus DC plans set by law has contributed to this decline. This issue brief discusses in detail a number of the rules that create a disadvantage for DB plans.



Quiet Communications

NEWS RELEASES, media calls, letters to the editor—by definition, most of the work of the Academy's communications department is, for lack of a better word, well publicized. For example, can you count how many times in the past month you've seen a mention of Academy Senior Pension Fellow Ron Gebhardtsbauer in a news article? Or seen his face on CNBC? This is the public side of Academy communications.

Ron Gebhardtsbauer being interviewed on AARP's "Prime Time Radio"

I've focused in past columns on the behind-the-scenes activities of Academy Pension Practice Council members and staff (particularly Ron). But there's a behind-the-scenes aspect to media relations that's just as important to the success of Academy objectives. With the assistance of Andrew Simonelli, the Academy's media relations manager, I spent some time looking at the quieter side of Academy communications. It's quiet, but it sure is busy.

Since the beginning of this year, the Academy has received more than 150 media calls, a number that's representative of initial inquiries and doesn't include follow-ups. Some of these calls generated interviews, and some of those interviews resulted in media placements. But even when no placement occurs, there's often an exchange of information between staff and reporter that's highly productive.

For example, in May, the Academy took issue with the Department of Energy (DOE) because of a proposed new policy that would have eliminated reimbursement to contractors for costs associated with their defined benefit plans. You probably saw the council's letter to the DOE (which ran in the summer *EAR*), and you might have seen the news release the Academy issued or read a newspaper article or two that specifically referred to the Academy's letter. While the Academy wasn't mentioned in every *Washington Post* article on the subject, Academy staffers were continually involved in providing background information (including a bulleted list developed by the Pension Committee highlighting problems with the proposal) to the *Post* reporter as he followed unfolding events.

Similarly, while many of us caught Ron's appearance on the "Nightly Business Report," a live financial news television program with 2.6 million viewers weekly, what isn't well known is the relationship with the show's producers that was developed and cultivated long before we ever saw Ron take a question from moderator Darren Gersh.

Another area of communications activity is responding to erroneous newspaper articles, editorials, and other media reports. Because of the sheer number of articles per day in newspapers all over the country, the Academy can't respond to every inaccurate report. But Academy staffers actively monitor the media and are prepared to put together a quick response when necessary. In August, the Academy responded to an article and an editorial that appeared in the *Wall Street Journal* on two succeeding days (see story, Page 2). In both

instances, once it was agreed that it was important to correct inaccurate information, Academy staff worked quickly to develop letters to the editor that were written, reviewed, and approved in the space of a day. Only the letter objecting to the conclusions in the editorial made it into print. But the time invested in developing the other letter wasn't wasted. These letters can often lead to media inquiries as reporters realize that the Academy has the interest and expertise to provide accurate, objective information.

Academy staffers also actively participate in communications forums in which they receive hourly lists of media inquiries from all over the country. The inquiries are not sent specifically to the Academy, but they offer the Academy an opportunity to respond. A positive reaction can mean Academy-specific inquiries in the future. This is another facet of the Academy's strategy to garner name recognition as well as publicize the numerous public statements already developed by various councils and committees. Not many people see these communications, but they are as important in getting the Academy's name out in the media universe as many other, more public, methods.

Just as is the case on the public policy side, it isn't always the work that you see but what occurs behind the scenes that can make all the difference.

—HEATHER JERBI

PBGC Extends Reporting Relief

ON JULY 12, the Pension Benefit Guaranty Corp. (PBGC) extended reporting relief to employers using the corporate bond rate for purposes of Sec. 4010 gateway testing.

The action came in Technical Update 06-2, which updates Technical Update 06-1 released in January. The original technical update waived reporting of financial and actuarial information under Sec. 4010 for employers who would not have to file if vested benefits were valued using the 85 percent corporate bond rate as required by the Pension Funding Equity Act. The reporting relief applied to years ending on or after Dec. 31, 2005, and on or before June 30, 2006, and was provided because of uncertainty about the applicable interest rate given the pending pension reform legislation (see Page 1).

The new technical update extends the reporting relief to years ending on or after July 1, 2006, and on or before Dec. 30, 2006, provided no filing is required (for purposes of Sec. 4010), if the 85 percent corporate bond rate is used to value vested benefits for years ending on or after Dec. 31, 2005.

According to the PBGC, this technical update has no effect on the determination of premiums or other reporting requirements.

A copy of the technical update is available online at www.pbgc.gov/practitioners/law-regulations-informal-guidance/content/tu15773.html.

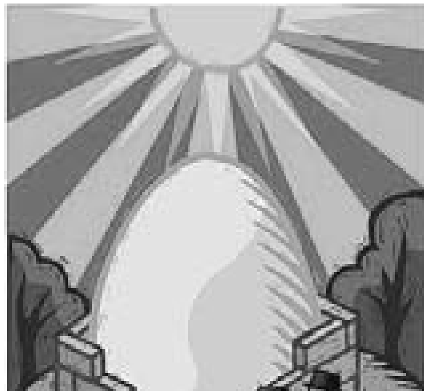
Highlights of the new legislation include:

➤ **CURRENT FUNDING RULES.** Current funding rules using 90 percent to 100 percent of the four-year weighted average of high-quality, long-term corporate bond rates will be extended through 2007. The extension for certain government contractors will be longer—until 2011 or until cost accounting standards are revised, whichever comes first.

➤ **MINIMUM REQUIRED CONTRIBUTIONS.** Beginning in 2008, the minimum contribution will equal the target normal cost (under the traditional unit credit cost method) plus seven-year amortization of the unfunded target liability for accrued benefits. The funding target will phase in over four years (92 percent in 2008, 94 percent in 2009, 96 percent in 2010, and 100 percent in 2011 and thereafter) for plans not subject to the deficit reduction contribution. Gains and losses will be amortized over seven years, waivers over five years.

➤ **AIRLINE PROVISIONS.** Two options are offered in the legislation. Airlines that are unwilling to freeze benefits will be given 10 years to amortize their 2008 shortfall. This option would not create any special termination premium or limits on Pension Benefit Guaranty Corp. (PBGC) benefits. Airlines that are willing to freeze benefits will be given 17 years to fund their shortfalls, which will be determined by using a fixed interest rate of 8.85 percent. This option must be elected in 2006 or 2007, and the airline will then be exempt from any deficit reduction contributions. Under the second option, PBGC guarantees will be frozen for 10 years. Stiff exit premiums will apply if the plan is terminated within five years.

➤ **INTEREST ASSUMPTION.** Two options are available: either a three-segment yield curve from an unweighted 24-month average yield curve for high-rated corporate bonds (A–AAA rated); or a full yield



curve without 24-month averaging. The segmented yield curve could be phased in over a three-year period for plans that are in existence in 2007.

➤ **MORTALITY ASSUMPTION.** Use of the RP2000 table did not end up in the final legislation. The Internal Revenue Service (IRS) will continue to set mortality rates for healthy and disabled participants. Larger companies will be able to seek IRS permission to use plan-specific mortality tables, as long as every plan in the controlled group employs an experience table and there is adequate experience to justify the table.

➤ **AT-RISK PLANS.** Higher target normal costs and funding targets will apply to at-risk plans, based on assuming the earliest retirement age and most valuable forms of payment for participants. A plan will be considered at risk if it has more than 500 participants and its smoothed assets (less credit balance) are less than 80 percent of target liabilities and less than 70 percent of at-risk liabilities. (The 80 percent target is phased in over four years from 65 percent.) If a plan is deemed to have been at risk for two of the past four years, the at-risk liability will rise by an additional $700-per-participant charge plus 4 percent of the funding target. The at-risk liability increase will be phased in over five years.

➤ **CREDIT BALANCES.** Credit balances will reflect the investment performance of plan assets. If assets (minus the credit balance) are less than 80 percent of target liabilities, then the credit balance cannot be used to reduce contributions. For the purposes of the 80 percent test, carryover credit balances from 2007 will not be subtracted from assets. Otherwise, assets will generally be reduced by the full credit balance for minimum funding and benefit restriction purposes (unless restricted under a binding agreement with the PBGC).

➤ **ASSET SMOOTHING.** Asset values will be limited to 90 percent to 110 percent of market value as of the plan's valuation date and can be averaged over any period up to 24 months.

➤ **PBGC PREMIUMS.** The full funding limit exemption is eliminated. Also, the legislation makes special termination premiums permanent.

➤ **LUMP-SUM INTEREST ASSUMPTION.** The segmented yield curve for the prior month (phased in 20 percent per year from 2008 to 2012) will be used to determine minimum lump-sum payments.

➤ **BENEFIT RESTRICTIONS.** Benefit restrictions will depend on a plan's adjusted funded status, which will be determined by looking at assets reduced by the credit balance and increased by security provided by the employer outside of the plan. Most benefit restrictions will take effect in 2008, with more time for collectively bargained plans.

➤ **MAXIMUM DEDUCTIBLE CONTRIBUTIONS.** Beginning in 2008, the maximum deductible contribution will equal the target cost plus 150 percent of the appropriate funding target and an allowance for future pay/benefit increases, minus any assets.

➤ **MINIMUM FUNDING STANDARDS FOR MULTI-EMPLOYER PLANS.** A 15-year amortization will be used for all regular funding standard account bases established after 2007. In cases of plan amendments paying increased benefits over shorter periods, amortization will

be over the time frame in which the increased benefits are paid.

➤ **ENDANGERED OR CRITICAL-STATUS MULTI-EMPLOYER PLANS.** Certain poorly funded multi-employer plans will have to set a funding improvement program (reducing benefits, increasing contributions, or both) to meet certain improvement benchmarks.

➤ **AGE DISCRIMINATION.** The legislation clarifies prospectively that as long as benefits cannot be larger for a similarly situated younger person and are fully vested after three years of service, and that interest credits don't exceed a market rate of return, cash balances and pension equity plans are not age discriminatory. Whipsaw is also fixed prospectively. Wear-away at normal and early retirement ages is banned on conversions that occurred after June 29, 2005.

➤ **SECTION 420 RULES.** Internal Revenue Code Sec. 420 is expanded to allow the transfer of pension assets over 120 percent funding levels to cover future retiree health costs, as long as the 120 percent funding level is maintained.

➤ **MISCELLANEOUS PROVISIONS.** The legislation makes permanent certain provisions of the Economic Growth and Tax Reconciliation Act of 2001. It also includes sections on in-service distributions at age 62 (for phased retirement), expanded participant disclosure of recent funding levels and benefit statements (for both defined benefit and defined contribution plans), investment advice, automatic enrollment, default investments, faster vesting for non-elective contributions, and diversification of company stock.

The text of the Pension Protection Act of 2006, H.R. 4, S. 1783, and H.R. 2830, is available through the Library of Congress' online legislative service (thomas.loc.gov) or by contacting Samuel Genson, the Academy's legislative assistant (genson@actuary.org).

Webcast Series on New Pension Legislation

THE ACADEMY IS JOINTLY SPONSORING a series of live funding reform webcasts in conjunction with the American Society of Pension Professionals and Actuaries (ASPPA), the Conference of Consulting Actuaries (CCA), and the Society of Actuaries (SOA). In each webcast, held on succeeding Wednesdays from noon to 1:30 p.m. EDT, experts will discuss different aspects of the Pension Protection Act of 2006.

You can register for an individual session or the whole series. Those who register for three or more webcasts will receive a discount. A CD capturing the synchronized audio and visual presentation will be available for purchase after each webcast. A copy of the presentation materials will be included with each CD.

Each webcast offers 1.8 hours of Academy, CCA, and ASPPA continuing education (CE) credit and two units of SOA professional development credit. Each webcast is recommended to meet enrolled actuary CE requirements. While the program sponsors recommend that each webcast would satisfy 90 minutes core CE credit for enrolled actuaries, the final decision rests with the Joint Board for the Enrollment of Actuaries.

The webcast schedule is as follows:

➤ SEPT. 6—**OVERVIEW OF THE NEW LEGISLATION:** A comparison with the existing law and an overview of the new legislation.

➤ SEPT. 13—**FUNDING IN DETAIL:** A discussion of changes to minimum required and maximum deductible contributions and of transition rules.

➤ SEPT. 20—**FUNDING FOR AT-RISK PLANS:** A discussion of special funding and other requirements for at-risk plans, including any special rule for industry and other groups.

➤ SEPT. 27—**SMALL PLANS:** A discussion of special rules and considerations for small plans and DB(k) plans, including funding requirements and other changes.

➤ OCT. 4—**MULTI-EMPLOYER PLANS:** A discussion of special rules and considerations for multi-employer plans, including funding requirements and other changes.

➤ OCT. 11—**NON-FUNDING ISSUES:** An overview of other changes, including for 401(k) accounts, cash balance plans, and in Pension Benefit Guaranty Corp. disclosures and premiums.

For fee information and to register, go to www.soa.org/ccm/content/ce-meetings-seminars/conference-and-symposiums/funding-reform-webcast-series/funding-reform-webcast-series.

Stock Option Valuation Practice Note

The practice note helps actuaries evaluate and select valuation methodologies and actuarial assumptions and document and report on stock option valuations and related analyses.

WOULD YOU BE surprised to learn that there are a number of similarities between pension valuation and stock option valuation? Or that these similarities make actuaries uniquely positioned to engage in this area of practice? With the intent of assisting actuaries who are moving into this emerging field, the Academy's Stock Options Task Force recently completed a new practice note, *Valuation of Employee Stock Options*.

"We, as actuaries, have an opportunity to bring our expertise to the valuation of stock options," said task force Chairperson Thomas Terry. "The task force recognized the need for a practice note to provide some guidance to actuaries who are becoming involved in this area and to contribute to the growing body of knowledge on the development of option models."

The practice note focuses on valuations performed under Financial Accounting Standard 123R, *Share Based Payments*. The nonbinding guidance in the note is intended to assist actuaries in the evaluation and selection of valuation methodologies, the selection of actuarial assumptions, and the documentation and reporting of the results of stock option valuations and related analyses.

Using a question-and-answer format, the practice note is broken into six different sections:

- Section 1 discusses background information including categories of stock option valuation models and other relevant guidance available from the Actuarial Standards Board, the Financial Accounting Standards Board, and the Securities and Exchange Commission.
- Section 2 outlines the necessary considerations for model selection, as well as the steps in selecting a model and how stock prices are modeled.
- Section 3 examines the validation of the model.
- Section 4 provides an overview of the analysis of historical data—what is available and how it should be analyzed and weighted.
- Section 5 discusses the volatility assumption and how an actuary would set such an assumption, including what experience has to be considered and over what time period.
- Section 6 delves into the necessary reporting and disclosure requirements for valuation results.

The practice note has an open comment period of 60 days, and actuaries are encouraged to provide the task force with any input or experience that might be helpful for inclusion in the final version of the note. Comments can be directed to Heather Jerbi, the Academy's senior pension policy analyst (Jerbi@actuary.org).

Academy Again Seeks Circular 230 Clarification

THE ACADEMY'S Pension Practice Council renewed its request for guidance on revisions to Circular 230 in a July 28 letter to the Internal Revenue Service (IRS).

The Academy previously sent letters to the IRS in May 2005, before the guidance was finalized, and again in October 2005 seeking advice on how certain sections of the circular relate to pension actuarial practice.

In addition to a definition of the expression "best practices," the Academy is seeking advice on:

- The meaning of the exception regarding the qualification of a qualified plan;
- The meaning of "written advice" with respect to a "federal definitive tax issue";
- The treatment, in general, of tasks apparently not covered by the exception;
- The status of the actuary not authorized to practice law;
- The applicability of the circular to issues in areas where the enrolled actuary isn't authorized to practice before the IRS.

In its letter, the Academy said it would have additional follow-up implementation questions for the IRS if its guidance indicated that some of the normal activities of pension actuaries involved covered opinions as defined by the circular. The Academy also indicated concern about the steps that a practitioner might need to follow when taking control of the work of a subordinate practitioner.

The complete text of the letter is available on the Academy's website at www.actuary.org/pension.asp.