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Academy Measures Pension Reform Options

CULMINATING MONTHS OF RESEARCH, discussion, revision, and expansion, the Academy's Pension Practice Council has published its issue analysis on pension funding reform.

The timing couldn't be better.

On Feb. 7, the Bush administration released its 2005 budget, which included a detailed proposal designed to bring simplicity, accuracy, stability, and flexibility to pension funding rules.

"We are encouraged that the administration has taken positive steps to frame pension funding reform and that they are similar to the principles that the Academy has outlined," said Ken Kent, the Academy's vice president for pension issues. "The defined benefit (DB) system is essential for national retirement security, and any reform needs to foster an environment that encourages the creation and maintenance of DB plans."

The council distributed the analysis to congressional staffers and other policy-makers during annual Capitol Hill visits Feb. 28.

In addition to simplicity and flexibility (including incentives for funding), other principles for pension funding reform that are outlined in the Academy's analysis, *Pension Funding Reform for Single Employer Plans*, are solvency, predictability, transparency, avoiding moral hazards, and ensuring a smooth transition. As part of its examination of incremental reform alternatives, the Acad-

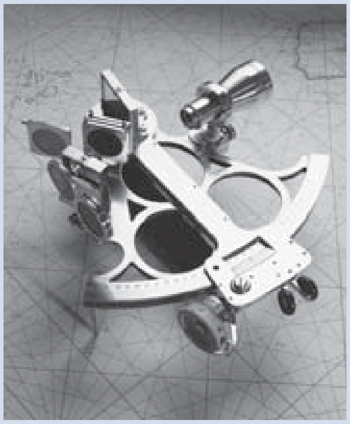
PENSION REFORM, PAGE 6

Inside this issue

Navigating the Yield Curve

INTEREST IN PENSION FUNDING reform received a bounce earlier this year when the Bush administration proposed establishing a corporate bond yield curve as the permanent replacement for the 30-year Treasury rate used in measuring pension plan liabilities.

Having already anticipated the need for more education on the basic functionality of a yield curve, particularly for pension plan funding, the Academy's Pension Committee is working quickly to finish a new issue brief that outlines the advantages and disadvantages of the method.



The use of a yield curve may serve to improve the accuracy of the liability measure. However, the minor improvement in accuracy doesn't justify the increase in cost and complexity. The current single rate, based on high-quality corporate bonds, provides similar results and is much simpler to calculate.

A yield curve requires a significant number of high-quality corporate bonds at various points in time. It must be based on bonds with short-, medium-, and long-term duration to be effective in measuring pension liabilities. Cash flows payable at different times would be dis-

YIELD CURVE, PAGE 7

Annuities Versus Lump Sums—Weighing the Benefits

S THE U.S. PENSION SYSTEM moving away from annuitization precisely at a time when people are starting to live longer in retirement?

The numbers would seem to support the theory: Bureau of Labor Statistics data indicate that a mere 27 percent of 401(k) plan participants in companies with more than 100 individuals have access to an annuity distribution option as part of their plan. At the same time, defined benefit plans (spurred by reduced mandated interest rates) are increasingly offering their participants lump sums.

While annuities are a valuable element in retirement planning, the choice of an annuity or a lump sum depends on a variety of elements, including often conflicting forces of personal needs and philosophies, risk tolerance, financial means, tax implications, and legal and government requirements. A subgroup of the Academy's Pension Committee has studied a number of these factors—including longevity, inflation, financial or stock market risk, and changes in financial needs, including health care and functional status, housing needs, and the death of a spouse—in order to compare how lump sums and annuities address retirement risk. The comparison will be incorporated into a new issue brief to be published later this year.

Because various studies have pointed to annuitization (through both Social Security and qualified plans) as a substantial reason for the reduction in poverty rates among this country's elderly, the subgroup is also studying possible regulatory or legislative changes that could encourage greater annuitization, including:

Ë Requiring all DC pension plans to provide annuity purchase options

Ë Restricting the payment of lump sums from qualified plans as the funded status of the plan deteriorates

Ë Encouraging insurance companies to develop more flexible annuity options by easing the restrictions currently imposed on their use in tax-favored plans

Ë Allowing flexible spending accounts to be funded by annuity income.

The subgroup also plans to review the feasibility of possible tax sanctions and sanctions by the Pension Benefit Guaranty Corp. to discourage lump sums.

EMILY KESSLER

Proper Management of Retirement System Risks

AS ENROLLED ACTUARIES, one of our many roles is to help plan sponsors manage the risks inherent in sponsoring a pension plan. Since the passage of ERISA, this job has gotten more difficult. Thirty years ago, defined benefit plans were relatively smaller in relation to the plan sponsor's core business or sponsoring government's infrastructure. A graying baby-boom population, increased longevity, and the contraction of old-line industries have combined to increase the cost and financial risk engendered by pension plans. Many plan sponsors have reacted by terminating or freezing plans and moving to defined contribution plans. In the meantime, the tight regulatory environment for private plans has led sponsors to lose sight of these changes in the bustle of compliance with myriad complex and obscure rules.

Faced with proposed solvency funding standards, a move to mark-to-market accounting, and sponsors' freezing and/or terminating plans, how can we, as actuaries, work with plan sponsors to address these changes and get back to the business of managing the risks of retirement systems? A new seminar sponsored by the Society of Actuaries, "Addressing the Financial Risks of Retirement Systems," is designed to help actuaries better measure, discuss, manage, and mitigate risks that pension plans bring to their sponsoring organizations. The seminar, scheduled for June 15-16, will run on the first two days of the SOA's spring meeting in New Orleans.

Session topics include:

- **Putting retirement system risk into context.** This session will set the stage for issues and ideas to be discussed throughout the seminar. We'll consider how things have changed since funding rules and accounting rules were set in the 1970s and 1980s. We'll focus on the risks to the plan sponsor but also consider complementary and competing risks faced by employees, shareholders, management, fiduciaries, and guaranty agencies.
- **How consideration of risk may change plan-sponsor strategies: Looking beyond the rules.** This double session focuses on the nitty-gritty of issues that plan sponsors and actuaries face in balancing accounting for and funding and investing in pension plans. How might sponsors make different decisions based on their specific operational risk, the nature of the risk from the pension plan, and changing regulation? What strategies might be useful to mitigate and manage funding, accounting, and investing risk? On funding, we'll look at the specific risks that drive funding strategies (e.g., cash flow variability) and examine how those risks can be mitigated or exacerbated. In accounting, we'll look at potential risks in a mark-to-market (FRS 17) accounting world. For investing, we'll tie together the risks that drive investment policy and again look at how those might change under mark-to-market accounting and/or solvency-funding standards.
- **Plan design.** When all is said and done, plan design may be the most powerful tool to manage and mitigate the pension-plan risk. We'll discuss how various plan-design features can minimize risk and how others can exacerbate it, and how this can vary from sponsor to sponsor.
- **The actuary's role in managing risk, and how that fits in our standards of practice.** This session will consider how examining the pension plan within this risk context fits within our professionalism guidelines.
- **Changing our focus: consulting about risk.** This session will focus exclusively on consulting and communicating these risks, risk management, and mitigation strategies to plan sponsors. We'll consider the actuary's responsibility to identify multiple risk strategies, and the advantages and disadvantages of each.

For more information about the seminar and to register online, go to the SOA website, http://www.soa.org/ccm/content/?categoryID=344002.

A graying baby-boom population, increased longevity, and the contraction of old-line industries have combined to increase the cost and financial risk engendered by pension plans.

EMILY KESSLER *is the staff fellow, retirement systems, for the Society of Actuaries in Schaumburg, Ill., and a member of the Academy's Pension Practice Council.*

TOM SCHRYER

Negative Unfunded Liability: Confusion and Relief

MANY ACTUARIES WORKING ON QUALIFIED PENSION PLANS are ignoring parts of Revenue Ruling 81-213. Rev. Rul. 81-213 tells us how to set up new minimum funding amortization bases if the old bases have been eliminated due to full funding in the prior plan year. Both of the major software systems I checked offer alternatives to the treatment specified in Rev. Rul. 81-213. EFAST's integrity scanner automatically identifies equation-of-balance problems in Schedule B filings but does not challenge the out-of-balance filings for the many plans using these alternatives. Clearly, something is unsettled here.

The Confusion

Many actuaries feel that the amortization charges under Section 7.02 of Rev. Rul. 81-213 deplete funding standard account (FSA) balances too rapidly and are not justifiable. Part of the problem is that Section 7.02 often violates the universal equation of balance in Section 1.412(c)(3)-1(b)(1) (which is repeated in Section 7.01 of 81-213).

Example Facts (unit credit method)

$1,700,000	present value of all future benefits (PVFB)
$700,000	present value of future normal cost (PVFNC)
$1,000,000	accrued liability
$1,100,000	assets
$100,000	FSA balance
8.00 %	interest rate
Yes	ERISA full funding credit in prior year

Section 7.01 and Section 1.412(c)(3)-1(b)(1)		Section 7.02 (governs)	
$700,000	PVFNC	$0	Actual Unfunded Liability (5.01)
+1,100,000	Assets	+100,000	FSA
+0	Amortization Base		
−100,000	FSA		
$1,700,000	PVFB		

Section 7.01 seems to provide the more logical equation of balance. Unfortunately, Section 7.02 generally governs and ends up amortizing $100,000 (the FSA balance) over five years when there is no unfunded accrued liability (even after subtracting the FSA from the assets).

Significant Relief

The IRS doesn't seem to object to using an equation of balance based on a negative actual unfunded liability—as long as such overfunding is limited to the sum of the FSA and reconciliation account balances. More than one senior person at the IRS has indicated this, and the IRS will approve a change in funding method that uses the approach illustrated below.

Examples (using a reasonable alternative with varying levels of overfunding):

OBRA FFL Base	$80,000	$80,000	$80,000
7.02 Base	+(30,000)	+(80,000)	+(80,000)
FSA	−100,000	−100,000	−100,000
UAL (limited)	$(50,000)	$(100,000)	$(100,000)
UAL (overfunded)	$(50,000)	$(100,000)	$(140,000)

Request for IRS Action

The need for guidance in this situation is greater today than when Rev. Rul. 81-213 was promulgated because more plan sponsors fund above the full funding limit (up to unfunded current liability) as they attempt to avoid charges to equity under FAS 87.

The process is inching forward, and at least one key person at the IRS is rumored to be trying to fashion a comprehensive solution and is keeping a file with proposals, problems, etc. A class ruling for a change in funding method was submitted to the IRS but was sent back because the IRS was working on the issue for wider distribution. Currently, the IRS is considering a request for general information that may result in some new public guidance so that all enrolled actuaries will know which approaches the IRS doesn't find objectionable.

Two secondary concerns were addressed in the request to the IRS. An enrolled actuary needs to check the box at the bottom of Page 1 of the Schedule B when he or she has "not fully reflected any regulation or ruling." An actuary following the current IRS interpretation of Rev. Rul. 81-213 would seem to be fully reflecting this ruling, but guidance from the IRS would be reassuring. Also, if an actuary changes these rules for a pension plan, does this constitute a change in funding method? Does it use up an automatically approved change in funding method (from one variant of a standard method to another)?

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

Planning for Phased Retirement

At the request of the Internal Revenue Service (IRS), the Academy's Pension Practice Council commented Feb. 8 on proposed regulations on pension plan distributions under a phased retirement program.

WHILE EXPRESSING APPRECIATION for the IRS' interest in establishing regulations that would facilitate gradual retirement, the Academy's letter outlined several points of concern as well as areas in need of clarification, including the proposed definition of normal retirement age and those aspects of the regulations covering actual distributions from a phased retirement program.

The proposed regulations state that normal retirement age cannot be set so low as to avoid the requirements of IRC Sec. 401(a) and that it "cannot be earlier than the earliest age that is reasonably representative of a typical retirement age for the covered workforce." In its comments, the Academy questioned how a "reasonably representative" age might be determined for different companies.

Other topics raised in the letter include:

Ë DEFINITION OF PHASED RETIREMENT. The proposed regulations allow payment of benefits when an employee plans a reduction in hours of 20 percent or more. While this matches a suggestion made by the Academy in a 2002 letter to the IRS, the Academy recognizes that such a process could be burdensome to employers who would be required to count hours to comply with the program. In its recent comments, the Academy suggested a number of alternatives including basing the threshold on scheduled hours, base compensation, or percentage of time worked.

Ë MINIMUM AGE/SERVICE. The Academy again recommended that the eligible retirement age for a phased retirement program should be consistent with an individual plan's designated earliest retirement age. The proposed regulations would not allow payment of benefits before age 59½.

Ë LUMP SUMS. To maintain a level playing field with defined contribution (DC) plans, the Academy suggested that de minimis benefits be allowed in the form of a lump-sum payment. Under the regulations, all optional forms of benefit available upon retirement would be offered as part of the phased retirement program, with the exception of lump sums.

Ë SECTION 415 MAXIMUM. For the regulations to be complete, they must address the conditions under which a participant's benefits may initially be limited under IRS Code Section 415 and what happens during a phased retirement period as the limits increase. The Academy also recommended that companies be allowed to restrict the total of the pension benefits paid and the partial salary earned to the amount of the participant's full-time annualized salary.

Ë AGE DISCRIMINATION IN EMPLOYMENT AND SAFE HARBORS ON REHIRES. The letter suggested that the regulations provide some guidance with respect to safe harbors for age discrimination and the rehiring of retirees.

The Academy also noted in its comments that while the proposed regulations are a move in the right direction for people who want gradually to phase out of employment, they don't help those who would like to continue working full time but must retire from their current employer to receive their pension. At the same time, the Academy said, it recognized that allowing access to pensions before retirement could raise adequacy issues.

Members of the Academy's Retirement Security Principles Task Force, chaired by Bruce Schobel, and its Pension Committee, chaired by Carolyn Zimmerman, contributed to the letter. To read the letter, go to www.actuary.org/pdf/pension/phased_feb05.pdf.

—HEATHER JERBI

The Academy noted in its comments that while the proposed regulations are a move in the right direction for people who want gradually to phase out of employment, they don't help those who would like to continue working full time but must retire from their current employer to receive their pension.

emy discusses different means of improving the financial condition of the Pension Benefit Guaranty Corp. (PBGC), ensuring predictable and flexible funding for pension plans, and increasing transparency for employees and investors.

Of particular interest in the administration's proposal, Kent said, was the proposed use of one funding rule and one amortization period to improve transparency and simplicity. Similarly, flexibility is enhanced through the administration's provision to increase the maximum deductible contribution; and its elimination of rules that currently allow sponsors of underfunded plans to avoid paying contributions and variable premiums would improve solvency.

However, the Academy is troubled that the proposal may cause employers to freeze and/or terminate their pension plans because there is still the potential for their minimum required pension contributions to become volatile and unpredictable. This would have negative repercussions on employers' ability to manage their workforce, as well as on national retirement security, the markets, employee morale, and the PBGC.

From left, Tom Terry, Ken Kent, and Ron Gebhardtsbauer pause before meeting at the White House during Pension Practice Council Capitol Hill visits.

Among other elements, the administration's proposal would:

- Offer a single liability measure based on a current duration-matched yield curve of corporate bond rates
- Provide a seven-year amortization period for funding shortfalls
- Allow for assumptions that reflect a plan's risk of termination
- Permit sponsors to make additional deductible contributions in good economic times
- Clarify the treatment of hybrid plans, including removing the effective ceiling on interest credits in cash balance plans
- Improve the PBGC's ability to enforce contributions on firms in bankruptcy
- Eliminate the use of credit balances
- Restrict underfunded plans or weak sponsors from increasing benefits
- Automatically call for amendment and benefit accrual freezes based on funded status
- Call for earlier financial status disclosure
- Mandate the use of the yield curve not only for liability deter-

Joint Board Names Advisory Committee

PATRICK MCDONOUGH, executive director of the Joint Board for the Enrollment of Actuaries, recently announced the appointment of actuaries to the Joint Board's Advisory Committee on Enrollment Examinations for the term ending in February 2007. Those appointed are:

Larry Deutsch
President
Larry Deutsch Enterprises
Fallbrook, Calif.

Janet Eisenberg
President
Eisenberg Associates Ltd.
Skokie, Ill.

Ann Gineo
Senior Vice President and Actuary
The Segal Co.
Farmington, Conn.

Pamela Marlin
Consultant
The McKeogh Co.
West Conshohocken, Pa.

Ho Kuen Ng
Professor, Department of Mathematics
San Jose State University
San Jose, Calif.

Carl Shalit
Principal
Carl Shalit & Associates
Salem, Mass.

Hal Tepfer
Vice President
Clark Consulting
Newton, Mass.

David Ziegler
Consultant
Centreville, Va.

Carolyn Zimmerman
Consulting Actuary
Harmony, Pa.

At the committee's first meeting, **Shalit** and **Gineo** were re-elected to their positions as committee coordinator and committee secretary, respectively.

mination but also for amortization of unfunded balances.

Additionally, the administration's proposal would alter the PBGC's premium structure to reflect a plan's cost. The flat-rate premium would increase to $30 per participant per plan year (it is currently $19 per participant per plan year), and future increases would be indexed for growth in the national average wage. At the same time, underfunded plans would be charged risk-based premiums according to the underfunding relative to its funding target. The PBGC's board would have the authority to adjust the risk-based premium rates periodically to ensure that it has enough revenue to cover expected losses.

In response to the administration's proposal, the Academy has indicated that, at a minimum, reform should control the volatility of contributions, retain the credit balance concept (with modifications), and allow employers to access super surpluses for other employee benefits.

PBGC actuary Dave Gustafson greets Carolyn Zimmerman at the Academy's Feb. 28 meeting.

The analysis was a group effort of the Pension Practice Council, chaired by Kent, and the Pension Committee, chaired by Carolyn Zimmerman. To read the issue brief online, go to www.

MULTIEMPLOYER PLAN REFORM

SEEKING TO ALERT CONGRESS to the impact pension reform might have on multiemployer plans, the Academy's Multiemployer Plans Task Force released a January issue brief, *Principles of Pension Funding Reform for Multiemployer Plans*.

According to the Pension Benefit Guaranty Corp., there are approximately 1,600 multiemployer defined benefit (DB) plans in the United States, covering some 9.7 million participants in 2003. Multiemployer DB plans differ from single-employer plans because all of the assets and liabilities are a shared responsibility of the participating employers and aren't segregated or credited to any one employer.

The issue brief establishes principles similar to those associated with reform of the single-employer system, and it encourages Congress to weigh the impact of changes to single-employer funding rules on multiemployer plans.

To read the issue brief online, go to www.actuary.org/pdf/pension/funding_issuebrief_05.pdf.

YIELD CURVE, FROM PAGE 1

counted at different rates. The implication for mature pension plan liabilities when measured using a typical yield curve with lower short-term rates will be higher liability values over those measured under the current requirements.

The Academy's new brief will provide three charts to illustrate the different potential shapes of a yield curve, the change in spread by duration in the Citigroup pension discount curve, and the Treasury spread since the 1980s. The charts will offer a historical perspective on the variation in rates over time and the implication of the various shapes of the yield curve.

In addition to the issue of accuracy, the brief will examine a number of other effects the yield curve would have on pension plan funding, including:

- Adding a layer of complexity to funding requirements with potentially only small improvements in accuracy
- Increasing contribution volatility since yield curves often get steep in difficult times. To avoid the volatility, employers could change their asset allocation entirely to bonds. Such a move would have significant implications for employer cost and, on a larger scale, for the capital markets.
- Uncertainty about the disparity in value for older and younger workers if, as the administration has proposed, the yield curve is applied to lump sums.

—HEATHER JERBI

30th Annual
Enrolled Actuaries Meeting

APRIL 3-6 MARRIOTT WARDMAN PARK HOTEL WASHINGTON, D.C.

THERE IS STILL TIME TO REGISTER TO ATTEND the 2005 Enrolled Actuaries Meeting, a popular way for pension professionals to earn both EA continuing education credits and professional development credits from the Society of Actuaries.

The Enrolled Actuaries Meeting is jointly sponsored by the American Academy of Actuaries and the Conference of Consulting Actuaries, in cooperation with the American Society of Pension Professionals and Actuaries and the Society of Actuaries.

Download the complete brochure and registration form at http://www.ccactuaries.org/events/ea2005/brochure.pdf.

To view what continuing education and professional development credits are available for each session, go to the program schedule online at www.ccactuaries.org/events/ea2005/programschedule-sun-mon.html.

Hotel Reservations

To make hotel reservations, call the Washington Marriott Wardman Park Hotel, 202-328-2983, or go online to www.stayatmarriott.com/2005enrolledactuaries/.

Rooms are provided on a space-available basis.

ADDITIONAL SEMINARS

Maximize your options by also attending one of the pre- and post-meeting seminars being offered in conjunction with this year's Enrolled Actuaries Meeting.

Professional Standards Seminar

Sunday, April 3, Noon-5:00 PM
EA Core 5.4 Credits

An informative session on Actuarial Standards of Practice and professional ethics, with a focus on retirement benefits, the seminar will consider whether the standards are serving their purpose, what actuaries and their employers can do to mitigate exposure, and other similar topics. Presenters at the seminar will include Lauren Bloom, the Academy's general counsel and director of professionalism issues, and pension practitioners. The seminar is co-sponsored by the Academy, the ASPPA, the CAS, the CCA, and the SOA.

Medicare Prescription Drugs Seminar

Wednesday, April 6, 2:00–6:00 PM
Thursday, April 7, 8:00 AM-Noon

Rising healthcare costs, driven in part by surging drug prices, are exerting pressures on employers, benefit-plan designers, and health providers. New higher-priced drugs on the market are adding to claims expenses, and this year Medicare is implementing the largest benefit expansion since its inception. The Medicare Modernization Act of 2003 provides employers with a variety of ways to coordinate with Medicare's prescription drug plan. Plan alternatives will have a significant impact on overall retiree medical design and employers' financial statements. This seminar focuses on the design and actuarial aspects of the new law's impact on employer plans and is designed for those with moderate to advanced knowledge of the subject. Seminar presenters will include Mark White and Dale Yamamoto. The seminar is co-sponsored by the Academy, the ASPPA, the CCA, and the SOA.

Small Consulting Firms and Practices Roundtable

Wednesday, April 6, 2:00-6:00 PM
EA Core 4.2 Credits

Discussions at the roundtable, led by CCA members with multiple years of consulting experience who have run successful consulting firms, will focus on running and marketing a small business. This roundtable will be helpful for actuaries currently working in smaller consulting firms, those who are thinking about starting a consulting firm, and those who are planning to consult part time in retirement. Much of the discussion also applies to small consulting practices at large firms. Seminar presenters include Margaret Tiller Sherwood, former president of the CCA, and Academy President Robert Wilcox. The seminar is co-sponsored by the Academy, the ASPPA, the CAS, the CCA, and the SOA.

2005 Pension Symposium — Pension Funding Reform

Wednesday, April 6, 2:00-6:00 PM
Thursday, April 7, 8:00 AM-Noon
EA Core 4.2 / EA Noncore 4.2 Credits

Kicking off with the third general session of the Enrolled Actuaries Meeting, the symposium will convene a panel of Bush administration staff to discuss administration proposals on pension and Social Security reform. Follow-up sessions will allow symposium participants to explore reform proposals in greater detail, as well as the broad and specific impact they will have on U.S. retirement security systems. Other sessions will consider four key elements of reform: solvency, predictability, transparency, and promises. The symposium is co-sponsored by the Academy, the ASPPA, the CCA, and the SOA.