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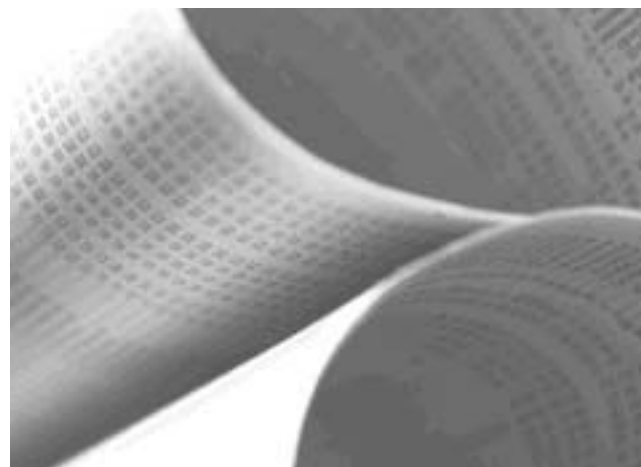
ADRIEN LABOMBARDE

New Accounting Looms for Pensions and OPEBs

UNRECOGNIZED BALANCES for single-employer defined benefit (DB) pensions and other post-employment benefits (OPEBs) currently disclosed in footnote reconciliations will hit corporate balance sheets at the end of fiscal year 2006 under phase 1 of a major project of the Financial Accounting Standards Board (FASB). The phase 1 charges would not pass through corporate income statements, but phase 2 of FASB's project may eliminate smoothing from the calculation of pension and OPEB costs.

Funded Status on Balance Sheet

In part spurred on by an Enron-fallout Securities and Exchange Commission report challenging "off balance" sheet liabilities, FASB will require the difference between pension assets and projected benefit obligations (PBO) to be recognized on the sponsor's balance sheet. The difference between the PBO funded status and the prepaid or accrued pension cost (net of tax-timing differences) will go on the balance sheet as



other comprehensive income (OCI), essentially a component of shareholder equity. Offsetting intangible assets, reported under the current rules when there are unrecognized prior

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FASB Project: The Academy's Take

ON BEHALF OF the American Academy of Actuaries' Committee on Pension Accounting, I commend the Board on its decision to pursue a thorough reconsideration, consistent with its other broad commitments, of pension and other postemployment benefit (OPEB) accounting, which in its current form lacks transparency.

We are sympathetic to the Board's decision to break the project into phases, with phase 1 limited to recognition issues and phase 2 devoted to the more difficult measurement issues. However, we are concerned about two aspects of the phase 1 program.

Those aspects are—

- *Use of the projected benefit obligation (PBO) under Statement of Financial Accounting Standard 87 (SFAS 87) to measure a balance sheet pension liability.* We

Editor's Note: This is the text of an Academy letter commenting on phase 1 of the Financial Accounting Standards Board's (FASB) project to reconsider pension and other postemployment benefit accounting. Signed by William Sohn, chairperson of the Academy's Committee on Pension Accounting, the letter was sent to FASB Chairman Robert Herz on Feb. 10.

believe that the PBO is inconsistent with the common understanding of a balance sheet liability. The accumulated benefit obligation (ABO) represents, at least during phase 1 of the project, a more appropriate measure.¹ A temporary use of the PBO as a balance sheet liability may be reversed on reconsideration in phase II, but needless damage to companies and plans will already have occurred.

- *Disallowance of measurement dates in advance of the statement date.* **FASB PROJECT, PAGE 6** →

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Pension Finance Resources Available Making Sense of Financial Economics

THE Joint Academy/Society Task Force on Financial Economics has an online resource page for pension actuaries at www.soa.org/ccm/content/areas-of-practice/special-interest-sections/pension/pension-finance/pension-finance-resources/. The page features links to papers and articles on pension finance (also known as financial economics) by a variety of authors, including actuaries and other pension practitioners from the United States, Canada, and around the world. A special section is devoted to papers on the possible

effects of pension finance on funding, accounting, investments, plan design, and public funds. There is also a link to papers from the 2003 Financial Economics Symposium in Vancouver.

If you have suggestions for other resources to link to the page, or any other comments, contact Sue Martz (smartz@soa.org). For more information about the task force, contact Heather Jerbi, the Academy's senior pension policy analyst (jerbi@actuary.org), or Emily Kessler, SOA's staff fellow for retirement systems (ekessler@soa.org).



JAMES KENNEY

An Inverted View

THERE SEEMS TO BE A VERY HO-HUM ATTITUDE among actuaries about the recent interest rate inversion in U.S. Treasuries. On Feb. 9, the Treasury Department auctioned off \$14 billion worth of 30-year bonds, at a yield of 4.53 percent. This meant that the two-year notes were yielding 11 basis points more than the long bond. Common sense tells us that such a state is unnatural and, therefore, unstable. In the past, inversions have almost invariably led to extreme fluctuations in interest rates and economic activity.

One commonly offered explanation for inversions is that the marketplace believes short-term interest rates will fall, leading to an inability to re-invest maturing notes at currently prevailing levels. This creates demand for longer-duration bonds, thus causing the yields on such notes to drop. In this case, such conventional wisdom seems to be refuted by the widespread expectation that unless the economy stalls, the Federal Reserve will continue to raise short-term rates at least two more times.

So is this inversion, as so often in the past, a harbinger of recession? Or have we achieved a sort of economic nirvana in which inflation is truly tamed at last and long-term rates simply reflect this new reality? Perhaps we are undergoing a fundamental shift in how debt is perceived: “Neither a borrower nor a lender be” on a long-term basis is the new paradigm. In this view, there is no inherent premium for the willingness to lend money in the long term, perhaps because of the risks to both sides posed by any long-term arrangement. Short term’s the thing now, whether it’s quarterly earnings or financing the federal deficit.

Certainly the Treasury wasn’t overly enthusiastic about committing to pay even 4.53 percent for 30 years—the money



raised by this first auction in four years was a small drop in the bucket of federal expenditures. The last time the long bond was auctioned (in August 2001), its yield was 5.52 percent—nearly a full point higher. This reluctance on the part of the Treasury to issue 30-year bonds is the fundamental reason these rates are so low. Over the past decade, there has been a gradual shortening of the duration of the Treasury’s debt load. Partially, this was related to the pay-down of the federal deficit under President Clinton. The strategy was continued during the Bush years, despite an increase in the national debt of nearly \$2 trillion.

When short-term rates were low, this financing strategy made a great deal of sense. But just as adjustable-rate mortgage holders have discovered, it makes less sense when rates are going up relative

to long-term rates. Like many homeowners, the federal government may decide to move from adjustable rate financing to fixed rates. Perhaps our current national debt is a short-term problem that the economy will grow its way out of, as the administration claims, and that therefore should be financed on a short-term basis. But many of our commitments as a nation are long term in nature and lend themselves to long-term solutions. This is especially true of retirement income in an aging population.

Personally, I’ve missed the 30-year bond. I’m glad to see it making a comeback, however modest at this point.

JAMES KENNEY is a member of the EAR editorial board and a consulting actuary in Berkeley, Calif.

service costs, would not exist under the new rule. Net changes arising from asset gains or losses offset by decreases or increases in PBO will be reflected each year as direct credits or charges to OCI, independent of pension costs reported in the company's income statement. Comparable rules would apply for OPEBs.

The practical effect will be an immediate showing on the balance sheet of all unrecognized net gains or losses, all unrecognized prior service costs, and any remaining unrecognized transition assets or obligations. Remaining transition balances that are left over from implementation of the current rules will be eliminated outright, but cost recognition of remaining prior service cost and gains or losses should continue to reflect current attribution methods, pending attention under phase 2 of the project. Changes will be made to disclosure requirements to reflect the new balance sheet presentation.

If an OCI balance is being reported for a pension plan under current minimum liability rules, then the change to shareholder equity (before tax adjustments) will be the portion of PBO attributable to future salaries. For other plans (including OPEBs, which do not currently have a minimum ability rule), the net charge or credit (before tax adjustments) will be the aggregate of the unrecognized balances. For most pension plans, damage from the perfect storm of low discount rates and sub-par investment performance will generate a significant reduction in shareholder equity. Most OPEBs have suffered only the discount rate side of that storm (typically offset by negative prior service costs from benefit reductions), so the OPEB hit to shareholder equity, while still material, may not be as severe.

Even sponsors of overfunded pension plans could be hit under the new rule: Pension assets that exceed PBO do not prevent a charge to shareholder equity if the current aggregate balance of unrec-

ognized amounts is a net loss or liability. Furthermore, an employer cannot fund its way out of a charge to shareholder equity, as many had recently done under the operational ceiling of the minimum liability rule. But for many companies already seeing numerous other employers freezing or terminating their DB plans, the most troublesome threat will not be the level or persistency of the equity hit, but rather the sharp increase in balance sheet volatility risk.

For companies with calendar fiscal years, the new balance sheet rules most likely will be applicable for the Dec. 31, 2006, financial statement. OCI balances for all prior years shown on that initial statement must retrospectively reflect the new rules.

Measurement Date Change

The current rule permitting a measurement date as early as three months before the financial statement date will be eliminated under phase 1 of FASB's project. For amounts reported on the balance sheet, the new rule would take effect one year after the new OCI rules described above, without retrospectively restating prior balance sheet amounts for any measurement date shift. For pension or OPEB cost, however, the new measurement date rule will apply for the 2007 fiscal year. For example, a company with a calendar fiscal year that had been using a Sept. 30 measurement date would not be required to use Dec. 31 for its balance sheet until Dec. 31, 2007. But it must be prepared by the end of 2006 to use Dec. 31, 2006, as the measurement date for 2007 costs.

Phase 2—Everything Else

Phase 2 of FASB's project will be a comprehensive two- to three-year effort addressing all other aspects of an employer's accounting for pensions and OPEBs. Most notably, current spreading mechanisms for recognition of prior service costs and gains or losses will probably be eliminat-

ed. Reference to a market-related value of plan assets for cost determination will also be revisited. Curiously, even a pension's salary projection basis for attribution of costs and measurement of liabilities will be reconsidered, although under phase 1 the PBO funded status already would have been taken to the company's balance sheet.

Phase 2 will also take another look at multiemployer plans, for which current accounting treatment is similar to the rules for defined contribution plans, based primarily on required contribution. Separate from FASB's project, one credit rating agency is already proposing to introduce new rules for multiemployer pension plan sponsors that echo the single-employer pension plan changes of FASB's phase 1. Under the credit rating agency's proposal, average underfunding for multiemployer pension plans for an industry would be used to impute a debt for any company within that industry if that company contributes to any multiemployer plan.

Prepare for Change

Although the respective authorities are seeking comment for both the FASB project and the credit agency's multiemployer pension proposal, there is enough momentum behind them that it is very likely that they will be implemented largely as proposed. Whether or not improved financial accounting emerges for pensions and OPEBs, the new snapshot of benefits programs will be drastically different from the old daguerreotype. For many plan sponsors and practitioners, the new basis for decision-making will require major long-term changes that may affect administrative practices, actuarial valuations, plan investment policies, and even the design of the plans themselves.

ADRIEN LABOMBARDE is a member of the EAR editorial board and a principal with Milliman in Houston.



Correcting Misinformation Quickly

IT WOULD BE WONDERFUL IF I COULD EXPAND on the variety of issues that members of the Academy's Pension Practice Council are discussing with congressional staff, regulators, and media. However, for the past few months, it has been funding reform all day, every day. It appears that Social Security reform is dead for now (possibly even until 2009). Tax reform is heating up, but the Academy isn't fielding nearly as many requests for information on tax reform as it receives on funding reform, thanks, in part, to funding reform analyses released last year by the Pension Committee and the Multiemployer Plans Task Force.

Providing those analyses was part of the Academy's mission to offer objective educational material to Congress, regulatory agencies, and other employee benefits organizations. But we are also often called upon to clarify material that others provide to the same groups. Activity along this line, with the exception of letters to the editor, usually goes unpublicized.

A few months ago, for example, we found ourselves in a position to correct inaccurate information that was included in a report that went to Congress. The information concerned the potential effects of discount rate flexibility on at least one airline's funding requirements under proposed pension reform legislation in the Senate. While the information was not intentionally inaccurate, Academy Senior Pension Fellow Ron Gebhardt's quickly became the preferred source for clarification. He spoke with a number of Capitol Hill staffers about the erroneous report, which stated that a particular airline wouldn't have to contribute to its pension plan under proposed Senate rules. In fact, according to Ron's calculations, the airline would have to contribute without

a credit balance to offset the contribution. Ron also corrected the misinformation in an interview with a reporter who later published an article highlighting the true effect of the legislation on the airline's pension contributions.

While Academy publications often focus on our members' interactions with congressional staff on pension reform is-

For example, while the Pension Practice Council was drafting its Nov. 28 letter to the Government Accountability Office (GAO) disputing findings in its November report on cash balance plans, newspapers were already reporting on the study's conclusions and implications. Without immediate input from the Academy, media coverage could have perpetuated poten-



ties, relationships with the media are just as crucial. Council members, working through the Academy's communications staff, often use media contacts to correct misinformation. Given the necessary Academy review processes, it can take a number of days to draft and obtain appropriate peer review for a letter to the editor or a response to a specific report. Speaking directly with media contacts is, frequently, a more efficient way to ensure that misinformation is corrected in a timely manner.

tially misleading information. To forestall that from happening, several members of the council alerted their media contacts to voice the Academy's concerns.

Ultimately, and this goes without saying, the efforts of Ron and other council members are key to the dissemination of actuarially sound information and the maintenance of the actuarial profession's credibility—both in front of and behind the scenes.

—HEATHER JERBI

We agree with the Board’s conclusion that eliminating prior measurement dates improves transparency. We are concerned, however, that a requirement to determine discount rates and asset values *precisely* at the statement date will cause major inconvenience with little benefit to statement users. We would prefer to see the standard permit the use of estimated discount rates and asset values that have been determined within a reasonable period of time before the financial report date.

Discussion

Measuring pension obligation by use of the PBO

Mandating the PBO for use as a balance sheet liability in phase 1 of the project preempts the outcome of conceptual issues that the Board is expected to address when it considers measurement issues in phase 2. We believe that the Board may reasonably conclude, in its phase 2 deliberations, that the PBO is inappropriate and may substitute the ABO or some other measure that is often less than the PBO. Mandating the PBO in phase 1 is likely to result in increased liabilities for many plan sponsors, a result that will have the unintended effect of discouraging the continuation of defined benefit plans. When a more appropriate measure is selected in phase 2, damage to participants and sponsors will have already occurred and cannot be easily repaired. We think that the Board should review this measurement issue before going forward with the mandate. We analyze the issue as follows:

1. *Inclusion of the effect of future salary increases in a liability appears to be in conflict with Concept Statement 6.* Paragraph 36 of Concept Statement 6 provides, in part, as follows:

“A liability has three essential characteristics: ... (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the

transaction or other event obligating the entity has already happened.”

With respect to clause (b), we note that there is ample evidence that employers have unilaterally withdrawn from an obligation to consider future compensation levels in paying defined pension benefits. With respect to (c), we note that the existence of a defined benefit plan does not create an obligation to increase pay in the future.

2. *Including future salary levels misrepresents the value of the contract.* We assume that salary and total compensation are under the control of employer and employee, and that salaries are set to keep total compensation competitive. So long as both parties stick to ABO pricing, both parties emerge each year with a fair exchange. Increases in pension value can be easily coupled to increases in compensation.

Consider what happens with PBO

Mandating the PBO in phase 1 is likely to result in increased liabilities for many plan sponsors, a result that will have the unintended effect of discouraging the continuation of defined benefit plans.

pricing. The employer will have “paid” more than the employee will have “received” for a year of service. The employer may freeze or terminate the plan and take a curtailment gain. This moral hazard, from the employee’s point of the view, is only avoidable if there is an enforceable multi-period contract between the employer and the employee. Except in the government sector and in some negotiated plans (which are usually not salary-based), recent experience confirms that such multi-period contracts don’t exist

or are not enforceable. Thus, there is no basis for the employee to assume that he will be entitled to anything more than his accrued benefit and, if he does so, he will have accepted lower current pay in return for a renegable promise of his employer.²

3. *Including future salary levels in pension liabilities does not provide shareholders with the most relevant information about the current value of their obligations.* Balance sheet liabilities presumably represent shareholders’ economic obligations as of the statement date. Unless an obligation to increase future pay levels exists, beyond the level of competitive rates, there appears to be no justification for including the value of future salary increases directly in the balance sheet. Few, if any, preparers have undertaken such an obligation, and accordingly, few, if any, preparers include an allowance for future salary increases in their balance sheets.

Is there any reason to treat salary increases differently if the preparer sponsors a final-pay defined benefit plan? The plan, if not amended, will pay benefits indexed to pay, but the plan sponsor makes no commitment to increase the pay itself. An employer that commits itself to providing competitive total compensation has not thereby committed itself to recognizing future pay increases by offering a defined benefit plan. PBO accounting would force recognition of future salary increases for sponsors of defined benefit plans but not otherwise, a distinction for which we see no justification.

4. *The PBO cannot be settled while the ABO can.* Since pay is under the control of the sponsor, no insurance company will accept an obligation to pay benefits based on future pay levels to be set independently by the annuity purchaser. Settlement accounting under SFAS 88 appears to recognize that only the ABO can be settled. The lack of marketability of the excess of PBO over ABO is a strong indication of the lack of economic substance to the PBO.

5. *Recognition of the ABO is consis-*

tent with use of the accumulated postretirement benefit obligation (APBO) under SFAS 106 for eligible employees and retirees. The APBO includes an allowance for postretirement health care cost inflation. Unlike salary escalation in a pension plan, however, health care cost inflation is outside the employer's control. Thus, based on the contractual exchange, fair value, and settlement theories outlined above, using the ABO under SFAS 87 would be compatible with using the APBO for eligible employees under SFAS 106.³

6. *Recognition of the ABO is a reasonable extension of accounting under SFAS 87.* The excess, if any, of the value of the ABO over the fair value of assets is recognized in the balance sheet in some cases. It would be a logical extension of current practice to require that the difference between ABO and fair value of assets be the balance sheet entry in all cases while eliminating the intangible asset.

7. *Some historical comments on the PBO.* In a traditional final-pay plan, the increase in value of the accrued benefit for each unit of pay raise increases rapidly with increasing age and service. In order to recognize the ultimate projected benefit more evenly over an employee's career, actuaries devised the projected unit credit method (PUCM) many years ago as one means of ensuring a relatively level contribution flow in a final-pay plan. By design, the PUCM attributes more cost than the benefit earned in the early years, and less cost than the benefit earned in the later years. Mathematically, the consequence is to build up a reserve in excess of the value of accrued benefits.

When the PUCM is used as an actuarial funding method, the PBO is an intermediate result in the determination of the contribution and is not inherently meaningful by itself. In 1985, FASB adopted the

PUCM as the only acceptable cost allocation method. However, the PBO remained an intermediate result that appeared only in the footnotes, except in the limited context of purchase accounting.

One reason given for moving the PBO (net of assets) to the balance sheet is that it would merely confirm what FASB had in mind in 1985 and get rid of the objectionable "off balance sheet" implications of current accounting. We do not think it is so simple. In 2006, placing the PBO on the balance sheet would not simply straighten out today's bookkeeping; it would significantly change it and should be so treated.

8. *A comment on purchase accounting.* We note that the unfunded PBO is recognized as a liability by an acquirer under Paragraph 74 of SFAS 87. Consistent with the views expressed previously, we believe it is the unfunded ABO that should be so recognized and hope the Board will address this matter at an appropriate time.

Measurement dates other than statement dates

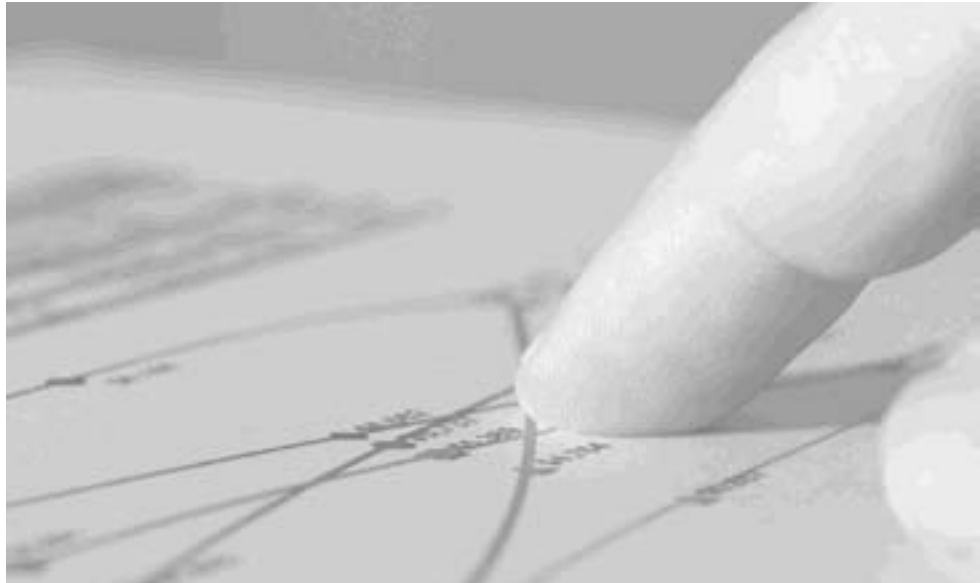
Under current practice, it is permissible to use a measurement date up to three months before the statement date. It is also acceptable to project either data or earlier valuations to the measurement date, taking into account significant interim events.

We agree that using the statement date as the measurement date is preferable. Our concerns lie with the wishes of the preparer who wants to publish accurate results as early as possible after the statement date (for example, Dec. 31). Note also the Securities and Exchange Commission (SEC) has been pressing preparers to publish results earlier, and accurate⁴ results are often needed only a few business days following fiscal year-end in order to prepare for boards of directors meetings two or three weeks into the fiscal year. Our specific concerns are as follows:

1. *Availability of asset values.* We continue to research the availability of timely asset values, especially from entities abroad. First indications are that asset values may not be readily available, especially if the reporting entity's fiscal year-end differs from the statement date of the preparer; if plan trustees need to gather information from several asset managers; or if plan assets include investments that don't have published trading data (private placements or insurance contracts, for example).

2. *Determination of the discount rate.* Only a minority of sponsors have systems in place that enable them to produce several hypothetical valuations with varying discount rates and then later choose the appropriate valuation based on market

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conditions at the end of the year. It would greatly simplify and accelerate the valuation process, without significantly impairing the quality of the valuation results, if the preparer could choose a discount rate before the end of the year and have to modify it only if bond rates changed significantly in the interim.

3. *“Last-possible-moment” determinations of discount rates do not improve the value of the estimate.* Determination of an ABO, and even more so a PBO, is a statistical exercise in which the reliability of the estimate is no better than the reliability of the least reliable factor entering into the calculation of the estimate.⁵ Of the inputs to the actuarial calculation of the PBO, the employee data may be a year out of date and the discount rate may, in large part, be a theoretical construct.⁶ Thus, insisting on the use of a discount rate based on market conditions as of the last possible moment should not be expected to improve the reliability of the estimate.

4. *Alternative proposal on selecting a discount rate.* We would prefer to be able to choose a discount rate based on market information as of no more than 60 days before the statement date and use that rate to determine obligations as of the statement date, provided that market rates had not changed significantly in the interim. The as-of date should be consistent from year to year. As before, we believe that the additional reliability gained by waiting until the statement date would be small compared to the additional administrative burden.

Footnotes

¹ The ABO is present value of benefits accrued to the valuation date. The PBO is the present value of benefits accrued to the valuation date but reflecting assumed pay increases between the valuation date and the assumed date of retirement. In pay-related plans, the PBO will usually exceed the ABO.

² The argument in point 2 is taken from Jeremy Gold: “Retirement Benefits, Economics and Accounting: Moral Hazard and Frail Benefit Designs” (North American Actuarial Journal, Vol. 9, No. 1, January 2005, p 88 et seq.).

³ For an actuary’s view of measurement problems with the APBO, see Jeffrey P. Peteril: Measuring Terminable Postretirement Obligations, (North American Actuarial Journal, Vol. 9, No. 1, January 2005, p 112 et seq.).

⁴ “Accurate” in the sense that they are the numbers that will appear in the financial statements, not necessarily that they are more accurate than statistical estimates can otherwise be.

⁵ In many cases, the ABO can be hedged with financial instruments of suitable quality, or an insurance company can sell an annuity for the obligation. The PBO, when it exceeds the ABO, is always a statistical estimate for which there is no market.

⁶ Discount curves or indices for calculating SFAS 87/106 liabilities have been constructed by Citigroup, Merrill Lynch, the actuarial consulting firms, and other financial houses. They differ significantly for a number of legitimate reasons, including the sparseness of reliable data at the longer maturities. Choosing a discount rate may come down to choosing among a number of theories of future interest rates, none of which can be confirmed in today’s market.

2006 Pension Hill Visits

ACADEMY MEMBERS CONVERGED on Washington Feb. 27 to discuss pension issues with congressional staff and other policy-makers. Six teams with 21 actuaries fanned out to the White House, various congressional offices, the Treasury and Labor departments, and the Internal Revenue Service, Government Accountability Office, Congressional Research Service, Pension Benefit Guaranty Corp., and National Academy of Social Insurance.



From left, Academy staffer Andrew Simonelli confers with Brian O’Konski, Lisa Larsen, and Ed Burrows prior to a meeting with the policy director for House Majority Whip Roy Blunt (R-Mo.).



From left, Don Segal, Sarah Wright, and Ken Butfin prepare to meet with the policy adviser for House Minority Leader Nancy Pelosi (D-Calif.).