EAR

ENROLLED ACTUARIES REPORT

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EMILY KESSLER

Guide to Financial Economics

THE JOINT ACADEMY/SOCIETY OF ACTUARIES (SOA) Task Force on Financial Economics and the Pension Actuarial Model recently released a guide to help pension actuaries understand how financial economics affects their practice.

The guide, *Pension Actuary's Guide to Financial Economics,* and an accompanying spreadsheet, provides an overview of financial economics and then takes the lessons of financial economics and shows how they might apply to the funding, accounting, investing, and design of pension plans.

Unique to the guide are tables illustrating how, under the current tax structure, value for shareholders can be created by investing pension assets in bonds and directing other investments that aren't tax sheltered into equities. The spreadsheet allows the user to test in theory the

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Inside this issue

Court Finds Cash Balance Discriminatory

Ruling at Odds With IBM Decision

DESPITE PASSAGE OF THE PENSION PROTECTION ACT OF 2006, which states that cash balance plans are not age discriminatory on a prospective basis, and a similar finding earlier this year in the landmark decision *Cooper v. IBM Pension Plan and IBM Corp.* in the 7th U.S. Circuit Court of Appeals, the question is still being debated through the courts.

In an Oct. 30 ruling at odds with the earlier IBM decision, U.S. District Judge Harold Baer Jr. found cash balance plans to be age discriminatory. In his ruling in *In Re J.P. Morgan Chase Cash Balance Litigation* in New York's Southern District, Baer wrote that cash balance plans combine elements of both defined benefit and defined contribution plans and that the "definition of the phrase 'rate of an employee's benefit accrual,' used only in the age-discrimination provision for defined benefit plans (ERISA Sec. 204(b)(1)(H)(i)), is central to this analysis."

Defendants in the case argued that the term "rate of benefit accrual" refers to the employer's contributions (pay credits and interest credits), while the plaintiffs contended that it refers to the amount an employee receives from the hypothetical account in the form of a retirement benefit. In

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Letters to the Editor

Should Actuaries Share the Blame for Pension Problems?

IN THE FALL 2006 *EAR*, I read a portion of the Academy's response to a *Wall Street Journal* editorial on problems with public-sector defined benefit (DB) plans. The Academy argued, "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." Blaming others for the problems with defined benefit plans has become tiresome.

DB plans are valuable retirement programs, and there seems to be plenty of blame to go around, but where have the actuaries been? Everyone involved in sponsoring or monitoring programs want, or say they want, what is best for the participants. Why are actuaries left off the list of those open to criticism?

Some consulting actuaries seem to have been more concerned with keeping their well-paid jobs than with doing their work. Telling clients what they think they want to hear, such as that the plan has little or no cost, serves nobody. Making insufficient effort toward creating an administration/valuation process that is affordable serves nobody. The result has been plans being poorly valued, at high expense, with numerous misunderstandings, and the provision of inadequate information to properly sponsor or manage plans.

It may be late for DB plans, as many have already had to be terminated because of shortsighted thinking. Actuaries should be in the forefront in anticipating problems instead of contributing to them. Blaming others does no credit to our profession. Continuing education programs should require more than attendance. Review programs should cover professionalism, not just technical matters. Until we are prepared to take the hard stands in the best interest of participants and our profession, not those of our jobs or our employers, we should not be so quick to point fingers at other groups.

— LARRY O'MALEY
Fort Wayne, Ind.

JAMES VERLAUTZ, *chairperson of the Academy's Pension Committee, replies on behalf of the committee: We appreciate the author's comments, and many of his points are well taken. However, we are not aware of instances of actuaries engaging in egregious behavior, such as providing inadequate information necessary to properly manage plans, offering misrepresentations merely to please clients, or employing "insufficient effort" toward making the valuation processes affordable.*

To the extent such behaviors have occurred, Precept 13 of the Code of Professional Conduct requires actuaries with specific knowledge to report such behavior to the Actuarial Board for Counseling and Discipline.

What Do Retirees Want?

THE CLAIM WAS MADE IN THE FALL 2006 *EAR* that DB plans are good because they provide a predictable lifetime income to retirees. I suggest that what retirees want is not a predictable flat-dollar retirement pension; they want a pension that at least maintains its purchasing power, one that is inflation-proofed. No working actuary wants to stay at the same pay level until he or she retires. It is absurd to expect retirees to want a progressively declining standard of living through (a) inflation, and (b) the whims of Congress changing how much pension, pay, and Social Security benefits are taxed from year to year.

Also, there is a certain inconsistency in batting for the DB plan team, while pitching for the hybrid plan team. Why not design legislation that would allow significantly more flexibility in employer contributions to defined contribution (DC) plans, including a requirement for conversion to an index-linked lifetime pension of any fraction of a participant's DC fund, for up to a five-year period, to avoid cashing in at a low price. As for the PBGC, eliminate the flat-rate premium from employers who have a DB plan that provides accruals of benefits for all full-time employees, and charge it instead on employers with no DB plan or with frozen DB plans. That would encourage employers to adopt DB plans and to fund them adequately—thus avoiding both flat and variable premiums.

— JAN HARRINGTON
New York

DONALD SEGAL

In Memoriam: Judy Anderson

JUDY ANDERSON, staff fellow for actuarial education at the Society of Actuaries (SOA), former SOA staff fellow for retirement systems, and a former member of the *EAR* editorial board, passed away on Nov. 25 after a yearlong battle with cancer.

As a staff member at the SOA for more than 16 years, Judy touched the lives of many actuaries. In addition to her various responsibilities at the SOA, she was a warm and valuable presence at many meetings of the Academy's Pension Practice Council and Pension Committee. She was also a valued adviser to the Joint Board for the Enrollment of Actuaries Advisory Committee on Examinations.

Judy was a joy to be with. She was always smiling, had a wonderful sense of humor, and loved the give-and-take of good, animated discussion with friends (and many, many actuaries considered themselves to be her friend). She especially enjoyed conversations when she knew someone was "pushing her buttons."

Judy's contributions have made retirement actuarial practice a better place. She will be sorely missed. Donations in her memory can be sent to the American Cancer Society at 820 Davis St., Suite 340, Evanston, Ill. 60201. Donations may also be made online at www.cancer.org/docroot/don/don_0.asp?from=hpbox.

DONALD SEGAL, *a consultant with CCA Strategies in New York, is the editor of the* EAR *and the Academy's vice president for pension issues.*

In Memoriam: Leslie Shapiro

LESLIE SHAPIRO, the former director of practice and executive director of the Joint Board for the Enrollment of Actuaries, died Oct. 2 of complications after heart surgery. He was 70.

Shapiro, an attorney, retired in 1995 after 31 years working for the federal government, 20 of them as the Joint Board's executive director. For three years following his retirement from the federal government, Shapiro was general counsel to the National Society of Accountants. At the time of his death, he was president of the Padgett Foundation, which advocates for small businesses in the areas of education, research, and policy.

Although highly regarded by the actuarial profession, Shapiro frequently withstood a certain amount of teasing because of his status as a lawyer. Carl Shalit, coordinator of the Joint Board's Advisory Committee on Enrollment Examinations, passed along an anecdote about an occasion when Shapiro was working on procedures for continuing education and suggested to actuaries on the advisory board that retesting was a possibility. "A couple of actuaries reportedly got up and said, 'When you retake the bar, we will retake the test,'" Shalit recalled. It is said the rump revolt elicited a smile from the executive director.

Shapiro was well known for his wit and could hold his own when it came to snappy comebacks. During a conference of the American Society of Pension Actuaries some years ago, Shapiro fielded a question from a pension practitioner who wasn't an actuary. He had been in the business for 25 years and knew as much about pension practice as any actuary, the questioner said. Why was he prohibited from signing a Schedule B, just because he hadn't taken the actuarial exams? Without skipping a beat, Shapiro reportedly replied: "I have a great bedside manner. Why shouldn't I be able to be a doctor?"

Updated Social Security and IRS Amounts for 2007

These three tables list updated figures for IRS pension limits, Social Security amounts, and covered compensation for 2007.

Andrew Eisner of Buck Consultants Research Department compiled the tables.

Covered Compensation, 2007

2007 WAGE BASE $97,500

YEAR OF BIRTH	AGE IN 2007	SSRA	SSRA	YEAR OF COVERED COMPENSATION ROUNDED TO $1*	$12	600**	$3000
1940	67	66	2006	48,820	48,816	48,600	48,000
1941	66	66	2007	51,349	51,348	51,600	51,000
1942	65	66	2008	53,826	53,820	54,000	54,000
1943	64	66	2009	56,234	56,232	56,400	57,000
1944	63	66	2010	58,617	58,608	58,800	60,000
1945	62	66	2011	60,966	60,960	61,200	60,000
1946	61	66	2012	63,280	63,276	63,000	63,000
1947	60	66	2013	65,560	65,556	65,400	66,000
1948	59	66	2014	67,691	67,680	67,800	69,000
1949	58	66	2015	69,737	69,732	69,600	69,000
1950	57	66	2016	71,674	71,664	71,400	72,000
1951	56	66	2017	73,534	73,524	73,800	75,000
1952	55	66	2018	75,300	75,300	75,600	75,000
1953	54	66	2019	77,006	77,004	76,800	78,000
1954	53	66	2020	78,660	78,660	78,600	78,000
1955	52	67	2022	81,780	81,780	81,600	81,000
1956	51	67	2023	83,280	83,280	83,400	84,000
1957	50	67	2024	84,694	84,684	84,600	84,000
1958	49	67	2025	86,014	86,004	85,800	87,000
1959	48	67	2026	87,274	87,264	87,000	87,000
1960	47	67	2027	88,474	88,464	88,200	87,000
1961	46	67	2028	89,614	89,604	89,400	90,000
1962	45	67	2029	90,669	90,660	90,600	90,000
1963	44	67	2030	91,706	91,704	91,800	93,000
1964	43	67	2031	92,700	92,700	93,000	93,000
1965	42	67	2032	93,617	93,612	93,600	93,000
1966	41	67	2033	94,449	94,440	94,200	93,000
1967	40	67	2034	95,160	95,160	95,400	96,000
1968	39	67	2035	95,769	95,760	96,000	96,000
1969	38	67	2036	96,257	96,252	96,000	96,000
1970	37	67	2037	96,617	96,612	96,600	96,000
1971	36	67	2038	96,917	96,912	97,200	97,500
1972	35	67	2039	97,191	97,188	97,200	97,500
1973	34	67	2040	97,406	97,404	97,500	97,500
1974	33	67	2041	97,500	97,500	97,500	97,500

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

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

Social Security - 2007 Factors

On Oct. 18, the Social Security Administration announced updated factors for 2007.

Wage Base The maximum amount of earnings taxable in 2007 is $97,500 for Social Security purposes.

COLA The cost-of-living increase in benefits is 3.3 percent—first applicable to December 2006 benefits, payable in January 2007.

Wage Index The average annual wage figure of $36,952.94 will be used in computing benefits for workers who become eligible in 2007. This figure is based on data for the last complete year (2005) and was used to determine other wage-indexed numbers given in the table below.

FACTOR	2007	2006
Wage base:		
for Social Security	$ 97,500	$ 94,200
for Medicare	No Limit	No Limit
old-law wage base, for indexing PBGC maximum, etc.	$ 72,600	$ 69,900
Cost-of-living increase (applies to December benefits, payable in January)	3.3%	4.1%
Average annual wage (based on data two years earlier)	$36,952.94	$35,648.55
PIA formula, 1st bend point	$ 680	$ 656
PIA formula, 2nd bend point	$ 4,100	$ 3,955
Maximum family benefit, 1st bend point	$ 869	$ 838
Maximum family benefit, 2nd bend point	$ 1,255	$ 1,210
Maximum family benefit, 3rd bend point	$ 1,636	$ 1,578
Retirement test exempt amount (annual)		
below SSNRA	$ 12,960	$ 12,480
year of SSNRA	$ 34,440	$ 33,240
Wages needed for one quarter of coverage	$ 1,000	$ 970
FICA (employee) tax rate:		
Social Security (OASDI)	6.20%	6.20%
Medicare (HI)	1.45%	1.45%
Total	7.65%	7.65%
SECA (self-employed) tax rate, total	15.30%	15.30%

IRS Pension Limits for 2007

Principal Limits

IRC	LIMIT	2007 ROUNDED	2006 ROUNDED	2007 UNROUNDED	NEXT INCREMENT	% INCREASE NEEDED
415(b)(1)	Defined benefit plan limit	$180,000	$175,000	$183,104	$185,000	1.0%
415(c)(1)	Defined contribution plan limit	45,000	44,000	45,776	46,000	0.5%
401(a)(17)	Limit on includible compensation *	225,000	220,000	228,880	230,000	0.5%
402(g)(1)	Limit on 401(k)/403(b) elective deferrals	15,500	15,000	15,501	16,000	3.2%
414(q)	HCE definition	100,000	100,000	103,416	105,000	1.5%
414(v)(2)	401(k)/403(b)/457(b) Catch-up deferral limit	5,000	5,000	5,167	5,500	6.4%

Other Limits

IRC	LIMIT	2007 ROUNDED	2006 ROUNDED	2007 UNROUNDED	NEXT INCREMENT	% INCREASE NEEDED
457(b)	Limit on nonqualified deferrals	15,500	15,000	15,501	16,000	3.2%
409(o)(1)(C)	ESOP payouts, 5-year limit	915,000	885,000	915,520	920,000	0.5%
409(o)(1)(C)	ESOP payouts, additional 1-year limit	180,000	175,000	183,104	185,000	1.0%
408(k)(2)(C)	SEP pay threshold	500	450	515	550	6.8%

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

PBGC Reports Improved Financial Status

ON NOV. 15, the Pension Benefit Guaranty Corp. (PBGC) released its 2006 Annual Management Report, detailing its current financial position. The PBGC posted an $18.1 billion deficit in 2006 for single-employer pension plans, a decrease of $4.7 billion from 2005. The improvement in single-employer pension plans is primarily a result of airline relief provisions included in the Pension Protection Act of 2006.

In a report issued on Sept. 30, the PBGC recorded single-employer pension program assets of $60 billion and $78.1 billion in liabilities. The total underfunding of insured single-employer plans decreased by approximately $100 billion, to $350 billion in 2006. The PBGC insures pensions for approximately 34 million Americans, participating in 28,800 different plans. In 2006, it was responsible for the pension benefits of 1.3 million working and retired Americans.

The PBGC's program insuring workers enrolled in multi-employer pension plans posted a loss of $404 million in 2006. This brings the net deficit of the program to $739 million, up from $335 million in 2005. The loss is primarily due to a projected increase in loss of $257 million from providing financial assistance to multi-employer plans, although the amount was partially offset by an increase in premium income of $32 million. The total estimated underfunding of the multi-employer system is $150 million, a decrease of $50 million from the previous year. The PBGC reports the multi-employer program has $1.2 billion in assets and $1.9 billion in liabilities. This program insures pensions for 10 million workers and retirees in 1,540 plans.

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tax arbitrage under different assumptions about investment returns and personal and corporate tax rates. A built-in toolbar allows users to modify asset allocations, expected returns, and assumed tax rates; direct user input is also enabled.

Other topics in the new guide include:

- Why measures for solvency, market-value reporting, and contribution budgeting for pension liabilities differ and how these differences can confuse plan sponsors.
- Why users of financial statements, many of whom have been influenced by financial economics, are demanding certain changes to financial accounting standard (FAS) 87 (currently being amended as part of FAS 158, which reflects changes to defined benefit and other post-retirement accounting) and why measuring cost on a projected-benefit-obligation basis isn't supported by financial economists.
- Why it may be advantageous for a company to borrow to finance its pension "debt" (unfunded accrued liability).
- How the existence of the Pension Benefit Guaranty Corp. invites economically unsound decisions.
- How designing for value can improve pension plans going forward.

The guide also contains a resource list for those wishing to undertake a deeper study of financial economics and its effect on pension plans. Many of the resources are publicly available on the SOA website.

Copies of the guide are available on the SOA website for $15. To purchase the guide online or access the spreadsheet, go to http://www.soa.org/ccm/content/areas-of-practice/special-interest-sections/pension/research-thinking-ahead/pension-finance/pension-finance-resources/.

The guide takes the lessons of financial economics and shows how they might apply to the funding, accounting, investing, and design of pension plans.

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

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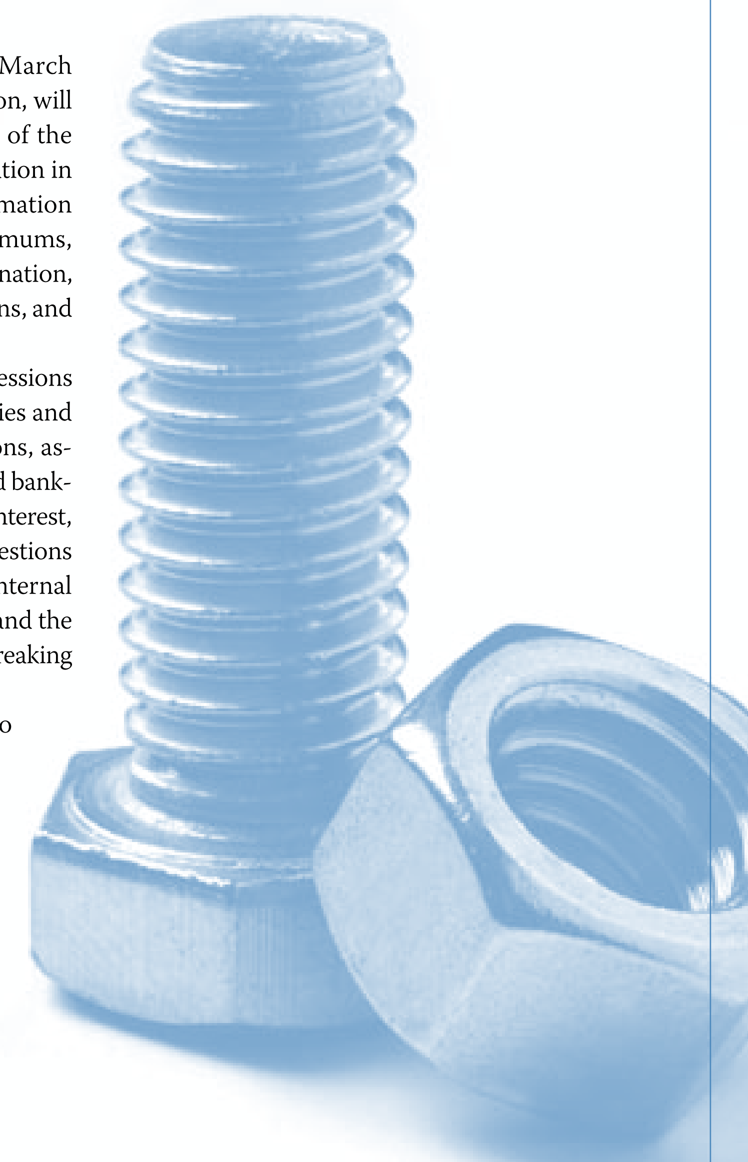
the defendants' argument, there is no violation of ERISA as long as the rate at which payments are made to an employee's account does not decrease from year to year. The plaintiffs contended that the rate at which an employee accumulates retirement benefits must increase as the employee gets older in order to avoid a violation.

Since a defined benefit plan promises "a retirement benefit, not employer contributions to a retirement account," Baer ruled, the language in the statute suggests that "rate of benefit accrual" refers to the outputs of a plan, thereby favoring the plaintiffs' arguments.

In his appellate court decision in the IBM case, U.S. Circuit Judge Frank Easterbrook found the exact opposite. He ruled that the "phrase 'benefit accrual' reads most naturally as a reference to what the employer puts in (either in absolute terms or as a rate of change), while the defined phrase 'accrued benefit' [under the age discrimination test for defined contribution plans] refers to outputs after compounding."

J.P. Morgan plans to appeal the decision to the 2nd U.S. Circuit Court of Appeals.

Pension Reform From Nuts and Bolts to Advanced Strategies



THE 2007 ENROLLED ACTUARIES MEETING, March 26-28 at the Marriott Wardman Park Hotel in Washington, will offer attendees an intensive introduction to all aspects of the Pension Protection Act of 2005. With sessions on the new legislation in each time track of the meeting, you can pick up valuable information on new liability calculations, asset valuations, minimums, maximums, and transition rules, as well as new rules for hybrids, age discrimination, benefit restrictions, disclosure requirements, multi-employer plans, and defined contribution plans.

But there's more. Broaden your professional horizons with sessions on valuing stock options, 409A, executive compensation, Securities and Exchange Commission proxy rules requiring actuarial calculations, asset/liability modeling, financial economics, accounting reform, and bankruptcy. The meeting will also offer sessions on topics of perennial interest, including a review of the Gray Book, an annual compilation of questions posed to representatives of the Treasury Department and the Internal Revenue Service (IRS), dialogues with representatives of the IRS and the Joint Board for the Enrollment of Actuaries, and sessions on late-breaking developments, standards, ethics, and current court cases.

You already know that the EA Meeting is a convenient way to maximize your networking opportunities and continuing education dollars. But this year there is value added, with a Pension Symposium and the Academy's 2007 Spring Meeting kicking off at the same location on the final day of the 2007 EA Meeting.

Focus on basic nuts and bolts, attend sessions on advanced strategies, or do both. There's something for everyone at the 2007 EA Meeting (well, for every pension actuary). Come listen, learn, and earn up to 18 hours of continuing education credits as you explore the ever-changing pension landscape. Sign up early for the best prices. Registration material is available at www.ccactuaries.org.

Expand Your Perspective, Extend Your CE!

March 28, 2007

ACADEMY 2007 SPRING MEETING

IF YOU ARE COMING TO WASHINGTON FOR THE 2007 ENROLLED ACTUARIES MEETING, why not plan on extending your stay by a day to take advantage of the Academy's 2007 Spring Meeting?

The Academy meeting is conveniently scheduled to coincide with the conclusion of the Enrolled Actuaries Meeting and will be held at the same location, the Marriott Wardman Park Hotel in Washington. The Academy meeting is expected to include:

➜ A casualty seminar on reinsurance risk transfer, including accounting issues and insurance bifurcation proposals, offered in cooperation with the Casualty Actuarial Society;

➜ Health sessions on such topics as congressional health care priorities in the new Congress, applying principles-based methodologies to long-term care, and current retiree health issues;

➜ A general session on actuarial standards, sponsored by the Actuarial Standards Board;

➜ A luncheon session and a pre-meeting reception the night before.

Further details and registration information will be posted shortly on the Academy website, www.actuary.org.

Educational Webcasts

PLAN NOW TO SOAK UP SOME CONTINUING EDUCATION from the comfort of your desk chair. The Academy and the Conference of Consulting Actuaries are co-sponsoring a series of audio seminars on professionalism and other topics of interest to pension actuaries in 2007. Among offerings scheduled so far:

Gotcha Yet Again: More ERISA Traps for the Unwary Actuary
Jan. 24
12:30-1:45 p.m. EST

GASB 43/45 Update
Feb. 14
12:30-1:45 p.m. EST

CRUSAP Debate
March 14
12:30-1:45 p.m. EDT

Executive Compensation—Looking Back, Looking Forward
April 11
12:30-1:45 p.m. EDT

Actuarial/Client Communications—ASOP 41, ABCD Aspects
May 9
12:30-1:45 p.m. EDT

Hot Pension Topics
June 13
12:30-1:45 p.m. EDT

Actuarial Discipline/Ethics Debate—What Should I Do When?
July 11
12:30-1:45 p.m. EDT

Conflict of Interest/ Confidentiality Concerns/ Identify Your Client
Sept. 12
12:30-1:45 p.m. EDT

Actuarial Aspects of Investment Education
Oct. 10
12:30-1:45 p.m. EDT

Code of Conduct
Nov. 14
12:30-1:45 p.m. EST

Breaking Policy Issues
Dec. 12
12:30-1:45 p.m. EST

For more information and to sign up, go to www.ccactuaries.org.