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ACTUARIAL REPORTS UNDER ERISA

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1. Allocation of plan termination liabilities
2. Reports between triennial valuations
3. Actuarial certification
4. Justifying changes in assumptions
5. Experience with Canadian requirements

MR. NEIL R. CRONQUIST: My primary responsibility on this panel is to discuss, and stimulate discussion about, our program subtopics 1 and 2. At the start, it is important to focus on the responsibility given to the enrolled actuary both with respect to what he reports and how he reports. Clearly, the enrolled actuary cannot be arbitrary or capricious in the all-important process of picking actuarial assumptions as well as the other actuarial elements, but he must recommend these choices with due regard for the appropriate principles and practices established by the profession, the philosophy (if any) of his own firm, and the consulting process with his client. The possibility of fiduciary liability may have some influence here as well.

Subtopic (1) on our program "Allocation of Plan Termination Liabilities" is nested within subtopic (2) "Reports between Triennial Valuations," since the allocation of plan termination liabilities is simply one of the items to be reported each year. My primary focus here will be on subtopic (2). This subtopic description can be read in several ways. For instance, if read as a question, "Reports between Triennial Valuations?", the answer is, "Yes, by using form EBS-2." If read as a statement of opinion, many eyes will fasten on the word triennial. What did the Committee have in mind here? Let me suggest a few possibilities:

One, the triennial valuation should be linked with a traditional annual valuation and the question is how should annual reports differ from those required every 3 years.

Alternatively, perhaps the enrolled actuary should make only a triennial valuation, coupled with an interim report, and the problem is to discuss the appropriate reports between those valuations.

My own study of ERISA leads me to a conclusion that the actuary, and the plan sponsor who engages him, can find plenty of comfort in the Law and its Committee Reports for a triennial, biennial, or the more usual annual actuarial valuation. If that is so, reports between triennial valuations need not be seen as any different from making the triennial report.

ERISA requires an actuarial reporting annually as well as triennially. The triennial report to IRS is under Title II, Section 1033. The first such report must be presented for the initial plan year to which the new funding requirements apply and of course every third year thereafter (or more frequently if required by the IRS). Presumably the more frequent reports will be required if there is some question as to the legitimacy of a tax deduction.

The annual actuarial reporting cycle is a function of the Title I, Section 103 requirement that plans file a report with the Labor Department. This rather comprehensive annual report, as described in the Law, is not yet finalized but is to be designated form EBS-2. It is to include the plan's financial statement certified by an independent qualified public accountant, as well as an actuarial report. The increased responsibility and involvement of the accounting profession in pension matters, both as accountants and auditors, is extremely important. We can expect to hear more from them. In order to support the actuarial information presented in this annual report, the enrolled actuary is required to perform the full actuarial valuation at least every third plan year. Both Labor and IRS are charged with the responsibility of coordinating their actuarial reporting requirements to present duplication or overlap. The structure of the statute suggests that this should not be difficult. Several encouraging steps have already been taken in that general direction. In view of this coordination requirement, and other relevant considerations, it is appropriate for purposes of these remarks to ignore any further distinction between triennial actuarial certification to IRS and annual certification to the Labor Department. Although Section 103(d) identifies 11 items to be included in the annual actuarial statement, these can be grouped into essentially 4 categories of information:

1. The first group of information includes an <u>opinion</u>, and a rather similar looking <u>statement</u>, by the enrolled actuary. By now, all of you are probably familiar with the actuarial opinion required by Section 103(a)(4)(A) (requiring) that "The enrolled actuary shall utilize such assumptions and techniques as are necessary to enable him to form an opinion as to whether the contents of the matters reported under subsection (d), (i) are in the aggregate reasonably related to the experience of the plan and to reasonable expectations, and (ii) represent his best estimate of anticipated experience under the plan."

   This later concept of a "best estimate" has already received much attention--and will doubtless receive a lot more in the years ahead. The actuary's "best estimate" can--and should be--influenced by many sources including the plan sponsor, the investment manager, economists and others. A most interesting and provocative question is whether the "best estimate" is a single number or can be a range of acceptable numbers. My present view is that a single number is inconsistent with the inherent uncertainty of any actuarial calculation; but presenting one's best estimate as a range of numbers also gives me some difficulty. It seems to me that, for a number of reasons, the actuary is going to be effectively required to present a single number as his best estimate. The actuary can always discuss, as permitted by item (11) of Section 103(d), the concept of a range of acceptable numbers--perhaps even bringing in statistical demonstrations involving confidence levels, etc.

   In addition, item (8) in this subsection requires a statement by the enrolled actuary that "(a) to the best of his knowledge the report is complete and accurate and (b) the requirements of Section 302(c)(3) (relating to reasonable actuarial assumptions and methods) have been complied with." It is not clear as to why Title I should require both an opinion and a statement on similar actuarial matters.

2. The second category of actuarial information is not spelled out in the Law, but the Secretary of Labor can define it at some future time. For instance, in Section 103(c)(5), "such financial and actuarial information including but not limited to the material described in subsections (b) and (d) of this section as the Secretary may find necessary or appropriate."

Again a similar reference under Section 103(d) item (10) which reads, "such other information regarding the plan as the Secretary may by regulation require."

In one case we have information that can be required by future regulations, but in another part of this subsection, actuarial information can be required if the Secretary finds it to be either necessary or appropriate. All of this leaves rather wide open, in some circumstances, the question of what information must be reported on demand.

3. The third category is the detailed actuarial information specified by Section 103(d). There are generally no surprises here since it includes such items as the normal costs, accrued actuarial liabilities, a description of actuarial assumptions and methods as well as other items typically provided in an actuary's report. Item (6) of this specific information, the allocation of plan termination liabilities, is a rather complex looking calculation. However, the mechanical problem of generating the numbers does not seem serious when you consider that:
   a. The calculation applies only to vested benefits, and
   b. The Act explicitly permits use of "approximate methods, for allocating the plan's liabilities to such termination priority categories."

   But I wonder why this item should be included as part of the annual report? As apparently defined in the Law, it is not a particularly good measure of the participant's benefit security. Although the results can be readily compared to plan assets, the liability item does not appear to be appropriately offset by the PBGC's potential benefit quaranty. Another possibility is that the calculation is useful to the PBGC for measuring their contingent liabilities. If that is so, perhaps this item should be reported only to the PBGC--and thereby reduce the exposure of potentially misleading information to plan participants.

4. The fourth category is the most open-ended actuarial information requirement in this section of the Law. It is the last of 11 items and appears to be addressed to the enrolled actuary, "such other information as may be necessary to fully and fairly disclose the actuarial position of the plan." If this item is to represent something other than a nice collection of words, it obviously requires enrolled actuaries with a high order of actuarial skill and judgment--not to mention professional integrity--to make an appropriate response. In making that response, the actuary must keep in mind such matters as:
   a. The annual report is to be summarized and distributed to plan participants. In addition, on request, a plan participant can obtain a copy of the complete report.
   b. The preponderance of current opinion suggests that the actuary has a fiduciary responsibility in making this response. Of course, that means he is to act in the best interest of plan participants and beneficiaries--but what that means is far from obvious.

In closing, I will observe that the reporting and associated requirements are potentially powerful, but this potential to improve the tone of our national pension system--and thereby benefit its participants and those who serve the system--will not be realized unless:

1. Enrolled actuaries bring to the task the best their profession has to offer, and, equally important,

2. Labor and IRS are vigorous and effective in following up on apparent deficiencies.

MR. GEORGE B. SWICK: It is my understanding that the Labor Department and the IRS have made significant progress in attempting to agree on one form which will satisfy the requirements of each. In view of the possible differences in plan year and tax year, this seems like a difficult task. I, for one, certainly wish them luck.

As a member of the Academy of Actuaries Task Force on Reporting and Disclosure, I attended a meeting last October with representatives of both the Labor Department and IRS. At that time, it appeared that they certainly intended to develop one form suitable for both.

The items of information expected to be entered on the actuarial statement include the following:

1. Date of plan year-end

2. Number of participants and beneficiaries, broken down by:
   i. retired
   ii. beneficiaries in receipt
   iii. active
   iv. deferred-vested

3. Contributions for plan year (showing date and amount of each payment), indicating the amount received in the current year but applicable to a prior year.

   These contributions are to be reported on an accrued basis; contributions deductible with respect to a plan year will be the amount credited for purposes of the funding standard account.

4. The amount required to maintain a positive balance in the funding standard account.

   Our Task Force pointed out the need to make provision for the alternative minimum under Section 305 of ERISA.

5. Statement of any accumulated deficiency at the year-end.

6. Normal cost for the plan year

7. Past service
   i. accrued liability
   ii. actuarial value of assets for purposes of funding standard account
   iii. unfunded accrued liability

   Under the "frozen initial" cost method, it was agreed that accrued liability is equal to (a) actuarial assets plus (b) unfunded actuarial liability.

8. Current (market) value of assets.

   Section 3(26) of ERISA defines "current value" as follows:
   The term "current value" means fair market value where available and otherwise the fair value determined in good faith by a trustee or a named fiduciary (as defined in Section 402(a)(2)) pursuant to

the terms of the plan and in accordance with regulations of the Secretary, assuming an orderly liquidation of the time of such determination.

Our Task Force pointed out, in this regard, that we should be permitted to rely upon (a) an audited current value, (b) the statement of an insurance carrier regarding the balance in a DA or IPG contract, or (c) the cash values of ordinary policies where applicable.

With regard to a DA or IPG contract, there is a question as to whether current value refers to market value reported by the carrier or to the amount after reflection of any withdrawal penalty.

9. Actuarial liabilities for nonforfeitable benefits by termination priorities as set forth in Section 4044 of ERISA, as follows:
   i. accrued benefits from voluntary participants' contributions,
   ii. accrued benefits from compulsory participants' contributions,
   iii. benefits to present pensioners and beneficiaries in receipt,
   iv. all other benefits specified under Section 4044(a)(4) of ERISA,
   v. all other nonforfeitable benefits, and
   vi. total

   Our Task Force pointed out the problems of (a) average final salary plans and (b) suspended group annuity offsets. It was indicated that we would be permitted to use a flat percentage to go backwards from the current valuation compensation, where back earnings are not available. Also we will probably be permitted to offset guaranteed group annuities.

10. Date of last actuarial valuation applicable to the plan year.

11. Actuarial assumptions and methods. This includes a statement of the actuarial assumptions and methods used to determine the following:
   i. costs and actuarial liabilities for purposes of the funding standard account;
   ii. actuarial liabilities for nonforfeitable benefits under Section 4044 of ERISA; and
   iii. actuarial value of assets for the funding standard account.

   The statement is to include an identification of (a) benefits not included in valuation, such as early retirement benefits in excess of the actuarial equivalent, and (b) other facts such as any change in actuarial assumptions or cost methods, and a justification for such change.

The annual report is also expected to contain an "actuary's opinion." It is, perhaps, interesting that, under ERISA, Section 103(a)(4) refers to an "opinion" rather than a "certificate," as required by the Canadian Income Tax Act. Hopefully, we can avoid the strained words of the Canadian certificate which says, "I hereby certify that, in my opinion, - - - -."

The first draft of this "actuary's opinion" specified the following information:

The annual report filed for the plan is to contain a statement by the enrolled actuary--

1. With reference to Section 103(d)(8):
   a. that to the best of his knowledge the information contained in

the actuarial statement is complete and accurate, and

b. the requirements of Section 302(c)(3) (relating to reasonable actuarial assumptions and methods) have been complied with.

2. With reference to Section 103(a)(4)(B): an opinion by the enrolled actuary that

   a. the assumptions and techniques are in the aggregate reasonably related to the experience of the plan and to reasonable expectations; and

   b. represent his best estimate of anticipated experience under the plan.

Our Task Force submitted a letter to Mr. Wayland Coe of the Department of Labor, regarding the proposed "actuary's opinion." Our main thrust was that they had ignored Section 103(d)(11) of ERISA, which is perhaps the most important provision related to the "actuary's opinion." This provision refers to "such other information regarding the plan as may be necessary to fully and fairly disclose the actuarial position of the plan."

There are three additional points which I would like to cover.

First, I would point out that, for plans on a calendar year basis, the first new annual report form is due by July 29, 1976, to cover the calendar year 1975. At the same time the new funding requirements are effective as of January 1, 1976. As a result the first annual report will cover a year prior to the establishment of the funding standard account. I would merely call to your attention that, if you change assumptions and methods as of January 1, 1976, applicable to the year 1976, you will be required to itemize such changes in the annual report filed in 1977, and give reasons for the changes.

As a result, you may want to consider reporting the revised assumptions and methods in the 1976 report even though not applicable until January 1, 1976.

Second, both the Labor Department and the IRS indicated that they believe the plan year-end funding standard account balance should be reported. We pointed out the difficulty of completing a year-end valuation by August 31 in many situations, since the actuary does not control the submission of data. Since valuations are only required every three years, this position seems particularly ludicrous.

Finally, there is a potential problem with the accountants. Our Task Force met with a similar Task Force of the AICPA on April 25 of this year.

Subject to interpretation by either (i) the Labor Department and IRS or (ii) the FASB, they are concerned that the actuarial statement is a financial statement, and is therefore subject to audit. We pointed out that the actuarial statement is set forth in Section 103(d), while the financial statements are set forth in Section 103(b).

This seems to bring us back to the 1973 Exposure Draft on Audits of Pension Funds.

I can only hope that reason will prevail, and the accountants will eventually realize that actuarial present values are outside of their area. What we have here is a situation where the AICPA believes market values of assets have some relevance in the long-term relationships of pension plan commitments; and, as a result, they are critical of actuaries for not taking a firm position on the most meaningful disclosure of actuarial present values.

MR. ELLIS W. SCOTT: My function on this panel, initially, was to present an overview of the topics for discussion from the perspective of the Department of Labor. The implication of the assignment is that the Department of Labor has developed a position or proposed regulations regarding the topics to be discussed. This is not the case. Under the assumption that considerations of the annual report could possibly be deferred to at least the middle of 1975, we have devoted our efforts to more urgent areas such as the fiduciary provisions and the summary plan description. This choice had to be made because of our severely limited staff. Moreover, I think it is important to note that a position taken on any of the topics would not be in the sole purview of the Department of Labor. For it appears definite that the Department of Labor and the Department of Treasury will have a joint form for the annual report; and therefore, any position taken by Labor must be coordinated with Treasury. In addition, to the extent that the liability assumed by the Pension Benefit Guaranty Corporation may be affected, the Corporation must be included in the coordination.

In view of the foregoing, my remarks will represent my personal views.

Section 103(d)(6) of the Act provides that the present value of all of a plan's liabilities for nonforfeitable pension benefits be allocated by the termination priority categories specified in Section 4044 of the Act. The Secretary of Labor is to establish regulations defining, for purposes of the allocation, termination priority categories and acceptable methods of allocation. These regulations have not been approached at this juncture.

Compliance with Section 103(d)(6) will require that the actuary perform an additional valuation of the plan under actuarial assumptions which differ from those of the regular valuation. The additional valuation will generate additional expense to the fund. In addition, I seriously question the meaningfulness of the results to interested parties of a plan sponsored by a going concern. The allocation becomes meaningful at such time as the plan faces termination. In view of the additional expense involved and in the absence of compelling evidence of its utility, I seriously question the propriety of requiring the allocation.

The question as to whether the allocation should be included in the annual report form is under consideration and will be resolved prior to the finalization of the form

Congress has provided the Secretary of Labor some latitude in this area under the provisions of Section 104(a)(2)(A). This section provides that the Secretary may waive or modify the requirements of Section 103(d)(6) in such cases or categories of cases as to which he finds that:

1. The interests of the plan participants are not harmed thereby, and

2. The expense of compliance with the specific requirements of Section 103(d)(6) is not justified by the needs of the participants, the Pension Benefit Guaranty Corporation, and the Department of Labor for some portion or all of the information otherwise required under such section.

Under Section 103(d), the actuary is required to make an actuarial valuation of the plan every third year. It is left to his judgment as to whether more frequent valuations are necessary to support his certification statement. I have no feel for the extent to which actuaries are currently making other than annual valuations. I suspect, however, that the practice is not very widespread. It would appear, however, that, to the extent an actuary feels secure in certifying the annual actuarial report without making a complete valuation and with consideration for the additional expenses incident to the passage of ERISA, the trend would be toward other than annual valuations.

The Act is silent regarding any requirements for the derivation of the values for intervaluation years. However, the actuary will very likely be asked, on the annual report form, to describe the method he uses to extrapolate such values.

The Act requires that an annual actuarial report include an opinion by an enrolled actuary as to whether the actuarial assumptions in the aggregate reasonably reflect the past experience of the plan and represent his best estimate of anticipated experience; also, that the values entered on the annual report accurately reflect the actuarial assumptions. I feel that this requirement on the part of an enrolled actuary gives him leverage he has not had in the past. Under the provision, the enrolled actuary who makes and signs the opinion must be satisfied with the assumptions and results.

I don't feel that the required inclusion in the annual report of a statement justifying changes in the actuarial assumptions presents any problems to the actuary with which he has not previously coped. He traditionally has had to explain and justify such changes to the plan accountant or to the plan sponsor.

Many of the provisions regarding the annual actuarial report, including those under discussion, will require clarifying publications and regulations. I would expect these to be forthcoming prior to the issuance of the forms or to accompany the forms.

I close with the following comment: Perhaps the comprehensiveness of the Act causes the actuary to feel that he is unduly constrained. However, I don't feel that it was the intent of Congress to substitute provisions or regulations for the actuary's individual judgment in areas where such judgment is clearly called for. I think this is particularly applicable to the areas under discussion during this session.

CHAIRMAN M. DAVID R. BROWN: In Canada our experience has been in connection with income tax regulation and with pension benefit regulation as two distinct kinds of laws. The income tax department wants to know whether you can justify the deduction you're taking for the money you put in, and the pension benefits regulators want to be sure that you're putting in enough to secure the benefits as promised. In both areas actuaries are required to submit reports or certificates. We've had the pension benefits legislation for ten years now in one province at least, and for a shorter time in other provinces, and we're still evolving towards a satisfactory way of dealing with the problem of expression of actuarial opinion. The Canadian Institute of Actuaries, which is the sole source of enrolled actuaries in our country, has moved in the last two years to adopt an opinion, which is also the opinion of the Academy, on actuarial reporting on pension plans. It gives at least some suggestion as to what the minimum requirements of the contents of good actuarial reporting on a pension plan should be. The Canadian Institute of Actuaries has also promulgated a model language for actuarial certificates which are intended to be used both in connection with the pension benefits legislation and with the income tax legislation.

MR. WILLIAM H. CROSSON,III: I observe that the language of ERISA as to annual reports requires an allocation of plan liabilities in accordance with stipulated plan termination classifications. The purpose of these remarks is to present a plea for a general relaxation of these reporting requirements, particularly with respect to the termination liabilities that are covered by the pension plan's current assets. The reason for this plea is to avoid incurring a lot of unnecessary expense for the plan and the sponsor in situations where the information reported would serve no useful purpose.