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ERISA

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1. What are the major pension plan design problems under ERISA?

2. What practical approaches are being taken to resolve these problems?

MR. LESLIE S. SHAPIRO*: To generations of ambitious Americans, the goal sought after is the professions - law, medicine, accounting, engineering, to name a few. The professional has been referred to as the most admired individual in society because of the social status bestowed, the intellectual prowess attributed and the excellent income earned. However, Business Week Magazine recently has made an observation that the professions and society have been sensing, perhaps even knowing, for some time - professionals are in trouble. Those who use professional services have found that professionals have promised society more than they can deliver. Business Week referred to opinion polls which show the public increasingly skeptical of professionals' claims to probity and competence. Such skepticism is attributed by the magazine to two trends beyond the professionals' control - technical complexity and egalitarianism. Both trends are forcing a reassessment of how well professionals do their jobs and redefinition of what it is they do. Business Week feels that the outcome of the reassessment will have great impact not only on professionals, but society as well.

It is interesting that at a time that may be considered one of insecurity in the visible professions, another profession which, since the time of "Actuarius", has enjoyed relative anonymity, is at the threshhold of public awareness Congress, in enacting modern social legislation, has noticed the actuarial profession. It appears that the bubble of mystique in which the actuary has shrouded himself may be about to burst.

The modern social legislation to which I refer is, of course, ERISA and the advent of the enrolled actuary. The legislative history of ERISA shows that Congress recognized that actuaries would be required to perform professional services under ERISA. It believed that actuaries who perform services for qualified pension plans and report to the Government regarding those plans should be held to a standard of reasonableness in choosing their methods and assumptions. Hence, Congress proposed that an enrollment procedure be established similar to that used for non-attorneys and non-certified public accountants who wish to engage in practice before the Internal Revenue Service, and that the enrollment procedure would appropriately recognize the need for independent, competent, professional work.

While the legislation is directed only at pension actuaries who are enrolled to perform services under ERISA, I am of the view that it has significant impact on the actuarial profession as a whole. With the current so-called professional crisis, it seems inevitable that the public is going to look at all professionals, including the actuarial profession, with a jaundiced eye.

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It doesn't seem possible that the public will ever understand what actuaries do. But they will understand results and the effectiveness of an actuary in accomplishing those results. Therefore, the duties, restrictions and controls placed on enrolled actuaries consistent with current trends may extend beyond those enrolled - to the entire profession.

As you all know, the Joint Board for the Enrollment of Actuaries was formed for the purpose of carrying out the Congressional mandate assigned it by Section 3042 of ERISA - a mandate to insure the competence and integrity of the actuary who wishes to perform services under ERISA. For almost two years, the Board has been dedicated to that responsibility.

The legislation provides for two periods of enrollment. The first is for those making application before January 1, 1976. Of the 3,753 applications received relative thereto, 2,434 have received enrollment certificates to date. There have been 237 applications either abandoned or withdrawn and 740 denied. Requests for reconsideration of 273 applications for which denial was proposed are still pending. Those requests are, of course, receiving our individual and careful consideration for disposition in accordance with the regulations. No initial disposition has been made of the remaining 69 applications.

The second period of enrollment provided by ERISA is for those applying on or after January 1, 1976.

On May 18, 1976, the Joint Board published in the Federal Register proposed regulations governing enrollment consistent with the legislative requirement. Briefly, they provide for:

1. A responsible pension actuarial experience requirement of 36 months or a responsible actuarial experience requirement of 60 months, which must include at least 18 months of responsible pension actuarial experience. The experience requirement must be satisfied within a 10 year period immediately preceding the date of application.

2. A basic actuarial knowledge requirement in basic actuarial mathematics and methodology. This requirement may be demonstrated by successful completion of a proctored examination given by the Joint Board or by successful completion of one or more proctored examinations given by an actuarial organization, or by receipt of an academic degree from an accredited college or university after successful completion of a course of study in actuarial mathematics or its equivalent.

3. A pension actuarial knowledge requirement. This may be satisfied by successful completion of a Joint Board examination or by successful completion of one or more proctored examinations given by an actuarial organization.

Under the proposed regulations, an applicant must satisfy all three requirements, i.e., experience, basic actuarial knowledge and pension actuarial knowledge. Written comments were received from many organizations of actuaries, including the Society of Actuaries. In addition, representatives of actuarial organizations testified at the public hearing held on July 12. I will not attempt to give a verbatim account of their comments and testimony. However, their primary concern was with the implementation of the proposed regulations rather than with their form, and specifically with that part of the preamble to the proposed regulations which states that successful completion of proctored examinations given by actuarial organizations will satisfy

the basic or pension actuarial knowledge requirement for enrollment if the Joint Board determines any such examination to be equivalent to its examination. A question was raised as to the Board's use of "equivalent". The language of the statute refers to an organization examination having to be "adequate". This connoted to those testifying a somewhat different standard than an "equivalent" test, the term used in the preamble. This issue, coupled with the statement made at the time the proposed regulations were published that no examination of an actuarial organization had been deemed "equivalent" by the Joint Board, appears to have caused a great deal of concern to many actuaries - a concern which is somewhat unfounded. While the problem may be one of semantics, it is the Board's intention to clarify the preamble by substituting the word "adequate" for "equivalent". Further, I am confident that the Board will carefully consider the examinations offered by actuarial organizations, including, of course, those of the Society of Actuaries, and will determine which examinations reflect the minimum level of competence Congress mandated the Board to judge as meeting the qualifications for enrollment on or after January 1, 1976. As of this time, that determination has not been made.

Subsequent to the public hearing, the subjects of future examinations and the interrelation of actuaries and the Joint Board were further discussed. The Society, in conjunction with the Academy of Actuaries, presented to the Joint Board a proposal that an instrumentality of the Society be formed for the purpose of developing and administering the examinations for enrollment. Even before the proposal was received, the Board had devoted many hours to the question of involvement of actuaries outside the Board (and government) in developing those examinations. It had, in fact, prepared a charter under the Federal Advisory Committee Act for that purpose and had submitted to the Office of Management and Budget its proposal. In weighing the Society-Academy proposal, as well as similar proposals received from other individuals and actuarial organizations, and the Board's itself, it was felt that everyone was, at least ostensibly, aiming at substantially the same goal. The Board felt its proposal more clearly reflected its responsibility under the legislation and was more consistent with the constraints placed on government agencies in the area of openness in government.

The Joint Board hopes to administer actuarial examinations for the purpose of qualifying individuals for enrollment. It wishes maximum practicable involvement of competent actuaries outside the government in rendering advice and service in connection with those examinations. Consequently, the Board anticipates the formation of an Advisory Committee. Notification of the Advisory Committee's formation appeared in the Federal Register on October 12. The Committee will consider, develop and prepare examination questions for the Joint Board's use in administering its examinations and offer any advice it wishes regarding them. In addition, the Committee will be called upon to make recommendations to the Joint Board as to which organization examinations satisfy the requirements for enrollment. The Advisory Committee's membership will not exceed eight enrolled actuaries, and it is hoped that they will fairly represent the actuarial organizations, actuaries who were enrolled by routes other than proctored organization examinations, and, to the extent possible, educators. All interested enrolled actuaries who feel they have suitable backgrounds, interest and dedication are urged to advise me, preferably in writing, of their interest in membership on the Committee. To this end, actuarial organizations also are invited to submit candidates for service on the Committee.

Thus far, I have dwelled on one facet of responsible profession - that of the competence of its members. The other facet of a responsible profession to which ERISA addresses itself is that of ethical conduct. This, to many, is the real heart of a profession. A professional must be willing to assume responsibilities of an ethical nature in behalf of his client, his profession and society. However, the Joint Board has not yet promulgated regulations to implement that part of the legislation which states that "The Joint Board may, after notice and an opportunity for hearing, suspend or terminate the enrollment of an individual under this section if the Joint Board finds that such individual (1) has failed to discharge his duties under this Act, or (2) does not satisfy the requirements for enrollment as in effect at the time of his enrollment." Until there are regulations on the subject and perhaps some experience with them, I find it difficult to discuss it with any specificity.

Many actuaries have asked how the "notice and opportunity for hearing" language of ERISA will be implemented. I am confident in stating that the Joint Board will adhere to the requirements provided in the Administrative Procedure Act. Simply stated, that act provides administrative due process to an individual affected by government regulations. Accordingly, an enrolled actuary who is believed to have engaged in disreputable conduct as set forth in the regulations will be accorded a full evidentiary hearing for the revocation of his or her enrollment. At that hearing, both representatives of the Joint Board and the actuary could present witnesses who would testify under oath, present other evidence, and could provide the administrative law judge with briefs and statements relative to the matter under consideration. The judge would then issue an initial or interim decision in the matter. That decision may be appealed by either party. If an appeal were taken, the decision on appeal would constitute the final agency action. Thereafter, the case could be taken into the federal courts. Presumably, the formal administrative proceeding would be commenced only after the enrolled actuary was advised of the matter and given an opportunity to respond and meet with the Board's representative relative to the facts. At that meeting, the actuary, either personally or through his representative would have an opportunity to explain the matter under consideration and present any mitigating circumstances he wishes.

This responsibility of the Joint Board is a critical part of the enrollment program and reflects the demands of society on the professions. It is one thing to set up enrollment requirements. It is quite another to authorize a government agency to take away that enrollment for cause.

The status of enrolled actuary carries with it professional duties and responsibilities that an actuary previously did not have. It is true that the Society of Actuaries has recognized elements of professional conduct to which its members must adhere. While rules of professional responsibility are a hallmark of a true profession, an actuary's violation of a code of ethics or failure to fulfill his responsibility heretofore did not generally deprive an individual of the opportunity to provide services as an actuary. With the enrollment, an enrolled actuary's eligibility to perform services required under ERISA may be suspended or terminated. The enrollment program fills what Congress saw to be a void in the actuarial profession - the lack of regulation. This gives the government, the profession and the public an assurance they previously did not have - that an actuary shown to be incompetent or who does not comply with the rules and regulations governing his profession may be prohibited from continuing his services.

Violation of the regulations governing enrolled actuaries will vary in complexity and interpretations. Some will be obvious as acts of disreputable conduct. Such conduct would include convictions for such offenses as bribery, embezzlement or failure to file a personal income tax return. A conviction of that nature or, in fact, conduct that could lead to such conviction, should be so patently disreputable that most, if not all, actuaries will regard prescriptions relating to it as welcome safeguards of their profession's integrity.

There are some areas of misconduct that are less obvious but which may nevertheless face an actuary in his everyday work. For example, ERISA has posed some difficult ethical problems. The legislative history and the act itself indicates that an actuary who prepares the actuarial report required of him under ERISA must certify that, to the best of his knowledge, the report is complete and accurate. He must also certify that, in his opinion, the funding method is reasonable and the actuarial assumptions used to determine the plan costs are reasonable in the aggregate.

It was contemplated that a falsely certified report could result in the revocation of the actuary's enrollment. I believe that an abuse of diligence in submitting a report also could have that effect. It would seem that a false or fraudulent report would fall within the ambit of patently disreputable conduct. However, the due diligence requirement for certifying a report is not always readily ascertainable. The question of what is "reasonable" is perplexing. Should reasonableness be considered the actuary's best judgement based on generally accepted actuarial principles (whatever they may be)? Is this an area where the somewhat tired actuarial joke of "How much is 2 plus 2", heretofore abhorrent to some actuaries, should now be abhorrent to all? Some skeptics have stated that since the actuary can, merely by "juggling" his assumptions, come up with almost any level of contributions desired, he is, in fact, a charlatan. Some have suggested that the charlatan concept is the ultimate heresy and that if that is all the actuary claims to be engaged in, how can he be accused of wrongdoing. Moreover, pervading the entire juggling concept is the thought that wherever we have pension legislation, we also have a government body to review the reasonableness of the actuary's assumptions. These government supervisory authorities effectively have the right to reject any valuations they feel are based on unwarranted assumptions. I disagree with the underlying concept of that theory.

While it may be true that a plan reflecting unwarranted assumptions will be rejected by the government, the actuary must still consider at what point the choice of assumptions involves more than just the criteria for "reasonableness" and becomes an issue of professional conduct.

Another problem that appears to have manifested itself in the post-ERISA era is that of the enrolled actuary's allegiance and is somewhat related to the concept already discussed. It is my understanding from the legislation that the responsibility of an actuary who performs services under ERISA is to the pension plan participants. Indeed, the very philosophy behind the Act is to protect the so-called "working-man". Yet, the practicalities of a normal working arrangement for an actuary are that he submits his statement to the plan administrators who, along with the actuary, are paid by the plan sponsor. Inasmuch as sound actuarial principles vary to the extent that valuations may reflect advantages to either the sponsor or the participant, a conflict of interest may arise for the actuary - one which I find understandable.

Society's demands of other professions may serve as a point of reference in the actuarial area. The certified public accountant, for example, has built a reputation for independence and objectivity and has rendered opinions on annual reports based on conformity with generally accepted accounting principles. In recent years, courts have held that accountants must go beyond generally accepted accounting principles and concern themselves with the overall fairness of the statements they certify.

In one such case, the court held that where an accountant finds that corporate affairs are not being honestly conducted, at least if he finds diversions so large as to imperil or destroy the very solvency of the enterprise, he *must make full disclosure in connection with a financial statement or make* sure the wrong has been righted and procedures have been established to avoid repetition. This was the holding even though the defendants called as witnesses eight expert independent accountants, an impressive array of leaders of the profession. Their general testimony was that the financial statement's treatment of the matter in issue was in no way inconsistent with generally accepted accounting principles since it made all the informative disclosures reasonably necessary for fair presentation of the corporation's financial position.

The court was of the view that generally accepted accounting principles instruct an accountant what to do in the usual case where he had no reason to doubt that the affairs of the corporation are being honestly conducted. Once he has reason to believe this basic assumption is false, an entirely different situation confronts him.

To what extent should an actuary be wary of the added responsibilities the courts have given the accounting profession? After all, like the accountant, the degree of exposure of the actuary to the possibility of economic loss to third persons because of professional inadequacies is greater than the degree of exposure of other professionals. This and the other questions I have posed are not answerable by me at this time. However, the Joint Board will not shirk its responsibility to take appropriate disciplinary action against actuaries who are not fully discharging their duties under the regulations.

Let me pose this admonition in closing - in discharging services as an actuary, we should consider professional responsibility to be broad enough to embrace the standards of competence and integrity that emanate from courts and other governmental agencies, from professional societies, from professional traditions, and from the professional person's own conscience. I am confident that this blend of sources for guidance will meet the demands made of the actuarial profession today and in the days ahead.

MR. JOSEPH A. LaVIGNE: For pension plans which provide for the payment of benefits in the form of a life annuity, ERISA attempts to provide security for the spouses of plan participants in two ways: (1) for all such plans, by providing that a qualified joint and survivor annuity will be the form of benefit payment at retirement for a married participant unless he elects otherwise, and (2) for such plans which allow benefits before the normal retirement date, by providing that a married participant may elect a pre-retirement spouse's benefit during this period (but not earlier than 120 months prior to his normal retirement date) if he continues his employment during this period.

The effective date for incorporating the qualified joint and survivor requirements into pension plans was the plan anniversary beginning in 1976. Proposed regulations in this area (Section 1.401(a)-11) were published in the Federal Register on October 3, 1975. Many of the proposed regulations made the plan design and administration for this section of the law rather cumbersome, but we had to proceed.

Paragraph (a) of the proposed regulations prescribes that any plan which includes a life annuity option must be revised to make a joint and survivor annuity the automatic form of retirement benefit. Profit-sharing and savings plans are typically designed to provide a lump-sum payment as the automatic option. However, many do provide an annuity option as an alternative.

The only practical approach toward solving this problem for those plans that do provide an annuity option is to recommend that the plan either (1) make the joint and survivor option the automatic one or (2) drop the annuity options from the plan to avoid considerable administrative headache and expense. This is an unfortunate choice!

The final regulations should be changed to provide that a joint and survivor annuity need be made the automatic benefit form only in those situations where a single life annuity would otherwise be the automatic form. Hopefully, written comments to the IRS along these lines (such as those submitted by the American Life Insurance Association (ALIA)) will be heeded.

Presumably, the provisions regarding the pre-retirement spouse's benefit also apply to profit-sharing and savings plans where a life annuity option is offered. However, profit-sharing plans generally provide that the full amount in a participant's account is payable at his death. Since this pre-retirement death benefit exceeds the value of the minimum pre-retirement spouse benefit specified in the law, such a plan should not have to provide the pre-retirement spouse's benefit.

The practical approach here is to assume that the pre-retirement spouse option does not have to be offered. To ultimately solve this problem, it would be better to provide in the final regulations that the pre-retirement spouse benefit need not be provided in any plan which provides a pre-retirement death benefit (regardless of the form in which it is payable) which exceeds the value of the minimum pre-retirement spouse benefit specified in the law. The ALIA has submitted comments along these lines.

ERISA states that a plan may take into account in any equitable fashion (as determined by the Secretary of the Treasury) any increased costs resulting from providing the pre-retirement spouse's benefit. The basic issue is whether the employer is willing to subsidize this benefit or whether each married employee who elects coverage will bear the cost of such coverage.

There are merits to having the employer pick up the tab (which may increase his contribution outlay 4 ½ %) as this is a very worthwhile benefit and substantial administrative costs and headaches are thereby avoided. The plan administrator avoids the detailed explanations and benefit calculations involved with enrollment, the maintenance of forms and records, plus the possible employee misunderstandings and claim administration problems.

However, if it is decided that each participant who elects the coverage will bear the cost of the coverage, the most practical administrative approach

would seem to be a small reduction in the eventual retirement benefit payable to the participants. We considered an alternate arrangement of having the covered participants pay for the coverage with a direct additional employee contribution during the period covered so as to avoid any reduction in benefit, but felt this method would be too impractical to administer.

For the standard survivor benefit (50% of the reduced annuity the employee would have received) and actuarially equivalent early retirement factors, we developed reduction factors of .04% per month (.48% per year) for coverage between ages 55 and 60, and .06% per month (.72% per year) for coverage between ages 60 and 65. This formula results in a total reduction in retirement benefit of 6% for a participant covered between the ages of 55 and 65. We felt that it was more equitable to recognize the relatively greater cost of providing the benefit between ages 60 and 65 as compared to the period between ages 55 and 60. In addition, for those plans with subsidized early retirement factors which produced comparatively larger survivor benefits, we developed comparatively larger reduction factors on a case-by-case basis.

ERISA states that a participant must have a reasonable period in which he may elect the pre-retirement spouse's benefit coverage. The proposed regulations (paragraph (d)(3)(iii)) prescribe an election period beginning not later than 90 days prior to the prescribed coverage period and continuing all the way through it, ending only on the date the participant terminates his employment. Further, the regulations prescribed that, if the plan contains a provision that any election made does not become effective if the participant dies within a stated period not longer than 2 years beginning on the date of the election, the length of such period shall be added to the minimum 90-day election period. An election may be revoked at any time during the election period; after an election is revoked, another election may be made during the election period; and so on, apparently without limit.

The regulations were published in October 1975 and there was little time to digest them and commence notifying our hundreds of customers who were looking to us for guidance in setting up procedures for electing pre-retirement spouse benefit. We decided to send our customers a letter outlining very briefly our recommendations for the design of this provision and setting forth procedures to aid the plan administrator in notifying married employees of the availability of this coverage. The major problem was to quickly take care of all those employees who were already eligible for or very close to being eligible for this coverage on the plan anniversary in 1976.

The letter urged that the plan administrator contact immediately each active married employee who has already reached the earliest date he could retire under the plan and each employee who will reach this date within the next three months. An election form was enclosed outlining the pre-retirement spouse benefit coverage, the manner in which accrued benefits would be reduced to provide the coverage, and three alternative boxes to check as follows:

(A) I am married and I do wish to elect the option described above. I understand that my retirement benefits will be reduced as described above. (Below this, we left spaces for the participant to provide information concerning his spouses.)

(B) I do not wish to elect the option described above.

(C) I am not married, and therefore I am not eligible to elect this option.

As you can see, it was deemed important to have each participant check off either A, B or C so that there would be no misunderstanding concerning this coverage.

Because of the anti-selection involved in the election procedures set up by the proposed regulations, we felt that the election should not become effective if the participant dies other than accidentally during the option period but within one year following election of the option. We felt that a one-year period is sufficient to deal with the anti-selection problem and generally simpler to administer. However, as there was no way of notifying the initial group becoming eligible for this coverage on the plan anniversary in 1976 at least 15 months prior to their eligibility date, no mention of the one-year death restriction was referred to in the election form for this initial group. By attempting to sign up this initial group within 90 days after initial notification, we hoped to dampen the effect of any anti-selection.

Later on, in 1976, we sent each of our customers a new letter accompanied by a new election form which described the one-year death restriction and advised our customers to notify potential eligible employees at least 15 months prior to their coverage date in the future.

As to post-retirement joint and survivor benefits, ERISA states that a participant shall have a reasonable period before the annuity starting date during which he may elect not to take the joint and survivor annuity.

The proposed regulations (paragraph (c)) prescribe an election period of at least 90 days before the annuity starting date. It also contains extremely cumbersome provisions connected with the time frame in which information must be provided to the participant concerning this election. In addition, an election may be revoked at any time during the election period; after an election is revoked, another election may be made during the election period; and so on, apparently without limit. Unlike the pre-retirement spouse benefit election, however, if the plan contains a provision that any election made does not become effective if the participant dies within a stated period not longer than 2 years from the date of the election, the length of such period does not have to be added to the minimum 90-day election period.

As in the case of the pre-retirement spouse benefit, we decided to send our customers a letter outlining briefly our recommendations for the design of this provision and setting forth procedures to aid the plan administrator in notifying married employees of their automatic form of retirement benefit and their right to elect not to take the automatic joint and survivor form.

The letter urged that the plan administrator contact immediately each active married employee whose retirement date is expected to occur within the four months following the plan anniversary in 1976. Once this initial group of employees has been taken care of, the letter instructs the plan administrator to contact employees in the future at least 90 days prior to the date they expect to retire. Two election forms were enclosed, the first to be given to employees who have not previously elected an optional form of retirement benefit under the plan, and the second to be given to employees who have previously elected an optional form of retirement benefit under the plan.

Both election forms outlined the automatic form of retirement benefit payable to married participants and gave an example of the reduction the participant might expect in this form of payment.

The first form contained three alternative boxes to check:

(A) I am married and I understand and agree to having my retirement benefits payable to me on a reduced basis after I have been married for at least one year, in order to provide for the 50% spouse's benefit arrangement previously described. (Below this we left spaces for the participant to provide information concerning his spouse.)

(B) I elect to receive my full benefits under the plan and elect not to have them payable on a reduced basis in accordance with the 50% spouse's benefit arrangement.

(C) I am not married. Therefore, I am not eligible for the 50% spouse's benefit arrangement.

The second form contained two alternative boxes to check:

(A) I am married and I understand and agree to having my retirement benefits payable to me on a reduced basis after I have been married for at least one year, in order to provide for the 50% spouse's benefit arrangement previously described. This revokes any option previously elected. (Below this we left spaces for the participant to provide information concerning his spouse.)

(B) I elect to receive my benefits under the plan in accordance with the option previously elected and elect not to have them payable on a reduced basis in accordance with the 50% spouse's benefit arrangement.

There would not appear to be any significant anti-selection involved in a plan participant electing not to receive a joint and survivor annuity and to receive a life annuity in its place. There would, however, appear to be some anti-selection in the case of a participant who elects not to receive the joint and survivor annuity but later revokes this election, presumably because his health condition has changed since the election. Since this would all have to happen within a 90-day period, we feel that the anti-selection would be minimal. Accordingly, we did not deem it important to add the provision that the election or any revocation of such election would not become effective if the participant dies other than accidentally during a period of time beginning on the date of the election or revocation. This should greatly simplify the handling of the post-retirement joint and survivor annuity.

The plan design problems posed by the qualified joint and survivor provisions would be complicated enough if we only had to worry about designing the plan to handle either a straight life annuity or the qualified joint and survivor annuity. However, most of our plans contain other optional forms of benefit payment, e.g., period certain and life annuity, joint and survivor annuity with a contingent annuitant other than the spouse, or a joint and survivor annuity with the spouse as contingent annuitant but for a percentage different from the automatic form of benefit payment. These options generally

contain election provisions requiring that the evidence of good health of the participant must be submitted unless the option is elected at least one year prior to the retirement date.

We have attempted to keep the provisions for these other optional forms of annuity the same as they always had been in the various plans. Hence, if a married participant had elected one of these other options, we deemed that this previous election in effect constitutes an election not to have his retirement benefit paid in the automatic joint and survivor annuity form. However, under ERISA this participant would have the right to revoke this election out of the automatic joint and survivor arrangement during the 90-day period prior to his retirement date. He is therefore in a position to void the previous election and have his retirement benefit paid under the automatic joint and survivor annuity form.

Having done this, he can then during the final 90-day period elect once more not to have his retirement benefit paid in the automatic joint and survivor form. Under these circumstances, we would design the plan so that he would now revert to a single life annuity. If he wanted some other option at this point of time he would have to submit evidence of good health.

CHAIRMAN AVON GUY SHANNON, JR.: While we are on the subject of joint and survivor benefits, I might just mention where I've come out on the subject after wrestling with it for a couple of years. Unlike some of the people here in the room, my lawyer friends for example, I find I'm allergic to the details of the law and the regulations. I've been looking for a simple path through the thicket.

The thing that concerns me most is the perpetuation of the practice of simply putting in the plan document that the factors for any kind of optional form will be actuarially equivalent. Now I can see the arguments that it has to be that way, otherwise it's not fair. But in the post-ERISA climate, the calculation of actuarially equivalent factors strikes me as a grounds for suit early and often. ERISA is an open invitation for individual participants to come asking and saying okay, prove to me you have in fact made a fair calculation. You add to that the complexity of plans in the real world, where assumptions change (and I expect they'll change often under ERISA), and where employees transfer back and forth between plans of a given employer which may not have the same assumptions. A further element in our consideration is simply the climate under EEOC. I'm ready to adopt the principle that benefits that differ by sex are a bad idea, and I include all the options. Although the actuarial facts to the contrary are there, the social decision has apparently been made.

As a result, my preferred approach is to adopt simple factors written into the plan and avoid the "actuarial equivalent" language. IRS has conveniently issued their recent material on equivalence factors. You can expand readily on this to develop a surprisingly simple set of factors for early retirement and all of the options. For example, 88% may be used as the reduction for the 50% J&S option with ½% adjustment plus or minus for difference in ages. The difference in ages seems a sufficiently important variable to be retained although there is precedent to the contrary in some of the union plans.

This method is easy to document and easy to put in a booklet and explain. It is easy for the administrators to use in the calculations. And not least, the actuary is less likely to find himself testifying on the other side of a calculation here.

MR. STANLEY R. FREILICH: Perhaps the most plaguing problems for us and for all actuaries currently are presented by the various methods of determining service for eligibility, vesting and benefit accrual purposes. These problems more than others are presently holding back companies from finalizing their plans and filing them with IRS. There are a number of reasons why it is urgent to file calendar year plans prior to the year end, and since we don't expect any regulations prior to the year end, it seems we have to deal with the situation as we understand it at the moment. Also, we're beginning to be worried about the summary plan description requirements. Timing there is the end of March next year, and I don't think it is too soon to be worrying about those requirements. Plans should be finalized, approved by management, and filed with the IRS, and all the work that has to go into employee communications should certainly begin by the first of the year.

Let us examine the specific problems in this area. Under the law and the ERISA Technical Releases 2001, 2002, and 2003, I see four practical approaches to determining service. I'll try and outline the advantages and disadvantages of each of these and then describe the actual choices that our clients have made and the reasons for those choices.

Before defining service, we first have to talk about the hour of service. The basic definition of hour of service counts each hour for which an employee is paid directly or indirectly, regardless of whether or not services are actually performed. This definition therefore includes regular time, overtime, vacations, holidays, disability pay (probably including disability insurance) and layoffs. Now, this is a very inclusive definition and if adopted would be a major liberalization for many companies. The first of several alternatives to this would be to credit a full year of service for 750 rather than 1,000 hours, counting only regular hours for which the employee is paid for the performance of service. A break in service occurs if there are 375 or less paid hours in a computation period.

Another alternative deals with earnings. A year of service is credited if earnings exceed 750 times the lowest hourly rate payable in the same of general job class for non-exempt employees and 750 times the federal minimum wage for exempt employees. These are pretty low figures.

With those three definitions of hour of service, there are four approaches to defining service. First, there is the letter of the law: count the hours and use the basic definition of an hour of service. Second, you can count hours, but use the 750 regular hours alternative. Third, you could use the equivalencies in ERISA Technical Release 2002 with either definition of hour of service, where 1 day equals 10 hours, 1 week equals 45 hours, and 1 month equals 190 hours. Fourth, there is an elapsed time approach. This involved crediting service under the basic definition of the hour of service plus unpaid layoff of absence without limit prior to termination.

So there is a great deal of flexibility now that wasn't present in the temporary regulations. Length of service can be determined in a variety of ways. And there are possibilities to minimize record keeping, or at least to have less record keeping than we thought would be required initially. Now I'll try and discuss the trade-offs between the various approaches and I'll call them pros and cons. For the first approach, the letter of the law, the pros are clear acceptability under ERISA and no risk of litigation in the future. Secondly, it eliminates part-time employees, people who do not work 1,000 hours. Also, fewer employees will probably become vested under this approach

than under other approaches, perhaps an advantage from the plan sponsor's viewpoint.

On the negative side of this approach, you will have to count hours of exempt employees. This is the nub of the record keeping burden. Very few if any of our clients are in a position at this point to count all these hours. Also-employees vest after approximately 9½ years, since 1,000 hours count as a year and an employee would certainly work 1,000 hours in half a year. Also, this approach would include periods of long term disability if the plan is self-insured, and probably if the plan is insured. There would also be computation year problems, of various kinds which I won't get into now.

The second approach is to count the hours, but use the 750-hour regular hour alternative. This is simpler in that you count regular hours only. It includes the part-time employees, but only those who work less than 750 hours rather than 1,000. On the negative side of this approach, you still have a record keeping burden because you are still counting hours, although the benchmark is 750 hours instead of 1,000. You have the same computation year problems as under what I call the letter of the law approach. Employees here vest approximately after 9-1/3 years. And also, I think there may be future litigation by the employee who works 749 regular hours, but 251 overtime hours. He doesn't meet the 750-hour rule, but he would have met the 1,000-hour rule. He might look to the letter of the law and bring some action here.

A third approach would be the equivalencies I mentioned before, where one day equals 10 hours, and so on. Here on the positive side, the record keeping burdens would be reduced and the method is easy to communicate to employees. On the negative side, this approach is obviously more liberal that the others, particularly for the part-time employees.

Finally, there is the elapsed time approach. This one is most similar to what employers were doing pre-ERISA, which is a very strong positive. Also, it is easy to administer and communicate, since it is in line with the present understanding of most people. On the negative side, we are not sure how part-time employees would be treated. There is liberal treatment of non-paid absence to the extent that it falls within the elapsed time, and again this method seems open to a possible court challenge. Here, an employee who works 1,000 hours in a 5-month period would receive five months credit rather than one year.

In closing, I would like to discuss a factual situation where a client has already made this decision. This client is a manufacturing company with a final-pay offset plan covering non-union employees, both hourly and salaried. In recent years they have had significant periods of layoff, and such periods are possible in the future. They considered the elapsed time approach, since that was comparable to what they had been doing and was understood by all their employees, but that approach would result in counting layoff time. They had the administrative capability to count hours, so they considered that approach, particularly since it would exclude periods of layoff a principal concern. The equivalencies approach was also considered. It would solve the layoff problem, since no time would be granted for the layoff period, but it would be quite liberal otherwise, since the employees in this company do not work very much overtime. The company opted for the elapsed time approach, feeling that comparability to prior practice was far more important than the problem of granting service during periods of layoffs.

I think the main point here is that all of us should be examining these various pros and cons and perhaps others as well. Each company's situation should be considered individually.

CHAIRMAN SHANNON: As to the decisions that are presently being made, is there a direction that a consensus of your clients are taking or is it still pretty much an even spread here?

MR. LaVIGNE: When we were first designing plans to conform to ERISA, we didn't have the latest regulation permitting the use of elapsed time, so we were drafting them based on the 1,000-hour rule. Once the new regulations came out, we quickly went back to our customers and indicated that we would consider an elapsed time approach. Many of them have decided to keep the elapsed time approach, since it is what people are used to and is easier to explain and to administer.

Several of our contract holders wanted to use an elapsed time method even before the new regulations were proposed, and we actually designed a few plans that way. We assumed that they met the spirit of ERISA since they were at least as generous as the rules that were published.

CHAIRMAN SHANNON: I certainly agree with you as to the philosophy about the spirit of ERISA, but in filling out a form where the government is looking for appropriate citations to the law, I am reluctant to fill in "spirit of ERISA" as an answer. Stan, have you noticed any direction?

MR. FRELICH: Very recently, there seems to be a trend toward people looking with favor on the monthly equivalency of 190 hours for each month, particularly if part-time employees are not a problem. It removes the need to count disability time and reduces some of the record keeping requirements, so I do see a trend in that direction.

CHAIRMAN SHANNON: Having some exposure to the record keeping systems of various clients, I wonder that any of those hours counts are there, much less whether all of these complicated regulations can be met. I have heard a respected benefits lawyer suggest (I hope not in public) that, you put this language in (it'll sail through the IRS approval stage), and then you can go ahead and do what you were doing, since full-time employees will get credit anyway. I would not feel comfortable suggesting to a client that he write down something and then not do it. Playing fast and loose is an attractive concept to me only if it is in a single direction, simplifying the rules by being more generous.

MR. FREILICH: One thing that disturbs me to no end is to have a plan designed solely or largely for administrative ease. Often, the client's first reaction is that these records cannot be kept, but if you press the point, this turns out not to be the case. Even if it is the case, the cost of fixing up the administrative side would be far less than the cost of adopting an approach toward service which would increase the plan cost dramatically.

CHAIRMAN SHANNON: Your point is well taken. My instincts say do something simple, but I do try and point out the cost impact to clients. Frequently, the costs are surprisingly low. But you must determine how much casual service is out there before you can cheaply simplify the approaches.

Let me touch just briefly on two other smaller matters. They're like many other problems under ERISA, but I single them out because it is only recently that I have stumbled onto them as real problems. They didn't leap off the page of the law as a tough item.

One of these is transfers between plans of a controlled group, or between the hourly and salaried plans of a single employer. Now this sounds like no particular problem. We had that problem before ERISA. But this is not a simple matter at all. I have a client with many plans, some of which have mutually compatible transfer language. These people move from division to division, there's a west coast salaried plan, an east coast salaried plan, and so on. They want to be able to move management types freely, so these plans have been sorted out in earlier days. But when we got into looking at this presumably simple matter, it turned out that some of the transfer language was mutally contradictory, and some of which was simply not there. In many companies, people transfer all the time from hourly to salaried plans with no language in any of the hourly plans about this situation.

We have discussed this matter at considerable length now. We decided not to transfer assets between the plan, because the ERISA problems are so great that it is easier to leave liabilities and assets behind. How you define those liabilities is quite another matter. In general terms, the approach this client is taking is that the final pay governs for all service. As you move to another plan, you leave behind essentially an accrued benefit. You shut off the operation of the final pay on the plan he is leaving, and you let it pick up if there is another one in the future plan. There are still a lot of problems when you get into the general approach. It is a much more difficult problem than we had assumed I think the worst thing we found was to inquire about transfer practices at one of these little divisions that had its own salaried plan. They looked at the plans the employee had been in and gave him the best of all worlds. If he was ever in the final pay plan, they used the final pay figures, and if he was ever in our 2% career average plan over here, they gave him the 2% formula on the final pay, and on and on. This kind of thing is not supported by anything in any of the plan language. It is certainly generous and the employees are not likely to sue you on this type of calculation, except for the employees who are having their assets distributed in this fashion.

A related problem concerns employees who return to work after they retire. Nice easy question, doesn't happen very often, but again when you start peeling that onion the layers and layers keep appearing. Some people feel that when you come back to work after a period of retirement, all of your earlier period of service must be recomputed under today's pension formula. And given what happens to plans they go from career average to final pay, or if the benefits units are up, this practice does not make much sense. It is wide open to abuse in a large corporation where there is really no control on who's called back to work. All it takes is one crony in the personnel shop and you can come back to work for a month and have all your benefits recomputed on the latest benefit calculation.

I do not know the answer here. I'm certainly assuming for the moment that it is adequate to suspend the benefit payment when somebody returns to work but even then, what do you do? If he went out early, there was probably an actuarial reduction. Do you restore an actuarial reduction for that period? I would be very reluctant to talk in terms of an actuarially equivalent adjustment, because it gets extraordinarily complicated in the real world.

Suppose the actuarial factors or the early retirement subsidy have changed when he comes back to work. Do you give credit for the second period of work? Some accrual seems reasonable, but plan language giving "an appropriate actuarial adjustment" seems to be a quick way to lawsuits. This will not have much affect on the overall plan cost, but the individual needs to be satisfied that he was not shortchanged by actuarial black magic.

MR. FREILICH: While we're raising problems without solutions, I'll raise another series of problems, plans that were previously unfunded. I will use a particular client as an example. This particular company has about 5,000 employees with a qualified final pay plan. But they had four additional plans that were completely outside the qualified plan. First, they had a 50% post-retirement spouse's benefit, which was completely unfunded. The solution there was to build that into the qualified plan. They were unhappy about the prefunding aspects, but they understood the long term advantages. Secondly, they had once in the past given an increase to retirees, and they decided to build that also into their qualified plan. Thirdly, they had a policy of about 10 years standing of restoring the early retirement reduction to anyone who retired at age 60 or above. We analyzed the integration requirements here and found that because of the post-retirement spouse's benefit they could only build unreduced benefits at age 62 and above into their qualified plan. We're hoping for some relief on the integration limits, but at this point, that was the result of our test. They are still left with a plan which makes up the early retirement factor for those two years, age 60-62, and they just do not know what to do at the moment. Finally, they had a program, a 100% offset minimum designed quite obviously for the higher paid employees. At this point, they are taking the position that this plan is exempt from ERISA requirements because it applies only to the highly compensated.

CHAIRMAN SHANNON: One solution to your integration problem would be to fill in the integration gap. Interestingly, this often winds up with a little higher dearly retirement subsidy. It is just a quirk in the integration rules.

MR. LaVIGNE: If we're talking about unsolvable problems, let me just put one more in here. This is on formerly contributory plans. The law indicates that where the employee gets a refund of his contributions from a plan that is no longer contributory, and I want to get approximately correct language here, you can forfeit the "proportional" employer-provided annuity. Now just what does that mean where, in changing the plan to a non-contributory status, the benefit formula was changed from career average to final pay? Is it okay to exclude the service that he earned while the plan was contributory from the final pay formula? There are a lot of questions in this area.