RECORD OF SOCIETY OF ACTUARIES
1979 VOL. 5 NO. 2

CURRENT TOPICS

Moderator: SUSAN J. VELLEMAN. Panelists: PRESTON C. BASSETT, DONALD S. GRUBBS, JR.

PRESTON C. BASSETT: President Carter announced the formation of a President's Commission on Pension Policy many months ago. However, all the members to this Commission were not named until last February, and they held their first meeting on March 23rd. Mr. C. Peter McColough, Chairman of the Board and Chief Executive Officer of Xerox, is Chairman of the Commission. Other members of the Commission include William Greenough, head of TIAA - CREF, whom many of you know, former Congresswoman Martha Griffiths from Michigan who was active in ERISA, an accountant, two State legislators, three professors, one from the AFL - CIO and one lawyer.

One of the early criticisms of the makeup of the Commission was that there was very little representation from the business world. There is no one from the banks or insurance companies. Mr. McColough has a big assignment to represent the business community. I am pleased that I have been asked to assist on the actuarial side because I think I can also present the business point of view. There is another person also serving from the Corporate Loan Program, Judy Mars from General Mills, who will be helping out on the investment side and from a corporation point of view.

The staff is headed by Tom Woodruff. He was formerly with the Department of Labor where I have known him for the past couple of years. Prior to this assignment he was with United Mine Workers.

The study has been divided into four groups. Group I is to look at Utopia, that is, what are the needs and desires of the retired people. Group II is to look at where we are under our present system and how well our present system provides for those needs. The third group will be looking at capital formation and the economic impact of meeting the needs of the retireds. And the fourth group is to look at comparative systems, particularly what other countries have done to solve these problems.

I will be acting as actuarial advisor to any of the groups, but I am mainly responsible for the forecast of where the private corporate pension system is and where it will go over the next fifty or so years in providing for these needs.

DONALD S. GRUBBS, JR: I am going to talk about some of the legislative developments. First of all, let us look at the developments under Title IV, Plan Termination Insurance. We now have two bills before each House that were just introduced. One is simply a bill to extend the deadlines for making plan termination

insurance effective for multiemployer plans, while the other addressed far more broadly the problems of multiemployer plans and to some extent other plans. The comprehensive bill, which was designed by the PBGC, has two distinct parts.

One, a very simple provision that affects all plans, deals with contingent employer liability insurance (CELI). ERISA imposed contingent employer liability and required PBGC to come up with some kind of insurance against that liability. PBGC concluded that this is not feasible at all and, therefore, they have proposed to delete the section of ERISA that calls for CELI.

The far broader parts deal only with multiemployer plans. When ERISA was passed, some thought that multiemployer plans did not have as many problems as other plans. Therefore, we had funding requirements that were not as stringent; longer amortization periods for example. In terms of plan termination insurance, the premium was set lower, only 50¢ instead of $1.00 required for single employer plans, because it was felt multiemployer plans hardly ever terminated.

ERISA delayed the effective date for making plan termination insurance effective for multiemployer plans until January 1, 1978. Before that date arrived, it became apparent that the original assumptions were totally invalid, that multiemployer plans had problems far greater than single employer plans, that there were some very large plans in danger of terminating and that these plans, if they terminated, would bankrupt the whole system.

To give them time to handle that problem, Congress deferred the effective date until July 1, 1979, in order to give PBGC time to come up with some proposals. Now PBGC has presented their proposals, and Congress recognized that there is not time to do anything before July 1. Therefore we have bills to make a ten-month extension until next May 1, 1980. It is safe to say that an extension will be passed.

What will happen to the other proposals, though, is far more doubtful. The problem is essentially that there are very large, potential losses. The whole question is who is going to bear the loss. Will the loss be borne by participants through lower guarantees, will it be borne by employers who withdraw from terminating multiemployer plans, will it be borne by the employers who are continuing in terminating multiemployers plans, will they be spread over all multiemployer plans, will they be combined with the single employer plans so that those plans have to fund part of it, or will it be paid through general revenues? All answers are bad. Start with that assumption because there are losses and, when you are talking about how to spread the loss, no one is going to be happy with the answer.

The proposal would do a variety of things. The first is to increase the premium rate from 50¢ to $2.60, the same rate for single employer plans. It would also change the funding requirements for

multiemployer plans to require the same amortization periods as single employer plans. There was not much reason for different amortization periods in the first place. In addition, it would set a second, more stringent kind of funding requirement for certain multiemployer plans that are determined to be in trouble, those plans which are described as being in reorganization, and I am going to come back to that alternative funding requirement in a minute.

It puts a different obligation on a withdrawing employer in a multiemployer plan. Under present law, if an employer withdraws from a multiemployer plan, its treatment depends on whether it is a substantial employer, i.e. an employer that has been contributing more than 10% of the contributions. If that employer is a substantial employer, then at the time it withdraws from the plan it is required to make an escrow payment to PBGC to be held in case the plan terminates within the next 5 years. If it is not a substantial employer when it withdraws, no escrow is required. There are some alternatives to the escrow requirement. But regardless of whether an employer is or is not, if the plan subsequently terminates during the next 5 years, part of the obligation of contingent employer liability gets allocated to employers who withdrew during the last 5 years. But if the plan does not terminate within 5 years, the withdrawing employer is off the hook completely.

That obligation of the withdrawing employer would be changed under the new proposal. The withdrawing employer would have an obligation to continue funding its share of any unfunded vested liabilities, not just guaranteed benefits as currently, but all vested benefits. When an employer withdrew, the plan would calculate the value of all vested benefits and subtract the assets to obtain the unfunded value of vested benefits, which would be allocated among the employers in proportion to their contributions during the last 5 years. The withdrawing employer would be required to fund that liability over a period of not more than 15 years. There is a de minimus rule which would let small employers off the hook, and if you are in the construction industry, you might get off the hook anyway.

The bill would also change the guarantees for multiemployer plans. One of the ways of cutting down the loss to employers and to the system is to give less protection to employees and to have them bear part of the loss. So the maximum guarantees, which are now $750 of monthly pension with cost-of-living increases, would be changed. The maximum would, instead, be a benefit per year of service. The guarantee per year would be 100% of the first $5 of monthly benefit per year of service, and 60% of the next $15 of monthly benefits, and no guarantee of any benefit in excess of $20 monthly per year of service.

If you look at that formula, the maximum guarantee would be $14 monthly per year of service. The net effect is lower guarantees for many plans.

The phase-in provisions of the guarantees would be substantially changed and this would have more effect than the maximum. Under current law, if you increase benefits, the amount of the increase is phased-in over approximately 5 years. The bill would change that to a 5 year 'cliff' phase-in, that is, after an amendment, there would be no guarantee of the increases for 5 years and at the end of the 5 years the entire increase would be guaranteed.

The bill would establish a new creature known as plan reorganization. What is plan reorganization? Each year the actuary would need to calculate the value of vested benefits for the plan, and compare that with the assets. If the value of vested benefits exceeded the assets, then he would determine the annual charge to amortize the unfunded value of the vested benefits, the portion attributable to retired employees being amortized over 10 years and the portion attributable to other employees being amortized over 25 years. Then he would compare that total amortization charge with the normal minimum funding requirements; if these amortization charges were greater than the normal funding requirements, then he would say the plan was in reorganization. This is a test to indicate that a plan is not in good shape. In that case, these higher amortization charges replace the regular minimum funding requirements.

Being in reorganization would have some other effects, also. If you are in reorganization, the plan has the privilege of decreasing accrued benefits if they are not yet phased in. If you had an amendment increasing benefits during the last 5 years, you could undo it and reduce benefits. This would change the present rule regarding accrued benefits regardless of whether they are vested, and regardless of whether participants actively involved are actually retired.

Decreasing future service benefits, which is an option that plans have now, would not really help in this situation because if you are in reorganization your obligation is not to pay the current costs, but to amortize the vested benefits that you have for the past. If a plan is in reorganization, its funding obligations would be increased at a time when you might be having trouble paying them anyway. You might decide to terminate the plan.

Plan termination would no longer be an insurable event. There is something else called insolvency that is an insurable event, but plan termination would not be an insurable event.

There would be two kinds of plan termination. One would be if a plan stops giving future service credits. That would constitute a plan termination, and employers would be obligated to keep contributing. They could not reduce the rate of contributions. The old funding requirements of the plan would continue to apply, and you would still be considered in reorganization.

The other kind of plan termination would occur if all employers withdrew from the plan, and none of them had any more covered employees or obligation to contribute. In that case the minimum funding requirements would not apply at all. The reorganization

rules that were described would not apply, but the employers would have a withdrawal liability to the plan as withdrawing employers, to amortize their share of the unfunded values over the periods I described a moment ago.

This withdrawal liability would be considered an asset of the plan. However, if these assets of the plan, including the withdrawal liability of employers, turned out to be less than the value of vested benefits, then the plan would be required to make amendments to reduce all benefits that were not yet phased-in to get the plan in balance as well as possible.

Eventually we come to the thing that would really be insured, plan insolvency. A plan insolvency would occur only when the multiemployer plan actually could not pay benefits due in the current year. In that case, the guarantees would apply at the reduced levels of guarantee that I have referred to.

In my judgement the proposal has the following problems:

1. It would impose an obligation upon employers that was far beyond that bargained for. That is, the employer would have to continue funding even after he withdrew.

2. It would create great new complexity in the funding requirements as well as in the plan termination provisions.

3. It would provide only limited protection for employees, particularly because of the phase-in rules and the ability to reduce benefits that were previously increased, even for people already retired.

4. It would create substantial additional expense for actuarial services. Perhaps some regard that as not all bad. But each extra dollar of expense in a multi-employer plan directly reduces the assets available to provide benefits, which can only be adverse to the interests of participants.

5. It would discourage, in some cases, the design of plans to meet the needs of participants. This reorganization test is one that might apply at times even though it might be very clear that the continuing contributions would be quite adequate to pay the normal cost and the usual funding requirements. Reorganization could create a crisis at times when there was no real long-term funding problem at all. This would tend to discourage plans from providing past-service benefits, or providing earlier vesting, or providing increases for retirees, even in those situations where these might be affordable.

6. It would discourage employers from participating in multiemployer plans at all, often to the detriment of employees.

I think it is time for us to give consideration to alternatives. One of the alternatives to be considered is to conclude that plan termination insurance will not work for multiemployer plans. Perhaps we should recognize that by ending plan termination insurance for multiemployer plans and making a refund of premiums for those multiemployer plans which still continue. Such a refund of contributions plus the elimination of future contributions would help all of the plans which have not terminated to do a better job for their participants. I confess that my alternative would have the bad effect of hurting some employees' plans that are going under. Under any alternative, someone is going to lose, and it is a matter of which is the least bad alternative.

MR. BASSETT: I would like to take a minute to describe to you the various projects that the profession has underway at the present time through our present actuarial organizations.

The Society of Actuaries Pension Committee is headed by Stuart Nagler. We now have a Joint Committee on Pensions which is composed of the members of the various actuarial organizations, and the purpose of the Joint Committee is to be sure, as well as we can, that none of the things that should be investigated or any of the projects that should be under way do not get overlooked or have someone say that we thought someone else was doing it, and also to prevent any duplication of effort to the extent possible.

The Joint Committee is not a project-oriented committee, but more of a committee to assign and see that things are being done in the most efficient way.

The primary function of the Society Pension Committee is in the research area and the developing of research and background material. Much of the output may be used by the Academy's Pension Committee which is responsible for the interface with the public.

One of the projects that the Society committee has under its wing is looking into how we can best integrate private pension plans with Social Security. As many of you are aware, last year we had a threat of legislation on a basis that would not be satisfactory. So we thought that, rather than wait until another bill is introduced in Congress, we ought to do a little research on this project.

One of the subcommittees that has been very active has been the ERISA subcommittee which is concerned about amendments to ERISA. Don Grubbs is responsible for that group.

MR. GRUBBS: Yes, we are struggling with the question of when it is appropriate for the Academy to say anything, and what kind of criteria we should have for saying anything.

We do not have any guidelines to address that issue. The majority feel that there may be many times when it is appropriate to present a statement of fact, to present information that might be helpful. We would distinguish, however, between a bill that might merely be introduced and for which there might never be a hearing, and one which we feel might be going somewhere. We want to consider whether our effort will be well spent.

When we addressed expressions of opinion, we became aware that there are more problems with respect to opinion, as distinguished from fact, particularly when the members have quite divergent opinions. We felt that we should approach opinion far more cautiously, not that there are not some situations where we should present an opinion, but we have to be very careful when trying to determine how the members of the Academy feel, to what extent there is divergent opinion, and how that divergency should be expressed.

MR. BASSETT: I might say that the profession testified on the proposed amendments to ERISA (S209), and we tried to be careful only to give testimony on actuarial matters.

Another one of our Task Forces is involved with the PBGC. Fenton Isaacson did a tremendous job on presenting the actuarial insight into the work that the PBGC did on this multi-employer problem. They worked very closely with the PBGC and did an excellent job.

THOMAS P. BLEAKNEY: PERISA is the ERISA for public employees' systems.

A bill was introduced in Congress last fall, HR14138. It had one hearing at which the Academy presented a position which was strictly related to the relationship between ourselves and the accountants.

But more is needed. Our committee met yesterday to review this and we have an all day meeting scheduled in the next couple of weeks. Specifically, one of the interesting aspects of HR14138 is that it uses terminology which is in the strange language no one has fully accepted, and one of the questions we are going to have to live with is just exactly how do we handle that.

Another very fundamental one deals with present value of accrued benefits, and that also has been addressed by various groups.

The Academy has been asked to give input regarding PERISA, and to those of you who have seen a copy of the bill already and would like to react, the bill will be much the same as that, subject to our input. We can have input before the bill is drafted, and certainly have an opportunity to present more input later.

MS. SUSAN J. VELLEMAN: The IRS published Revenue Proceeding 79-28, effective April 27, 1979. They had published IR-1947 back in January of 1978, drawing our attention to areas where final regulations were more stringent than some of the proposed regulations reminding us that we needed to amend plans that had already received approval on the basis of the proposed regs.

The new revenue proceeding has really set up a simplified procedure for getting approval of those amendments, rather than requiring the full formal submission of the plan using Form 5300.

The revenue proceeding has very specific rules for prototype plans, master plans and pattern plans. I will focus on its provisions with respect to single-employer plans, because I think that is where most of us spend much of our time.

The amendments have to be effective as of the first day of the plan year after the regulation is adopted, or if later, and if the plan met the special reliance procedures, then the first day of the plan year which began after 1977.

The adoption date has to be no later than the end of the plan year for which the amendment is effective, or June 30, 1979 if later. So for most plans we are talking about an amendment that has to be adopted by June 30, 1979.

There are two basic sets of rules. One for plans that did satisfy the special reliance procedure and then a second set for the plans that did not. The basic difference is that if you have a plan that did satisfy the procedure, then you need to submit only a statement with the request that it is in accordance with this revenue proceeding, a statement that interested parties have been notified, a copy of the amendment, a list of the amended sections, and the relevant sections of the final regulations with which the amendments are designed to comply.

If you happen to have a SRP plan, even if you have made other amendments, that were not required by the final regs, you still can submit just this information. You do not have to go through a more formal submittal, and the IRS will limit their review to the amendments. They will not review the entire plan again.

If you did not comply with the special reliance procedure, in order to submit a plan using this informal method, it can contain no other amendment other than those that are required to comply with final regs. You also have to submit the first page of the 5300, 5301, or 5303 that you used originally to submit the plan, and you have to make a statement that the amendments are solely to comply with final regulations and again give the information about what sections of the plan have been amended and with which final regulations they are designed to comply.

You do need to notify interested parties. If any interested parties submit material to the government, questioning the qualification of the plan, then you have to go through a formal submission.

Most of the plans that I have seen have several areas that we need to amend. Most of them do not really affect the plan participants, in that they are primarily technical. We are finding that most of our earliest plans have to be amended to change the definition of "Hour of Service." We have many plans where the joint and survivor regulations require changes, such as providing automatic joint and survivor coverage to someone who terminates employment after they reach early retirement age, but before they begin receiving benefits; that is, an early retiree with deferred benefits.

One other area that I have not seen specifically spelled out which has received attention elsewhere, is the issue of whether or not you can, in your plan, provide that the 415 limitations, the limitations on maximum benefits and contributions, can automatically be changed in accordance with cost of living changes.

MR. GRUBBS: Some of us have suggested that it may be too early to have round two, that this date of June 30 should be pushed back. After all, it is the responsibility of the government to tell us what the rules are; let us wait until we get all of the rules adopted and then make one round of clean-up amendments to solve them all.

MR. BASSETT: Don, I have got one that I wonder if you could help me on. I understand that there is a group of actuaries who are very concerned right now with a regulation that has not been published but is being talked about that would prohibit the use of certain actuarial methods in the valuation of pension plans. Are you familiar with that?

MR. GRUBBS: We have no regulations yet under Section 412, the funding requirements, except for some very small portions of Section 412.

IRS has an obligation to develop regulations. There are six actuarial cost methods enumerated in the act. We do not have any clear definition of what those are and I would expect that regulations would try to define those actuarial cost methods.

We use words for an actuarial cost method when really there may be a considerable number of variations of a particular method. IRS is going to have to define those methods in such a way that we can tell whether a variation really falls into the definition of this actuarial cost method, or whether it does not.

Actuaries can reasonably disagree on that. Whenever we get regulations, this would be one of the areas in which there would be some disagreement.

MS VELLEMAN: That to me is a little bit scary because it seems to me that it is also going to call up the whole question of what is really part of the actuarial funding method, as opposed to what is not clearly part of the method, but is a way of making approximations or even some things that we might consider to be an assumption.

MR. BASSETT: I understand that the actual method that is under attack by the IRS is the projected unit cost method whereby you project the benefits to retirement and prorate them according to salaries over years of service, and they are questioning that method. Does anyone know where that project stands off-hand other than

MR. GRUBBS: A draft regulation has been sent by the IRS to the Treasury Department to be reviewed in the office of Tax Legislative Counsel. Various people have given their ideas about it. Several actuaries have been involved in that. It has been mostly informal discussions and suggestions.

After we get proposed regulations, which I expect will be next month, there will be an opportunity for all of us to submit comments. This will certainly be one of the things on which the Academy will consider commenting.

LAURENCE N. MARGEL: There was an attempt by the Academy's committee on Pension Practice and Principles to try and reason with the Treasury that such a regulation is an infringement upon their professional prerogative, notwithstanding the merits or the demerits of the particular funding method. It is conceivable there will be some discussion with the governmental people before that regulation comes out as being unacceptable by definition, with regard to what it says.

I do not know at this point whether to be optimistic or pessimistic, but it is certainly worth a chance for us to head them off at the pass. It is liable to be the first of many areas on which the government feels they can narrow the options available to us in proper pension funding to make their job of control and administration much easier.

There seems to be a general tendency now that if there is the slightest possibility of something going awry, that the Treasury would prefer to disallow such a technique to eliminate the 1% abuse even though 99% disappears just as well.

MS. VELLEMAN: While we are on the topic of unpopular government action, another one is revenue ruling 79-90. This was published on April 4.

The ruling basically says that to satisfy the definitely determinable benefits requirement, a plan must specify any actuarial assumptions to be used in determining a benefit

amount, precluding employer discretion.

In the ruling they specify two acceptable fixed standards. One is to specify the assumptions to be used in the plan, or alternatively to give a listing of the factors that would be used in determining benefits.

They also mention two acceptable variable standards. One is to tie the factors to a specified insurance or annuity contract from an insurance company. The second is to tie the interest rate to the primary rate of a specified bank or a group of banks. If you use that alternative, you would then have to specify in the plan any other assumptions such as a mortality assumption.

This ruling and requirement that the information be in the plan was effective immediately for any plan that comes into being after March 12, 1979. For any plan that was already in existence on that date, then it is effective for plan years beginning on or after December 31, 1983.

Of course, the fact that they list these four standards does not mean that they are the only acceptable ones. There may be others you can think of that might satisfy the definitely determinable and employer discretion requirements.

I have one problem with the variable standards, and this is a practical problem I have had with a client where we are using insurance company rates for a specific option. People frequently ask for benefit estimates in advance and we find that we are giving out benefits estimates then, before the person actually retires, the insurance company's rate basis changes. In many cases, of course, the benefit has gone down and it has been a very difficult problem to deal with from the employee relations standpoint.

One way to deal with this is to delay the effectiveness of any change for a certain period to cover this problem. Another way is to give benefit estimates, introduce some element of conservatism in the amount of the benefit that you quote and specify, of course, that it is an estimate and might be higher. That would give you some protection.

MR. GRUBBS: What is the background? Why is this stance taken? IRS has tended to use the definitely determinable benefit rule as a means for getting a handle on discrimination, particularly for smaller plans which allow lump-sum distributions. John Doe comes up to retirement and wants a lump-sum distribution and it is calculated at 6% interest; next week the president comes up for retirement and they change to 2% interest in calculating his lump sum.

It is that particular problem which is the concern of IRS. The decision about how we are going to determine actuarial equivalents needs to be pinned down so that the employer can not say on the day the person comes up for retirement, let us figure out how to

calculate it.

Rev. Rule 79-90 compounds the problems of the anti-cutback rules relating to the regulations on vested benefits. An amendment cannot reduce accrued benefits. A change in actuarial assumptions, even though it does not change the normal form of benefit, may reduce the benefit under optional forms, and this is judged by the Internal Revenue Service to be a decrease in accrued benefits violating the anti-cutback rules.

Regarding that, IRS has indicated certain clarifications. First, if you have not had the assumptions in your plan document, the first time you put them in is not considered an amendment to which the anti-cutback rules apply. So the first time you put them into your plan you do not have any problem.

Secondly, IRS has indicated the effect if you use one of these flexible schemes, such as to tie the interest assumption to the prime rate at a particular bank. The mere fact that the interest rate fluctuates automatically outside the control of the plan will not be considered to trigger the anti-cutback rules. You do not have to worry if, because the interest rate changes, your early retirement factor goes down or your joint and survivor factor goes down.

Third, you can solve the problem to a considerable extent by a grandfather clause. The anti-cutback rule affects only the benefit accrued at the date of the plan amendment. If you make a plan amendment changing the actuarial assumptions, you can put in a grandfather clause providing that in no case will any benefit under any form be less than it would have been, based upon the accrued benefit at the date of the amendment and the old factors. Usually additional accruals will wash this out within a year or two anyway.

On another subject, we had the addition to Schedule B of the requirement for the value of accrued benefits, both the value of vested benefits and the value of non-vested accrued benefits.

For 1978 we do not have to enter the value of the non-vested accrued benefits, and you do not have to worry about the value of vested benefits if you have not calculated them.

This has been a highly debated subject. It has been one in which several parties are involved - the accounting profession, particularly the Financial Accounting Standards Board, the actuarial profession, and the Department of Labor. The Financial Accounting Standards Board published a discussion draft, in March, 1977 if I recall correctly, and there was considerable reaction. It said that financial statements to participants and statements for plans should include certain actuarial information. The actuarial profession reacted rather strongly against that, indicating among other things that it would increase actuarial costs. Many employers reacted against it and FASB withdrew it.

When the FASB withdrew it, though, they were not saying they were not going to do anything, but that they were going to reconsider the matter.

Meanwhile the Department of Labor was considering what to do. DOL was concerned that the FASB might grab the ball and start running with it, because accounting statements are a part of Form 5500. That gives the FASB some authority to control what goes into the attachments to 5500. The FASB appeared to be
Department of Labor, saying that if you do not add some things to Form 5500 that we want there, we are going to come out with our own alternative.

That was the basis for where we came out. My personal opinion is that both the value of vested benefits and the value of accrued benefits are meaningless figures for an ongoing plan. The value of vested benefits may be significant for a plan which is discontinuing, but Schedule B clearly states that the values are supposed to be computed for ongoing plans,for which they are not meaningful at all.

The Academy of Actuaries worked out a compromise with the FASB. The final thing which DOL came out with is admittedly far better than the first proposal, which would have required the value of accrued benefits on a projected basis as well. Some of us have questioned whether the Academy has compromised unnecessarily. I felt that they did and that they weakened the position of those of us who were saying that we should not have the value of accrued benefits at all. The Labor Department had substantial authority under Section 110 of alternative methods of compliance to bypass the power of the FASB entirely.

MR. BASSETT: I have a little different point of view. I feel that the Academy's Committee on Principles and Practices and the other Actuaries involved came to a reasonable compromise, a solution we can live with.

I think that some good can come out of publishing figures like present value of vested benefits and present value of accrued benefits. It does give a kind of a measure of the financial status of pension plans, even if the plans are going to continue.

The current status on the FASB proposal in regard to accounting for pension costs is that it went back to the drawing board.

Several months ago they put out an
informal memo. You might call it an exposure draft, but limited the distribution to people who had been involved in and interested in this problem. They did not want to upset the whole countryside as they did with their first exposure draft. They put it out as a trial balloon to see what the reaction from the actuarial profession and others would be. It follows somewhat closely what is now required in Schedule B.

We won a few points and we lost a few. I have been told by the FASB that as a result of this informal polling, they will be putting out another exposure draft which means we all have another crack at it. This new exposure draft is supposed to be out within another month. I do not know what is going to be in it, so what I can report on now is what was in the informal one. They received a lot of reaction to it.

The one that came out informally requires a financial statement which shows the net assets of the fund at the beginning and end of the year. Accrued assets will be valued at market values. The statement will show the change in assets, that is the income and out-go. It will show the actuarial present value of accumulated plan benefits, as of the beginning of the plan year.

This was one of our big problems since the accounting profession, as you may recall, wanted values as at the end of the year. We argued the impracticality of being able to give it at the end of the year because our valuations were generally produced as at the beginning of the year. They have agreed to let us use actuarial present values as at the beginning of the year.

We are to show any significant changes in this present value from the present value of the prior report, so actually it is necessary to go back 2 years.

Insurance funds created a problem. Their proposal was that we can use either fair value, which is market value or contract values, in valuing the insurance contract. This is again a break for us in that we can use the value that is shown for the contract.

If the benefits are purchased under a guaranteed insurance contract, those assets are to be excluded. In other words, allocated assets have be be excluded, unallocated assets have to be included.

They define benefits credited to prior service, or what they mean by accrued benefits, very carefully, and I believe accurately. They use the plan definition of vested benefits and a similar formula for unvested benefits.

Cost of living allowances that are provided for within the plan must be taken into consideration. The actuarial assumptions for determining present values must be explicit. They have withdrawn the requirement to use PBGC rates. We can use the assumptions we feel are appropriate. The assumptions must obviously be consistent and if you want to and you have the facility, you may use current insurance company rates.

They want to show values separately for employees currently receiving benefits, for other vested benefits and for non-vested benefits and also a statement of the amount of the employees accumulated contributions with interest.

We have to disclose what methods and assumptions are being used for

the actuarial present values and also, any methods and assumptions in connection with the market value of assets.

Various other items of information in regard to plan amendments, plan changes, funding policy and so forth are to be included. This will be effective for plan years beginning after December 15, 1979.

The actuarial profession has submitted comments on this informal exposure draft. We are still arguing for use of the actuarial value of assets rather than market value. We think we ought to be able to exclude or include in our figures the assets of insurance companies even though they may be allocated. There are some inconsistencies with Schedule B that we are also trying to straighten out.

MR. GRUBBS: This shows in part the difficulty of expressing any opinion by the Academy of Actuaries. This is a matter in which the members of the Academy have had some very strong and definite differences of opinion, some good grounds for all of them. At the hearings at the Department of Labor a question was raised as to whether the value of non-vested accrued benefits should be shown, and the American Academy spokesman said "yes". Three other members of the Academy who were testifying separately testified "no". I am not sure which one represents the majority of Academy viewpoints. It is difficult to try and find out what the Academy ought to say as an opinion.

The Manhart decision addressed the question of whether employee contributions can differ by sex. It was a case which required higher employee contributions for females on the theory that the cost of pensions for females was about 15% higher. The Supreme Court said clearly that you cannot require different employee contributions by sex.

But the Court did not address some of the other questions of discrimination which will be coming up. Colby College was in a TIAA - CREF plan, a money purchase plan in which equal dollars are going in for males and females, equal account balances. At the time of retirement that account balance is required to be converted to purchase an annuity. That annuity provides less income for females than for males.

The First Circuit Court of Appeals decided that the Colby College plan was prohibited discrimination. That is not a Supreme Court decision. It is now the law in one circuit court of appeals. Undoubtedly that issue will come up in other circuits, and eventually I would expect a Supreme Court decision.

I expect that the Supreme Court will uphold the Colby College decision. If so, then we will have a similar question arise in the typical profit-sharing plan which allows payment of the account balance in a lump sum, but also allows the option of receiving an annuity.

Then, of course, we will have questions arising in defined benefit plans as to actuarial equivalents. We will have plans funded by retirement income policies where you can get a lump-sum equal to the cash value, and other plans that pay out cash values. There are some unique problems for those plans for which all of the funding is done with insurance contracts that fully guarantee the benefits.

In many plans there is no problem in making a transition to unisex factors, and indeed many plans have done that. But for plans funded with insurance contracts, we would have transition problems and would certainly need a grandfather clause and some opportunity to make appropriate adjustments.

MS VELLEMAN: There was a case that was just settled the tail end of last month, won by the PBGC against a company called Leer Siegler, Inc. This was the U. S. District Court in Detroit. This case is similar to the Nachman Corporation case which was settled in February.

The basic situation was that the LSI pension plan was a negotiated plan which had a provision in it from 1973 which said that the vested benefits were limited to the benefits that could be provided by the assets in the fund.

The plan year began on July 1. On April 30, 1976 a plant was shut down and therefore the plan terminated. The company argued that because the plan did not yet come under the ERISA minimum vesting standards, that the benefits were limited to those vested under the terms of the plan. That is, those based on assets in the fund.

Of course, the PBGC said that that was not true, that although the new vesting did not take effect, the benefits still had to be covered and it did come under Title IV of ERISA because the termination occurred after September 2, 1974.

The PBGC won and these benefits were considered to be nonforfeitable, but then there was another issue that I thought was quite interesting. There had been a plan amendment increasing benefits on May 1, 1975, and now again, I remind you that the plan terminated on April 30, 1976. Under the phase-in rule the PBGC argued that those benefits had been in effect for one year, and would be partially phased-in. On that score the PBGC lost because, since the benefits became effective on May 1, 1975, the year started on May 2, 1975 and therefore the year ended on May 1, 1976 by which time the plan was already terminated. On the basis of that one-day difference, the company saved themselves about $100,000.

One other court case that I thought was interesting involved Morgan Guarantee Corporation. Morgan has been sued by employees in a plan that participated in their pooled funds because investment return was not as good as some of the market indices. The employees lost and Morgan won, on the grounds that the question of whether or not the investments were prudent did not come from whether or not they were successful. Morgan could show that they had done all

their research, monitored the investments and tried to come up with good performance. The fact that they were unsuccessful did not leave them open to charges of imprudence.

For years beginning with 1979, an employer can establish a simplified employee pension plan. The way it works is that an employee can have an IRA and the employer can contribute up to the lesser of 15% or $1500 to that IRA. It then becomes part of the individual's income shown on his W-2 form but then it is deductible.

If the employer contribution is less than the amount of the allowable contribution in a normal IRA, that is 15% or $1500, then the employee can make up the difference on a deductible basis.

If the employee is already in a qualified plan, or in a government plan, or has a tax sheltered annuity, an employe can still set this up but the employee can not make any deductible contributions himself.

SEPP has all of the restrictions of a qualified plan with respect to the requirements for a written formula and no discrimination. It has participation and vesting requirements. The employer deductions work in a manner very similar to those for a qualified plan. You have the 415 limits on benefits and contributions. There are some other even more restrictive provisions. Other than union and non-resident alien employees you have to cover all of your employees who are over 25 and have had performed services in at least three of the last five years for the employer. Immediate vesting makes it more restrictive.

The IRS is authorized to issue regulations providing for simplified reporting and disclosure under this type of plan. They have not yet done so and the Department of Labor regulations on plans do cover SEPP. Therefore you have all of the regular reporting and disclosure.

MR. GRUBBS: In the lack of regulation no one has gone for the simplified IRA's yet. The purpose behind the simplified IRA s was to encourage small employers to have plans since many small employers have been scared off by the excessive reporting and disclosure requirements. It was hoped that this would encourage plans. It is expected that we will have regulations on that by the end of the year. Then we will see how much real coverage we will receive from it.

MR. BASSETT: The 1977 Social Security Act contained a provision that the Administration study the appropriateness, if you want to put it that way, of universal coverage of Social Security. More specifically, should Social Security be mandated for the Federal Pension System and also should it be mandated for the state and local municipal plans which have, of course, the option of Social Security coverage. Some 30% of the local plans are not under Social Security coverage.

Because of this law, the Department of HEW has set up a Study Group to investigate and report back to Congress on this topic. They have divided up the project. The government actuary is working on how to bring the civil service employees under Social Security. The balance of the project of giving universal coverage or mandatory coverage for state and local plans has been put under the wing of the Actuarial Education and Research Fund. They have set up a Task Force to report on how this integration with Social Security can be accomplished or what the various alternatives are.

MR. GRUBBS: ERISA established IRAs so the employees who were not participants in a plan can contribute to an IRA and claim a deduction of $1500 or 15% of pay, or if you have a spouse involved, up to $1750.

This has created a number of objections from an equity viewpoint, from people who are employees under a pension plan and can not have an IRA. They say two things. First, "I'm a member of a profit-sharing plan but my employer only put one dollar in for me last year. If I hadn't been in a plan at all I could have put $1500 into an IRA. Shouldn't I be allowed at least to put $1499 into an IRA?" That makes sense from an equity viewpoint. Second, the participant who is not vested says, "I'm never going to stay 10 years. I'm going to get zero out of this plan. Since I'm getting zero out of my company plan, why can't I establish an IRA like the person who isn't covered? After all, I'm not really covered because I'm not going to get anything from the plan."

We have had several proposals over the last several years trying to solve that problem. Some of them, like Representative Corman's bill, are quite complex. Part of the problem of getting an equitable solution is that if you have a pension plan, as opposed to a defined contribution plan, it is difficult to decide how much the employer did contribute for you last year.

There is also a timing problem. We do not have to contribute to a pension or profit-sharing plan until 8 1/2 months after the year is over.

The IRA has also created problems for pension plans. The employer has the problem of John Doe saying, "I want to opt out of your pension plan. I'm not going to get anything out of it and it keeps me from having an IRA. I want an IRA instead."

We are generally recommending that the employer not give in to that demand, but that creates a bad personnel relation. "My employer isn't really giving me anything in benefits and he is keeping me from having an IRA for myself." on the other hand, if the employer does give in to that demand, two things may happen. First, of those employees who say they are not going to stay ten years, some of them really will. If they elect out, they will really hurt themselves and receive inadequate benefits. You can say that it is their own fault, but they have really deprived themselves of benefit accruals. Second, it may cause your plan

to be disqualified because you do not meet the coverage requirements, when these people drop out.

To solve these various problems, three Senate bills would allow employees who are covered under a pension plan, regardless of whether they are vested or not and regardless of what has been put into them, to establish an IRA and make deductible contributions to it. The Dole - Nelson and Williams - Javits bills would allow them up to $1000 or 10% of pay; the Bentson bill goes to 15% or $1500.

It would be inequitable to allow employees who make contributions to an IRA to get a deduction. Other people making employee contributions under a qualified pension plan are not getting a deduction. So if you are going to allow deductions for the IRA's, you have to allow deductions for employee contributions; all three of these bills would do that. But the Dole - Nelson and the Williams - Javits bills have nondiscrimination tests, quite apart from whether the plan itself is nondiscriminatory. The employee contributions would have to be nondiscriminatory. Even if the plan had universal coverage and covered every employee, if relatively more of the higher paid people decided to make voluntary contributions to the plan, they would not get the benefit of a deduction.

Similarly, this would be a problem in thrift plans. It is common under thrift and savings plans to allow an employee to contribute anything from 1% to 6% of pay. If, as so often happens, the higher paid people tend to contribute more, then you would find these not meeting the test. The Bentson bill, which is far simpler, has no such requirements.

One other difference is that the Williams - Javits bill would not allow any deduction for mandatory employee contributions, except for those plans that already require employee contributions. Senator Williams is opposed to mandatory employee contributions but realizes some plans already have them. He wants to stop the expansion, so therefore, he would not allow new contributory plans.

A fourth bill is the so called "housewives" bill which would impute one spouse's earnings to another spouse so the other spouse could set up an IRA based upon the first one's earnings. That generally would affect only the housewife, and that is why it is so labeled.

MS.VELLEMAN: There are proposed regulations on the definition of an active participant for purposes of eligibility for IRA deductions. They were issued in March. They would be effective for taxable years after 1978. They would replace a proportion of proposed regulations that were effective in 1975.

The surprising thing that I found in them was that a person is considered to be an active participant in the defined benefit plan if he is not excluded from the plan for the plan years ending with or within his taxable year. That means that if a person

is not in the plan for the plan year, and that plan year ends within the calendar year, but he enters the plan on the first day of the plan year, September 1, he then can make a deductible contribution to an IRA for that calendar year.

My understanding in the past had been that, if he were in the plan at all during the calendar year, he could not have a deduction. The other change was that a person who does not accrue benefits because he is earning less than the minimum salary necessary to accrue a benefit in an excess plan is not considered to be a participant. On the contrary, for someone who does not accrue a benefit because he has less than 1000 hours of service within a year, he is a participant. So you have someone who is in your plan and works less than 1000 hours, he receives no benefit accrual for the year, he is still a participant and cannot have an IRA deduction for the year.

MR. GRUBBS: PBGC proposes to issue their rates prospectively. To date the rates to be used on termination are only retrospective. If you have a plan terminating today you do not know what rates to use. You use the ones that were used for the last period and hope that they have not changed, but you may have to do the calculations over again. You really can not advise people on it rather than on an approximate basis. PBGC proposes to issue those rates prospectively, which would be a great improvement.

ROBERT T. McCRORY: I have a fairly large client with a number of hourly plans, most of which are cleanly drafted; there are no lump-sum distributions. We were discussing the issue of what form of actuarial assumption should be included in the plan. Their attorney brought up the question of whether we should include some kind of variable interest rates or mortality.

The question I asked myself was what sort of financial impact did this issue have on the plan. I found that if you vary the actual fund earnings from the actuarial interest assumption, the plan cost remained relatively stable. Under current actuarial assumptions and using their early retirement reduction factors, they were giving something like a 4.1% subsidy relative to true actuarial factors, mainly in the area of early retirement. In other words, the option factors that were used were not exactly in accordance with the actuarial assumptions.

As the earned interest rate on the fund changed significantly from the 5-1/2% interest assumption, to 7% or 4%, that relative subsidy changed between something like 4.3% and 3.9%. So the effect on plan costs was really not very severe.

The point I am trying to make is that before you go about putting some complicated option factors in a plan, you should make at least some preliminary investigations to see how sensitive to those factors your plan is in the financial area. You may be able to get away with a simple table of specific numbers that bear some close resemblance to your current actuarial assumption, with

perhaps some degree of conservation.

The other point I would like to make is that I am extremely unenthusiastic about the idea of using a prime rate of AA bonds as an interest rate assumption for such option factors. It appears to me that the purpose of the option factors is to make the plan financially indifferent as to what form of benefit the participant chooses. The plan is indifferent or not, depending on the plan assets' own earnings -- not the earnings of some outside index.

This leads me to the conclusion that if you use variable interest rates at all, you should use something that is somehow related to the earnings of the plan assets, such as a five-year average of historical plan earnings or something like that.

MR. MARGEL: People seem to assume that the prime rate example in the regulation is all that you are allowed to use. That is just an example. You could have any outside reference point. One should really read this requirement of definitely determinable benefits as being translated, through IRS logic, to be an inability to manipulate benefits. It has nothing to do with definitely determinable benefits.

The reference point you can use could be anything you care to make it, so long as it is not subject to an individual choice and outside the control of the plan sponsor and the actuary. It could be anything, including the earnings within the particular fund.

Secondly, I have always felt that the actuarial equivalent value should not be viewed from the plan point of view, but rather should be viewed from the employee's point of view. The employee, if he is supposed to be selecting an option from amongst alternatives which are supposedly actuarially equivalent, is making one that best suits his circumstances and is gaining neither advantage nor being disadvantaged by the option he picks. The plan may gain or lose depending on that option but the key thing is that he cannot benefit himself through selecting one option as opposed to another, and therefore, if you were looking for an example of a lump-sum option it would be more logical from my point of view to say, what will the employee do with the lump-sum that he takes from the plan? You would say a very reasonable choice for many employees is to place the money in a savings account or certificate of deposit or roll it over into an IRA earning perhaps 9%. I would say that that is the reasonable interest rate to use as defining actuarial equivalence because it meets the employee's side of that equation and not necessarily the plan's side.

Thirdly, an observation was made about the factors in the plan document where the cutback provisions were phasing out rather rapidly. It is really a short term situation until the cutback would no longer apply to given employees.

It is not so much the active employee problem as it is the vested terminated employee problem in that you basically would have to utilize the factors that were in the plan document on the date that a particular employee terminated. After many years this could just be an administrative headache of having to keep track of which factors were applicable when the employee terminated.

You eliminate this problem if you use the outside reference point. The outside reference point is not a change in plan when the reference point changes. If you wanted to be able to have convenience of administration and use an interest rate that was truly indicative of the economic conditions when benefits commenced, you could utilize the outside reference point. You would never have the problem of the grandfather situation and the cutback rule for 40 years ultimately for vested terminations.

MR. GRUBBS: Being an advocate of simplicity, I still prefer factors like a half percent per month for early retirement and 90% for the J & S option.