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CURRENT DEVELOPMENTS IN PENSIONS: U.S.

Moderator: PETER B. HUTZEL. Panelists: ROBERT S. BYRNE, JR., JEREMY GOLD, MITCHELL I. SEROTA. Recorder: MITCHELL I. SEROTA

MR. PETER HUTZEL: This Session covers recent developments in pensions. Our speakers will be: Jeremy Gold from Buck Consultants, who will be discussing the 1982 Tax Equity and Fiscal Responsibility Act (TEFRA); Mitch Serota from Johnson & Higgins analyzing the impact of the 1983 Social Security amendments on pension plans; and Bob Byrne from Kwasha Lipton covering the recent proposals from the Financial Accounting Standards Board (FASB).

MR. JEREMY GOLD: TEFRA, the Tax Equity and Fiscal Responsibility Act, was a compromise worked out by Congress in 1982. To raise revenues, the fiscal responsibility part, was one goal. Tax equity, the other goal, basically translated into "get the highly paid."

So TEFRA not suprisingly has a much larger effect on highly compensated employees. The two primary ways in which TEFRA does that are the new rules in §415, which affect all qualified pension profit sharing plans, and the top heavy concept, which was aimed at the small corporations and professional corporations. We will also look at some changes that TEFRA made in the estate tax treatment to qualified plans, incentive stock options, and loan provisions. I shall stay away from life and health insurance aspects of the Act.

Section 415 limits started out at $75,000 under ERISA for defined benefit plans and $25,000 for defined contribution plans. There are some combined limits, and now actuarial reductions, which were handed to us by TEFRA. Before TEFRA the the maximum annual benefits from a pension plan was $136,425, or if less, 100% of three-year average pay. That figure was being indexed each year from 1976, and grew to the 1982 figure of $136,425. Defined contribution plans were limited to $45,475 of annual additions or 25% of pay in the year. If we look at an individual making $50,000, we see a maximum pension of $50,000 or maximum annual deductions of $12,500 through a profit sharing plan. A $300,000 employee would be hitting the dollar limits rather than the percentage limits and would be restricted to $136,425 pension benefit or $45,475 profit sharing contribution.

Before TEFRA, the combined rules said that one could not have 100% of both the defined benefit and the defined contribution limits. One could have 100% of one and 40% of the other or maybe 70% of each, as long as the sum of the percentages did not exceed 140%. The way this affected the $50,000 individual was to reduce the maximum under one plan or the other; if you wanted the whole $50,000 pension you had to restrict your defined contribution to $5,000. The $300,000 individual, facing the $136,425 and $45,475 limits, could choose to have the latter reduced to $18,190 if he wanted the whole $136,425 or the $136,425 could be reduced to $54,570 if he wanted

the whole $45,475. That represents 40% and 100%. Now that we have ERISA, we are ready to look at TEFRA.

TEFRA has made some sharp changes in those 415 limits. The dollar amounts were lowered from $136,425 and $45,475 to $90,000 and $30,000 respectively. Indexing has been halted, meaning that the $90,000 and the $30,000 will remain for 1983, 1984, 1985 and then indexing will resume in 1986. These are pretty substantial cuts in the dollar maximum benefits.

The $50,000 employee, though, remains unaffected. He is still affected by the percentage limits, 100% of defined benefit and 25% of defined contribution. However, the $300,000 employee, who is immediatly cut back to the new dollar limits, has a further change in the way the combined rules work. The 140% rule is allowed when considering the percentage limits alone. Alternatively, dollar limits are lowered to 100% of one dollar limit and 25% of the other dollar limit or some combination adding to 125%. If we look in total at the $50,000 individual we see no changes before and after TEFRA. Congress was not after the $50,000 individual; they were after the highly compensated $300,000 in-dividual. Comparing these numbers, you see that the benefits for the highly paid have been cut in half. If you consider the lack of indexing for the next three years, it is probably a little worse than that.

TEFRA granted a concession, however, for the defined benefit side only. Formerly, the whole $136,425 was available any time after age 55; TEFRA now requires reductions for early retirement prior to age 60 but $75,000 is available from age 55 on up. Furthermore, actuarial increases for deferred and late retirement are allowed within limits. We have computed $104,000 as a possible benefit at age 68. One saving pro-vision was that benefits accrued through the end of last year based on the plan in effect on June 30, 1982 are protected and there are some complicated transitional rules to effect that protection. We note further that changes in Internal Revenue Code Section 415, by changing the maximum allowable benefits, affect Section 404 (governing tax deductibility) and Section 412 (governing the Funding Standard Account).

To circumvent these restrictions, supplementary retirement benefits are attracting a great deal of attention. These are the plans that allow you to pay benefits beyond those from the qualified plan. They usually pay directly out of the company's cash after retirement. All kinds of issues such as expensing, accrual, book reserving, and funding have brought forward creativity from many consultants. Supplementary select management plans, which are also called top hat plans, and in-dividual employment contracts are ways in which people have dealt with excess benefits for the highly paid.

When we talk to employers about new §415 restrictions, we propose two ways we can deal with them. We can look at it in a broad way, which amounts to saying, "Have we changed our benefit policies, or should our benefit policies be changed as a result of TEFRA?" Or we can take the more narrow approach, whose strategy is to find out whose projected benefits were diminished and to see what we can do to fix it.

Since it usually concerns the boss of the people we are talking to, the narrow approach is the more favored. In the narrow approach we like to look at data of individual executives and we do very exact calculations. We go back into the history of their defined contributions to take advantage of as many of the transitional rules as we can. We do projections into the future to see what problems might exist. We always focus on the after-tax effects, because these excess and supplementary plans do not necessarily reproduce the benefit value that can be gotten from qualified plans. Qualified plans, particularly lump sum distributions, receive very favorable tax treatment.

Here is an example of some of the choices employers make. Suppose that the plan would have paid a $150,000 annual pension benefit to the $300,000 executive, and each year we would have put $45,000 into the profit sharing plan. The value of this package approximates $2,000,000. As a result of TEFRA we are limited to $90,000 and $7,500 or alternatively $22,500 in pension and $30,000 in profit sharing. Most employers opt for the second choice. After imposing the §415 limits the accumulated value has dropped from $2,000,000 to about $1,000,000. Now we can talk about what we are going to do to recoup the lost $1,000,000. If we do nothing but pay the difference between the $150,000 and the $22,500 out of the corporate books, in effect paying $127,500 to the executive each year after retirement, we can restore half of the loss after taxes. This approach brings back $500,000 to the executive. A deferred compensation account for the lacking $15,000 on the defined contribution side, when put away annually with interest, can bring the total value after taxes to $1,800,000. We can not bring it to $2,000,000 just by mirroring or duplicating the benefits. That is because we can not get the favorable tax treatment. If we wanted to make this executive completely whole we would have to add another $200,000 after tax, and assuming a 50% tax bracket that means $400,000 to the amount paid to him at retirement. Indeed, fairly large amounts of money are finding their way into supplementary retirement plans.

The broader approach, I think, will be in vogue for the next couple of years. The relationships between defined benefits and defined contributions, are really the benefit policy of a corporation. The benefit policy determines who gets how much and under what circumstances. Just before TEFRA, if we were pleased with our consulting in the last two years we may have felt we had all these pieces in balance, but TEFRA shook the whole framework. I think that employers who do take this broad approach step back from the narrower problems of their top executives and prefer to consider the rebalancing of the defined benefit, defined contribution and supplementary plans.

Among the miscellaneous TEFRA provisions, estate tax changes merit first analysis. Prior to TEFRA, a qualified plan could pay a death benefit that would not generally be included in the decedent's estate. This has provided some planning opportunities particularily when the beneficiary was other than the spouse so that an executive could pay grandchildren a death benefit, and there was no estate implication. However, TEFRA has put a $100,000 limit, meaning that some of the estate plans need to be reviewed.

TEFRA has also affected the Incentive Stock Options (ISOs). These have had a relatively short life, having only been created by ERTA, the tax law of the previous summer. Usually there is an exercise price for the stock option which is below market. When the executive buys the stock at the lower price, he in effect creates a bargain. ISOs allowed this and did not tax the capital gain until the stock was eventually sold. TEFRA now states that that bargain element is now a tax preference item which is subject to the altered minimum tax. For the highly compensated that can be significant. TEFRA also raised the rates to a flat 20% on the altered minimum tax. So ISOs were given in 1981 and somewhat taken back in 1982. If executives have ISOs, the plan must be reviewed.

Lastly, I would like to talk about loan provisions. Major corporations are more likely to permit loans from their plans today than they were before TEFRA. 401(k) plans, which are rapidly replacing the traditional profit sharing and thrift plans, have deposits put in by employees which are hard to get back out, so there is a desire to find ways to get it back out. Allowance of loans to participants from profit sharing plans of the 401(k) type has led to a spawning of them.

The whole area of loans was rather unclear before TEFRA, which has made it clearer. The new rules are restrictive but the very presence of them makes it more likely that we will see loan provisions added to plans. Pre TEFRA loans at the time the money was taken out of the plan did not create any taxable event but TEFRA says that a loan may be treated as a taxable distribution if it exceeds a certain size and does not meet some other rules. The participant can now borrow up to $50,000 or, if smaller, half of the vested account, and that will not be a taxable event as long as it is repaid within 5 years. There are a couple of possible escapes. First, even if half the plan balance does not equal $10,000, $10,000 can be borrowed without taxable implication. Furthermore, the "repayment within 5 years" provision can be lengthened in the case of mortage for principal residence. As a result of this I think we are going to see some wide spread use of loan provisions.

MR. MITCHELL SEROTA: The 1977 amendments to the Social Security Act rocked the pension consulting community when actuaries realized that funding costs for private pension plans were about to increase sharply in the short range. These amendments changed the formulas by which Social Security benefits were calculated. The attendant reduction in benefit levels did slow the depletion of the Social Security Trust Fund. But most laymen believed that the Social Security system was nevertheless "going bankrupt." Now again in 1983, the public perceives the system as going broke. Moreover, several provisions in the new law departed from historical precedent thus exacerbating the fears of the lay public.

The purpose of this talk is to ask whether the concerns aroused among pension consultants by the 1977 amendments are justifiably rekindled by the 1983 amendments. First, I will discuss two sections of the Act which depart significantly from historical precedent. Second, I will list those new provisions which directly affect the funding of private pension plans. Finally, I will tell how those provisions affect plan design and funding.

Among the new changes in the law, the most significant departure from historical precedent is the provision for taxation of benefits paid upon retirement. IRS in 1938 and 1941 had declared that Social Security benefits would not be taxable. In 1979, when the President's Advisory Council proposed taxation of half the granted benefits exceeding $4,300, Congress chose to ignore the suggestion. Now Congress broke with its tradition of providing untaxed benefits simply because taxation will bring $30 billion back into the Trust.

Congress' second manoeuver was another attempt to being much needed revenue to the Social Security Trust Fund. Here Congress diverted General Revenue from the Treasury into the Social Security System Fund. This decision undermined the policy that the system should be self-supporting. Until this 1983 Act, Congress had recognized that subsidizing of the Social Security Trust by the Treasury was merely a roundabout way of increasing Social Security taxes. In this instance, Congress has granted an outright transfer of $18 billion from the Treasury. In addition, in 1984 Social Security taxation for non-self-employed people will increase by .3%. However, IRS will grant a .3% credit against federal income taxes for those same Social Security taxes. Thus, Congress will in effect have transferred funds from the Treasury to the Social Security Trust for the first time in its fifty-year history.

These financial contortions, taxation of benefits and subsidation by the Treasury, might be construed as further indication that the Social Security system is in deep trouble. Do these manoeuvers forbode repercussions in pension plan funding comparable to those brought by the 1977 amendments?

Three specific provisions in the amendments do affect the funding of pension plans directly. The first is the increase in the retirement age at which full PIA benefits would be paid. For people born in 1938, full retirement benefits will be deferred until they attain the age of 65-2/12. People born in 1939 will have to wait 2 months more, that is, until 65-4/12. And so on for people born each year

until the 1943, whey they will receive full benefits at age 66. This procedure starts up again for people born in 1955 and continues until people born in 1960 will have to wait until they are 67.

Secondly, commensurate with these increases in the age for receiving full benefits is a modification of early retirement factors. Early retirement will be allowed at age 62 as before, but any premature retirement, that is, one starting more than 36 months before full benefits are payable, will be penalized by 5/12% per month instead of by 5/9% per month.

Thirdly, the new law provides for a gradual increase in late retirement allowances from 5% per year to 8% per year. These changes apply to every other year of birth after 1924.

I now turn to the issue of how the amendments affect plan design and funding. First, we need to know how benefits will be changing. Benefits for participants earning a salary at least equal to the wage base during their full working lifetimes do not change from those under the old law for people born before 1938 and change only slightly for those born in 1938 or later. Since those born from 1938 through 1940 will have a 6-month or less deferral in benefits under the current law, their full benefits levels will not change. For those born in 1940 or later, there is one additional year of salary at a higher wage base which offsets a year of salary at a lower wage base. For people born in 1953 or later, there is no change at all.

Now that we know how benefits have changed, and they changed minimally, we can examine what happens to plan design. Excess defined benefit plans will not be affected. The major impact of Social Security benefit modifications will tend to make offset plans more expensive. Or will they? I believe many consultants assume that since the 1977 amendments made offset plans considerably more costly to fund, the 1983 amendments would do likewise. I have performed some valuations to see what happens.

The following normal cost rates were determined using a spread-gain or aggregate-type funding method with no unfunded liabilities and no assets. The inclusion of either of these two would uniformly change the normal cost rate by a constant, and I will be comparing normal cost rates to show percentage changes in contribution levels. In a typical valuation of a plan with 50% FAP less 50% PIA, I arrived at a normal cost rate of 7.279%. Under the new law, I determined the normal cost rate would change to 7.328%. Such a difference is substantially less than what could be accountable in a gain-loss analysis by interest assumption, salary scale, or termination scale.

I did not say yet how I applied the "new law". Since Revenue Ruling 71-446 refers to the benefit payable at 65, I used the full PIA, reduced with early retirement factors. However, a plan drafter may wish to amend his plans to use the unreduced PIA to offset the final average pay. Obviously, the normal cost rate declines, specifically to 7.197%.

A very interesting result came from speculating about what the government may do to coordinate ERISA with the Social Security amendments. If we anticipate a change in ERISA which would set normal retirement age to correspond to that age at which the full PIA benefit could be collected, the normal cost rate for this plan would drop from 7.279% to 7.073%. The reasons for the drop are threefold.

First, of course the 50% of final average pay portion of the benefit formula increases slightly, with up to two years of higher salary to account for. But the compensation is discounted, under common assumptions, by up to two years of an interest rate greater than the salary scale. Second, the participants affected are all younger than 45 and are the lower paid, higher turnover plan participants, so their impact on the whole is minimal. Third, the present value of future salary increases, thus lowering the normal cost.

In conclusion, the new law does not substantially affect funding, and compared to the 1977 Social Security amendments, there is really no cause for concern that consultants should scramble madly to change offset plans to excess plans.

MR. ROBERT BYRNE: Before delving into the issues raised in the FASB's Preliminary Views and recent discussion memorandum on Pensions and other Post-Employment Benefits, I wish to give credence to the notion that the fundamental reason underpinning the establishment of private pension plans is that the employer believes a pension plan will impart future value to his business. That is, he believes it will result in greater revenues or smaller expenses than can be expected without a plan. To begin the discussion, let us consider examples supporting the hypothesis:

1. Employers can expect increased or sustained productivity through the retirement of employees who are no longer sufficiently productive, but whom the employer would be reluctant to terminate without a pension.

2. Employers can expect increased or sustained productivity through diminished turnover because the career employees can count on pension benefits at retirement and because the employer's ability to hire high quality personnel is improved.

3. In collective bargaining, demand for a pension plan or improved pension plan benefits often takes place in lieu of additional cash wages or other benefits.

4. Sometimes a pension plan is established because government controls, which were in existence at the time, restricted other forms of pay increases. This, for example, happened during World War II.

Therefore, there seems to be no basis for the view that an employer adopts a pension plan primarily as a reward for services rendered prior to the adoption of the plan, except perhaps as an incidental in the minds of paternalistic employers (who are in the minority). Pension funds represent reward for future service and productivity.

The same conclusion can be reached for amendments to a pension plan. That a plan may use pre-adoption service or pay as one of the factors in its benefit formula does not detract from the conclusion that the plan is an exchange for future service. Its inclusion really is only incidental to the design of the plan in order to accomplish its intended future purposes. I offer two observations:

1. To encourage career employment, length of service is an expected and logical element in the benefit formula, but the importance of service varies significantly among plans.
   Some plans provide the same benefits so long as a minimum period of service, such as 15 or 20 years, is completed; some plans limit the length of service for benefit purposes to a maximum ranging from 25 to 40 years; and some plans give greater credit to the first 15, 30 or 35 years of service, and lesser weight to service in excess of these amounts.

2. For most businesses, and I feel this is most important, exclusion of preadoption service from the benefit formula would substantially diminish the expected future value of the plan to the business. That is, those employees who retire in the near future would not receive as large a benefit as employees who will retire in the distant future. Additionally, it would decrease the value of the plan in the view of younger employees since they tend to evaluate a program by how well it does for persons currently receiving benefits. As a note, the relatively few plans which do not credit preadoption service generally were adopted by businesses which have few, if any, employees close to retirement age when the plan was adopted.

For the reasons just cited then, it becomes clear that the structure of most pension plans and the circumstances surrounding their adoption and subsequent amendments is an exchange between the employer and the covered employee group as a whole and <u>not</u> between the employer and each individual employee. Present accounting rules acknowledge this principle as illustrated by three well-established perspectives for dealing with pension cost.

The first states that the amount expensed is the amount which is actually charged against income in an employer's financial statement. Current limitations are basically set forth in APB Opinion No. 8 and have been amplified by other FASB opinions. APB Opinion No. 8's components of pension expense are the current service cost and the prior service cost. Prior service cost is contrained by a minimum amount equal to a 40-year amortization of the unfunded liabilities (if there is no unfunded vested liability, interest on the unfunded alone is acceptable) and, a maximum amount which is equal to 10% of the initial unfunded amounts. Furthermore, the funding should follow a systematic plan which results in stable annual amounts. Any acceptable actuarial cost method may be used to determine the expense.

The ERISA minimum funding requirements deal with pension costs from a second perspective. The 1974 Act which allows the use of almost any acceptable actuarial cost method, consist of the current service cost and the prior service cost which basically has differing

amortization periods of 40, 30, and 15 years for the original unfunded amount, amendments or assumption changes, and actuarial gains and losses respectively.

The third perspective is the constraint of the IRS maximum amortization of each layer of the unfunded over a period of 10 years. No more may ever be deducted than the amount actually contributed.

Tying these three perspectives together, current balance sheet entries can arise in any number of ways. The most common occurs when the amount contributed is different from the amount expensed on the employer's income sheet. For example, if the amount contributed is less than the amount expensed, a book reserve (a liability), will be set up on the employer's balance sheet. Conversely, if the amount contributed is greater than the amount expensed, there will be a prepaid pension expense asset item. There are other items when, because of an extraordinary event such as a plant shutdown, the unfunded vested liabilities of a plan may have to be booked as a liability.

The approach I have been describing represents a commitment to allocate adequate financial resources for the pension program in a rational and systematic manner over the future service of the workforce or the future life of the plan (or even of the Company itself). The Financial Accounting Standards Board, however, has approached the pension cost with a fixed idea that a balance sheet liability needs to be recognized. The Preliminary Views, based on a liability argument, make pension expense an almost mechanical bi-product of the liability process. Under this view, FASB's misguided preoccupation with past service achieves greater importance than future service!

The Preliminary Views set the balance sheet liability equal to the pension benefit obligation, which is made up of the present value of accumulated plan benefits and the additional value assessed to future salary increases as determined under the unit credit method. Subtracted from this is the market value of plan assets and added to this is the measurement valuation allowance (with a loss being a negative item). On the inception date, the measurement valuation allowance (MVA), which is an account including unamortized gains and losses as well as changes in assumptions, would be set equal to zero. On the asset side of the balance sheet lies an intangible asset (IA) of equal amount to the net pension liability under the propective transitional method.

Therefore, under the Preliminary Views, pension cost becomes the bi-product of the sum or the change in the net pension liability and the intangible assets, excluding decreases in the net pension liability that result from employer contributions for the period. In actuarial terminology, this pension cost is equal to the normal cost as determined under the unit credit method (including salary increases, if any) plus interest on the unfunded liability, determined on the unit credit funding method, and amortization of the intangible assets and measurement valuation allowance. I use the word "amortization" to be consistent with the language used in

the Preliminary Views. The principal write-down for any one year is equal to one divided by the average future service life times the unamortized IA and MVA.

Liabilities

Personally, I disagree with the views expressed in the Preliminary Views regarding treatment of liabilities and assets. Inclusion of the net pension liability, the intangible asset, and the liability due to future salary increases on the balance sheet seems inappropriate.

I believe that there is usually no liability in an accounting sense which warrants a balance sheet entry, except when amounts contributed differ from amounts expensed. My reasons stem from the basic hypothesis that the pension arrangement is an exchange for future value between the employer and the covered employee group as a whole.

In particular:

1. A pension is a form of deferred compensation for the group and not for each employee individually;

2. all pension costs should be expensed over the years following the plan's adoption or (amendment); and

3. determination of the pension cost can never be more than an estimate with subsequent changes in estimates due to plan changes and assumptions or experience expensed over subsequent accounting periods.

To buttress further this argument one need only take a look at the proposed balance sheet item, net pension liability, at any given point in time. Assuming that either the retroactive or prospective transitional approach is used, I have computed the net pension liability under a final average pay plan as prescribed in the Preliminary Views as of December 31, 1982 and contrasted this with what I feel are two more palatable alternatives. (See chart.)

As of December 31, 1982 the so-called "liability" of a client's plan, as determined under the projected unit credit method, is approximately $37 million. Assuming the company had always contributed the amount expensed, under APB Opinion No. 8 there would be no liability regardless of the initial date of application. Even though I do not concede that the unfunded accumulated plan benefits qualifies as a liability, two more acceptable alternatives than the FASB proposal would be:

Alternative No. 1--"APB Opinion No. 8 Grandfather"--would set the net pension liability and intangible assets equal to zero as of the effective date of the FASB proposal. My reasoning is that in the past the rules of APB Opinion No. 8 stated that no liability existed and since the company has been following these rules, no liability or asset should exist as of that date. The effect of future amendments on the accumulated plan benefits would be reflected on

NET PENSION LIABILITY AS OF DECEMBER 31, 1982

LIABILITIES
(in 1,000,000's)

100
90
80
70
60
50
40
30
20
10
0
−10
−20

INITIAL DATE OF APPLICATION

JAN. 1, 1979
79

JAN. 1, 1981
81

DEC. 31, 1982
83

79 81 83 | 79 81 83 | 79 81 83 | 79 81 83

APB #8 | **ALT #1** | **ALT #2** | **FASB PROP**

the balance sheet as well as the difference in the amounts expensed and contributed. (The plan examined here was amended every year. Assumptions were changed also.)

Alternative No. 2--"No Grandfather"--would be similar to Alternative No. 1 except that on the initial application date the unfunded present value of accumulated plan benefits would be shown.

As can be seen from this exhibit, the liability measure proposed by the FASB lacks those measurement qualities usually associated with a liability entry. One can see the fallacy of trying to define a meaningful balance sheet liability figure. Contributions are assumed to be equal to pension expense while the alternatives to the FASB proposal measure the liability differently depending only on the date the FASB proposal is assumed to be effective. Only the APB Opinion No. 8 view allows for a meaningful entry which can serve as a comparison between companies. A balance sheet entry on the liability side indicates aggregate actual contributions which are less than those required for pension costs.

Assets

I also take exception to the FASB's views on the market value of assets in determining pension expense. Even a simple fiveyear arithmetic average shows the smoothing effect of an average market value method. To illustrate my concerns I have attempted to show what would happen to the prior service component of costs (which is the only component of cost affected) by using market value rather than an average market value figure. I have assumed:

1. the market value of assets and average market value of assets are initially equal to $100 million;

2. an average market value method, which is prescribed in the IRS regulations, to which all qualified pension plans may compare their asset value (for the purpose of the "85-115" corridor test);

3. use of the FASB amortization method for amortizing gains and losses which results in a principal charge exceeding 8% of the remaining balance. (average remaining future service period is over 11 years);

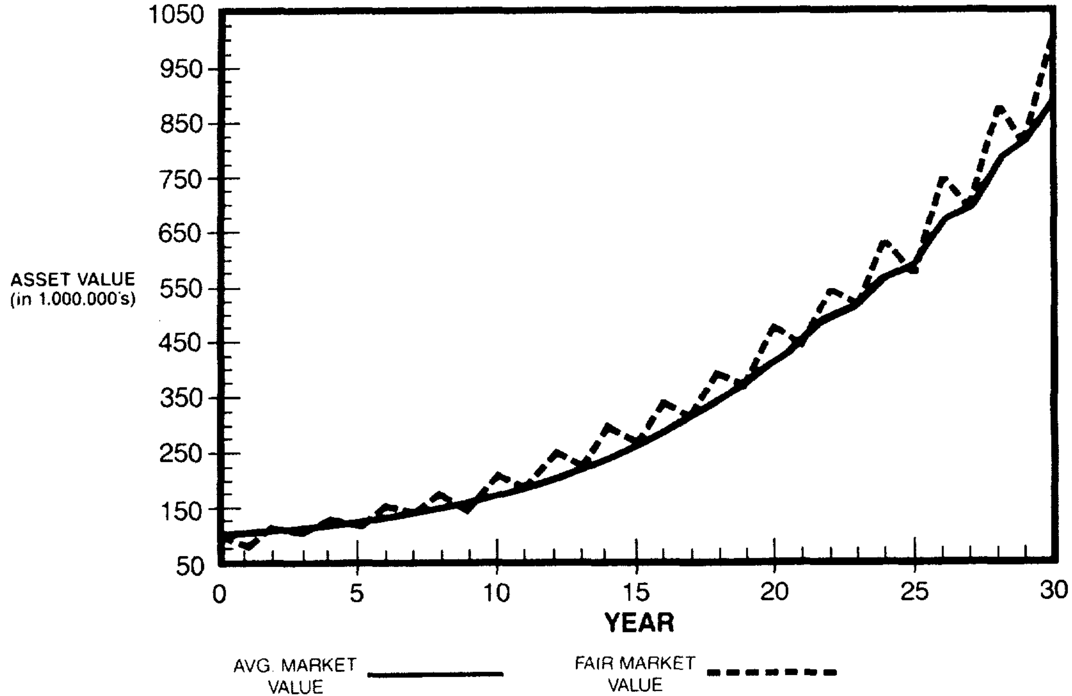
4. contributions and disbursements are equal over the 30-year time period analyzed;

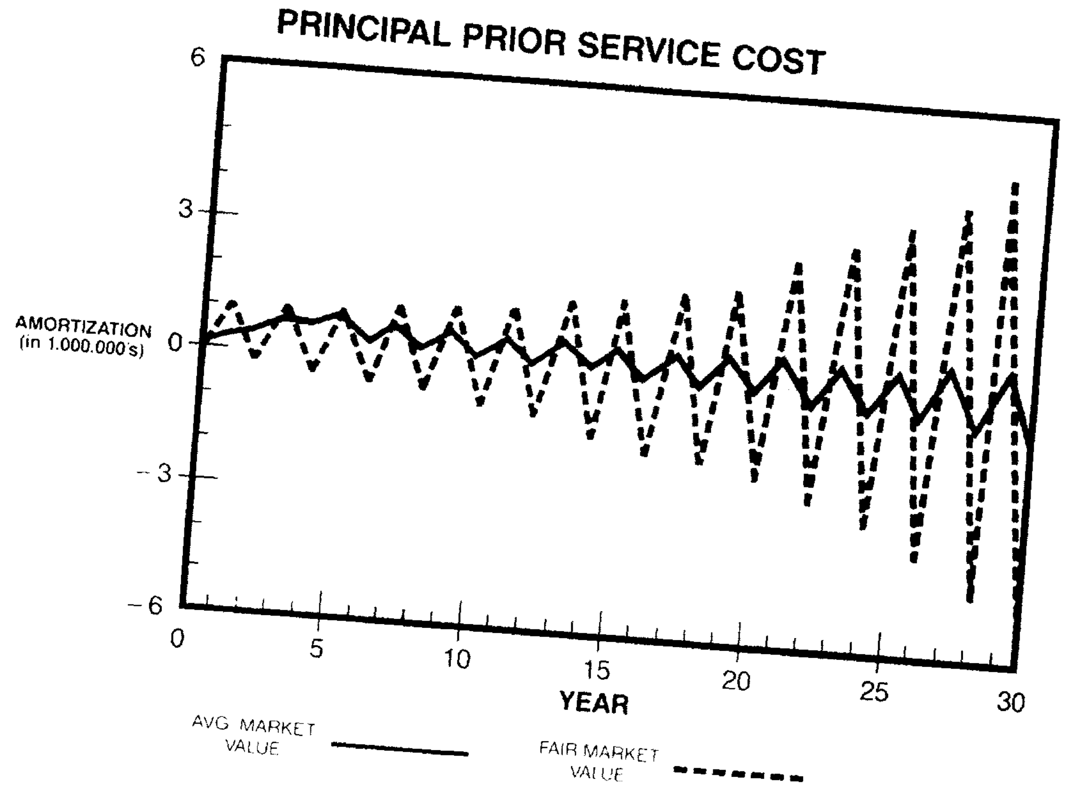
5. interest and dividends received at year end will yield 51/2%; and

6. an annual yield of 8% over any two-year period, while the market value will fluctuate so as to produce depreciation of 10% every other year.

The graph shows how an averaging technique serves to smooth market value fluctuation. While other differences may appear relatively small, the fluctuations caused by the use of market value become

COMPARISON OF AVERAGE VS. FAIR MARKET VALUE




PRINCIPAL PRIOR SERVICE COST
6
3
AMORTIZATION
(in 1.000.000's)
0
-3
-6
0
5
10
15
20
25
30
YEAR
AVG. MARKET VALUE
FAIR MARKET VALUE

apparent. An averaging technique reduces year-toyear discrepancies from the assumed rate of return allowing for a more consistent pension expense determination.

I also take exception from the Preliminary Views' use of the amortization percentage. The amortization percentage method prescribed by the FASB, which is equal to the expected value of the employees' future working lifetime, causes a large initial increase in pension expense for those plans having a net unfunded liability. I feel that the FASB's amortization requirement is too much at odds with the methods companies presently employ. The FASB believes that there is no relation between pension accounting and expense policy. Practically speaking, pension plan sponsors do not wish to have an identifiable long-term balance sheet item reflecting the difference between their expense and funding policies. For a long time many employers have tried to have identical policies for both funding and expense. Required use of both the unit credit method with the amortization method cited by the FASB would be a case of accounting policy leading decision-making policy, which should not be the FASB's intention.

As an additional note, the field test conducted by the FASB showed many companies with a decrease in pension expense. Besides the obvious reasons (the change to a less conservative expense method and differing amortization period), the use of the market value of assets in conjunction with an end-of-the-year valuation requirement during a time of significant market value appreciation can lower expenses. Discussion of the end-of-year valuation requirement will take place due to the issuance of the new discussion memorandum which came out on April 19, 1983. Accepted methods for costing negotiated contracts may come into question. Security, credit and bond ratings may be renegotiated or at least reworded. There may be a push, again an example of the tail wagging the dog, towards switching to defined contribution plans rather than keeping defined benefit plans since the latter would necessitate the inclusion of a pension liability on the balance sheets. There also may be a push towards career average pay plans. I am not implying that moves in these directions are evil, but it is always the overall benefits program of any employer, in combination with its objectives, which should be looked at. A move towards these plans solely because of the FASB ruling would be undesirable.

At most, I would suggest that FASB modify the determination of the pension cost to upgrade the present APB #8 minimum pension expense requirement. That is, use of the unit credit method with an acceptable average market method could be a first step. The initial amortization period should be fixed for a period of, say 40 years, with a subsequent amortization period basis based on two commonly accepted actuarial techniques, the present value of future lives and the present value of future pay.

In this way, a minimum amortization period basis similar to that desired by the FASB would be more consistent with respect to flat dollar, career average and final average pay pension plans. Any currently accepted actuarial method, as long as the pension expense determined was greater than the FASB minimum, should be acceptable.

Once having determined the pension expense and method, my suggested modifications to the balance sheet entries would be just to maintain the current APB Opinion No. 8 basis with possibly an expanded footnote. If the FASB felt that any of their currently desired required amounts, such as the total actuarial reserve, which used to be required on the SEC 10K form, were still desirable, such amounts could be included in the footnote after if it was resolved that it was warranted.

MR. HUTZEL: The FASB also deals with funding of any post-retirement benefits. There is not a great deal of certainty about how to expense for post-retirement benefits other than pension plans. The FASB has been very loose in that regard. We did some tests using the unit credit service prorata method with actuarial assumptions similiar to those used in a pension program. We have found that for a large corporation, with a generous post-retirement life program and a modest post-retirement medical program, the expense of the life and medical programs, after recognizing proposed FASB changes may very well exceed or at least equal the pension expense. Particularly with a highly funded pension plan, the pension expense goes down but the retiree life and health expense, which currently essentially does not exist for most corporations or is at best pay-as-you-go, will come way up and the result is going to shock a lot of corporate financial people who do not believe that the retiree life and medical can be that expensive. Mr. Byrne has confirmed that his company's tests have yielded similiar results.

MR. DAVID COPLAND: If there is an actuarial gain from the reduction in the §415 maximum benefit limitation from $136,425 down to $90,000, should it be considered an experience gain to be amortized over 15 years or as a gain from a plan amendment to be amortized over 30?

MR. GOLD: At the Enrolled Actuaries meeting last January, I understood from Ira Cohen that making a change in benefit level due to the 415 limits to be considered an amendment so it would be funded over 30 years.

MR. MARK MEYER: Is an intangible asset established for each amendment which increases the accrual liability?

MR. BYRNE: Yes. The intangible asset is increased for each amendment to the plan under the FASB Preliminary Views.

MR. MEYER: Do you have a paragraph cite for the current year 40 year amortization minimum expense? I thought it was interest only.

MR. BYRNE: You are right, current minimum funding of pension expense requirement is equal to the current service cost, plus interest only on the unfunded liability. However, if there is an unfunded present value of vested benefits, then it is reduced to the 40-year amortization requirement.

MR. MARVIN PAULL: How are we either expensing or funding supplemental plans?

MR. GOLD: I think that you have some choices; there are several ways to fund such plans but I would think that at the moment the most common are book reserving or pay-as-you-go without book reserving. They are really the same from a cash flow point of view. As to the option of setting up a reserve when choosing between book reserve and pay-as-you-go, that is really a question for the accountant to decide as to the materiality of the reserve and whether one should be set up.

MR. LES MARTIN: Mr. Gold, who are employers looking to for advice on implementing TEFRA's provisions: consulting actuaries, lawyers, accountants, in-house staff? Does the decision vary according to the size of the client?

MR. GOLD: I have a bias here, I assume it is consulting actuaries. Sometimes we have an issue that gives us a chance to talk to the clients of other consulting actuaries. I do not think TEFRA is doing that, but we are getting to talk to our own clients a lot about TEFRA issues. It is not a grabber that is sending people to new actuaries for new solutions. It seems to be getting relatively routine treatment. There is a great deal in the administrative area that has probably kept plan administrators and trustees busy, particularily trustees and the custodians of money. The witholding rules have probably kept their attention rather a lot for the last few months. I am not sure why one would go to an accountant to discuss TEFRA.

MR. JERRY SPIGAL: Mr. Byrne, might you support amortization period over the present value of future service given that the exchange period can be thought of as over future service?

MR. BYRNE: There are really three different ways to look at the exchange period. One is over the future service of the current employee group; second is over the future period that you expect the plan itself to be in existence; and third, the future period over which the company is in existence. I have no problem using present value of future service for a flat dollar plan on a perspective basis. The way I see it the FASB should be up-grading the minimum and there is too large a break by adopting this method at the outset, that is, initializing the unfunded liability and amortizing it over the present value of future lives. However I would take any subsequent amendments, experience, what have you, and fund that over a present value of future lives for a flat dollar plan. I think by just using turnover assumptions, you lose the link between the interest rate and the liability that is actually set up in combination with the turnover assumptions.

MR. MEYER: For valuation purposes, must I assume all participants will elect the most valuable annuity form, namely the 100% joint and survivor form at a $90,000 annual benefit, despite the fact that a reasonable cost of living adjustment projection shows that the §415 limit would not affect them when the election would be made?

MR. GOLD: Congress has made it clear that the $90,000 can not be indexed. Whether you assume that everyone married will elect the

100% J&S or whether you assume that everyone is indeed married is a question for each individual Enrolled Actuary to assume.

MR. HUTZEL: Most corporations fund pension plans based upon the current limits frozen under §415. Should they reserve for the excess cost attributable to a reasonable indexing of the limits? It appears to me that what is mandated as funding is not realistic funding anymore. I think it will understate pension costs.

MR. GOLD: I think we have been asked by the IRS to do two things. We have been asked as Enrolled Actuaries to reflect, in the aggregate, the best experience of the fund. At the same time we have been given a limitation on one aspect of the technique. The technique is restricted to not recognizing indexing on the $90,000. I personally think I am good enough an actuary to accomplish both of those tasks at the same time using aggregate assumptions which would get the right expense within the constraints of the $90,000 limits.

MR. HUTZEL: Would you recommend solving the problem with an explicit approach? I have discussed with a few clients the use of an explicit approach to that problem where we do not change assumptions to get around the restriction on indexing the limit. Instead we set up a reserve and expense item which is equal to the difference between the cost determined with an indexed §415 limit and a cost determined with the current limits.

MR. GOLD: There are three issues here. There are benefits which will be paid from the qualified plan and which are below the $90,000. There are benefits which will be paid from the qualified plan which a reasonable realistic projection would show to exceed $90,000. That is the one we are talking about right now. The third category consists of those benefits from an excess plan that will never be paid from a qualified plan and the procedure that Pete just outlined to the second category is one that I subscribe to for the third catergory as well.

MR. HUTZEL: Does the April 1983 discussion memorandum issued by FASB show some leaning toward exclusion of future salary increases?

MR. BYRNE: I believe so since, for example, they say in chapter two of that Discussion Memorandum that even if future salary increases are not included on the balance sheet, that does not lessen the impact on the questions which they have raised: that those questions should still be addressed. As an additional note I think the committee on corporate accounting for the Financial Executive Institute, which has co-sponsored the field test of 27 company participants, is going to be coming out with a statement which basically advocates maintaining the current APB Opinion #8 basis. I do not think the FASB hears actuaries too well. They will hear corporate accountants a little clearer and I believe that at the very least the future salary increases will probably be excluded. I think everything should be excluded, except for amounts different from those expensed which are actually contributed.

MR. WAYNE DYDO: Can or must the §415 limits be projected in determining FASB pension expense?

MR. GOLD: Even as early as APB #8, the distinction between the limits of a qualified plan or an excess plan where not there. In other words, the pension expense did not recognize where the qualified plan left off. If we are talking about a §415 limit being replaced by an excess plan, the answer is, if it is material, the excess plan would include the additional expense. If we are talking about the second category that just came up, the one for the increase within the qualified plan, I think I am going to leave that one to Mr. Byrne.

When the $90,000 goes up and creates that middle tier, that piece that you can not recognize today, but will eventually be paid out of the qualified plan, should that enter into your FASB-defined pension plan expense?

MR. BYRNE: That decision would be made by an actuary after considering the accountant's opinion. Whether the $90,000 limit is going to be going up in the future must be addressed first by assuming that there is only a qualified plan in existence and that no excess benefits are going to be paid. Then the pension expense can be computed accordingly. I do not see any limitations per se in the Preliminary Views that warrant either projecting the $90,000 limit going up from 1986 on or not doing it.

MR.HUTZEL: Will the later availability of full Social Security benefits cause delays in retirement which exceed the cost of increasing the qualified pension to make up for the loss of Social Security benefits at age 65?

MR. SEROTA: Probably not. Unless the Congress decides to amend ERISA to make the normal retirement age coincide with whenever full PIA benefits are available, people are still going to retire at 65 because everybody is used to retiring at 65. One of the objections, to increasing the retirement age to correspond to the timing for full Social Security benefits, was that it would keep older people in the working system longer and thus would not leave open room for younger people to take their places as they grew older. Perhaps one of the intentions of the amendments to the Social Security system was to encourage people to work longer so that Social Security would not have to pay them as early. Basically I think that it is going to be very difficult for the public as a whole to start realizing that 65 is not the universally accepted time to retire.

MR. ROLF TRAUTMANN: Why are plan sponsors choosing to maximize employee benefits under defined contribution plans rather than defined benefit plans when we take into account the combined limits?

MR. GOLD: I think there are several reasons. I start with the projected defined benefit rather than the accrued. If it is not cut back I may be projecting the maximum immediately and would be restricted to 25% of the defined contribution maximum. On the other hand the defined contribution sort of works year to year and you keep putting in 100% of that without necessarily trimming the retirement benefit. Moreover, except in the later years of most careers, more tax shelter in total is available under a defined contribution plan. In other words, it cost me less than $30,000 to

fund a $90,000 benefit until late in the career and only after it costs me more than $30,000 to fund a $90,000 benefit would I get as much tax shelter by favoring the defined benefit pension fund. In addition to the flexibility, there is a bird-in-the-hand attitude which induces me to adjust the pension at the end because it is a total calculation and I can get the money in and shelter it in the other plan immediately. Finally, more often than not, the lump sum treatment is permitted in the defined contribution plan whereas annual benefits are paid from the pension plan; and when that happens, there is a favorable lump sum tax treatment on the defined contribution plan and not on the defined benefit. You would like to have as much coming out of the qualified plan and getting that for your tax treatment as you possibly can. There are exceptional cases where you might want to do it the other way. It is not absolutely necessary but it is generally favorable to cut back the pension.