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NEW MINIMUM FUNDING RULES

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- o Discussion of minimum funding rules
- o What has been or will be the impact of the new rules on OBRA?
- o What has plan sponsor reaction been?
- o Are the changes significant?
- o What is the effect of statutory specifications on interest rate assumption?

MR. V. BENJAMIN HAAS: I'm going to turn this session over to my fellow panelists, but I would like to introduce them first. Barry Cohen is with Mercer-Meidinger-Hansen, Inc., and will be providing an overview of minimum funding rules. Following that, I will have some brief follow-up material looking at the Section 412(l) rules specifically. The third presentation is maximum funding rules and a case study which Wayne Foster is going to cover. Eric Lofgren will follow with some of the implications and other issues that impact funding for 1988 and 1989. Hopefully, we will then discuss some of the broader implications of the new rules.

I'd like to issue one caveat. We're clearly talking about a set of new rules, for which we have no regulations yet. We will try to point out as we move along those areas where there is uncertainty, where further guidance is needed in regulation.

MR. BARRY D. COHEN: I shall present an overall review of minimum funding rules, with emphasis on the part of the Omnibus Budget Reconciliation Act (OBRA) that is effective during the 1988 plan year. The first rule pertains to the actuarial asset value method as defined by the Internal Revenue Code. The 85-115% of the average rule is no longer applicable for plan years beginning in 1988. The average value equals the fair value plus any increment or decrement with the exception of any realized or unrealized appreciation, so in essence it's the fair value as of the valuation date, plus contributions, interest and dividends, less benefit payments and expenses. The average value can be averaged over a period of up to five years. That method will no longer be acceptable. So really, the method that is acceptable is the method where the value falls between 80% and 120% of fair value.

The second issue is actuarial assumptions. Prior to 1988, assumptions in the aggregate were deemed to be reasonable and an actuary would play one off the other, under the assumption that they would have balancing effects. Beginning in 1988, each assumption independently has to be the best estimate. There is one caveat to this and that's that the actuary can use assumptions that in the aggregate would produce the same contribution as if you used independently and

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individually the best estimate. Thus, if you don't want to change your assumptions, you first find out what's realistic independently, and then if you can prove that your old assumptions produce the same number, you can stick with your old assumptions. Any time you want to use assumptions that are not independently realistic, you must prove that your assumptions would generate the same contribution.

There is a required interest rate for the determination of current liability. If the funding rate is within a permissible corridor, then the funding rate used for other purposes can be used for determining current liability. If the rate used for other purposes is outside the permissible range, then you must use a rate that falls within the permissible range.

What is the permissible range? The definition is within 10% of a weighted average of 30-year Treasury securities during the four-year period ending on the last day before the beginning of the plan year. For plan years beginning January 1, 1988, the average rate is 9.17%. This explanation is actually a simplification that's defined in IRS notice 88-73. If your funding rate falls outside of the permissible range, what is the rate that you must use? Is it the rate that is closest to your funding assumption, or is it the rate that you think best determines the cost of the purchase of annuities? At this point I think it's unclear which definition one would use.

In addition to actuarial assumptions being independently determined, some amortization periods have changed as well. Actuarial gains and losses will now be amortized over five years. Actuarial assumption changes will now be over ten years, and funding waivers will now be over five years.

With respect to gains and losses, there's a question whether a 1987 gain or loss will be amortized over 5 or 15 years beginning in 1988. There are at least two schools of thought. One is that for a January 1 plan year, any gain or loss arising which would have encompassed the 1987 plan year would be over 15 years. If the plan year were January 2 or later, you would use 5 years. The second school of thought is saying that since it's somewhat unclear, we'll do whatever would maximize the minimum contributions. So that if you had a gain in 1987, that would be amortized over 15 years. If you had a loss for the 1987 period, you would amortize that over five years.

With respect to funding waivers, a number of changes have occurred. First, you must apply within 2.5 months after the end of the plan year in order to be approved for the funding waiver. Secondly, business hardship is a requirement, and it's a requirement not just with the subsidiary for which you are applying, but for the whole controlled group. Third, there is a maximum within any 15-year period of three funding waivers. In addition, the interest rate to amortize the funding waiver is the greater of 150% of the federal midterm rate or your funding assumption.

The last point I would like to cover is quarterly contributions. The quarterly contribution is the lesser of 100% of the prior year minimum, or 90% of the current year minimum. There is a phase-in of the quarterly amount. Beginning in 1989 the quarterly amounts are 6.25% of the contribution. That is phased into 25% beginning in 1992. There are penalties if the contribution is not made within the appropriate time.

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MR. HAAS: Code Section 412 introduces a whole new set of terminology to the actuary's vocabulary for purposes of determining minimum funding. Specifically, Code Section 412(1) stipulates that certain additional funding may be required if the current liability is not fully funded.

The additional funding is essentially the sum of two pieces: (1) the excess of the deficit reduction contribution over certain charges and credits to the funding standard account (FSA), and (2) unpredictable contingent event amount. In turn, the deficit reduction contribution is made up of two pieces, the unfunded old liability amount and the unfunded new liability amount. So a number of new terms have to be defined and calculated for purposes of determining minimum funding requirements.

For minimum funding purposes, there are two points to note about current liability. (1) It should not include employees who are not yet participants in the plan. (2) There is a provision that excludes, on a pro rata basis, a certain amount of service prior to the time that an employee became a participant in the plan. The rules apply for anyone who becomes a participant after December 31, 1987. So technically, for example, if you are dealing with a calendar year plan and calculating current liability as of January 1, 1988, then you would exclude from that calculation those employees who became plan participants at January 1, 1988, since they would be in the group that has less than one year of participation. So all of this service prior to that date would be appropriately excluded.

Practically speaking, it's our guess that we'll see a lot of actuaries not making this kind of refinement in the calculation. If a plan's current liability exceeds assets, even when you fully recognize past service, we don't think this should be an issue. Where it does become significant is for a new plan with significant amounts of past service, or for a new group of participants with a significant amount of past service.

Unfunded current liability is fairly straightforward. It's simply current liability minus the actuarial value of assets. The assets include any receivable contributions for the prior plan year and exclude any credit balance.

The first new calculation that we have to deal with is the unfunded old liability amount. You actually have to look at the amount of the unfunded current liability as of the beginning of the 1988 plan year for purposes of determining the unfunded old liability amount for funding in 1989. Once you determine the unfunded current liability as of the beginning of the 1988 plan year, it's amortized over an 18-year period beginning with the charge in the 1989 plan year. For nonbargained plans, any benefit improvements that went into effect after October 16, 1987 are excluded. They will be picked up when you determine the unfunded new liability amount. For collectively bargained plans, any increases that were included in the collective bargaining agreement in effect on October 16, 1987 are taken into account as part of the old liability amount. The employer has two options for amortization of these amounts. Those amounts can be recognized in the year that they become effective, or the employer may elect to recognize all of the changes that will take place during the course of the October 16, 1987 contract and amortize them over 18 years beginning in 1989.

There are a number of issues which currently have no answers. What happens if there is a change in the interest rate that's used in determining the current liability? My best guess is that there would be no adjustment to the unamortized

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balance of the unfunded old liability, but that the amount of the amortization charge itself would change to reflect the new interest rate. Again, this is something that needs to be clarified when we get regulations.

A more significant issue, and one for which I don't have a good guess is: What happens if you've got an unfunded old liability as of the beginning of the 1988 plan year? You have an amortization charge in 1989. But now, in 1990, suppose the plan's currently liability is fully funded. Also, suppose that in 1991, because of investment losses, you again have an unfunded current liability. At that point, is the old liability amount considered fully funded and this new piece strictly a part of the new liability? Again, this is an area where we simply don't know the rules.

The unfunded new liability amount is simply the additional charge attributable to any unfunded current liability other than the unfunded old current liability. In addition, to the extent that there is any liability attributable to such things as plant shutdowns or other unpredictable contingent events that occurred after October 16, 1987, those would also be excluded in determining the unfunded new liability amount. Once the unfunded liability itself is determined, the incremental charge is a percentage of that amount. The percentage is equal to 30% reduced by .25 of the excess of the actual funded percentage over 35%. For example, if you're 35% funded, then the charge is 30% of the unfunded current liability. If you're 55% funded, then 30% is reduced by .25 of that excess over 35%, or 25%. So if a plan is approaching full funding, say 95% funded, the amortization charge is 15%. Thus, for severely underfunded plans, the incremental charge as a percentage of current liability is significant. This should tend to move funding levels up fairly rapidly.

The additional contribution is equal to this deficit reduction contribution, which is the sum of the unfunded old liability amount, plus the unfunded new liability amount, over certain of the FSA charges, but not all of them. What's included here is any charge attributable to the initial past service liability, plan improvements and waived funding deficiencies. Presumably also included in this are such items as the base arising from a change in funding method or a restart after plan termination. What is clearly not included is a base that is attributable to changes in actuarial assumptions or actuarial gains and losses.

There are a number of open issues. What happens if you have a series of bases that have been combined and offset, including some of one variety and some of another variety of bases? One of the other practical implications arises relative to plans that have been in existence for a period of time and have liberalized the assumptions since 1976. To the extent that liberalization has occurred, there are significant credits in the FSA. Since we are not taking that very negative base into account in determining whether there is an additional contribution, we may very well have a significantly underfunded plan for which no additional contribution emerges under these rules. While the IRS has the authority to make adjustments in the rules to reflect any omissions or fundamental errors in the rules, it's our understanding at this point that the IRS does not intend to use that as a panacea for addressing these kind of issues as the rules are actually applied in practice.

The unpredictable contingent event amount addresses the issue of plant shutdowns, where benefits arise that have significant additional liabilities on a relatively unpredictable basis. It is my contention that there really is no effective way to address funding problems related to shutdown benefits through traditional

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funding simply because we're dealing with an event that does not relate to self-insurance, which is what we're talking about here. Nevertheless, there are some changes in the minimum funding standards that apply when these types of benefits emerge. There is an additional amortization charge that's equal to the greater of a seven-year amortization of liabilities that emerge as a result of the shutdown, or some percentage of the benefits actually paid during the year. The percentage of benefits that has to be recognized is equal to the excess of 100% over the actual current liability funded percentage. So if a plan is 80% funded, you must recognize 20% of the contingent event benefits as an amortization charge if that exceeds the seven-year amortization. However, that 20% is phased in over a number of years culminating in full recognition in the year 2001, but for the next couple of years, only 5% of that incremental amount would need to be recognized. For the first year, the amortization charge is normally 150% of the contingent benefit amount unless the employer elects otherwise. Again, there is no guidance in the law itself in terms of how that election would occur, what restrictions might be placed on whether the employer could make that election, or other guidance to explain what happens.

There are a number of other open issues. If you have a plan that's fully funded as of the beginning of the year in which this shutdown occurs, presumably you're not subject to any additional funding under Section 412(l) and therefore you can do whatever you want during that year and it would only be in the following year that you would begin to recognize this additional charge to the FSA.

Another open issue is the exact definition of the contingent benefit amounts. For example, if a plan provides, in the event of plant shutdown, that you can get unreduced benefits under the plan, would the full unreduced benefit be considered part of this unpredictable contingent benefit amount, or would you only look at the increment over the normal reduced benefit? Again, until we get regulations, it's going to be very difficult for any of us to try to deal with the application of these rules.

What actually happens when we look at the FSA? Number one, in no event is the maximum additional contribution going to be more than what's required to fully fund the current liability. Some questions arise here. Presumably for minimum funding purposes, when we are looking at current liability, we're looking at numbers as of the beginning of the year. When we look at the limitation on the maximum additional charge, logically it seems that one would tend to look at that as an end-of-year calculation rather than a beginning-of-year calculation. However, there is no guidance at this point.

Presumably no new base is established that would be associated with this incremental charge. Thus, if one were simply to recognize this additional charge, and otherwise bring all the bases forward in the normal fashion, the required balance equation does not work. Our guess is that this additional charge would simply be prorated among the other bases so that you would reduce the outstanding amounts of the other bases in conjunction with this charge. We need regulatory guidance.

What becomes clear in this brief overview of Section 412 is that there are more unanswered questions at this point than answered questions. What's equally clear is that you must deal with current liability for the 1988 plan year.

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MR. GEORGE C. WICKS: If you have a plan where you are overfunded on the OBRA basis, but not on the old ERISA basis, is it clear that you wipe out the bases?

MR. WAYNE R. FOSTER: If you look at the statute, it says that you don't wipe the bases out if the old full funding limit is not reached, but the new 150% rule is reached. Presumably there is a short fall base that will have to be set up. We'll talk about that later.

MR. RALPH J. BRASKETT: Are these 412(l) current liabilities done on the IRS interest rate or on the valuation interest rate?

MR. HAAS: The current liability must be calculated on an interest rate that lies within the permitted range. To the extent that your valuation rate is already within that range, then the requirement is that you use the valuation interest rate. To the extent that the valuation interest rate does not fall within that range, the specific guidance in the statute would require that you use an interest rate that is within that range and consistent with what you think current annuity purchase rates would be for that group. I think it's important that this new interest rate applies solely for purposes of determining current liability and for purposes of Section 412(l). Presumably you could have a situation where you are using one interest rate under Section 412(l) and a second interest rate for other purposes under the FSA. That appears to be what's permitted, and again, as you start to actually work through examples on that basis it raises a large number of issues in terms of how the FSA is going to operate.

MR. FOSTER: The current liability definition and the 150% rule of maximum funding are really minimum funding issues for plans that are fully funded or for plans that have very little in the way of retiree liabilities. In addition, I have a client who is very affected by this and has done a fair amount of work in this area, so we would like to share with you what we've discovered.

Prior to OBRA 87, the maximum contribution was the greater of the normal cost plus 10-year amortization of the unfunded liability, but not less than the minimum contribution. In addition, you could not make a contribution if the lesser of market value or actuarial value of assets was greater than the actuarial liability.

It's very clear on the maximum side that current liability is an end-of-year number. The law itself is unclear, but the only way to make it work is an end-of-year number and the IRS has already confirmed that. In looking at this definition of current liability, the committee report says that you are not allowed to include certain things in the definition of current liability that seem to make, from my perspective, no sense. You must fund for the normal form of benefit. That means if you have a standard plan with a normal form of benefit of a life annuity, you cannot fund for any lump sum cashout subsidies, such as the extra cost of PBGC basis cashouts. This could get you into a situation in which you have a frozen plan where everybody takes lump sum cashouts using PBGC basis, but you'd be using 8.25% discount rate if it were a January 1, 1988 valuation. Yet, we all know that the PBGC basis cashout rates give a greater liability than what you would be permitted to fund. On an ongoing basis this isn't a problem because you can get up to 150% of your current liability, but if you have a frozen plan, where you are essentially limited to 100% of your Accumulated Benefit Obligation (ABO) as your funding objective, you can find that you wouldn't be able to fund on the appropriate long-term basis.

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The full funding calculation, instead of being simple, is now a relatively sophisticated and complicated calculation. Since we're dealing with a year-end calculation, it's not a simple matter of finding the basic funded status at the beginning of the year. You must now roll everything forward to the end of the year. Actuarial accrued liability and the current liability are rolled forward to the end of the year. Separate interest rates are applicable in this instance. For example, the funding assumption is at 8% and the current liability is at 8.25%. Because of this differential in interest rate, you need to bring both of them forward independently to the end of the year. The end-of-year estimates are based on the best estimate of benefit payments and expenses. The maximum liability equals the lesser of 100% of the actuarial accrued liability or 150% of the current liability. Then taking the lesser of market or actuarial value of assets yields the maximum funding amount for the current year.

There is another opportunity for funding. If there are more than 100 employees in the plan, you are allowed to make a contribution in any year that will fully fund the current liability. There is a controversy on the application of this particular deduction. If you read carefully, it would appear that the law was not as clear as it should have been. Some contend that this can be done on a plan-by-plan basis, others say that this is a controlled group basis only. That is, if you have a large salaried plan with excess funding and an hourly plan that is underfunded, the surplus in the salaried plan goes to reduce the amount of contribution that you could make to bring the hourly plan up to fully funded status. We must wait for clarification from the IRS on this issue.

This gets to the question that was raised earlier. That is, "If we are not permitted to make a contribution that the old FSA would otherwise require us to make, what happens to our FSA amortization tracking?" The statute is clear that the amortization bases are not eliminated. The statute is also clear that it's left to the IRS to decide how to deal with this issue. We have no idea at this time whether they are going to require you to set up a shortfall base every year and bring that into your FSA, or whether they will just let the whole thing ride until such time as you come back out of full funding on the 150% rule basis.

Let me make a brief point about the quarterly contribution issue. If you expect to be in full funding this year, but you weren't last year, then you've got a problem. If you contribute and it turns out you shouldn't have, you're in trouble. If you don't and it turns out you should have, you're also in trouble. About the only thing I can recommend is to save some of the contribution from the prior year to make on April 15, and that way you can call it either way. Hopefully you will have your valuation done by the time the second contribution is due. I have to believe that the IRS is going to give us some relief on this issue. It doesn't make any sense to have a requirement that can't be followed on a reasonable basis.

I think we've seen the beginning of a major change in funding orientation. The concept of a long-range view toward funding is going to be much shortened, and it's not going to be done on a uniform basis throughout the pension world. While the old law really was meant to encourage stability of contributions, the new law basically says, "We can't afford to give you that basis anymore. We don't give you that basis, for instance, for term life insurance or your medical contributions for active employees, so there's no reason why we should give it to you for pensions. Instead, we're going to make sure that you have enough in the plan to terminate the plan on a sufficient basis with a margin to make sure

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that market fluctuations are not going to drive you into an unfunded situation and future benefits are not of that much of a concern at this point in time."

Let's see what this can do. I've put together an example of a mature plan with a significant number of retirees versus a young plan where retirees are less than 10% of total liabilities. For this particular example, my mature company with an actuarial liability of \$650 million under the old law would actually have been entitled to \$660 had the the new 150% rule been a replacement. Of course we know that it is the lesser of the two, so in their particular situation they are held at the \$650. My young company finds its funding opportunity cut from \$620 million down to \$360 million, a significant drop, because there are no retirees.

In addition to distorting the funded status of the plan based on the mix of retirees versus nonretirees, the current liability definition is very sensitive to the discount rate because there is a long discount period and there is no salary increase projection to offset some of the volatility. In my mature company situation, if we were to do the calculation at a 4% inflation assumption, and then a 6% inflation assumption, we see some decrease in funding under both the new or the old basis. If I go to my young company and take a look at it by group, I find that the retirees have a very small decrease for each 1% change in the current liability discount rate. My mature company, with an average age of around 41 for the actives and probably an average liability weighted age of about 53, has a duration of 16%. My young company has a duration of about 24%. For an organization of some 70,000 active employees, this is a significant variability.

What does this mean for this young company? Their Financial Accounting Standard Number 87 (FAS 87) pension cost under the pre-OBRA '87 rules was expected to maintain a relatively stable trend. Over the next ten years, with the ability of funding being cut off, we project about 6 or 7 years of no funding. Their pension cost is going to be roughly twice what it was before and it continues to be significantly higher in the future. When will it turn around? When will they get to the point where they become a mature company? We don't know. If they continue using the lump sum option as is the current culture, they may never become a mature company, so there always may be reductions in funding opportunities. Thus the mix of retirees versus active employees has a significant profound effect on the funding ability of various organizations.

There are regulatory adjustments permitted to this 150% rule under the law. They are very vague as to what is intended, or even what is desired, but the idea is that these adjustments must be revenue neutral, and that is raising a fair amount of questions. Speakers at an IRS hearing on this issue in June presented a number of alternatives. Some were arguing for exempting multi-employer plans which are presumably much less subject to abuse, and therefore not of such a concern as to revenue raising potential.

In summary, we have a new funding rule which we can contend unfairly penalizes young companies where the mix of retirees versus actives is the most important determinant of large funding requirements or small funding requirements; a basis which requires cuts when inflation goes up rather than an increase in funding; a basis which maximizes the contribution in the declining phase of the company's life cycle when you can argue it's least affordable rather than putting the money aside in the beginning.

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MR. ERIC P. LOFGREN: The new minimum funding rules are based on a termination concept rather than on traditional funding concepts. They're a PBGC driven law and with that thought in mind, it makes sense to look at the PBGC requirements, because they are really intertwined. The new minimum funding standards and the new PBGC premium standards come together under the new law.

The PBGC premium under OBRA now has a flat rate portion and a variable rate portion. The flat rate has almost doubled and the variable rate portion is a percent of unfunded vested benefit, with a maximum of \$34 per head. The \$34 is reduced by up to \$15 if you've been contributing at the maximum in the years 1983-1987, so if the maximum contribution had been made (even if you had a full funding limitation and the maximum contribution was zero), the \$34 could be reduced to \$19. Let's take a look now at some of the concepts in the PBGC premium. The unfunded vested benefits are really unfunded current liability. Unfunded vested benefits are simply the vested benefits less the actuarial value of assets. When looking at the actuarial value of assets, the law says not to subtract out the credit balance from the assets. In the assets for the calculation of unfunded vested benefits, you can reflect contributions that you know to have been paid for the year prior to the premium payment year.

For vested benefits, we have a mandated interest rate, but no corridor -- it's a unique number. The interest rate is 80% of annual yield for a 30-year Treasury bond for the month preceding the beginning the premium payment year. During 1988, this rate has varied between 6.75% and 7.25%. Naturally, if you must value your liabilities at a very low rate, around 7%, whereas you have 90-110% of the weighted average for other purposes, which is different from your regular valuation interest assumption, you can get some odd results. One of those odd results is that you can have a fully funded plan with unfunded vested benefits. A committee on technical corrections is addressing that matter. If a ruling on technical corrections is passed, you won't have to pay an extra variable premium.

You must use a consistent definition of current liability for the funding calculations and the PBGC calculations. So, if you are recognizing the option to disregard participants with less than 5 years of service for one purpose, you must do the same thing for the other purpose.

There are a number of ways to get to your results. You can calculate directly as of the first day of the plan year -- you might not have time to do that -- or you can use a prior valuation result and adjust it to reflect plan population and plan provisions as of the first day of the premium payment year to reflect any significant events that have occurred, and of course also adjust your prior valuation results to reflect the mandated interest rate.

You must also adjust for significant events. There is a specific list of seven significant events in the regulations. If minimum cost goes up by more than 5% for a plan amendment, that is a significant event and your liability for the PBGC premium would have to explicitly incorporate a liability increase or decrease for the significant event. If you have a new employee group worth 10% of accrued liability, you have a significant event. A merger or spin-off is another one. If the average age changes by two years, that is a significant event. If shutdown benefits kick in, that is a significant event. If you have a retirement window, that, of course, is a significant event. If you have a cost-of-living adjustment

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that changes the total liability of the plan by more than 5%, you have a significant event. Anything else is not a significant event.

If you are a small plan and you're fully funded and you have under 100 lives, and you left part of your Schedule B blank, which you are allowed to do if you are a small plan, and you get enrolled actuary certification, then you don't have to pay the variable premium.

If you have no vested liabilities, the plan administrator can simply certify to that effect and you'll have no variable premium. If you're a fully insured plan, of course, there's nothing for the PBGC to insure, and all that's needed is a plan administrator certification. There is also a \$5 rule. If you are under 100 lives and the Schedule B has blanks on the items that can be left blank in a small plan, you can simply pay \$5 a head.

When you use last year's Schedule B, you have an imposing-looking formula for adjusting vested benefits. The formula really is saying that the duration of your liabilities is six. Most plans liabilities have a duration of more than six and most plans use interest rate assumptions above 7.3%, so what they are really doing here is giving you a little bit of a break. They start you off using an interest rate far below market and give part of it back in the calculation method.

A second assumption in the formula is that the average age of the participant group is 50. This was taken from the average age of participant groups of terminating plans of the PBGC. Since active ongoing plans are more likely to have an average age of 35-45, we're getting a break in the calculation of the adjustment of the vested benefits based on the prior year's Schedule B numbers. You apply this formula and then you adjust the vested benefit for significant events. You subtract out your assets from the liabilities, you get unfunded vested benefits and you adjust it forward from last year's Schedule B to this year's date for one year's interest at the mandated rate. Again, since your interest rate assumption is probably higher than the PBGC assumption in the current environment, adjusting the unfunded vested benefits for a year's interest at the lower rate is giving you a little back.

MR. DONALD S. GRUBBS, JR.: On the PBGC premiums, I see nothing in the forms for taking account of short plan years, either because a plan started in the middle of the first plan year or you had a termination or you changed a year. People from PBGC tell me that they are going to take account of that. What do we do with short plan years?

MR. LOFGREN: I'm left with the same problem you were. The form said nothing and the regulations had some vague wording about consistent treatment, but I really don't have an answer. Do any of you?

MR. HAAS: I'm afraid that we don't have an answer on that one either.