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BENEFITS AND ASSUMPTIONS UNDERLYING CURRENT LIABILITY

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- What is included in current liabilities?
- What is the purpose for which the current liability is used?
- What assumptions are permitted and required regarding the current liability?
- What are Canadian solvency valuation requirements?

MR. ALLAN W. RYAN: We're going to cover what is included in current liability: what is the purpose for which it's used, and what assumptions are permitted and required. Also, we will not be able to cover the Canadian topic -- we were just not able to get anyone.

The subject is current liability, so it's a fairly focused topic. Some of you probably attended the Minimum/Maximum panel discussion, and that was a good lead in. I noticed there were several points in the outline for that session which referred you to this panel discussion. I'm not sure if we're going to be able to answer those questions necessarily, but we'll do our best.

Just a little bit about my background. I'm basically a consulting actuary now with Deloitte, and my responsibilities have been really more in the life insurance consulting, audit support type of work. My pension experience of late has been more of an academic one -- I'm the outgoing chairman of the EA2 exam committee, the pension law exam that's required for enrollment.

Basically, there will be two presentations. The first panelist will be John Marshall, who is a consulting actuary with TPF&C/Towers Perrin. John's in the Cleveland office, and he works in the pension area now. Next is Dan Laline, also with the same firm but in the Stamford office, and also a practicing consulting actuary in the pension field.

John is going to cover the legal and technical issues of current liability. Then Dan will expand a little on that and try to cover some of the practical issues and consulting issues that have come up such as how to deal with clients. It's just one wave of new legislation after another. And, as you obviously know, there hasn't been much guidance since the Omnibus Budget Reconciliation Act (OBRA). I have in my outline here "Late Breaking Developments" -- that's easy, there isn't anything. Or if there is and someone out there is aware of something, we'd be happy to hear it.

MR. JOHN D. MARSHALL: I'm going to talk about which actual assumptions and which benefits are valued in determining current liability. Then Dan will follow me by talking about some of the consulting issues surrounding current liability and its applications. It's difficult to speak only of the components that comprise current liability without touching on some of the consulting issues. But I'll do my best not to steal any of Dan's thunder.

First, current liability is a child of OBRA 1987. And in some respects it's a cantankerous child, or at least a child with an identity crisis. The identity problems stem from the fact that we're still waiting for the issuance of regulations from the IRS. In the meantime, we as actuaries are nevertheless required to use current liability in determining several items. First is the additional minimum funding requirement for underfunded pension plans. That is, the additional accelerated amortization portion, otherwise known as the deficit reduction contribution. Another item is the maximum deductible contribution limit: the 100% of unfunded current liability limit, and the new 150% current liability full-funding limitation. And lastly, we use it in determining the variable portion of the PBGC premium.

Since regulations are not yet issued, much of how we determine current liability is based on our best guess of what the IRS regulations will eventually look like. We have little guidance from the IRS on when to expect regulations, although I did hear from someone that an IRS representative said they would be issued next year. But there are some, I've heard, in the IRS who believe that our current understanding of current liability may be our working understanding for some years to come.

How did current liability come about? The legislative development shows that one reason for its development was to assist the PBGC in shoring up the minimum funding standards -- the deficit reduction contribution -- and permitting the 100% unfunded current liability deduction limit. However, the greater motive was, I believe, to restrict the full-funding limitation by means of the 150% current liability limitation, which was designed to raise revenues, which, after all, was what OBRA was all about anyway. Both the blue book and the conference committee reports indicate that the designers of current liability refer to section 401(a)(2) of the Code. That reference states that all liabilities for fixed and contingent benefits must be satisfied before assets may revert to the employer on plan termination. So they were looking at a termination liability, in thinking of current liability. There is also reference to PBGC section 4044 concerning the definition of termination liability. However, the PBGC is currently debating what exactly is a termination liability. It's possible, on a planned termination, to amend certain benefits out of a plan. That is, disability benefits and preretirement survivor benefits can be amended so that plan participants bear the cost of those benefits. The PBGC may not allow this option for long.

What finally came out of OBRA and what we now know of current liability is section 412(l)(7), the general rule concerning current liability. It states "benefits taken into account are all liabilities to participants and the beneficiaries under the plan, except those benefits that are unpredictable contingent event benefits for which the event has not occurred." So what we do know is that the definition is unclear, and it will probably be unclear for some time. However, we can speculate on what the eventual definition will be. There are two likely alternatives.

In the first alternative definition, the current liability would include all accrued benefits, including those benefits not protected under section 411(d)(6) of the code. Section 411(d)(6) pertains to the anti-cutback rule. And the so-called protected benefits that cannot be eliminated are as follows: early retirement subsidies (that's subsidized early retirement factors over and above true actual equivalence), optional forms of benefits, and lump sum options. However, in the definition of current liability, the lump sum option, as an optional form, is specifically excluded. And the reason for that is, the lump sum option is essentially a change in interest rate. The interest rate is one of the key elements that's specifically defined under current liability. Section 411(d)(6) allows the elimination of certain ancillary benefits and early retirement supplements. But under this particular definition, these benefits would be included in determining current liability.

Under the second alternative definition, the benefits under current liability would include only the accrued benefits protected under section 411(d)(6). Therefore, they would exclude certain ancillary benefits, including disability, preretirement spouses death benefits. By excluding them, it is possible to transfer that cost to employees via plan amendments. They would exclude temporary early retirement supplements. This particular benefit is near to my heart, because I personally deal with a number of steel plans that deal with this type of benefit, which is usually in the form of a $400 monthly annuity from early retirement to normal retirement date. This, once again, isn't referring to subsidized early retirement factors. And to the extent disability benefits would be excluded under this definition, the actuary would still continue to keep the disability decrement and treat the benefit as a vested benefit. This is a similar benefit that we faced in the early 1980s, with FAS 35 and 36, regarding the exclusion of a disability benefit, while at the same time retaining the disability decrement. Again, as under alternative definition 1, we would exclude the lump sum option under this definition.

In January 1989, the SOA sponsored a teleconference that was jointly sponsored by the American Academy, the American Society of Pension Actuaries (ASPA), and the Conference of Actuaries in Public Practice (CAPP). In the opinion of the sponsors of the teleconference, current liability should include certain enhanced benefits, including early retirement subsidies, subsidized early retirement factors, Social Security bridge benefits (which are the temporary annuities), and enhanced death benefits. However, to the extent to which a participant is ineligible for one of these benefits, there would only be a pro rata inclusion of the benefit in determining current liability. Using the example of the $400 temporary annuity, if the plan required 20 years of eligibility service and the participant had only 10 years of service, the portion of the benefit that would be included would be 10/20ths of $400, or $200. After the teleconference, a certain IRS representative -- who I guess it would not be appropriate to name, but who bears the same name as a tunnel linking New York City to the outside world -- stated that this is an inappropriate translation of the law. And in his opinion, the benefits included in the Social Security supplement example should be zero dollars for the first 20 years and $400 after 20 years. And this definition corresponds closely with alternative definition 1. In fact, it seems that alternative definition 1 seems to be the more likely of the two definitions at this time. The definition of current liability excludes certain benefits called unpredictable contingent event benefits. These benefits, as the name implies, are benefits that cannot accurately be predicted. And they are not included in current liability until the event actually occurs. The key factor in determining unpredictable contingent events is that they cannot reasonably or reliably be predicted.

What are some examples of unpredictable contingent event benefits? Generally, these events are viewed as major corporate business decisions that affect pension plan liabilities, and they are made primarily for other reasons than to invoke pension plan liabilities. These benefits are not related to the participant's age, length of service, his level of compensation, whether he's dead or alive, whether he's healthy or not. And these are all "or" statements, and there should be another slash there -- it should be "or is not reasonably and reliably predictable." The last area is a gray area, because what is generally considered unpredictable may in some cases be predictable. For instance, if a manager of a corporation knows that a particular event is to occur, such as a plan termination in the near future, say two years hence -- is that event now considered predictable? I don't know the answer to that.

Some examples of unpredictable contingent events would be a plant shutdown; once again, this is an assumption I've worked with. There are some actuaries who don't believe that a plant shutdown assumption should be used in determining any liabilities, much less current liability. Once again, I've run into a situation where a shutdown has been imminent; it's very predictable. Should this be included or shouldn't it? Another example is a mass reduction in work force, which would trigger a partial termination. Essentially it would invoke the additional incremental vesting due to a partial termination. Another example is a termination of a pension plan.

The last example is an early retirement window. In general, early retirement windows are considered to be plan amendments. However, after talking with some IRS representatives, we've been told that early retirement windows could be considered unpredictable contingent events, based on the facts and circumstances surrounding the window. I'm not sure exactly what facts and circumstances would be the lines of demarcation between a plan amendment and an unpredictable contingent event. I suspect it would probably be an early retirement window that was done in conjunction with another unpredictable contingent event, for example, a mass reduction of work force or a plant shutdown. In aggregate, all of those events would be considered unpredictable contingent events.

When do we include these events in determining current liability? If the event occurs during the valuation year, the current liability may or may not have to be remeasured, depending on the purpose of the current liability calculation. If we're calculating the deficit reduction contribution, which is a beginning-of-year value, and the event occurs during the plan year, then it is not included as a benefit in determining the liability as a beginning-of-year calculation. In that case, the accelerated amortization of the deficit reduction contribution wouldn't begin until the following valuation, after the year in which the event occurred. For end-of-year values, the 100% unfunded current liability maximum deduction and the new 150% full-funding limitation limit. In those cases we would include the event in determining the end-of-year value with the current liability. Now if you issue a valuation before the event occurs, it is my opinion that you would have to reissue another valuation showing the liabilities to include the unpredictable contingent events.

In some cases, not all benefit service is used in determining current liability. In those cases, what's called the preparticipation service is partially excluded. And preparticipation service is differentiated from participation service in that its service, as it states, is retroactively granted, before an employee becomes a participant of a plan. This partial exclusion occurs in instances where certain requirements are met: if the participant has less than five years of participation, and became a participant after 1987, and has accrued no other accrued benefits in a defined benefit plan of the controlled group. I think an example of this last item is, if a participant transferred from division A to division B within the same control group and was granted pre-participation service in division B's pension plan and was also using the division A pension plan as an offset to plan B, the determination of his current liability in plan B would not be eligible for the preparticipation service exclusion.

Finally, service at participation must exceed the eligibility service. This is not part of the law yet; however, it's been proposed in technical corrections. The purpose of this item has been to prevent plans with a one-year eligibility requirement, which retroactively grants benefit service to date of hire, from using the preparticipation service exclusion for that one year of pre-participation service. In that case it's inappropriate, and that first year of participation is included 100%. The preparticipation service exclusion applies, in general, just to new plans established after 1987, and obviously only with regard to plans that provide retroactive service, for example, back to date of hire. The first year of application, in general, would be the 1989 valuation year, because for pension plans established after 1987, say on January 1, 1988, you wouldn't have a full year of participation until January 1, 1989.

The way the preparticipation service exclusion works is by including 20% of the preparticipation service for each year of participation, rounded to the nearest year. For example, if a plan was established January 1, 1988, granting service back to date of hire for a particular individual to January 1, 1980, providing him with eight years of service, of preparticipation service, for the January 1, 1988 valuation, there would be no preparticipation service inclusion, because at that point the participant would have no years of inclusion. But in the following valuation, January 1, 1989, after one year of participation, 20% of the preparticipation service would be included, where 20% times eight years equals 1.6 years, and that would be rounded up to two years of pre-participation service. The exclusion is not used in determining current liability for every purpose. The partial exclusion is used in determining the deficit reduction contribution amount and the 100% unfunded current liability maximum. For the new 150 current liability full-funding limitation, the exclusion doesn't apply. I'm not sure why this difference in treatment exists, but the law does require that the exclusion must be used in those situations where it applies. In other words, you must use it in deficit reduction contribution and the 100% unfunded current liability maximum. I would hope that the IRS would change this when regulations come out, perhaps leave it as an option to use the graded exclusion or to use 100% of all preparticipation service. Because these exercises can be very costly to clients, it's very time consuming, and it appears that in most cases the results are fairly insignificant. As a practical matter, if it doesn't apply, don't wait. That is, if currently the client isn't going to use the deficit reduction contribution, or doesn't have to use it, or is not going to make 100% on the unfunded current liability maximum, then don't bother calculating it.

The following is all unofficial information. It represents TPF&C's thinking on the treatment of preparticipation service for mergers and acquisitions. If a company is acquired through a stock purchase, then essentially the company has remained intact, the pension plan is essentially an ongoing type plan. And because of that, there's no partial exclusion in the successor plan. On the other hand, if the company's acquired through the purchase of assets, and there is no asset liability transfer, that is, a successor plan is set up granting preparticipation service, say back to date of hire, and using the predecessor plan as an offset, then the preparticipation service exclusion would apply. This is because the successor plan is essentially a new plan, under new organization. And if that's the case, if the assets are less than the current liability, then there may be a deficit reduction contribution.

Regarding mid-year amendments, for the deficit reduction contribution calculation, which is a beginning-of-year calculation, we use the same treatment for mid-year amendments as we did for mid-year unpredictable contingent events. They're excluded from the calculation. However, for end-of-year calculations, the treatment of the mid-year plan amendment is consistent with the valuation treatment for full-funding limitations and the 100% unfunded current liability maximum. If for valuation purposes, the plan amendment was excluded for the end-of-year values, then they would also be excluded for the end-of-year determination of current liability. However, if they were included, as permitted under Revenue Ruling 77-2 on a pro rata basis for the valuation, then for the end-of-year value of current liability they would be fully included.

The actuarial assumption requirements that the law stipulates in determining the current liability primarily concern the interest rate. The interest rate is mechanically defined to be a rate that is within a range. And that range is between 90-110% of the four-year average of 30-year

Treasuries. The average is a weighted average, sort of like the sum of the digits type of average; the twelve months prior to the valuation date is weighted by a factor of four, the next preceding twelve months by a factor of three, then two, and finally by a factor of one for the last preceding twelve months. And clearly this mechanical approach is not at all related to the particular plan experience or to reasonable expectations. The current liability interest rate is also supposed to reflect the purchase rate of annuities for insurance companies. If insurance company purchase rates are much lower than the 90% lower boundary of that range, then the Secretary of the Treasury has the authority to lower that rate, but not less than 80% of the four-year average of 30-year Treasuries. In March 1988, the IRS published a notice allowing any interest rate within the range to be used until further notice.

The actuary's ability to choose an interest rate within the prescribed range is apparently temporary. The IRS has officially said that the secretary will set a particular rate within the range for each pension plan, and that rate will be based on the particular demographics and characteristics of each plan. In setting the rate, the factors that will probably be taken into account could be the number of retirees, the number of plan participants, or the average age of plan participants. And a problem that employers are going to encounter with this is that, if the employer has many plans with many different plan characteristics, then he is going to end up with many different current liability interest rates. And obviously the enrolled actuary has no discretion in setting the interest rates in this case. For 1988 and up to the present, anything within the range is permitted. The IRS had promised a table that was going to be published in 1989, and the table would be similar to the PBGC tables in that it would be rates that would be published fifteen days prior to the month of application. And I suspect that the way this would work is that the enrolled actuary would have to perform some kind of mini-valuation based on the plan's demographics, and once he has completed that, he would look up on a table and find out what the current liability interest rate is. He would then calculate the current liability. For 1989 a suggestion that we're using is to use the valuation rate if it's within the range, or else use the lower limit -- the 90% limit.

With respect to other actuarial assumptions, the law requires that they be the same as valuation assumptions, except where the valuation interest rate reflects a subsidized lump sum interest rate that's not permitted or any other actuarial assumption of the unpredictable contingent events nature, such as the shutdown assumption.

MR. DANIEL G. LALINE, JR.: With respect to the shutdown assumption, the current liability specifically requires that one not be included. If you are currently including it in your regular calculations for funding standard account purposes, should that assumption be revisited and perhaps eliminated for the regular funding standard account purposes?

MR. MARSHALL: Well, I'm in the process of doing just such a valuation, and I've kept that shutdown assumption in the valuation but excluded it from the current liability calculation. And so, until there is further guidance, that's how this actuary is going to handle it.

MR. LALINE: One other question, perhaps a bit thought provoking. If you are taking the approach of using a package of assumptions that are reasonable in the aggregate, but not individually specifically explicit, and we are now required to use a mandated interest rate for current liability purposes, do you see that as putting strain on the other assumptions that will be involved in the current liability calculation? Perhaps leading to a challenge by the IRS that the determination of the current liability isn't reasonable?

MR. MARSHALL: Well, Dan, I think you're opening up a whole can of worms here. First of all, the whole concept, the mechanisms, and the procedures surrounding current liability are very onerous and unwieldy. I'm heartily against trying to raise revenues via this method. I've had plans where, for example, the 150% of the full-funding limitation clearly provides unsound funding for the plan, because of the structure of the benefits. And so I'll just try to remain calm and say that I don't know the answer to that, Dan.

MR. RYAN: Is there anyone on the floor who would like to make a comment or question?

MR. FARHAD K. MINWALLA: Isn't it true that if you use any rate within that range, you still can't go below 8%? Isn't that what they were saying? That if the range in fact dips below 8%, the least you can use is 8%?

MR. MARSHALL: That's not my understanding, because for January 1, 1989, I believe the rate was 7.93%. And as far as I'm concerned, that's a permissible rate to use. Does anybody know differently?

MR. RYAN: I have seen that. I can't remember exactly what context, but I think he's correct.

John, I had one question concerning preparticipation service. How does the partial exclusion work?

MR. MARSHALL: Well, essentially you take a block of service. If you have a new plan and you're providing service back to date of hire for everyone, you have this block of past service and you can phase it in, 20% a year. So, after one year that the plan's been in effect, you essentially phase in 20% of that service in determining the benefits. And the 40, 60, 80, 100, and after five years that the plan has been in effect you would be including 100% of that service. But only for those particular calculations, the deficit reduction contribution, 100 unfunded current liability calculation, not the full-funding limitation.

Current liability is essentially an accrued benefit calculation. So that's another obscure area, although it seems pretty clear that all the PBGC wants is a vested portion of those benefits. And they ask that it be gleaned right off the schedule B.

FROM THE FLOOR: The preamble. In the preamble to the PBGC they discussed the 20% phase then and it does say, not in the regulation itself and not in the instructions, but in the preamble discussion to it, it does refer to it as being allowed.

MR. MARSHALL: I'm sorry. What's allowed?

FROM THE FLOOR: To use the preparticipation grade-in to calculate current liability for PBGC premium purposes is allowed.

MR. MARSHALL: Okay. So that's another application of the exclusion. It can be used in determining the variable premium to the PBGC.

MR. RYAN: I'll turn it over to Dan now, and when he's finished his presentation, we can open the session to questions from the floor.

MR. LALINE: Basically, I'm going to cover three points. I'm going to discuss the impact on the maximum tax-deductible contribution of this new concept of current liability. Then I'm going to review the impact of current liability on the funding standard account entries. And then lastly, I'll discuss some consulting issues arising as a result of the current liability.

Current liability impacts the maximum deductible contributions in really two areas. If you recall, under the calculation of the maximum tax-deductible contribution, there's a limitation geared to the full-funding limit calculated under section 412. And we now have a new full-funding limitation which is related to the current liability. Secondly, there is a new deduction limitation which has been added by the 1987 budget reconciliation act, which adds a new section under 404 in determining the maximum tax-deductible contribution. As a result of these two changes, there are a couple of miscellaneous items that I'd like to point out in connection with maximum tax-deductible contributions.

Let's turn to the determination of the full-funding limitation for maximum tax deduction. The budget act amended the calculation of the full-funding limitation to now equal the lesser of what we had come to know and love as the old full-funding limit, and 150% of the current liability, reduced by the lesser of the market value of the assets or the actuarial value of the assets net of the credit balance. Now, for purposes of this determination, current liability is calculated based on all service. The exclusion of preparticipation service does not apply for purposes of calculating the full-funding limitation. And that's true for both minimum contribution purposes and maximum tax-deductible contribution purposes. The calculation is made by projecting the current liability and the assets to the end of the year from the valuation date. If we look at the calculation, our standard calculation of our full-funding limitation, it's very easy to take our actuarial liability and project it forward to the end of the year.

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A couple of issues come up now that we have to deal with this current liability and making a projection of it to the end of the year. Most valuation systems will have to be modified to some extent to get the proper accrual of benefits for the year. Essentially what we are looking for is a standard unit credit valuation to determine the growth in the current liability from the valuation date through the end of the year. Also, in doing the projection, note that the effect of the benefit payments must be recognized explicitly because when we get to the end of the year we're taking 150% of that current liability. So you don't get a cancelling effect of the impact of the benefit payments on the liabilities and on the assets. Hence, you also need to have an estimate of what your benefit payments are going to be during the course of the year. This is somewhat different from what we've had to handle traditionally.

Now, for purposes of the maximum tax deduction, the credit balance is not subtracted from the assets -- either the market value or the actuarial asset value. Note that this is a supposition on our part; regulations will clarify this point. It is an issue right now, because I think a fair reading of the law is that you would not subtract the credit balance. But if you look to the conference reports, there is wording -- and at least one version of the preliminary statute has similar wording -- that the credit balance would be subtracted, and that the treatment would be similar to the calculation of the old full-funding limitation.

Continuing to focus on the maximum tax deduction, the 1987 budget act introduced a new subsection to 404. Specifically, 404(a)(1)(d) has been added. This section now permits a tax-deductible contribution to be made equal to the difference between the current liability and the actuarial value of the assets. Note that this calculation, under the general heading of section 404 of the code, is now determined using current liability, which includes the service phase-in that we discussed earlier. And we're using only the actuarial value of the assets, not the lesser of the market value and the actuarial asset value. Again, the calculation is made as of the end of the plan year. We must do a projection of the current liability and the asset value from the valuation date to year end. The credit balance is not subtracted from the actuarial asset value.

This specific maximum tax-deductible calculation is only available to plans covering more than 100 participants. That determination is made on a controlled group basis. We look at the control group of employers. If all defined benefit plans within the control group cover more than 100 participants, then this calculation of maximum tax-deductible contribution would be available to any plan within the control group. If the control group has less than 100 participants, then this specific calculation is not available.

This new deduction limit potentially allows for a higher tax deductible contribution limit and would provide the ability to accelerate funding for some underfunded plans. This can have some ancillary benefits with respect to financial reporting disclosure, under statement 87 of the FASB. It also can help to increase the asset base for purpose of calculating any additional minimum premium for PBGC purposes.

As a final item for considerations under maximum tax deductions, where we have participants covered by both defined benefit and defined contribution plans, an issue arises if a corporation wants to take advantage of the contribution made on the basis of the 100% of current liability minus the actuarial value of assets. In particular, the limitation for participants covered under both defined benefit and defined contribution plans is phrased as the greater of 25% of compensation or the section 412, calculated minimum contribution, including the calculation of the 100% of unfunded current liability.

Situations may arise where a corporation may unwittingly attempt to make use of the 100% unfunded current liability contribution. Defined benefit contribution plus the defined contribution amounts could conceivably exceed 25% of compensation for participants covered by both defined benefit and defined contribution plans. The corporation would then find itself in the position of having no room to make a deductible contribution to the savings plan. Now granted, these situations don't come up frequently. But it is something to at least be aware of, that this change in the law to provide an additional maximum tax-deductible contribution can have some consequences in the savings plan area.

What I'd like to do now is turn to the impact of the new full-funding limitation on the funding standard account entries. Just by way of setting the stage for what we're going to talk about: The old full-funding limitation was calculated as the actuarial liability minus the lesser of the market value of assets or the actuarial value of assets, reduced by a credit balance. The new full-funding limitation that was introduced by the 1987 budget reconciliation act was 150% of the current liability (again this item calculated without the service phase-in), minus the lesser of the actuarial value of the assets or the market value, also reduced by the credit balance.

What happens now to our funding standard account? We all recall that under current rules, at least prior to this 1987 budget act, there were certain adjusting entries that would have to be made when we had the impact of the full-funding limitation. Those entries will now be somewhat different as a result of this new current liability concept.

There are really two cases that we have to consider. One is when the old full-funding limit is less than the new full-funding limitation. And the second, when the old full-funding limitation is greater than the new full-funding limitation. How will the schedule B entries be made in these situations?

Looking at case 1 first, the old full-funding limitation being less than the new full-funding limitation. Let's say for argument's sake that the full-funding limit based on actuarial liability would be $100,000. Under the new full-funding limitation using 150% of current liability, the new full-funding limitation might be $200,000. In this situation, the old full-funding limitation is operable, and there would be no change from current practice. The entry to balance the schedule B will be determined as has been done historically. At the beginning of the next plan year the amortization bases are eliminated. Now that gives one cause to pause for just a moment and think back to that deficit reduction contribution that has also been introduced as a result of the 1987 budget reconciliation act. There may be some amortization going on as a result of the deficit reduction contribution. We think that deficit reduction contribution amortization would also be eliminated as a result of the application of the old full-funding limitation. Again, this is a supposition on our part. Hopefully, regulations will clarify this question. But I think it's reasonable to assume that treatment.

The second and more interesting case is when the old full-funding limitation is greater than the new full-funding limitation. This breaks down into two subcategories, which I've called case 2a and 2b. Case 2a is where we would have had a full-funding credit under the prior full-funding calculations. So this is a situation where our new full-funding limitation is operative; the calculation of 150% of current liability minus the lesser of market value and actuarial asset value results in the operative limitation for our overall contribution. However, the old full-funding limitation would have also given us a credit. In that situation, what will probably happen (and again, this is our best supposition, at least at this point) is that the old bases would be eliminated just as if we had been operating under the old full-funding limitation. But in addition, we will have to establish a new base, equal to the difference between the new full-funding limitation based on the current liability credit and the old full-funding limitation credit based on the actuarial liability.

Basically what is happening under this scenario is that we have a situation where the old full-funding credit would have required a certain dollar amount of contribution, let's say $200,000. The new full-funding limitation reduces that $200,000 contribution to $100,000. So by operation of this new current liability limitation, we have reduced the normal operation of the funding standard account to generate a deficit going into the beginning of the next plan year of the difference between the $200,000 limitation and the $100,000 limitation. So as we go into the beginning of the next plan year, we've basically got an unfunded liability of $100,000 which is set up as a base. At least, that's what we think should happen.

Moving then to case 2b, which says that we would not have had a full-funding credit under the old calculations. So in that situation we would not have had any bases eliminated. In this case, we would expect a base to be established equal to the new full-funding credit, calculated under the new current liability rules. But an interesting issue arises at this point. The new full-funding limitation is calculated based on looking at the lesser of the actuarial value of assets and the market value of assets, whereas the unfunded liability is calculated looking at the actuarial value of the assets. If the calculation of the full-funding limitation is based on the market value of the assets because that's less than the actuarial value, we then move ahead to the beginning of the next plan year. By using a credit based on that market value of the assets, developing a difference between the regular operation of the plan based on the actuarial asset value, and this credit which has been developed using a lower number, namely the market value. Right now we don't know how to treat it but it will have to be dealt with. I think the issue basically is one of what amortization period will the necessary adjustment have to be taken over. If it's considered as part of the base set up in respect of the operation of the full-funding limitation calculated under current liability, the period will probably be ten years. At least, this is what the IRS is saying. If it is considered a gain or loss type of item, then the amortization period would be five years.

One final issue that arises in connection with the operation of the funding standard account is what interest rate is to be used to amortize a base that's been set up because of a current liability limitation. We would expect the valuation interest rate to be used as opposed to something like the Current liability rate.

Now, we'll turn to something that I've dubbed consulting issues that come up in connection with this entire area. We're dealing with a whole host of changes that have been introduced into determination of a minimum contribution and maximum tax-deductible contribution. As is the case with many recent laws, the changes that have been made are only the broad brush strokes of what needs to be done to prescribe how our calculations are to be made. And there's an awful lot of filling in that has to come through regulations. Unfortunately, the list of regulations to be issued is very long, and regulations in this area are probably toward the bottom of the list. However, we as actuaries have calculations to do for both 1988 and 1989 that depend on this current liability.

I would suggest that, in going out to clients and communicating results, we almost certainly want to indicate that the calculations that we are doing now are based on our best understanding of the law and information available. But our understandings are subject to change. In particular, the one area that concerns me the most is the use of the proper current liability interest rate. Certain disclosures and public statements made by the IRS would mandate an interest rate based on particular plan characteristics. We've already completed most 1988 calculations, which presumably are going to set the current liability for purposes of the deficit reduction contribution. Having to go back and change this work would create significant strains on us. It behooves all of us to at least communicate to our clients the uncertain nature of some of the results that we're putting out right now.

From an internal perspective of those of us who are doing calculations and dealing with development of computer systems that will give us the needed information to deal with the reporting and disclosure information, we have a series of new calculations that have arisen. As you've gleaned from the discussion so far, these have to be taken into account for funding purposes. I don't think we've come to grips with all the various issues that have arisen as a result of the introduction of these new concepts, and certainly we need more regulations. But in the meantime we've got to deal with this new law and advise our clients.

MR. RYAN: Dan, one comment I'd like to make or question, regards one of the things introduced by the new law, the ability to always fund up to 100% of the unfunded current liability. This can, in some instances, give a deduction that would be greater than would otherwise be allowed under prior law. This applies only to plans with 100 or more lives, is that correct?

MR. LALINE: That's done on a controlled group basis. So if you're covering 100 or more participants, within all defined benefit plans in the control group, then it's available to you.

MR. RYAN: And there's no grade-in. It's all or nothing?

MR. LALINE: That's correct.

MR. RYAN: Ninety-nine participants and you don't get to do it.

MR. LALINE: One hundred you don't get to do it. It's greater than 100.

MR. RYAN: Greater than 100. Now does that relate to the 150 graded provision in the law, I believe that's with respect to the 412(l) contribution, is that correct?

MR. LALINE: That refers to the deficit reduction contribution. The deficit reduction contribution first of all applies to plans with more than 100 participants. But there's a phase-in as to the amount of the contribution, if you have between 100 and 150 participants. Yes, there's some analogy there, but is there a direct relationship? I think the answer to that one is no.

MR. RYAN: Yes, that was my question. Is there a rationale, is there a connection, or is it just coincidence?

MR. LALINE: I think the rationale is not to overly burden small plans with a deficit reduction contribution. So this concept of phase-in was developed.

MR. RYAN: So I guess if they're not going to burden small plans with the deficit reduction contribution, they're not going to allow them to take this new maximum either. Is that the thinking? Or is it too much to think that there's a logical connection?

MR. MARSHALL: I think most larger plans wouldn't utilize the 100% limit. With the smaller plans, perhaps -- and this is my guess -- when you get the doctors and a couple of nurses, for example, it could be a very substantial tax break. And just maybe that's what the IRS was trying to avoid. Whereas, if you get more than 100, that's generally not the purpose of the plan.

MR. LALINE: I think we all have to keep in mind that a substantial amount of the design work that goes in from a legislative viewpoint is aimed toward small plans where for years there has been a perceived abuse of the tax laws and overly high tax deductions being taken. I think that is why the 100% current liability deduction doesn't apply to plans with less than 100 participants. It's because of the tax abuses that were perceived historically.

MR. RYAN: Okay, are there any other questions or comments from the floor?

FROM THE FLOOR: One of the discussions we've had in our office is, the calculation of current liability in treating nonvested turnover that, in calculating current liability you should ignore the nonvested and allow everybody to be vested even if they have, say, less than five years of service. Do you have those same discussions in your office?

MR. MARSHALL: Well, I know, despite everything we've said about how you're supposed to calculate current liability, and fine tune it to our best guess. The way at least our office is doing it, we're just using present value of accrued benefits that we've always used. Until we get further guidance, it just seems to be a waste of time to try to fine tune this thing. We would simply spend a lot of money doing it, and then we would have to fine tune it again when the regulations come out. So even though present value of accrued benefits, which is an ongoing plan basis of assumptions, may not be what our best guess is, for practical purpose, at least in the Cleveland office, that's what we're using. Does that answer your question?

MR. LALINE: Maybe if I could rephrase the question. I think the issue comes up, John, in connection with your reference to 401(a)(2), which is really a plan termination analysis of current liability. I think the issue is, did the lawmakers really intend it to be plan termination, which would require 100% vesting? Or was that just a way of getting at the calculation of the accrued benefit on an ongoing plan basis? I would agree with John in terms of the way at least that we're doing the calculations in Stamford. We're doing it on an ongoing plan assumption and would discount for nonvested turnover. Any other comments from the floor on that one?

MR. RYAN: Any other topics?

MR. RALPH J. BRASKETT: Combined plan limits. You stated the eligible payroll takes account of the $200,000 limit. Does it also take account of eligible participants only or all employees of the employer in the eligible group?

MR. LALINE: I think it's eligible participants only.

MR. BRASKETT: I heard the exact opposite. In a minimum/maximum contribution session, on both counts. No $200,000 limit, and all employees.

MR. LALINE: The $200,000 limit is right in 404. It's hard for me to believe that one.

MR. MARSHALL: What session was that?

MR. BRASKETT: Minimum/maximum contribution.

MR. RYAN: Yes, there seemed to be a little bit of confusion about that point.

MR. LALINE: There's a section in 404 that imposes the $200,000 pay cap for purposes of 404, as I read it.

MR. RYAN: That's right. It's 404(l).

MR. MARSHALL: I think the current liability issue is a case study of how the government has taken an idea and just let it grow uncontrollably, to the point where the tail is wagging the dog. And I hope they realize that when they come around issuing regulations.

MR. RYAN: Are there any other questions or comments?

MR. PETER M. HANSON: With regard to what happens to the funding standard account when you do have the new full-funding limit apply, I was wondering if you would go over it, because I wasn't quite clear what you were saying, as far as establishing new bases and eliminating bases.

MR. LALINE: Probably the best way to do it is by way of example. I will agree that trying to describe this in words is very difficult. This example runs through three years of plan operation and shows how the interaction of the old full-funding limitation and the new full-funding limitation would work. So to take you through this, we'll start in year one with an accrued liability of $5,000,000. Actuarial value and market value of assets being the same at $5,800,000, our unfunded liability is a negative $800,000, normal cost of $1,200,000 (Exhibit 1).

Now let's take a current liability calculated for full-funding limitation purposes of $3,000,000, and that's as of the end of the year. The status of the funding standard account bases at the beginning of the year is credits of $1,791,949 and charges of $991,949. The amortization payments are shown right below on Exhibit 1. A net amortization credit of $201,733. Now let's calculate our full-funding limitation amounts. The old full-funding limit would take our actuarial liability, normal cost, lesser of market value and actuarial value (which are the same in this case), project them forward to the end of the year. And we would have what I've called the old full-funding limitation of $434,000.

Now let's look at our new full-funding limitation. One hundred fifty percent of our $3,000,000 current liability is $4,500,000. Our assets projected to the end of the year, with just interest (no benefit payments are expected), are assumed to be $6,293,000. So we have a situation where our new full-funding limitation is less than our old full-funding limitation. If you look back, that was basically Case 2a that I described. Now what happens? The funding standard account entries would be as follows: for our charges, there's no difference from what you would have expected: normal cost, amortizations, and interest. The total charge is $1,395,051. For credits we're assuming no credit balance, our amortization credit is $287,494, and we have an interest adjustment on that to the end of the year of $24,437.

Now, how do we calculate our full-funding limit credit? Well, under our new full-funding limitation, no minimum contribution is required. So our adjustment to get us to a full-funding limitation credit is such that it will equal an amount sufficient to have our FSA credits equal to our funding standard account charges. Now, what implications does that have going forward to the next year? We are taking a full-funding limitation credit that is larger than the credit that we would have taken under the old full-funding limitation. Basically what that says is that we will not have a zero expected unfunded liability. We are creating an unfunded liability equal to the difference between the new full-funding credit and the old full-funding credit. So what we will be doing is setting up a new base as a result of the operation of the new full-funding limitation equal to $434,000. It is the difference between the new full-funding limit credit, minus the old full-funding limitation credit. Going into the next year, we'll be setting up a base of $434,000, and we'll be amortizing this over ten years based on at least verbal information from the IRS.

Let's go to year two now (Exhibit 2). In year two we're going to show an example where the old full-funding limitation credit is greater than the new full-funding limitation credit, but that we would not have had any adjustment for the old full-funding limitation; it would have been operative. Now we have an accrued liability of $7,500,000, assets of $6,200,000, and an unfunded

EXHIBIT 1

OBRA FUNDING
NEW FFL EXAMPLE: YEAR 1

Accrued Liability	5,000,000
Assets	
- Actuarial Value	5,800,000
- Market Value	5,800,000
Unfunded Accrued Liability	(800,000)
Normal Cost	1,200,000
Current Liability (EOY)	3,000,000
Amortization	
- Credits	1,791,949
- Charges	991,949
- Net Outstanding	(800,000)
Amortization Payments	
- Credits	287,494
- Charges	85,761
- Net Amount	(201,733)
Old FFL	
- Actuarial Liability	5,000,000
- Normal Cost	1,200,000
- Assets	5,800,000
- Interest	34,000
- Total	434,000

New FFL	
- 150% Current Liability	4,500,000
- Assets (EOY)	6,293,000
- Total	0
FSA Charges	
- Normal Cost	1,200,000
- Amortizations	85,761
- Interest	109,290
- Total	1,395,051
FSA Credits	
- Credit Balance	0
- Amortizations	287,494
- Interest	24,437
- FFL Credit* (Total Charges - Other Credits - FFL)	1,083,120
- Total	1,395,051
Minimum Required	0
* Old FFL Credit (Total Charges - Other Credits - Old FFL)	649,120
* New FFL Base (FFL Credit - Old FFL Credit)	434,000

EXHIBIT 2

OBRA FUNDING
NEW FFL EXAMPLE: YEAR 2

Accrued Liability	7,500,000
Assets	
- Actuarial Value	6,200,000
- Market Value	6,200,000
Unfunded Accrued Liability	1,300,000
Normal Cost	1,350,000
Current Liability (EOY)	4,800,000
Expected Unfunded Liability	434,000
Gain/(Loss)	(866,000)
Amortization Payments	
- Credits: last year	0
- Charges: last year	0
loss	866,000
FFL base	434,000
- Net Outstanding	1,300,000
Amortization Payments	
- Credits	0
- Charges	263,508
- Net Amount	263,508

Old FFL	
- Actuarial Liability	7,500,000
- Normal Cost	1,350,000
- Assets	6,200,000
- Interest	225,250
- Total	2,875,250
New FFL	
- 150% Current Liability	7,200,000
- Assets (EOY)	6,727,000
- Total	473,000
FSA Charges	
- Normal Cost	1,350,000
- Amortizations	263,508
- Interest	137,148
- Total	1,750,656
FSA Credits	
- Credit Balance	0
- Amortizations	0
- Interest	0
- FFL Credit* (Total Charges - Other Credits - FFL)	1,277,656
- Total	1,277,656
Minimum Required	473,000
* Old FFL Credit	0
* New FFL Base	1,277,656

accrued liability of $1,300,000. What has basically happened is now we have an expected unfunded liability of $434,000, which is a result of the operation of the 150% limitation, and we've had a significant loss for the year, $866,000. As of the beginning of the year, we've wiped out the bases for the prior year, we have established a loss base, and we have this full-funding limitation base, both of which have to be amortized. We've taken five-year amortization of the loss base and ten-year amortization of the full-funding limitation base. And the amortization payment, the combined ten- and five-year amortization amounts, is the $263,508 shown.

Now what happens? Let's do a calculation of the old full-funding limitation. Liability at the beginning of the year, normal cost, assets, interest until the end of the year. We would have an old full-funding limitation of $2,875,250. The new full-funding limitation, calculated on the current liability, is 150% of current liability, $7,200,000, less end-of-the-year assets. A limitation of $473,000. Again, the new full-funding limitation will become operative.

What does the funding standard account look like? The charges are no different than they would be under normal operation. Now looking at the credits. We have no credit balance, we've wiped out the prior credit amortizations, no interest adjustments, our full-funding credit is that amount needed to make the funding standard account develop a minimum required contribution of $473,000, equal to our new full-funding limitation. All right, by making an entry of $1,277,656, we get the proper development of our funding standard account entries. The result going forward into the next year is that we will need to set up a base equal to the full amount of the credit that we took to get the funding standard account to balance. We need a base of $1,277,656. And that is because no credit would have developed under the old full-funding limitation calculation.

Going forward then to the third year (Exhibit 3). Somewhat similar circumstances, another significant loss was assumed here. Liabilities and assets as shown, our expected unfunded liability is $2,402,250, we've developed a loss of $2,297,750, the amortization status would be as follows from the prior year, we have remaining $1,124,594, we establish new bases for the loss that arose this year, and a new base for the full-funding limitation adjustment that we saw at the end of Exhibit 2. Again, the loss is over five years, the full-funding limitation base we've taken over a ten-year period. Our total amortization payments now go up to $980,388.

And now let's do our calculation. The old full-funding limitation would result in a limit of $7,052,500. The new full-funding limitation is generating a limit of $5,372,000. We're now at the point where these limitations are no longer operative. As a result of the absence of contributions to the plan over these three years, the assets have been held down and neither one of the full-funding limitations apply, so our funding standard account consists simply of our charge for normal costs, amortization, and interest, and there are no credits entering into the calculation of the minimum. And that is a sample of what this might look like, going forward for several years.

FROM THE FLOOR: If you go back to the first year, the $434,000, I couldn't quite determine what numbers you were considering there.

MR. LALINE: The $434,000 is the old full-funding limitation. If we didn't have current liability, we would have had a full-funding limit of $434,000.

FROM THE FLOOR: And that is the new base for the following year automatically?

MR. LALINE: Right. Let me explain it this way. Under the operation of the funding standard account before the imposition of current liability, we would have had to contribute $434,000. And we would have a zero expected unfunded liability. The operation of the full-funding limitation under current liability has taken our contribution from $434,000 down to zero. So we're going to then have an expected unfunded liability of $434,000. That amount needs to be amortized starting in the next plan year. That's why a base is being set up. It's because of the imposition of this new current liability which has taken what would have been a zero unfunded liability as a result of the $434,000 contribution back up to an unfunded liability of $434,000, by imposing a zero contribution.

FROM THE FLOOR: All right.

MR. LALINE: It's $1,083,120 minus $649,120. So this should read full-funding limit credit.

EXHIBIT 3

OBRA FUNDING
NEW FFL EXAMPLE: YEAR 3

Accrued Liability (BOY)	11,500,000
Assets	
- Actuarial Value	6,800,000
- Market Value	6,800,000
Unfunded Accrued Liability	4,700,000
Normal Cost	1,800,000
Current Liability (EOY)	8,500,000
Expected Unfunded Liability	2,402,250
Gain/(Loss)	(2,297,750)
Amortization Payments	
- Credits: last year	0
- Charges: last year	1,124,594
loss	2,297,750
FFL base	1,277,656
- Net Outstanding	4,700,000
Amortization Payments	
- Credits	0
- Charges	980,388
- Net Amount	980,388

Old FFL	
- Actuarial Liability	11,500,000
- Normal Cost	1,800,000
- Assets	6,800,000
- Interest	552,500
- Total	7,052,500
New FFL	
- 150% Current Liability	12,750,000
- Assets (EOY)	7,378,000
- Total	5,372,000
FSA Charges	
- Normal Cost	1,800,000
- Amortizations	980,388
- Interest	236,333
- Total	3,016,721
FSA Credits	
- Credit Balance	0
- Amortizations	0
- Interest	0
- FFL Credit* (Total Charges - Other Credits - FFL)	0
- Total	0
Minimum Required	3,016,721
* Old FFL Credit	0
* New FFL Base	0

MR. RYAN: Anyone else have any other questions?

FROM THE FLOOR: You haven't been real explicit here, but are you carrying your current liability from beginning of year to end of year forward at the current liability interest rate and your assets forward at the valuation interest rate?

MR. LALINE: I think the answer to that is probably yes. That's the way I would have done it. And I think logically, at least, you can defend that. There's no requirement to change the interest rate on your assets, nor is there a specified interest rate on your assets as there is for current liability.