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WHAT THE PENSION IS ALL THE FUSS?

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Discussion of the contrasting views between a health actuary and a pension actuary performing the final analysis required under *FAS 106* for postretirement medical benefits.

MR. LEE A. JAMES: I'm with Hewitt and Jerry Dubner is from Coopers & Lybrand in Atlanta. Jerry has done both pension and group actuarial work, so he's qualified to lead the session from both sides. Both Jerry and I are EAs. I've been doing pension and group benefits work for 15 years.

MR. JERROLD DUBNER: The views we express are not necessarily the views of our employers, the Society of Actuaries, the American Academy of Actuaries (AAA), the Joint Board for the Enrollment of Actuaries, or any other organized body.

FROM THE FLOOR: Please talk about *FAS 106*, because I think most of us would be more interested in health topics. I, for one, would be more interested in health topics than pension topics.

MR. DUBNER: That's a good point. Is there an overwhelming desire from others to discuss *FAS 106* or some of the methods that are used in doing *FAS 106* valuations? It seems that the majority of the participants here are pension actuaries. As Lee indicated, he and I worked both in the pension and health areas, and we are well versed in *FAS 106*. We will be bringing up some of the differences in assumptions or differences in methodologies between pension plan valuations and the valuation of postretirement medical benefits under *FAS 106*, particularly when we get to a discussion of the assumptions and also some of the accounting requirements and accounting calculations.

MR. RALPH J. HEALEY, JR.: Maybe if you went through *FAS 87/88* and just talked about 106 as a variation on a theme, which it really is, you will satisfy his needs.

FROM THE FLOOR: And the fact that the new scatter-diagram requirements of the Schedule B make *FAS 106* much easier to do for most plans.

MR. DUBNER: So what do pension actuaries do? I'm sure that is a question that many of you are asked. There are three major areas that pension actuaries get into, in terms of calculations. Pension actuaries function in a number of different roles. They function as business consultants to their clients. Pension actuaries may work in a pension department of an insurance company. Strip those duties away and look at the meat-and-potatoes work of a pension actuary. First, a pension actuary must do a pension plan annual valuation, do calculations in connection with changes in pension plans and in the catch-all category of miscellaneous calculations.

The pension plan annual valuation is really performed for four main reasons. First, if the pension plan is a qualified plan under the Employee Retirement Income Security

Act (ERISA) of 1974, there are required calculations to be done in conjunction with the ERISA and IRS funding requirements. Second, for pension plans sponsored by employers that are required to report under generally accepted accounting principles (GAAP), *FAS 87* applies to the pension plan. There are other pension plans, typically public plans, that are governed by other accounting requirements from the Government Accounting Standards Board.

The third reason to do a pension plan annual valuation is in conjunction with determination of liabilities for Pension Benefit Guaranty Corporation (PBGC) premiums of a plan. This doesn't apply in all cases. For a well-funded plan or a small plan, certain liabilities are really not applicable; but for the majority of larger plans, PBGC premiums are required to be paid and liabilities need to be determined for those reasons. Finally, the plan itself has accounting requirements and those requirements come under the purview of *FAS 35*, which is a pension plan's accounting.

MR. JAMES: In the interest of addressing the *FAS 106* concerns of the audience, I'll give some of the main differences here. Number one is funding. There's no funding requirement to fund retiree medical benefits. Some companies do fund retiree medical benefits, but has it's been my experience that those are mainly regulated companies. They're regulated by the Federal Energy Regulatory Commission (FERC) or the Public Utilities Commission, etc. They can recoup that prefunding from their rate-payers. But as far as any IRS requirement to fund, like Section 412 or something like that, there isn't anything. There is obviously Section 501(c)(a), regarding Voluntary Employees' Beneficiary Associations (VEBAS), which is also under 419 and 419A of the code, and allows you to fund and take it as a deduction, but there's no requirement there.

Second, there are similar requirements, such as expense and disclosure requirements, under *FAS 106* as there are in *FAS 87, FAS 106* (which occurred just a few years earlier in its application). Of course there aren't PBGC premiums in a retiree medical situation. Does anybody remember what the initial PBGC premiums were?

FROM THE FLOOR: I think a dollar fifty.

MR. JAMES: Yes, it was about a dollar.

FROM THE FLOOR: Fifty cents.

MR. JAMES: Was it that low? It's up to a $72 maximum. I think I have a couple of clients that have to pay $72. Then *FAS 35* applies to the 5500 filing for plans that require an audit. They have to put together that *FAS 35* information. I'm not aware of that requirement in *FAS 106.*

MR. DUBNER: Historically there hasn't been a requirement in connection with postretirement medical liabilities. However, the American Institute of Certified Public Accountants (AICPA) came out with a Statement of Position, 92-6 effective April 19, 1993, which requires the addition of reporting postretirement medical and actual medical life insurance, and whatever liabilities are covered under a welfare plan, to be included on that welfare plan's financial statement. So what you see under a plan's liabilities, with the application of SOP 92-6, is significantly different from what you

saw before. Typically under a welfare benefits plan, the liabilities of the plan might be the liabilities for incurred-but-not-reported or incurred-but-not-paid claims, and perhaps some administrative expenses, but it certainly wasn't much. Typically these plans are not prefunded, so there is not much in assets either. So after SOP 92-6, there is an enormous unfunded liability that is slapped onto these welfare plan financial statements. No expenses are required to be disclosed. It simply states, "Here's an additional liability." In that way, 106 really has wormed its way into the plans' financial statements as well.

There are a number of different ways in which a pension plan can change. There can be a change in the benefit formula for a plan, a change in some of the requirements, vesting, early retirement, or optional form requirements for a plan. It seems as if every few years Congress passes a new law that changes pension plans. New regulations come out, so a lot of calculations are done by actuaries, by pension actuaries, in anticipation of or in reaction to legislative changes, or changes for other reasons. For instance, there can be changes for plans that are for groups whose benefits are subject to collective bargaining; these are typically cost increases and a flat-dollar benefit level, and those cost changes are determined by an actuary for negotiation purposes for an employer.

Other changes to plans that can take place are the cutback of benefits or changes when significant groups of employees terminate due to layoffs or plant closings. There are calculations done for funding purposes that reflect these changes as well as calculations done under *FAS 88*, a companion statement to *FAS 87*, which handles curtailments and settlements of pension obligations. *FAS 106* has incorporated all the calculations that are done for postretirement medical and life insurance, I should say postretirement welfare plans, that are covered under a separate statement for pensions.

Finally, in the most extreme case, a plan change can result from the discontinuance of a pension plan, although under ERISA, a plan is intended to be set up to function indefinitely. There are several plans that have terminated, particularly over the last few years, and a pension actuary will get involved in the calculation of plan termination liabilities. In fact, those plan termination calculations are required by the PBGC in connection with a plan termination.

MR. JAMES: Of course item B-1, cost studies, are estimates done when the plan is changing, and everyone who has worked with *FAS 106* knows that last year, when all the companies were adopting *FAS 106*, there were many studies going on about how to get the liability down. Let's change our assumptions or change the plan. Much was said about the appropriate trend rates and that sort of thing. It was also interesting to note that *FAS 87* and *88* were two statements, and *FAS 106* was one statement, but it had both of those things in there. If you look at paragraph 96 and back in *FAS 106*, you'll find the *FAS 88* piece of that.

MR. DUBNER: As far as miscellaneous calculations are concerned, it's a catch-all for different things that are done by pension actuaries. First of all, because a pension plan is a defined-benefit plan, the calculations that are performed in defining what the benefit is, as a function of service and earnings and age, are done in connection with the termination or retirement of employees. In addition, estimated calculations are

often done for annual statements that are presented to participants or in reaction to the requirements of ERISA, which state that estimated benefit information be provided to participants on an annual basis. There are also projections done by pension actuaries so that an employer can get some estimate of what pension plan funding is or what liabilities are for years into the future, when data are not available or trends are not known. The information is necessary for long-range planning by the employer.

Finally, an item resulting from some of the recent legislation are the many tests that pension plans need to pass in order to remain qualified. They're hoops that the plans need to jump through, particularly on those plans that have relatively complicated or unusual plan formulas. In the last two or three years, actuaries have gotten involved in testing plans for qualification both under coverage rules and under antidiscrimination rules.

These types of calculations are typically not done for postretirement medical plans with the exception of projections. Benefits under a postretirement medical plan are typically not defined benefits. If you don't get sick, there's no cost. If you have a heart bypass, the cost is very high. It's not something that can be determined as the result of a formula. But clearly the projections are important for employers, and in fact, it's often as a result of those projections that the employers decide that they're going to either completely do away with or severely curtail benefits, postretirement medical benefits in particular.

The valuation process is one of collecting information and taking the information, putting it in the actuarial black box, and coming up with some numbers. The data collection portion of the valuation for a pension plan primarily consists of collecting information in three different areas. The first is census data, or information on plan participants, such as age, sex, earnings, service, and, in some cases, additional ancillary information. Information is collected for retirees, particularly their age, sex, and benefit amount, which had been previously determined under a defined-benefit plan as well as the form of benefit currently being paid.

The second source of data that are collected is asset information, because for a prefunded pension plan, assets play a very large role in the calculation of benefits, or actually, in the calculation of funding and expense requirements.

Finally, the plan design is very important. Any changes in the plan design that have taken place since the previous valuation or any anticipated changes need to be incorporated, including any legislative changes that have taken place. These legislative changes can also encompass changes that have been mandated in things like benefit or compensation limits, which need to be reflected in a subsequent year's valuation.

MR. JAMES: I have a few comments about this and the differences in *FAS 106.* The census data, particularly the active data that you need for *FAS 106*, are similar to data that you would need for a pension plan valuation. When you get into the retirees, it's a little different. For example, if you've had some people who have taken lump sums, then you need to be sure that you get data on those people. You need to collect data on whether they've elected retiree-only coverage or retiree-and-spouse

coverage, so that you'll know how many people are actually collecting medical benefits. The asset information is usually zero, meaning that these plans aren't typically funded, so there are no assets in the plan.

The plan design can be a little trickier because *FAS 106* talks about the substantive plan, which is the understood agreement between the employee and employer. Many times there's not a plan document for a pension plan, and you have to get copies of the summary plan description (SPD) to find out what the substantive plan is. The auditors get involved in that discussion because they want to know what management intends to do, not necessarily what they've done or what they say they're intending to do. For example, if they say, "We're going to cap claims at the level that we're going to experience in the year 2000," then that significantly reduces the *FAS 106* expense, but the auditors are going to want to know, "Are you really going to do that?" So they look for signs; for example, increasing the cap would be a sign that maybe you don't intend to really have that in there.

Also, in a *FAS 106* you need an additional data element—the claims data. If you have a big enough group, you take the retirees and you get data on the retirees, both demographic data and claims data for pre- and post-65. After 65, the Medicare creates it a different calculation, because of the Medicare carve-out or coordination of benefits. If your group is not big enough, one of the things you can do is look at the group's active claims, use some age-graded utilization factors, project those up into retirement, and use them. Those are some of the primary differences in claims data collection for *FAS 106.*

MR. DUBNER: For plan design, there are some other differences between pension plans and non-pension plans. Certainly pension plans typically have a plan document, which is a legal document governing the benefits. As Lee mentioned, there may not be a written document at all for postretirement medical benefits.

I was talking to a client about postretirement medical liabilities and the client said, "We don't provide postretirement medical benefits to our employees." Things went along, so we said, "Well then you obviously don't have an *FAS 106* liability." We got a question at one of the divisions about the coordination of Medicare with benefits for retired employees, and discovered in the conversation that the division actually does provide postretirement medical benefits to employees. The division simply tells people when they retire, "Just continue to pay your premiums and we'll keep you on the medical plan." When we told the people at the corporate office about the division's practice, they did a survey or an inventory of the benefits that actually were being provided to retirees, and they found they had a multi-million-dollar liability on their hands. Their immediate reaction was to tell all their employees that if you don't retire by December 31, they will not be eligible for these benefits. So they significantly curtailed that liability even before they had to adopt *FAS 106.*

One of the other things in connection with *FAS 106* is the provision of benefits that are not medical benefits. The statement covers nonpension postretirement benefits, and these types of benefits can range from medical benefits, which are what's typically thought of when somebody mentions FAS 106 in life insurance benefits, to a whole host of benefits that are typically not material on the financial statement and therefore not really valued. But in some cases, it is rather interesting to see what

companies provide. I have a client that provides turkeys at Christmas to retirees. These are not pensions, and so they're covered under *FAS 106*. Other employers provide gold watches at retirement or in-kind types of benefits. For example, airlines provide discounted or free flights to retirees. Higher education institutions might provide reduced or free tuition to retirees or their dependents. So one part of the data collection process under *FAS 106* is to determine what exactly you are talking about when you say postretirement benefits other than pensions, and what is it that you provide.

MR. JAMES: I have a question about the turkey benefits. Are those material? I have a hard time believing a turkey is a material benefit.

MR. DUBNER: The turkeys in and of themselves are not material, but the same employer provides silver trays at retirement and a retirement bonus to employees, it pays the American Association of Retired Persons (AARP) dues for retirees, and it has a party for retirees every year. The sum of all of those benefits is a material benefit, and it is reflected on the corporate financial statement.

FROM THE FLOOR: At least one firm wants to include Consolidated Omnibus Budget Reconciliation Act (COBRA) of 1986 benefits for the early retirees as a retirement benefit.

MR. JAMES: As an *FAS 106* liability?

FROM THE FLOOR: Yes.

MR. JAMES: When you're doing the claims analysis, typically when you get the information from the insurance company, if you ask for it before and after age 65, information is provided by the age of the retiree. For example, if you have a retiree, who is 68, who has a 62-year-old spouse, you get a mixing of pre- and post-Medicare claims in there, so it messes up your analysis. You have to split those out separately or make some adjustments on that. It's something to watch out for.

MR. DUBNER: The data collection process for postretirement medical benefits, in particular, is more involved than the process for pension benefits. The second step in the valuation process is to select assumptions and methods. The third step is to calculate liabilities, which are calculated using the actuarial principles with which I'm sure that you're all familiar: the time value of money, the application of decrements, and discounting streams of payments to the present. Once the liabilities are determined, you take those liabilities and determine the expense and funding requirements, which is the application of certain actuarial cost methods as well as the requirements of the applicable governing body, either FASB and the expense determinations or the ERISA and IRS funding requirements.

What assumptions do you use in connection with pension valuations? It's probably safe to divide the assumptions into two main groups, demographic assumptions and economic assumptions. Demographic assumptions are basically the answer to the question of what can happen to an individual during his or her lifetime, particularly working lifetime, and retirement. You can die, you can quit, you can become disabled, or you can retire. The fifth demographic assumption listed, which is

marriage, is important in the situation where benefits differ for individuals, either benefits or forms of benefits, based upon their marital status. For mortality, what's typically done is, except for very large plans, a standard table is used. For very large employers, mortality studies are done to determine an appropriate mortality table to be used in connection with the valuation or, for example, adjustments might be made to a standard table to take into account the mortality of a specific employer group.

A turnover study is done more often than a mortality study to reflect appropriate turnover rates, and typically, particularly for large employees, turnover is determined on both a select-and-ultimate basis to reflect the fact that a 30-year-old with five years of experience is less likely to quit employment than a 30-year-old who was just hired. Disability is another assumption that perhaps has less impact, but is nonetheless important. It's another decrement to the active group.

The retirement assumption for a pension plan is perhaps not as important as it is for a postretirement medical plan because early-retirement benefits, or the liability for retirement benefits, do not differ significantly if you assume at least a moderate rate of early retirement from what it would be if you assumed that everybody retires at the normal retirement age under a pension plan. This is because pension benefits are reduced for early commencement of benefits and also because if someone works until 65 instead of working only until age 60, there is typically an additional accrual of service and higher earnings that would make the age 65 benefit higher, which would either completely and, perhaps in some cases, more than offset the earlier commencement of the benefits.

Under *FAS 106*, the earlier you retire, typically the higher your medical costs after retirement. There is typically not a deferral of coverage for people who retire early. You retire at age 55, you get medical coverage starting at age 55; in fact, under some plans retiree medical benefit coverage stops at age 65. So if the actuary were to say, "Well, I'll just use the same assumption that I used for the pension plan for early retirement," my pension plan's early retirement assumption is that everybody retires at the normal retirement age of age 65. It's easy to see that would generate a liability of zero for pre-65 medical benefits. Neither the auditors nor any other actuary taking a look at the results would deem this to be an appropriate valuation.

MR. JAMES: I'd like to comment on the retirement assumption. I think that has a much greater impact in *FAS 106* because in the typical retirement plan you reduce benefits if the person retires early. If you have somebody retire at age 55 under *FAS 106*, then you have not reduced the benefit, but the benefit is much greater because all the high years of benefits are from 55 to 65, and then at 65 the benefit due to Medicare is anywhere from a third to a fourth as much. Many employers, I think, are beginning to understand that and put in some sort of age-service grade that mimics their retirement plan design in the retiree medical plan. But the retirement assumption has quite a bit more impact in the *FAS 106* typically than it does in the pension plan.

MR. DENNIS J. GRAF: In my former career, I was a consultant. For the most part I could agree with the comments about the age-65-retirement assumption on pension plans, but even as a consultant I saw instances where benefits were heavily subsidized before age 65, and not actuarially reduced anywhere near the extent of true value. I think a typical plan I'm looking at nowadays, which covers hundreds of

thousands of people, also have a Social Security supplement of some sort that's payable from retirement until age 62 if certain prequalifications are met. In those situations, we have to be extremely careful about the retirement assumption for the pension plan as well, and having done so, that assumption typically carries over very easily to the retiree health valuation.

MR. JAMES: I didn't intend to imply that it wasn't an important assumption in the pension valuation. Typically the assumptions are the same in both the retiree medical and the pension plan, because it's a little difficult to argue that people retire at 65 for pension purposes and at 62 for retiree medical purposes or vice versa. I mean, people retire when they retire. The discount rate may have some validity there; that's a good point.

MR. DUBNER: Right. And to follow up on that, it's perhaps more typical in a situation where a retirement plan doesn't have sufficient experience to determine appropriate retirement rates than for a plan that doesn't provide subsidies prior to a normal retirement age, typically at 65. Therefore an actuary is not going to be too far off the mark by using an assumption that 100% of retirements occur at the normal retirement age. Clearly if there is a subsidized benefit, don't assume that individuals won't take advantage of the subsidy. As Lee pointed out, you would use the same assumptions for retiree medical retirements as you would for pension plan retirements. But that is a very good point; that assumption is not always the most appropriate one to use.

The other assumption that differs to some extent for pension purposes and under *FAS 106* is the marriage assumption. Typically benefits are reduced for a form of payment other than a life annuity under a pension plan, and typically those reductions are actuarial, so the liability for someone receiving a benefit under a qualified joint-and-survivor annuity form is going to be approximately, if not exactly, the same as the liability for somebody receiving a benefit under a life annuity form. Medical benefits are quite different. If coverage for an individual is for that individual's lifetime and the coverage for that retiree's spouse is for the spouse's lifetime, then the liability is clearly higher if you assume that individual has a spouse than if you assume that individual does not.

MR. DUBNER: There's really no difference between a 0% marriage assumption and 100% marriage assumption. So the marriage assumption that's used is a very important one under *FAS 106* valuation. The assumption is less important because some plans don't cover surviving spouses. Some plans don't cover spouses at all, and so the period over which a spouse has coverage is an important factor in determining how important the marriage assumption is; but typically it is much more important under a *FAS 106* valuation than it is in a pension valuation.

MR. JAMES: Not only is the number of people married or assumed to be married important, but the difference in the age that you assume between the retiree and the spouse also plays a role. We usually just put in three years and that's it; we assume wives are younger than husbands by three years. That may be sexist, but that's what we assume. I had a long discussion with a client about that assumption for *FAS 106* purposes, because there it does make quite a difference. We came up with several theories about this. Although the age differential was three years for the

current retiree population, it must be more like one year for the current active population because we're sure with demographic characteristics being what they are, people are now marrying someone who is closer to their age. I think we're probably just backing into the answer, but the age differential assumption does have much more play in an *FAS 106* valuation.

MR. DUBNER: The four important economic assumptions are the interest/discount rate, salary scale, an assumption with regard to general inflation or the cost-of-living increases, and asset return. The interest/discount rate is a source of discussion particularly for accounting purposes. In fact, at the Enrolled Actuaries Meeting this spring, one session was almost entirely devoted to discount rates. This was in response to a letter that came out from the SEC in the fall of 1993. Both *FAS 87* and *FAS 106* state that a reasonable assumption in connection with discount rates, in other words a good discount rate, is the rate of return on high-quality fixed-income instruments. Although *FAS 87* gives you some leeway to choose other rates, the SEC basically said that for SEC registrants, you don't have a choice anymore. High-quality fixed-income instruments determined the rate to use. In an environment of very low interest rates and precipitously falling interest rates, what this did was cause actuaries to have to value plans using much lower discount rates than they had in the past, it forced liabilities up, created significant unfunded liabilities under *FAS 87* and under *FAS 106*. In many cases, for many employers, this resulted in a reduction in shareholders' equity. These employers were not very happy with the SEC over this.

For funding purposes in a pension plan, the assumption must be the actuary's best estimate, but there is not the same kind of volatility that exists for expense for pension and 106 expense calculations. That's really the biggest difference between the assumption for these two purposes. The actuaries who, to some extent, have more of a voice in determining what interest rates to use for funding, said, "This is a long-term obligation. We should use some measure of stability in determining interest rates." The actuaries perhaps had less of a voice in determining the rationale for discount rates under *FAS 87* and *FAS 106*.

MR. JAMES: I'm curious to know how many of you had clients, particularly if they had a September 30 measurement date for *FAS 87* and *FAS 106*, that changed their assumption after that SEC letter came out. A few. I had several clients that had to go back and change their assumptions. I think what happened to my clients was that they thought they may have an SEC filing, and they were afraid the SEC would disallow their filing based on the fact that their discount rate for *FAS 87* was too high. Did you have any clients that had this experience?

MR. DUBNER: Yes, we had a lot of them. Working for a Big Six accounting firm, this was an enormous issue for us. We had discussions with the auditors and our national accounting and auditing directorate. We were basically told if you have a client that's choosing to use a rate higher than a particular number, then it needs to be looked at very carefully, because if the SEC comes out with a letter, the auditor, the client, and the actuary all need to justify the appropriateness of that rate to the SEC.

FROM THE FLOOR: Would you care to mention the number, sir?

MR. DUBNER: No.

MR. JAMES: And was that nationwide or in the Atlanta office?

MR. DUBNER: It was nationwide.

MR. JAMES: There was some rationale that was developed for splitting the active and the retiree liabilities and valuing them at different discount rates. Did anybody have any clients that split those two up? Nobody did that. I talked to a couple of clients about that. Does anybody have any clients that use one rate for *FAS 106* and a different one for *FAS 87?* Nobody? I've got one, and when they went down to 7, we went to 7.5 for *FAS 106* and 7 for pensions. In fact, I had a discussion with the CEO of one company who thought that 7 was a little too conservative. I said, "Well, a lot of companies really reduced their discount rate after that SEC letter came out."

This company has a September 30 measurement date, and I told him that many companies did reduce their discount rate, and I didn't think 7 was terribly out of line. Maybe I shouldn't put that to a vote in this room. I may lose on that. But I'm comforted to know that at least Jerry had some companies that did lower their discount rate after that SEC letter came out. Did a fair number of them go to 7?

MR. DUBNER: Yes.

MR. JAMES: I feel better now. Go ahead.

MR. DUBNER: The salary scale assumption is appropriate for pension plans in which benefits are salary-related. We saw, in a number of cases, partly because of the SEC letter, many employers who were focusing on some of the other assumptions that they had been using. They take a look at their discount rate and they say, "Well, we're going to have to drop our discount rate by 1% in order to fall within an acceptable range." This salary increase rate of 5% is probably much higher than we've historically been granting or that we plan to grant in the future. So there were a number of employers who lowered their salary scale assumption in connection with this revisitation of assumptions in light of the SEC letter.

MR. JAMES: For *FAS 87* only?

MR. DUBNER: Yes, just for *FAS 87*. In some cases it was also looked at for funding purposes. I think that both assumptions have a component in it for the cost of living or general inflation rate. The consumer price index (CPI) has decreased by about 2% over the last three years. So, in connection with the reduction in interest rates, which would trigger a reduction in discount rates, it may be appropriate that salary increase rates would also decline and be declining perhaps close to or, perhaps at the same rate. Similarly, asset returns are perhaps not as great for 1993 as they were for previous years. Certainly anybody who has employer with a significant amount of assets and fixed-income instruments would find that their asset returns have decreased as well. So a general decline in rates for *FAS 87* purposes is the norm that we have seen.

There is another economic assumption in connection with *FAS 106* that you don't find in pensions, and that is the health care cost trend rate. That is the rate at which health care costs are assumed to increase in the future. This assumption is a very powerful one, and in fact it's required in the disclosure under *FAS 106*, to disclose what the impact of a 1% change in this assumption would be. That's the only sensitivity analysis that's required in any kind of actuarial calculations that are done for financial statement purposes. Typically a 1% change has anywhere from a 0%, and in other cases, up to a 20% or 25% effect on liability, so it's a very powerful assumption. It's one that would probably justify a session of its own. We can probably answer any questions, and maybe you might have a couple of comments about it. It is a very powerful assumption.

MR. ROBERT J. MURPHY: I believe the number was 14% in 1992 and that the health costs went up 14%. I believe the number was 10% in 1993. I think it's going to be even lower for 1994. I think this has to do with health reform in general. The drug companies and the medical profession are aware of what's happening, and I think they're cooling it, for whatever reason. So when I do my next *FAS 106* valuation, I'm thinking about dropping that to reflect this change.

MR. DUBNER: I think in connection with some of the changes or the slowing of the rate of increase of medical costs, one of the things that needs to be considered is that much of the decrease in medical care inflation has resulted from employers changing the types of benefits that they provide and the level of benefits that they provide to employees. For an employer that doesn't make these kinds of changes, for instance, an employer that doesn't move to managed care or doesn't change utilization patterns for their retirees health benefits, it's not necessarily appropriate to reflect such a sharp drop in the health care cost trend rate. In particular, the health care cost trend rate is supposed to be the "true" rate of medical inflation, and simply looking at statistics that say overall employers medical costs have dropped, or that the rate of increase has dropped from 14% to 10% to perhaps under double digits for 1994, may not give an accurate reflection of what a plan's true underlying health care cost trend rate is.

MR. JAMES: I'll make a couple of points about the trend rate. One is that employers basically assume that it's going to go down over time. I think most of the *FAS 106* valuations are now done based on a graded trend rate, so that you start out at your 14–12% or even 10%, and you grade down to 5–6% over 8–12 years, etc. I think there's a general expectation that over time those numbers are going to start coming down for whatever reason. I was looking at a graph of the overall medical trend over the last five years and it had started coming down. I don't remember whether it was 1991 or 1992, but you could see where it peaked and was going down now. I'm not sure why, but these things happen in cycles. You can't expect the medical trend to stay where it was.

I think, and this is just based on what I've seen, that even in an indemnity plan for group insurance pricing, flex pricing, etc., if you're pricing an indemnity plan, I am becoming more comfortable with scaling back on the trend rate that we're using, the 15% or whatever. We can scale back on that a couple of percentage points. I fully expect that *FAS 106* valuations will certainly be no higher, or have no higher trend rate, in 1994 than they did in 1993, and maybe some sponsors that weren't too

aggressive last year may want to go back and revisit that. I know many sponsors got fairly aggressive on that because they were going to book the transition obligation and they wanted that number to be as low as possible.

MR. DUBNER: I have one aside about this whole matter of decreasing trend rates. In connection with a field test that we did for the Financial Executive Institute, back in the mid-to-late 1980s, before *FAS 106* came out, we were looking at health care cost trends and came up with an economic model of increasing gross national product (GNP) and increasing health care cost trends. We came to the conclusion that if the double-digit increases continued, it would not be too long before everybody's reason for working is to provide health care benefits. So there's really a logical reason for having a rate that eventually comes down close to, if not all the way down to, general inflation. The economy can't sustain double-digit health care cost trends when the GNP is growing at 3%. The math just doesn't work out. Something is going to have to happen eventually. That's one of the reasons that you'll see trends that start out perhaps in the 10–15% range, but will ultimately be down in the 5–6% range.

The pension valuation is the application not only of assumptions but also of methods and there are several different types. There is a laundry list of different pension-cost methods. There are perhaps a couple that are most appropriate to look at such as the unit credit method. That's important because it's the method of choice of the FASB for *FAS 87* and *FAS 106* calculations. The other method is the aggregate method, because that's the method of choice for VEBA funding. Also, if you prefund post-retirement medical benefits, typically either a unit credit method or an aggregate method is used for determining the VEBA funding requirements under Section 419A. I think it's outside the scope of this presentation to go into detail about pension-cost methods.

To look at what the ERISA and IRS funding requirements are and go into detail about that would take several hours, but suffice it to say that there are some minimum required contributions under ERISA. In order to stay in business (that is, to stay qualified), a plan is required to have a minimum contribution made. On the other side of the spectrum, you can't put as much money as you want into a pension plan and deduct all of it. You can actually put as much in as you want to, but you lose the deduction and also have to pay excise taxes on the excess. So there is a maximum deductible contribution for a qualified plan.

Then there was a wrinkle thrown in by the Omnibus Budget Reconciliation Act (OBRA 87), which introduced the concept of current liability and threw a bunch of additional calculations into the mix both for minimum and maximum contributions for qualified plans. There are, again, no funding requirements for postretirement plans, except for certain deductibility considerations for VEBA funding. There isn't any limit on the amount that you can prefund, but there is typically not a deduction for prefunding postretirement medical benefits, which is why nobody does it.

Let's look at the three FASB statements that govern pension plans, *FAS 35, 87,* and *88, FAS 35,* as we mentioned before is a statement for the plan's accounting, and typically these numbers go in the plan's financial statement, which is submitted along with Form 5500 as part of the plan's annual filing. The *FAS 35* information basically

contains a balance sheet, an income statement, and a set of assumptions. *FAS 35* liabilities are different from the liabilities for funding and expense because they are typically the present value of benefits accrued to date and make no assumption as to future pay increases, future service, or certain other projections. In that way they differ from the liabilities that are used for the other accounting statements, and typically also differ from the liabilities that are used for funding purposes.

The requirements under *FAS 87* include the determination of liabilities. There's an annual expense to be determined, which is typically independent of the funding contribution that is made to a pension plan. In fact, a statement on *FAS 87* was issued that there were a lot of pension plans around that didn't have contributions, and employers would indicate that the accrual for those plans was what they contributed to the plan, which was zero. The auditors felt that there was actually an accrual that needed to be booked, and so they came up with their own rules, which are to a large extent independent of the funding requirements. Then there are disclosure requirements under *FAS 87*, and there are certain assumptions, which we've talked about, that are different for *FAS 87* than they are for funding.

There are two main categories that *FAS 88* addresses. One is the settlement of pension obligations, which is basically the removal of the risk component from the employer. In other words, if employers purchase annuities or pay out lump sums to participants, then they have effectively settled those obligations. The second is curtailment, as we mentioned earlier, which is the cessation of the accrual of benefits for a significant portion of a plan's population.

Those are the three statements that govern pension plans from an accounting standpoint. *FAS 106* is a combination of *FAS 87* and *88* as it applies to postretirement nonpension plans.

MR. JAMES: Has anybody ever settled, sold, or bought the *FAS 106* liability? I've seen some things from some insurance companies. For example, in exchange for a premium they would take that *FAS 106* liability off your hands, but I've never seen anybody do it. I don't even know what the premium is. I expect it would be fairly significant.

FROM THE FLOOR: Yes, we're pricing it, but we haven't concluded a deal yet.

MR. JAMES: Is that a single-sum premium?

FROM THE FLOOR: Yes.

MR. JAMES: Is it a large group? Small group?

FROM THE FLOOR: Yes, one's the Air Force and one's the Navy.

MR. JAMES: Got it.

FROM THE FLOOR: But it's not concluded yet.

MR. JAMES: You'd have to do a great deal of work to price that out to make sure that it's right. Just thought I'd ask.

MR. DUBNER: Yes, that's typically not the case, and typically what happens when there is curtailment under *FAS 106* is that there is some allowance given to current retirees. But unlike pension benefits, which typically vest for individuals after five years of service, an individual who is not currently eligible for benefits under a postretirement plan is, for lack of a better term, left holding the bag. The most typical approach that employers take in reducing their *FAS 106* liabilities is to tell employees that if you're not currently eligible for benefits, and in some cases, if you're not already retired, then you're never going to be eligible for benefits, that they're going to cut the benefits off at that point in time. Although there's considerable curtailment of benefits, there's not going to be an associated settlement. What usually happens or what would typically happen to a retiree group is that the employer will continue to pay medical benefits for these retirees who currently have them or face a lawsuit from them, and as the current retiree population dwindles to nothing, their liability just eventually goes away.

MR. JAMES: I think there's at least one lawsuit that is in progress. I don't know where that is. It seems to me that employers are being less paternalistic with regard to the retiree medical benefits, and before *FAS 106* they wouldn't think of changing it, particularly for the current retirees. They may think of changing it for people who haven't been hired yet or something like that. But it seems to me, and I don't know if there's agreement or disagreement, I saw some heads go up and down, that employers in general are saying, "Well, we can reduce or eliminate those benefits without much repercussion." Does that seem like a reasonable statement? OK, yes.

FROM THE FLOOR: Yes.

MR. JAMES: Yes, the feeling is, we don't have to do it. It's not a vested benefit. It's a headache and an expense that we don't need.

FROM THE FLOOR: Back in 1987, they were paying some of the costs out of these pension plans, and they did away with that, too.

MR. JAMES: Yes.

FROM THE FLOOR: Does that eliminate your unfunded vested liabilities, too?

MR. JAMES: Yes.

FROM THE FLOOR: I guess I can share with you what my did. At the end of 1988 we curtailed the benefits to future retirees by requiring that they had to have certain years of service and age to qualify for certain levels of benefits. They would get full benefits only if they had long service and were fairly old at the time they retired. That stayed in effect until, I think, May 1993, at which time the company said, "We will no longer provide retiree medical benefits." So that's how we handled it under *FAS 106*. It depends on when you tell them.

MR. JAMES: For current retirees?

FROM THE FLOOR: Oh, no. We didn't do anything to current retirees. These are for future retirees. Anybody hired May 1, 1993 and later will have no retiree medical or dental benefits. We never mess with current retirees or at least we haven't so far.

MR. JAMES: Yes, a fairly easy decision seems to be to curtail that benefit for future hires.

FROM THE FLOOR: It is also not done to union benefits.

MR. JAMES: Did you say you were from the United Auto Workers (UAW)? Would you like to address that comment?

FROM THE FLOOR: Certainly. From my observations over the last few years, I think we've had almost all companies that we deal with attempt to do something with retiree health benefits. When you hear of auto workers, you may think of three companies, but we're talking about hundreds, maybe thousands of companies that we're dealing with in different sectors. Many would leave current retirees alone and do something for future retirees. A number of attempts have been made, and I think a few successfully, to take the benefits away from current retirees. There have been a number of court cases held to decide whether these benefits, at least for current retirees, are a right that cannot be taken away, and even the courts I think have come out differently on one case versus another. I think the majority have probably upheld the retirees, but there have been some that have upheld the company.

MR. JAMES: I have a question. What's your view of caps? You know what I'm talking about? Capping the benefit?

FROM THE FLOOR: Yes. I need to say this is my own view, not necessarily that of my employer. I see caps as useful tool in negotiating *FAS 106* liability, as it almost always has become an issue. I have heard individual accountants dismiss the cap idea as a total sham. However, I think that the accounting profession in general is accepting it now. There are other techniques that may also lead to similar results, such as a very rigid eligibility policy where somebody doesn't start accruing rights to these things until they're ten years from retirement age, or something like that. That's another effective tool and I've seen almost no disagreement with that one from the accounting community.

FROM THE FLOOR: I'd just like to ask a question that has been bothering me for some time. We talk about calculating all these *FAS 106* liabilities and costs as if these are annuities that will become payable at retirement. But according to the U.S. Department of Labor's study that was published, I believe in 1990, nearly all post-retirement medical costs are incurred in the last five years of a person's life. These are not life annuities. These are almost pseudo-death benefits. I wonder if people here have thought about how it should be valued and whether you have done anything about it.

MR. JAMES: Do we have a response?

FROM THE FLOOR: Yes, to the extent that I use different costs for active people over 65 as opposed to retirees, so implicitly I've built that into it, I think. As a matter of fact, looking at a large group, I think we've had some 80-year-old actives, and I think their cost is something like 40% or 45% of the retired group of the same age. The difference is striking.

MR. DUBNER: Right. In our analysis of postretirement average annual costs, we noticed in a typical group that there's between a 50% and 100% higher utilization rate or average annual costs for a retiree at a given age than for an active employee who's that same age. There are typically differences in utilization because retirees have the spare time to go seek medical treatment. They don't have to go to work. They can more easily make a doctor's appointment. Also, people who are in poorer health tend to retire earlier.

I'd like to address the issue of whether liability should be valued as annuities or as lump-sum payments in the year of death; that is a very interesting point. It is an issue that has been addressed as a problem, but not yet solved, both within our firm and also in a research group that I am a member of. We are still wrestling with that issue, but it is a very important point. I think it gives some food for thought to for people who think of the *FAS 106* calculation or a liability determination as nothing more than the application of some mathematical formulas that are cut and dried.

MR. JAMES: I think any time you compute average claims, obviously we don't know at what age that person's going to die, so we have to come up with some average claims for all the people that are that age. That is a good question.