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Actuarial Issues—Part 3 of Pension Negotiation Seminar

Track: Pension

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Summary: Panel members discuss their roles in actual pension negotiations. Topics covered include neutrality versus advocacy, maintaining a long-term relationship and the role of the "third" actuary in a dispute. Attendees learn how actuaries deal with common conflicts and how to conduct themselves in a professional manner in a difficult advocacy environment.

MR. PAUL ANGELO: The first speaker is going to be Bob McCrory from EFI Actuaries. The second speaker is going to be Steve Brannon from the Segal Company. And the third speaker is going to be Ira Summer from Public Pension Professionals. They're all FSAs.

MR. ROBERT MCCRORY: Let's talk about the negotiating environment that we often find ourselves in. Now, what we're looking at here are either multi-employer or public-sector plans. What's going on when we're negotiating? Negotiating could be dynamic and exciting. There are a lot of new ideas around for plan provisions. There are new people involved that we often don't get to interact with—sometimes people higher up in the organization, people we don't usually associate with. There's a lot of time pressure. It makes us feel almost like we're in an emergency room. And the actuarial input is really critical. They are paying close attention to what you have to say; whether a benefit gets in or not may hinge on it. So it's very important, and you are, in very many circumstances, the center of attention.

The negotiating environment is also dynamic and dangerous. If the ideas are new, they are sometimes half-baked. New things will be suggested, and you'll be given very little time to formulate an opinion. "Let's use the so-called excess earnings for benefit improvements," for example. What excess earnings? How do we define it?

If new people are involved, they often are very inexperienced with the pension plan and have different points of view. Some of these new people who are involved don't know what normal cost is. So your communication style may have to change radically.

The dynamics of the group that you're dealing with are completely different. There's a lot of time pressure, often 24 hours or less. You don't have time to think. The data that you need may be limited or nonexistent. And if they are listening to you, your liability is crystal clear, because what they will say is, "Had you not told us this, we would not have reached that decision." It's an exciting and dangerous type of an assignment.

So the plan today is for me to be your instructor in avoiding the "dark arts." What we're talking about here is how to stay out of trouble. We're going to be looking at three case studies. These are case studies where things went wrong. We're going to look at what happened, what mistakes were made, what caused the mistakes and what we can learn from them. And I will leave with you a quote, "Wise men learn by others' mistakes, fools by their own."

Now, the case studies, all three of them, involve both large and small errors. Some resulted in litigation, others did not. None of them involved gross negligence. None of them involved unprofessional conduct or deviations from professional standards. In a sense, these were smart, hardworking actuaries that got caught in a situation. They're people just like you. These are cases where bad things happened to good actuaries.

In case one, the client lies. This happened some 30 years ago. It was a brand-new multi-employer plan that was being established as part of negotiations. It covered department-store clerks. There were absolutely no member data available. There was no time to get any. The actuary was told, "Look, this is a very high-turnover group, probably the average service is three, four years. Just give us a ballpark estimate. We won't hold you to it."

Now, this actuary was smart, and he was experienced. He had a lot of multi-employer experience. He'd worked with a lot of plans. Based on what he was told by the client and his experience, he said that benefits usually cost around 10 cents an hour. Now, this was roughly a 30-year-old plan, so 10 cents an hour with department-store clerks was significant but manageable. So the plan was put into place.

What happened? Well, they gathered the member data. And, in fact, what the actuary was told was indeed true. They did have a very high turnover. The average service was, indeed, very short. But there was a core of little old ladies in the cosmetics department who had been there for 20 or 30 years and who were never going to leave, and that was the core of the liability of this plan. So instead of this plan costing about 10 cents an hour, it ended up costing like a $1 an hour. It got to be a pretty big deal. Litigation was avoided, mainly because of good relationships between the firm and the client.

So what was the mistake here? Well, maybe proceeding at all was a mistake. I'm very much of two minds about this. I have a lot of trouble saying "No" when someone asks me what my opinion is. I have lots of opinions, and I'm glad to share them. But perhaps the actuary would have been better off not saying anything. Relying on high turnover is probably a mistake.

So what lessons can we learn? Clients lie. I had a hospital administrator sit across from me and look at my assumptions for turnover and say to me that they were wrong. "We have 35 percent turnover a year in this hospital. You've got 5 percent and 10 percent. That's just wrong." Well, from his point of view, as someone who's responsible for running the hospital, and hiring and doing all that kind of work, he's right. They have 35 percent. But the turnover is on the lives that don't matter to us, the new hires and the people like that. From his point of view, those people matter a lot, because he is hiring them. From our point of view, they don't matter at all, because their liability is virtually nil. So clients lie, in the sense that they see the world differently from us. And we need to understand that difference.

However, client knowledge is absolutely indispensable in a lot of situations. One of the things that I keep telling my clients over and over again is, "I know the numbers, but you know the people." The knowledge that they have of the people can be very vital input. One time, I showed some clients a salary scale that I had just derived, and they looked at it and nodded. And they said, "Bob, that's all very nice, but we just renegotiated that." And I said, "Well, when I get the data after the negotiation, I'll take a look at it." And they were right; the data had changed significantly. They had a $500,000 difference in their annual contribution. So that client knowledge, that knowledge of the people, is really vital.

So here are some examples of where client knowledge is vital. Early-retirement windows are a classic case. How many are likely to take it? Who will take it? There's a lot of interaction that should occur between you and the client in this area.

The deferred-retirement-option-program (DROP) is where a public employee can announce that they're retiring, while they stay on staff for a period of five years. They receive their pay, and their benefits (computed as of the entry into DROP) go into an account, a virtual account in their name. When they finally retire, they get the lump-sump account, plus their benefits, computed as of the beginning of the DROP period. DROP is very sensitive to election rates and how other retirement

rates will be affected. Client input can be very important. You can think up questionnaires, but they can help you with that.

Benefit changes—is member behavior likely to change in the event of a benefit improvement? Again, your clients can help you a lot; but keep in mind, you've got to understand their point of view. Involve the client in the discussion of assumptions and pricing. They may be critical in setting new assumptions. But recognize that the client's point of view has limitations, as does your own. And remember that, ballpark estimate or not, once the number goes out, it has a life of its own, and you probably will be held to it.

Case two involved a statewide, multiple-employer plan, a big one. In 1993 the actuary computed the cost of a plan improvement. He was increasing the multiplier, so they went from something like 2 percent per year of service to 2.5 percent. They used the same actuarial assumptions, in particular for retirement, that they'd been using in the valuation. They made no change. In 1996 that improvement had gone into place, along with some others, and the actuary recomputed the cost of that increase in multiplier, and the cost of the improvement about doubled. And earlier retirement was assumed now, because of a change in assumptions.

There was an unfortunate phrase used in the letter communicating this information to the client that almost, to anyone who looked at it, said, "Litigation starts here." And it did; litigation ensued. Now, the plan and the state's argument was that the actuary computed the cost on valuation assumptions and that the actuary should have known that member behavior would have been changed by the increase in benefit. Therefore, by having not even considered a change in retirement assumptions or having priced on any sort of new assumptions, the actuary was liable.

The actuary's argument was, "Hey, we used the information that we had at the time, and it was the best data that we had at the time. And the cost increase actually was caused by compounding the cost of several benefit improvements together." And then there were other arguments that were brought up by the actuarial firm dealing with the changes in cost method and the passage of time.

So what was the mistake here? Probably it was failing to question the assumptions when the benefits changed. We all know benefits drive behavior. "If you build it, they will come." Look at some examples of where benefits drive behavior. Improved early-retirement benefits will cause more members to retire early. This may have been a factor here. An improved multiplier can have the same impact. If you have an interaction of the multiplier and a maximum benefit limit, you can have a particularly pernicious effect on cost. Because if your multiplier increases, for example, from 2 to 3 percent, but your maximum benefit remains, say, at 90 percent of high-average pay, that 90 percent, from being of academic interest, now moves right into the heart of your retirement rates. And if you look at studies of retirement behavior, you'll see that people often tend to leave when they hit that

maximum benefit level. That could have a major impact on your retirement rates and a major impact on the cost.

Other examples of benefit changes that can have an impact on costs include improved disability benefits. I once did a valuation for a police and fire system that in the nine years prior to the time I did the valuation did not have a single service retirement. Every single one of the couple of hundred people who retired did so on disability, because the disability benefit was better than the retirement benefit.

Introduction of a DROP will have an impact on your retirement rates. If you change the definition of pay for benefits, you can have major impacts on benefit levels. For example, I had one group of firefighters and police officers that were able to fold unused vacation and sick leave into their high-average pay for benefits. I did a quick study, after years of this being in place, and found that, on average, those firefighters and police officers eligible to retire had about 1,800 hours of unused vacation and sick leave, or approximately the equivalent of another full year of pay. The average impact on their benefit was about 40 percent. So adding volitional elements into a pay scheme, where the members have the freedom to take advantage of that, can have a major impact on cost. And you need to recognize that in the best way that you can.

What are lessons from this mistake? Changes in benefits force reexamination of assumptions. Take a second, at least, to consider changing the assumptions. Even if, for example, it's a relatively small increase in a multiplier, put somewhere in your project notes that you considered a change in assumptions but rejected it as being not likely to be material in this situation. Considering it and deciding against it is probably a lot more defensible than not having any evidence of having considered it at all, so at least make a note. Recognize, as I'm sure you all do, that you can have multiple improvements compounding costs. Involve the clients as you set the assumptions. Understand that they know the people. Try to draw them into the situation so that it becomes "our assumptions" rather than just "your assumptions, Mr. Actuary." Bargaining units also can help. They can tell you how interested their members are in these various plan improvements, and you may be able to get some feeling for utilization from that.

In case three, the plan goes into shock and requires a major transfusion of employer cash. This occurred in a school district. The members of the school district were covered by a statewide teachers retirement plan. They inaugurated a supplemental plan to pay early-retirement reductions for the members of the teachers plan. So, in other words, this gave them back the early-retirement reduction if they retired early.

We took over this case, and from under 1 percent of pay in 1996, it kept working its way up to nearly 2 percent in 2000. The cost had been increasing about 15 percent per year, compounded in the face of a tremendous bull market. What was happening here? Well, this plan was hemorrhaging, so we needed a type and cross-

match for an infusion of cash. So there was a pattern of actuarial losses in this plan. Where was it happening?

The asset allocation was pretty traditional. It was about a 60/40, two-thirds stock mix. There were tiny actuarial losses from investments in 1999 and 2000, but that wasn't enough to account for this increase in cost. Pay increases had been moderate and near assumptions. It all pointed to something demographic. And so we asked to see the actual retirement dates of the retirees, which they had not supplied us. We were just looking around for some average age at retirement, something that could give us a handle on things. And what we found was that most members were retiring before they were eligible. Now, that was kind of exciting to find out what was going on.

So one of the things we found was that the eligibility and benefit depended on all state service, not just your service with that particular school district. So if you worked 20 years in one place and 10 years at this particular school district, this particular school district would pick up your entire early-retirement reduction from the statewide plan, not just one-third of it. But the service data given to the actuaries included only the district service. That's all they were getting. There was a very brief plan outline in the valuation, but it did not even address the service issue, which ended up being very significant.

Moreover, they used the statewide retirement assumption, the statewide retirement rates to price this plan. Now, at this point, you should see a glaring error. If you build a supplemental plan to replace an early-retirement reduction, it is likely that more people will retire early than if they didn't have it. And that wasn't done.

So the outcome of this was that we gathered new member data that actually included all service. The cost went up roughly 25 percent to about 2 percent of pay. And we changed retirement assumptions to more closely match what actually was being observed. The new cost ended up being at 3 percent. Now, that's probably four to six times what they were told was the plan cost when this plan was established. We're not popular there. In fact, we lost the case the next year. They went back to the old actuary.

Did the state change its actuarial assumptions to recognize the existence of one or maybe more supplemental plans. The answer is, to my knowledge, "No."

In this circumstance, in which you're confronted with a new plan and no data, what do you do? I think that, number one, you should look around. See if there's anyone else that has it. I had success in one case in which they changed multipliers at age 65 to increase them. I looked at another similar transit district in which that had been done. And I was able to sort of blend, match and merge existing experience with a current plan with new experience, or experience from this other transit district, and come up with something that, oddly enough, actually worked and held

up. So look around to see if there are any other examples—in this case, supplemental plans.

Number two, it's not a bad idea to run the cost at the absolute extreme, the absolute worst-case scenario, to find out how bad it can be: if everyone takes early retirement at exactly the worst age, for example.

What can we learn from this particular case? Number one, use the plan outline to communicate. My rule of thumb that I share with my clients is that the plan outline ought to be comprehensive enough for me to write computer code from. I should be able to take a plan outline, give it to my client, have them approve it, and then give it to an actuarial programmer and say, "Code this." When I look at plan outlines for other valuations that I see from other actuarial firms, I don't find that the majority of them meet that criterion. I think it's a very valuable tool for communication and for risk reduction. Get your client to review and correct it. That way, your client is onboard, and they can notify you and you clearly have recorded their ability to notify you if you have any misconceptions about the plan.

Also, in negotiations it's frequently the case that one benefit change will affect others. If the multiplier changes for retirement, does that change the multiplier that's used for disability? In certain circumstances, it may not. You can work through the outline when you're looking at proposed plan changes and identify those half-baked ideas that have unintended consequences elsewhere in your plan. Benefits drive behavior, as we said in case two, and so your assumptions must depend on benefits.

That brings us to the end of our three case studies. The lessons that we can derive from these three are that clients lie, but clients also are a great source of information. The numbers have a life of their own, even if you wish they would die. Benefits drive behavior and, hence, assumptions. Cost increases can compound. And use the plan outline to communicate with your client and to reduce your risk.

MR. STEVEN BRANNON: As Mr. McCrory very eloquently put it, "If you build it, they will come." This is definitely an issue that you want to consider when you're doing negotiations, because you are considering a lot of new benefits for which you haven't had a lot of time to think about effects on the population. Early retirement and disability are, obviously, two that come to mind very easily, but there are others. And you're working with them very quickly. So you do want to keep in mind that changing benefits is going to change behavior, and changed behavior is what you're trying to model, after all. So you may need to change your assumptions.

But there's a second point that I want to raise about setting assumptions, and that is that, unlike funding valuations—where you're very interested in the long-term and you're assuming a continuing plan and a long-term plan—it may be that short-term effects are going to have some impact. Negotiation cycles are relatively short-term—two to five years, normally. And you are going to want to test some things,

such as what happens to the credit balances and what happens to maximum deductibility during the term of this contract. In a lot of the contracts that I work with, the contributions are put in as a fixed amount. On both of those items, you want to make sure that this fixed amount is going to be enough to pay for the funding standard account. And, on the other hand, you want this fixed amount to be deductible during the term of this contract. And short-term influences, especially in market results, can make a big difference in what is going to happen.

I also find myself working quite a bit from both ends, looking at the benefit side and what's going to happen with benefits. And the other side of the table may be understood in what's going to happen with contributions. I'd have to say that that's almost always the case in negotiations. One side is interested in benefits and how that's going to help them. The other side is very interested in the contributions and how much they're going to have to pay. And obviously, these two things are in conflict—especially with the traditional actuarial sense that, "Oh, we've got a 60-year plan in the fund here. We're not concerned what happens next year or the year after that, because it will all get fixed 15 or 20 years from now." Actually, a lot of very interesting things can happen, especially if you're going in and out of full funding. I mean, one side is going to be very upset about that. On the one hand, if you are in a situation where you're reducing or even suspending contributions, the funding standard account can disappear very quickly, so you want to watch out for that, too.

The other point that I want to make here is that you focus on normal costs versus contributions. I think most of us have run into this situation. When we're improving benefits, sometimes the deductibility issue causes us to need to do something with the benefits and improve the benefits to help the deductibility issue. At the same time, though, depending on the design of the benefits, it may increase the normal cost and drive your normal cost to a point where your long-term funding of the plan is no longer viable, although you're solving a short-term problem. That happens a lot of times while not even in the context of negotiations, but certainly, you have to be more aware of it when you're in negotiations.

Clearly, when the union brings proposals to you, they normally don't have anything in mind as to how well the plan's going to be funded over the future. They're much more interested in the benefits and the immediate effects. So you want to take that into consideration.

Negotiations are very exciting times, very dynamic, but it's also very important to be clear on what kind of work you're doing. Probably a lot of us are very familiar with pensions, and we consider ourselves to be pension experts. And when we're in the room discussing benefit changes and what the effect of various costs are going to be, we're thinking very hard about the pension plan.

However, negotiations don't happen in a vacuum. In most cases, the union and employer are not negotiating on the pension plan only. And it's very often the case

that changes in the pension are going to affect other benefits—most notably, the retiree medical, if there's a retiree medical program. But it also can effect other benefits if there's an long-term disability program that's being negotiated. And a lot of times, as an actuary, specifically if you've been retained for a long time on the pension plan, you may not even be aware of what these other plans are, and certainly you need to expand your mindset a little bit to bring them into consideration. It's probably best to reduce your risk by thinking outside the box, if you can.

There are a lot of things that get discussed in negotiations that are outside of the traditional benefit-setting role that you might traditionally think of. Operational aspects of the pension plan also commonly are discussed—not just a strict benefit design, but operational aspects, such as how work after retirement is going to be handled. Depending on the economy and the mood of the union employees, from time to time, these arrangements can run the gamut—anywhere from not wanting any retirees to come back to work at all to situations in which both the employers and the union might be very interested, if they've got a shortage of people, in increasing the amount of hours that retirees can come back and work. In most cases the assumptions really don't have any consideration of retirees coming back to work. But any changes that happen in these arrangements—which can happen in negotiations—can have a dramatic effect on the cost of the plan. If retirees are going to be allowed to start drawing their pensions and, essentially, just continue to work, things can happen. So you want to be aware of what's being discussed in this kind of area, and at least be prepared to give some input on how that might affect normal cost, how that's going to affect turnover. What's going to happen if retirees continue to work? Obviously, it depends on the plan design. In some cases they continue accruals. In some cases, the accruals don't continue. So you've got to be aware of that also. It's not a traditional benefit-design thing.

The return-to-work issue comes up quite frequently for you, as a consulting actuary, in negotiations as to what kind of you're work doing and whom you're working for. Plan sponsors and multi-employer plans really have two different hats to wear. Around the trust table and in the environment that we see them most of the time, for three or four years at a time between negotiations, they are trustees or fiduciaries. They—theoretically, at least, if not in practice—have the interests of participants as their primary obligation. In negotiations, however—although they may be dealing with exactly the same people—their role has changed somewhat. Now they're in what you might call a "settlor" function. They're operating for the benefit of either the company or the union, depending on which side they're on. Not only has their role changed, but it's possible that your role, or the way they see you, may have changed, as well.

I don't have to tell you that when we're working for plans, we are an employee of the participants, and we have the participants' best interests at heart. In negotiations you may be hired as the plan actuary, and you still have the plan as your primary client and the participants as your primary responsibility. You may be

hired by one or the other side in more of a settlor function. So I think it's important to keep in mind which of those roles you're acting in.

There are some changes that the bargaining parties might want to make—such as saying, "From now on participants can work, but they can't draw their pension and continue to work." Normally, trustees in the fiduciary-plan participant setting wouldn't want to make a decision like that. They'd be better off, from a legal standpoint, to make that kind of a decision as a settlor and put it into negotiations. So participants might see some of these things as a benefit cutback, if you will. You're going to find them happening in negotiations, because it's a safer place for the union and the employers to do it. And so you should be aware that that's where it's going to come up. It's not really a fiduciary type of issue.

In addition to setting assumptions, we also have asset methods that we can deal with. I said earlier that when I'm working negotiations, I'm not necessarily using exactly the same assumptions that I used when I was doing the valuation. Obviously, you want to know what the assumptions are for the valuation, because when the negotiation is over, you're going to be back in the role of signing a Schedule B. And whatever costs you've put on these things, it's going to have to be signed off on. But during negotiations, there may be some changes made, and you may want to model what's going to happen in the next year or two. That's particularly true with assets. In the role of negotiations, the parties may be interested in taking a look at what would happen under different assumptions, and they might also be interested in taking a look at what would happen under different asset-valuation methods.

Traditionally, at least in the way that we've practiced, assumptions are purely in the realm of the actuary. However, in things such as the asset-valuation method, the trustees are behind those, and the trustees are making decisions on that. And so the trustees could legitimately make a decision to use a different method, instead of whatever asset method was used in the past. It may involve writing up the assets, that is to say, using up some of the stored gains that you have had in the past several years and taking the difference between actuarial value of assets and market value of assets into account.

Actually, that was more popular a few years ago than it is right now. Because right now, there are not a whole lot of stored gains to take into account, and we have the opposite side of the question, which is that many of our plans, if not all of them, are upside down. Market value may be below actuarial value. Pretty obviously, most actuaries and most bargaining parties are not going to be interested in doing any kind of write-up and recognition of market value.

However, what you have to keep in mind is that you can't just say, "Okay, my assumption is 7.5 percent, so I'm going to get 7.5 percent for the next three or 10 years." Knowing you have these stored-up losses, it's at least possible—much more possible when you've got stored-up losses—that you're not going to be hitting 7.5

percent, at least for the next one, two or three years, depending on how big those stored-up losses are. I mean, this is the primary place where you're going to be thinking about the short-term versus the long-term. Despite the fact that we're looking for 7.5 percent, or whatever we're looking for over the long term, we may not be seeing it in the next two or three years. You actually have an idea of what your results can be for the next couple of years if you take a look at where your market is, compared to your actuarial.

Getting back to this issue of settlor versus fiduciary—I also, quite frequently, run into a situation where I may not be the sole consultant or the sole actuary on a plan or in a negotiation. It's something that you should think about. It happens frequently for me. It's something that you want to be thinking about and prepare for, because your role is a little different, depending on what you're doing there and who you're working for.

As actuaries working with plans, traditionally, we have this very middle-of-the-road stance. You know, "We're pure, and we only do the right thing." When it comes to negotiations, especially if you get into a co-consulting situation, you may not maintain your purity. You may not want to, and you may not be able to, actually.

Sole consultant—first of all, let me deal with that. Obviously, I'm not telling you anything that you don't know here. One of the risks that Mr. McCrory was talking about is the financial type of risk of getting sued for making an actuarial mistake. Obviously, there's another type of risk here, which is making the type of mistake that gets someone upset with you and causes you to lose the client, as a result of what was done in negotiations. So clearly, as a sole consultant, you're going to stay neutral, which is basically impossible to do. I mean, it won't be seen that way. Each side will see you as tilting toward the other, but if they both see that, then that's probably a very good indication that you're doing the right thing. Let the chips fall where they may. You've got to be aware that most things that you say can have a spin put on them by the receiving party. Each side hears you a little bit differently. When saying, "Oh, the unfunded liability is going to be $500 million," it may seem like a simple fact. But some people say, "$500 million? We've been higher than that before. It's not that bad. It will all get amortized over time." And, of course, the other side is saying, "Oh, $500 million, that's three times what our current unfunded liability is. It's a big disaster." From a simple statement like the amount of liability, there are definitely a lot of ways to hear the same thing. Even if you put it in writing, each side is going to read the part they like, and they're going to slight the part they don't. So you've just got to be aware of that and be extra careful.

As a sole consultant, you'll often be pulled aside by one side or the other, and they will say, "What if we just made this tweak in it? Instead of a benefit increase of up to $500, we only want to go to $350. But don't tell the other side that we're looking at this, because that will show a sign of weakness in our position." Although you want to be neutral and you want to give all the facts, I think that there will be situations in which it's very important to keep their confidence. If you've been told

something in confidence, you want to keep that to yourself, at least until the time that it comes out.

Whatever is said in that room doesn't come out. But whenever we're in the middle of anything, you have to verify those numbers. So I think it's very important to get an understanding of the parties. But if you've already been hired in that sole-consultant role, you are an expert, obviously. You have some expertise that they don't. They are depending on that. And you can walk that tightrope. It can be tricky, but it can be done as a sole consultant. And there are many situations in which they are relying on actuaries as sole consultants. The clients are going to make the decision, in most cases. But they might say, "We don't trust you. We have to have our own expert." And then it's going to devolve into either joint consultants, or it could even be three—one as a plan actuary, one for each side of the bargaining parties.

So, speaking of co-consultants—which is something that I do quite frequently—one of the first questions that you think about is what your role as a co-consultant is, especially when you get to negotiations. Are you now an advocate for one side, pushing your point solely, without regard to any actual principles or anything like that? Probably not. But clearly, we still have standards of professionalism. My traditional approach to this is to deal with the co-actuary and get some kind of an agreement on what assumptions we're going to be using. And presumably, if you have agreement on assumptions, you have agreement on what the numbers are for any particular benefit improvement or for any change in the funding method or the assumptions. That's not to say what the parties are going to agree on ultimately, but at least you know that if it's choice A, choice B or choice C, you have the same result.

In my experience, you are a much more credible expert if all the experts are agreeing on the numbers and leaving the policy to the policymakers, as opposed to when the experts start arguing between each other as to what the correct assumption is. It's an esoteric exercise that the clients can't fully appreciate.

I think this comes up in merger-and-acquisition work, as well, where the other side has developed a proposal and some numbers to go along with it. Even when you've agreed on the assumptions and you've agreed on the method, as you get it and check it, you say, "Wow, something is really off here." This gets to be a fun exercise, in which you decide what you are going to do with that information. "Did I make a mistake, and he or she is really correct on the other side? Or is the mistake on the other side? I know what it should be. Now, what am I going to do with that information? Am I going to tell my clients? Am I going to go back and tell my colleague across the aisle?" And I'm not giving you the answer here.

I work with the same consultant quite a bit, so in my case I have a long-term relationship not only with the client, but also with the co-consultant. So that might change your thinking about this a little bit. If you're going to be working with this

same person year after year, how are you going to deal with this kind of thing? But, eventually, negotiations are going to be done. You're going to be back in your role as a plan actuary or a plan co-actuary, as the case may be, and you're going to certify either the numbers that the other side gave you or your own. So at some point, you're going to have to disclose what you know, and you'll get into the question of what you knew when.

I'm not an attorney, but my understanding of law supporting negotiation is, to the extent that one side knows that something is an obvious error, they do have some duty to disclose it to the other side. So I'm throwing this question out for you. In my thinking, at a minimum, I want to disclose it to the client, and then I can at least get the client's input. And maybe if they tell me, "Go get it right," or on the other hand, if they tell me, "Definitely, don't do it," at least you'd be on a little better moral ground.

The fiduciary or settlor function is something that you have to think about. Obviously, we're not fiduciaries. I try to maintain that position. Not all attorneys agree with me, especially when a mistake has been made, but that's my position.

Plan design is not really a fiduciary function. There's a lot of discussion about this, not in multi-employer, but in single-employer plans. It's very clear that certain things are fiduciary functions. Plan functions and other things are company settlor functions. And never the twain shall meet.

A very interesting spin-off from that concept is, Who pays? You know, certain things can be paid from the plans. Other things that cannot be paid from the plan must be paid by the employer. I think the line is very clear when you're dealing with a single-employer plan, as to who pays for what and which functions are settlor and which functions are fiduciary.

When you get into multi-employer plans, I don't think the distinction is quite as clear. In fact, I think the line is quite muddled. I think that most things that multi-employer boards of trustees do could be considered part of plan functions and are legitimately part of plan operations, and therefore are payable from the plan—even things that very clearly, in a single-employer situation, could not be paid for from the plan.

MR. IRA SUMMER: I'm not talking about the standard actuarial stuff that goes on day-to-day. I'm talking about negotiations. So what should you be doing? Who are you doing it for? How do you do it? And then, what else do you have to do? Your clients are going to ask you to do some things, and there are times when you will do exactly what they ask you do. And there are times when you need to know what else you need to do, as an actuary.

I know that I'm going to get some whining, so we're going to get it out of the way right now. "No, I can't do it that way. I can't do the right thing. I don't have the

time. I don't have the budget. Nobody gave me any data. And I really don't know what they want." Yes, but you are still expected to do the right thing, whatever the right thing is. So what we're going to have to talk about is what you do when you don't have time, when you don't have the budget, when you don't have data, and when you have no clue as to what your client is actually asking you to do.

Okay, step one—you need to know your role and your responsibility. The first question is, "Who's my client?" You may be in a Taft-Hartley Act situation. You may be in a public-sector situation. You may be working for a union. You may be working for management. You may be working for the plan. Those are very different roles, depending on who your clients are and what you're doing. Someone asked before regarding what you do if you are the plan's actuary, and one side or the other is asking you to do something. Should there be more than one actuary involved? The answer is, It depends.

One of the things that I would recommend is that you don't make up the rules. You make sure that the other side decides what the rules are going to be. If you're the sole actuary and everything that you do is supposed to be disclosed to everybody, they make that clear, and you play by those rules. If somebody comes to you on the side and tries to get some extra information, if you intend to keep the client for longer than the answer to your question, you probably want to make sure that you follow the rules. And as long as they've made the rules, you at least have a better than 50/50 chance that they'll follow them. If their rules are that you're allowed to tell one side something and keep it quiet, they're their rules, and they'll understand if you've done it.

MR. MCCRORY: And on that point, there are a lot of different situations. In some cases, you have to ask them to set the rules. We have a lot of situations in which we may not be formally supporting the bargaining parties. We're working for a Taft-Hartley plan, let's say, and everybody knows that the bargaining is coming up. We start getting these questions coming up at the trust meetings. You know, "Oh, what if we went to a 30-year service pension? What if we shortened the 30-year service pension to 25?" And then you'll get a phone call from one trustee asking you to run these numbers.

Now, aside from the question of whether you have to send those answers to one side or both sides, there's a question of who's going to pay you for running these numbers, because you've not been authorized by the board. You've been authorized by one trustee. So I have, in almost all those situations, made it clear to the trustees that they need to decide who is allowed to authorize new cost studies to be done. What we usually do is say that anybody can come up with the idea, but it has to be agreed to by chair and co-chair, which usually will be the head of the labor side and the head of the management side. And then, when the "wild card" trustee says, "Hey, would you run these numbers?" I get to say, "No, I won't run those numbers, because you need to get it approved by both." You will get people

throwing these requests at you, and you frequently will have to go to the board and insist that they give you direction on who is authorized to incur cost studies.

MR. SUMMER: Will these rules be in writing? It depends on your group; it depends on the client. As long as both sides absolutely hear it and absolutely understand, you're fine—especially if you're doing it over a long time period of time. If you're starting something new, you may want to be careful. I don't know if you necessarily need to have it in writing. But, again, you need to have it announced; you need to have it clear.

MR. MCCRORY: Usually, get it in writing. At a board meeting, when minutes are being taken, raise the issue and turn to the administrator and say, "Please, be sure that's in the minutes." And if they send you the minutes to review—which, actually, a lot of our funds do—if it's not there, put it in there. The minutes are a good place for it.

MR. BRANNON: The other possibility is that if someone sends you something, you can actually send a letter back, along with everything else, saying, "This is my understanding of what you asked me to do."

MR. MCCRORY: In certain circumstances, with some clients, you can find someone who is part of the organization, in some way intimately involved with the day-to-day functioning of the board, who can advise you. So it might be, for example, a plan administrator, it might be a board member, it might be somebody who's served a long time and knows the politics of the situation. And they can advise you on some of these things about structuring this. Now, in many cases, in Taft-Hartley, for example, it's very cut-and-dried. You know who the players are, and that sort of a relationship doesn't exist. In other circumstances, particularly in the public sector, it can exist, and you can have somebody who can advise you in an informal way about these issues and give you some clues about what dynamics will exist during negotiations and how you should deal with these things. So, if that errant trustee calls you, you can then call your advisor and ask what to do.

MR. SUMMER: This actually gets to the next issue I've got here, which is, "What's my role?" Your role may be different in different situations. Maybe you work for the plan, and your job is to make sure the calculations are right. Your numbers are going to be trusted, and everything is going to be worked on, based on those numbers. On the other hand, you may be working for one side or the other. And in that role, for one side or the other, you may be behind the scenes, as an advisor, helping them figure out exactly what's going on. There may be a plan actuary. Your job is to help them figure out what kind of numbers the plan actuary would come up with if the plan actuary were asked to price something. (What should they say to the actuary to make the numbers come out a little better one way or the other?) Your job may be to behave as an advocate. You may be sitting at the table, and your job may be to yell at the other actuary and tell him that he doesn't know what he's talking about. There are different roles. Knowing where you are along the

spectrum may mean that your job is a little bit different, and your relationship with your client ends up being a little different. And the information that you prepare is a little bit different in each of those situations.

And then the other question is, "How's my work going to be used?" If this is for the Schedule B, then you've got the government looking over your shoulder, and you've got pages and pages and volumes of rules that you absolutely have to follow. Is it for employee communication? In that case, you not only have to answer the questions they ask, but you need to make sure that you understand how they're going to read this, and what questions they should have asked, whether they asked them or not. Or is this just background information? Is this just for people in the smoky room on the side to know, and nobody outside of that room will ever know the information you prepared? The type of information, the amount of background work that you do, and the way you communicate it need to be different in each of those situations.

Okay, step two—so you need to know what you're looking for—not just whom you're working for, but what you are looking for. Do they know the benefit they want? Do they want to know the costs, or do they know the costs and want to learn the benefits? I've been in situations before where people have said, "Yes, I want my multiplier to go from 2 to 2.5 percent." I've been in more situations where they've got $10 million to spend. "We'd really like to get this benefit, this benefit and this one. Tell us how much we can get. And if the total is more than $10 million, tell me what combination of these things I can get." If the total cost would be $20 million, I may want to start off asking for the $20 million in increases, even though I know they said $10 million. And then I know what everything costs, so I know what I could give away and what my priorities are. So what are the priorities? Which comes first?

When you're worrying about the cost, there are different issues in the short term versus the long term. In the short term, you may have situations in which you've got minimum-contribution issues and you've got maximum-deductible issues. You may have questions that came up in the recent past, very often in the public sector, in which the answer is that the contribution was zero. So if the contribution is zero, does that mean that it's free? It doesn't cost anything. "We've just increased the multiplier from 2 to 3 percent. Your contribution rate is still zero, therefore, this is free." I have heard that at the negotiation table before: that your contribution rate didn't increase this year, therefore it didn't cost anything. Depending on what your role is, you may have a responsibility to jump up and shout out loud that it's not really free, or you may have to sit on the side and hope the other actuary doesn't jump up and shout out loud that it's not free. I don't know if you really have a responsibility at that point, if he doesn't, to tell him that he's a fool.

And then the question is, How do you calculate the cost? What, really, are you coming up with? Again, you've got to start with a baseline someplace. Make sure you know where you're moving from, and make sure that you're always starting in

the right place. The contribution rate that they're paying right now may not start from the right baseline.

So let's say that your last valuation was June 30, 2001. And, like most of you, I'm sure, you finished it within a week or two at the end of the plan year. So now we're coming to June 30, 2002. You know you're about to come out with new numbers. Is your baseline the last set of numbers you have that are about to disappear, or the new set of numbers? If you know that one of those plans lost money last year, that your contribution rates are about to go up, if they know they can spend only $1 an hour for benefits, $10 an hour for benefits, $50 an hour for benefits, what do you do? Last year everything was fine at $45, but because of the loss, they're about to go up to $50 anyway. They no longer have the $5 to spend. It's gone already. You want to make sure that you're starting from the right baseline when you're talking about these things.

Regarding the question of static calculations versus moving calculations, benefits drive behavior. In a lot of cases, the whole reason why they are suggesting the benefit change or the employer is willing to take the benefit change is that they really think that it's going to change the behavior.

Just saying that you've bumped your multiplier by 20 percent, and therefore costs must change by 20 percent, may not be completely correct. To the extent that behavior changes, you may end up having your costs moving up by 50 percent. Your costs may double because of where you are. It's important to keep that in mind. You don't necessarily run the static changes. You need to make sure you take into account the assumption changes.

So how did we come up with these assumptions? Most actuarial firms have dartboards, Ouija boards, all sorts of advanced techniques. We do want to separate between things that are related changes and unrelated changes. To the extent that you have a multiplier change and people are going to be getting bigger benefits, they're going to be retiring earlier. You may have created an incentive to stop them from claiming that they were disabled.

DROP plans have done amazing things for the health of many retirees. They no longer become disabled, and they all go on service retirement. It's amazing how much healthier these people are, now that they have the DROP plan in place.

Some behavioral changes are reasonable. Salary increases may actually be a little bit different as they get closer to retirement age because of these changes. On the other hand, it would be difficult to argue that inflation changes because of a retirement benefit that you're creating. It may be difficult to argue that your investment return is changing because of this. So make sure that you realize the difference between those changes that are related to those things that you are doing and those that are unrelated.

I know that in Taft-Hartley situations, or any negotiated situation, there are times when people are going to try to negotiate the assumptions that are taken into account. If you are playing the plan's actuary role, you, more often than not, need to make sure that you differentiate between those assumption changes that are related and those that are not related in determining the cost. If you're in an advisor role and you see that there are some assumptions that may have been at the aggressive end that you can move toward the more conservative end or vice versa, in order to help pay for some of the increases, making those suggestions is always helpful and recommended. So there are times when you can play them and not play them.

So where are good places to get assumptions? Look at the past; see what's happened in similar situations. If you had an early-retirement program in the past, see what's happened in the past in those situations. Go to your client. Your client is a fountain of information. They know how people are going to behave much better than you do. So go to your client, and ask them what they think is going to happen.

Take a look at similar plans, to the extent that there are other plans that you work on that have similar characteristics. If you're doing a Taft-Hartley plan, if you're doing a plan for supermarkets, and you work on a few dozen of those, you know that you can go from one to the other. And if they've made a similar change, it will give you similar information. If you're doing public plans, say, if you're working on one police plan and there are other police plans that have made similar changes, that can give you some idea of how things are going to change. And finally, use your imagination or at least your common sense.

Think as though you are no longer an actuary. You're going to be a clerk, checking out at a supermarket. You're going to be a police officer for a little while. You're going to see that somebody is increasing your benefits and offering you more money than you've ever had an opportunity to see at one point at any time before. How do you think you're going to behave? What kinds of things might change? Take a look at it. Make sure that everything else looks reasonable, sounds reasonable and seems to work. So those are reasonable places to get assumptions.

Now, bad places to get assumptions: Past performance is no guarantee of future anything. Keep in mind that you need to know the difference between past and present. What drove something to happen? Is the past really the same? Is this just history repeating itself, or is this something that's completely different because the economy's going poorly or vice versa?

Other plans have other things going on. Sometimes they have multiple changes going on at once. They are having layoffs, or threats of layoffs. Sometimes their pay levels are just so absolutely miserable compared to yours, or more likely, your pay levels are miserable compared to theirs.

MR. BRANNON: Another complication is that sometimes—I'll use Taft-Hartley as an example where there are two clients—there's a labor side and a management side, and you will get very different answers on how a particular benefit will affect the members' behavior. The textbook example says that you're putting in a service pension, so people can get unreduced benefits when age plus service equals 85, or whatever. And the labor side says, "Yeah, but they still won't be able to afford to actually retire on this" (which makes you wonder why they're lobbying for it so hard). You'll ask them, of 100 people who reach service pension eligibility, how many will retire. Well, the answer is two, because a dog couldn't live on those benefits. And then the management, of course, will say that there could be a whole wave, and they want to see the worst case. This is where doing best case, worst case and intermediate case is often the only way to go. But you will not necessarily get a single answer from the client on how behavior will be impacted by a particular retirement-benefit change.

MR. SUMMER: So now, knowing you've come up with these assumptions, knowing that—short of having a time machine, seeing exactly what happens, and then coming back and putting them in place (which only the bigger firms tend to have)—what ends up happening is that your assumptions are going to be wrong. By "wrong," we don't mean that you've told them that it's 8 percent, and you didn't really put in 8 percent. We mean that things aren't going to happen in the future exactly the way that you put them into your actuarial assumptions.

So, when that happens, you need to make sure that there are five things that you do, at the very least. First of all, communicate with your clients. Let them know what you did; let them know why you did it. You need to do some "reasonableness checks." Make sure that things make sense. If you're going to be talking to a cop about exactly what the changes were, make sure that you actually can say it in a simple, straightforward enough way—and that it makes sense to someone who is carrying a gun when you are explaining it to them.

Next, sensitivity analysis: take a look at the best-case scenario, take a look at the worst-case scenario. See which things bring it from best case to worst case. To the extent that you're not really sure about certain assumptions, if you change some assumptions a lot, it will change your costs a very small amount. Other assumptions, if you change them a tiny bit, will blow the costs right through the roof. Know which are which, and make sure that you let the client know which are which—especially if you're guessing about the ones that are going to blow the costs right through the roof.

Make sure that you put down what you've done and why you've done it. Make it really clear. I mean, if you're making assumptions, if you're making guesses, if you're taking information from certain places—especially if it's the best that you could do—make it clear that it's the best that you could do, that you're trying to do the right thing. They'll understand. And, in most situations where they know better than you do, they'll let you know, awfully clear and awfully fast. You do want to

make sure that if somebody could let you know that your assumption is wrong, that your guess is wrong, that something you're relying on is wrong, that they tell you right away, that they don't make any irrevocable decisions based on your information, that you at least have a chance of fixing it before the lawyers get involved.

Finally, remember your responsibility. The actuarial community is relatively small, and the clients that you are dealing with are a relatively limited group. You are going to see most of these people at some point in the future. So make sure that you are consistent, that you're accurate, that you're complete. If you're going to have to deal with these people again, and if one group starts hearing about you being an advocate for the unions, you may not be able to get work from a neutral plan in the future, or from the employer side. And you may not care if you've got enough of that work. But if you plan to be a union actuary in one situation, and a management actuary in another and a plan actuary in a third, they will find out what you've said in other situations. They will bring it back to haunt you. So make sure that you are relatively consistent and that you can make it sound as though you're saying the same thing in a later situation.

Remember who your client is. You're being hired by one group, and you have responsibilities to them. As I mentioned before, if you are the actuary for one side during negotiations, and the cost has gone from zero to zero, and it's not your job to get up and yell, "But that doesn't mean it's not free," then don't get up and yell it. Know who your client is. Make sure that you've told your client in the back room that zero may not mean zero and that you expect the other actuary to jump up and shout it. Tell them what they need to know. Make sure that they're prepared. Make sure that there are no surprises. If they don't get surprised, they will like you, and you will probably be hired to come back again. And know when to put things in writing and know when not to put things in writing. Knowing that there are times when your client may not remember exactly what you've said, it may be very important to document the information that you have given them at one point or another.

Finally, in situations in which there are two actuaries, my general feeling is that the two actuaries should be able to find a way to get along. If the two actuaries can't talk the same language, figure things out, come out with the same numbers, and figure out where they agree and where they disagree, and the trustees have to make the decision for them, then they are not doing their jobs as an actuaries. The trustees shouldn't have to bring in a third actuary to interpret what the two of them are saying, or to judge which of you is doing better than the other. You should be able to work the whole thing out. You don't have to like the actuary on the other side, but you should be able to work things out. That's what we have rules for, and a profession.

FROM THE FLOOR: I think that all three of you mentioned that there are situations in which, if you are working for one side, you don't necessarily have a responsibility

to provide information to the other side, to tell them the questions that they should be asking and the information that they should be bringing forth at that point in time. On the other hand, are there situations where you do have a responsibility to let the other side know what's going on?

MR. MCCRORY: If you're in a situation in which you're signing a Schedule B, depending on the magnitude of the error, there may be no way to keep quiet in negotiations. First of all, you would want to talk to your client and discuss the issue with them. I have found that, in most cases, it's going to be in everyone's best interest to deal with accurate numbers, and your client is going to say that you have to get this out now. But ultimately, it's going to get resolved when you have to sign the Schedule B.

MR. BRANNON: I guess the one other case that I can think of is, suppose you're working with a union in a government negotiation, and the actuary working on the government side materially understates the cost. That's going to come out. It's probably going to hit the newspapers, and it's not going to do the profession any good on either side, for one actuary to keep it quiet and for the other actuary to make what appeared to be a mistake. In those circumstances—I don't know how far I would go—but I would push awfully hard to disclose that before it caused any harm.

MR. MCCRORY: I think your client is your first stop. And that's always true. At what point do you go beyond the client, and at what point are you then violating confidences and your obligation to them, versus a greater societal and professional issue—I don't know. Maybe an advisory call to the Actuarial Board for Counseling and Discipline would be a good thing to do. It's also a great time to call your own legal counsel and pull them into the situation. So at this point, you're no longer dealing with actuarial issues.

MR. SUMMER: In all of these instances, where they are talking about potentially bringing the situation up, they dealt with errors in which the other actuary doesn't seem to be interpreting things or they're looking short term instead of long term. If you're the plan's actuary, if you're supposed to be in the middle, you have some responsibilities. But if you're off on the side, I think it is not your responsibility to guess the other side's priorities.

FROM THE FLOOR: Whose responsibility is it to make sure that the right party, whether it's the settlor or the plan, pays the fees or, more accurately, that the plan doesn't pay fees that it's not supposed to pay?

MR. SUMMER: I don't think many people get too concerned if management or the union offers you money, and it was supposed to have come from the plan. Those checks usually have been cashable.

FROM THE FLOOR: I guess I would say that that issue had better be resolved before you do any work, because I actually served as an arbitrator in a three-person arbitration committee, in which each party was obligated to pay one of the arbitrators. One person got paid half from each party. And, oddly enough, the losing party never paid, so it's probably a good idea to get that straight in advance. So if you have some work that, in your mind, some of it probably could be paid from the trust, and some of it probably shouldn't be paid from the trust, and you send the invoice, and money shows up somewhere at your company that happens to equal the total amount of the invoice, how much responsibility do you have to go back and check to make sure the right money came from the right place?

MR. MCCRORY: I don't know. I think you do have a responsibility not to accept money if it's clear that it's a violation to take money from a plan. You wouldn't want to be doing that.

FROM THE FLOOR: But that wouldn't really be your call?

MR. MCCRORY: Maybe this goes to your own counsel, not to the counsel of the trust. But if you definitively felt that this is not a fiduciary function, and it should not be coming from the plan, I think that you have some responsibility not to take payments from a plan that shouldn't be making payments. Now, maybe if you say, "Oh, I can't take this from the plan," and the plan's counsel says, "Oh, yes, you can," it's payable. The only incorrect source is from the plan. Whoever else can pay you anything they want. I think that people have gotten into trouble by collecting money from the wrong plan. Regardless of whether you get in trouble or not, it's the wrong thing to do, so you wouldn't want to take money from a plan if you thought you couldn't.