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OPINION

Proposed standard change raises concern

In the April 1996 issue, Heidi Dexter discussed a possible amendment to the Actuarial Standard of Practice (ASOP) No. 4. Her article, "Proposed pension standards would require individually reasonable assumptions," drew these comments opposing the change from two different perspectives.

Eliminating 'inaggregate' approach would unnecessarily limit choices

by Donald E. Fuerst

The article presumes that the Actuarial Board for Counseling and Discipline should attempt to curb the legitimate practices of actuaries striving to help their clients and plan participants.

Consider the following real situation. A large manufacturer sponsors an hourly pension plan covering both bargaining and nonbargaining employees. The plan is a dollar per month per year of service plan, using the unit credit method. The plan has historically maintained a current liability funded ratio in excess of 100% at statutorily required rates. It exceeds 100% when measured using individually realistic assumptions (currently an 8% interest rate), which the plan uses for ERISA funding purposes. However, when measured using an interest rate equal to 80% of the 30-year treasury rate (4.85% for 1996), the funded ratio drops below 100%.

The result in recent years has been that the plan is subject to the full funding limit, with no contributions required and no tax-deductible contributions allowed. The sponsor is effectively precluded from contributing to the plan. Nevertheless, the plan has an unfunded vested liability as measured using assumptions mandated by the Pension Benefit Guaranty Corporation (PBGC). Fortunately, the law provides an exception to the PBGC variable premium for the plan because of the full funding limit.

Because no contributions have been allowed for several years, the funded ratio has declined. The sponsor was not comfortable with this and asked the actuary to suggest ways they could contribute to the plan to improve the funded ratio. The actuary suggested a change to the entry age method, which would allow a contribution in excess of $4 million.

Next comes the bad news. Switching funding methods not only permits a contribution, but removes the exemption from the variable premium requirement. After switching, the sponsor must pay a $500,000 variable premium. The sponsor seems to have three choices:

- Change to the entry age method, contribute $4 million, and pay the $500,000 variable premium. The sponsor quickly rejected this choice as an unreasonable cost.
- Maintain the unit credit method, make no contribution, and pay no variable premium.
- Change to the entry age method, adopt reasonable "in aggregate" assumptions, contribute $4 million, and pay no variable premium.

The sponsor asks the actuary for advice. As the enrolled actuary for the plan — with a responsibility to act on behalf of and in the best interest of plan participants — this is not a difficult choice. The reasonable "in aggregate" method:

- Complies with all federal law and regulations
- Allows the sponsor to contribute
- Improves the funded ratio as well as participants' benefit security
- Eliminates a "risk-related" premium while actually decreasing exposure to the PBGC

(continued on page 13)

Lemmings on the northern route

by Leslie John Lohmann

Where is our value to our publics? Is it in sheepishly agreeing with statutory impositions — pension plans are a social good that should have tax-favored status as long as they pay their fair share — or is it in sticking to, then clarifying and explaining, our principles regardless of the penalties? Our corporate agreement with the notion that there are "individually realistic actuarial assumptions" is the same as requiring you to reach Tokyo only through Hawaii. Now Hawaii may be more fun, but it is not the best nor most efficient way to go. Some say we should help legislators understand that the northern route is better. Then, they will legislate that route. It seems simple, but it's not.

An actuarial example of this metaphor is found in interest rates. More than 26 years ago, actuaries knew that the most reasonable assumption for interest rates was one that used a select and ultimate approach. However, they didn't use the method, because technology could not implement the assumption in a cost-effective and time-effective way.

Then, before technology improved, ERISA encoded the single interest rate assumption, which was taken to absurd lengths by the IRS. Select and ultimate interest rate usage, under ERISA, meant unreasonable assumptions after the first year or a "change in method" every year as the select and ultimate table was reset based on fresh knowledge, the most reasonable method of employing the assumption. We did nothing at the time, because it was

(continued on page 13)

Choices would be needlessly limited (continued from page 12)

The only problem is that the proposed amendment to ASOP No. 4 would cause the actuary to deviate from a published professional standard to accomplish the result. Fortunately, Section 6.6 of the standard allows the actuary to do this with appropriate disclosure. I anticipate this will be a widely used section.

This situation showcases the difficulties in trying to enforce bad policy through professional standards. The variable premium program is flawed. The PBGC is attempting to raise premiums for virtually all plans, not just plans subject to high risk. Defining a risk-related premium using 80% of the risk-free rate is a ruse to charge higher premiums to fully funded plans. It is equivalent to charging risk-related premiums to plans with a 120% or higher funded ratio using a risk-free rate. But to charge a risk premium to plans with a 120% funded ratio would be politically unacceptable, so we have been subjected to the subterfuge of the low rate.

I support the Actuarial Standard Board's intent of "improved quality and enhanced communication," but this amendment will not accomplish this purpose. To the extent actuaries comply with the standard, it will decrease the quality of our work in the eyes of sponsors and participants. To the extent actuaries use the reasonable in aggregate technique and disclose deviation from the professional standard, it will increase the potential for misunderstanding our work. **Donald E. Fuerst is managing director of William M. Mercer Incorporated in Denver.**

Lemmings taking the northern route (continued from page 12)

technically difficult to accomplish.

Now, technology has caught up with us. Select and ultimate interest rates are very easy to implement, even for small groups. However, the pendulous burden of ERISA remains and select interest rates are not used. The same is true with grouping methods. To apply the "reasonable funding methods" requirement means that the groups have to be aged one year each year, leading to an absurd application of a very good "method." The alternative was, as with select and ultimate interest rates, to request method changes every year.

The old "aggregate entry-age" method that reset the frozen initial liability (FIL) annually went the same way. According to Revenue Ruling, it wasn't reasonable from the outset. Nonetheless, many practitioners, who did not understand the method, continued to use it through the Retirement Equity Act (REA). The method reasonably allocated costs, it was self-correcting, and it quickly funded.

Where were our organizations when the IRS abused the literal language of the alternative funding standard to deny its use for funding methods that funded faster than the entry age normal (EAN) because the normal cost (NC) was not exactly equal to the EAN NC? Outside of those few involved directly with technical pension issues, our government doesn't yet know that an "accrued benefit" is something that can and does occur in the future. How can it understand the intricacies of pension funding?

Moving to projected unit credit, the "accrual" attribution method was appropriate when we used only the retirement decrement to value a front-loaded plan. This helped assure valuation benefits equal to termination benefits at all possible times a benefit could be paid. Now that we have a minimum of death, severance and retirement decrements where every individual benefit at every possible age is funded, theoretically, on time, why is the accrual method still legislated in ERISA and promulgated by the Financial Accounting Standards Board? If a group is so small that there is less than an even chance of a particular decrement during a year, why should we have to include probabilities for it? Remember, unless full and immediate funding of all termination benefits is required, there is always a statistical chance of inadequacy, even ignoring negative investment returns.

At the 1996 EA meeting, we discovered that changing the clerk who puts together the numbers for a valuation is actually a change in funding method, especially if he or she were rounding differently than the next clerk. Is this reasonable? I think not. How many firms have asked for funding method changes because of rounding method changes? How many signing actuaries even know all of the rounding rules in their software?

How many firms used single precision in 1974? How many continue to use it now? Of those who changed, how many filed for the required method change? In the same line, what about firms changing from a 60-bit machine on a time-sharing basis in 1977 to their own Fortran-based 16-bit machine by 1982 and now are using purchased software on their own PC-clones? Were the required method changes requested and approved?

As technology changes and new problems are attacked, one wonders about correcting the identified abuses by rigid statutes or regulations that are oversimplified when drafted and obsolete when adopted.

My goal will continue to be to advise ways for my clients to provide secure funding of corporate pension plans that do not materially shift costs from one generation to the next. I will also try to help them understand the least expensive route to that result.

(continued on page 18)