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ACADEMY/SOA ROUNDTABLE DISCUSSES PUBLIC PENSION PLAN DISCLOSURES

Paul Zorn

This article summarizes discussion at the Academy/SOA Roundtable on Public Plan Disclosures, held this past February and attended by almost 100 representatives of the actuarial profession, state and local governments, public retirement systems, public employees, legislative and regulatory organizations, credit rating agencies, academics and others. Full article>>

PUBLIC VERSUS PRIVATE SECTOR OPEB ACCOUNTING

Kevin Binder, FSA

Do you work with private sector clients and want to know more about OPEB accounting rules for the public sector? Read this

This year, the 2008 Halmstad Prize will be awarded to the best actuarial science paper published in 2006. The selection committee makes its determination taking into account the originality and thoroughness of the ideas expressed in the paper, the readability of the paper, and the timeliness and relevance of the research.

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article! Full article>>

WOMEN AND RETIREMENT: GREATER CHALLENGES AND MORE INDIVIDUAL RESPONSIBILITY

Anna Rappaport, FSA

The Committee on Post-Retirement Needs and Risks continues its important research and analysis... Full article>>

TECHNOLOGY—THEN AND NOW

Tom Sablak, FSA

Here's a look at our use of technology—then and now. A reprinted article from the very first Pension Section News in June of 1989, written by Barbara Choyke of the SOA ,entitled "1,100 View SOA's First Teleconference," is juxtaposed against a view of today's webcast communications. Full article>>

LETTER TO THE EDITOR: OVERHAULING THE PENSION-MEASURING METHOD TO REFLECT FUTURE PAY RAISES

Cicero Limberea CPA

Cicero Limberea expresses his view on certain changes in pension accounting standards promulgated in 2006. Full article>>

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CHAIRPERSON'S CORNER

Sandi Kruszenski, ASA

Many people ask me if the Pension Section Council thought "Retirement 20/20" would be an appropriate name for our current multi-year, strategic project because we thought it would last until the year 2020. It was not, and this thought strikes fear deep in my heart. One of my greatest hopes is that the name does not become a tragically self-fulfilling prophecy. By the year 2020, we should (will!) have a retirement system that works for all of our key stakeholders—Employers, Society, Markets, and the Individual.

I would like to share with you some information about this year's objectives for the *Retirement 20/20* project. Hopefully what we accomplish this year will go a long way towards ensuring that the initiative wraps up successfully long before the year 2020. We're already having a busy year, and much more is planned.

First, we issued three calls for papers (CFPs) that were based on issues identified in our first two (2006 and 2007) *Retirement 20/20* symposiums. The CFPs deal with:

- Changing individuals' retirement behavior by changing certain "signals" in our retirement system,
- Adopting self-adjusting mechanisms to ensure long-term retirement plan health, and
- Structuring default distributions in a way that benefits most retirees.

These topics will form the foundation of our 2008 *Retirement 20/20* symposium, tentatively scheduled for November. This year's conference will be a little different from the previous two. We are focusing on a smaller number of topics in order to cover them in considerable depth, but the event should be as lively and informative as the first two.

Another recently completed initiative is the Measurement Framework, and I recommend Cindy Levering's article on this topic (conveniently found in this very issue of the *Pension Section News*).

A new project that we would like to begin this year is directed at increasing the visibility of our *Retirement 20/20* effort within the actuarial community—to both pension and non-pension actuaries. Not only do we hope that this effort will lead to a greater appreciation within the Pension community of our efforts, but we would like to get actuaries in all practice areas involved in thinking about *Retirement 20/20* and the larger

societal implications of a healthy and sustainable retirement system. This project has not yet begun, and we welcome your suggestions as to how to proceed.

Please check out our progress at *www.retirement2020.soa.org*. If you would like to volunteer for any Pension Section Council activity (recall that along with our *Retirement 20/20* projects we also have three standing committees: Communications, Continuing Education, and Research), please contact me.

Sandi Kruszenski, ASA, MAAA, EA is the Pension Section Council Chair for 2008. She is a consulting actuary based near Seattle, Wash. She can be reached at *sandbrd@comcast.net*.

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YOUR VOTES ARE IN!

Art Assantes, FSA

In the January issue of the *Pension Section News (PSN)*, we asked you to give us some information about the type of organization in which you work. If you worked for a consulting firm, we also wanted to know if your firm had internal research capabilities and whether you were based in the United States or Canada. 176 members responded. Their answers, along with some information about all section members, are summarized in the chart below.

Employment Entity	Internal Research Capabilities	Country	Respondents		Section Members	
			Number	Percent	Number	Percent
Consulting Firm	Yes	United States	61	34	1,640	42
Consulting Firm	Yes	Canada	12	7	521	13
Consulting Firm	No	United States	28	16	541	14
Consulting Firm	No	Canada	8	5	87	2
Insurance Company			18	10	347	9
Government Agency			12	7	104	2
Private Sector Corporation			9	5	?	–
Educational Institution			3	2	25	1
Retired Section Member			10	6	80	2
Other			15	8	584	15
Total			176	100	3,929	100

Our hope is to learn more about you and to deliver relevant and interesting content. Of the approximately 3,900 Pension Section members, about 1,600 opened the January *PSN* and clicked on at least one article. Approximately 10 percent of those who opened an article answered the survey.

About 55 percent of our members work for consulting firms with internal research capabilities. Of the readers that responded to the survey, 41 percent were employed by such firms. One of the *PSN*'s tenets is that section members are looking for practical professional information and view the *PSN* as a source. Given the section census, more than half of the Pension Section members have access to such information through their firms' internal research units. If the survey can be considered representative of the *PSN* readers, more than half of them come from firms that don't have some type of internal unit responsible for research. These readers may still view the *PSN* as a resource, perhaps an important resource.

This raises an interesting question, and I invite you to write to me with your thoughts. Should the *Pension Section News*, as a service to

readers who do not work for firms with internal research capabilities, focus on providing practical profession information? Or, should the *PSN* have a broad focus that includes a wide variety of pension-related information?

Art Assantes, FSA, MAAA, FCA, EA is editor of the *Pension Section News*, and also president of Hooker & Holcombe in West Hartford, Conn. He can be reached at *PSN.Editor@pensionedge.com*.

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RETIREMENT 20/20 UPDATE—THE MEASUREMENT FRAMEWORK

Cindy Levering, ASA

Actuaries have been thinking about how to improve North American retirement systems in big and small ways for a number of years. Read Bob Berin's thoughts from the September 1990 *Pension Section News*, followed by Cindy Levering's update on the *Retirement 20/20* initiative.

Pension Rules—What If?

By Bob Berin

I was asked, as part of a meeting in another country, to "consider a blank sheet of paper and broad-brush a viable private pension system." Although this was an interesting challenge, nothing came of it because a private pension system requires free investment markets, and this requires a free enterprise system and, ultimately, a democratic form of government.

Original Goal

In the United States, we seem to have lost sight of the original goal of a private pension system: the encouragement of pension programs so that workers and their families can live in dignity in retirement.

One reason we have lost sight of the original goal is because the government is trying to raise tax revenue to meet the budget crisis. However, private pension plans designed to maintain adequate retirement income relieve the pressure on Social Security and other public programs dealing with poverty in retirement. With an aging population, retaining this goal may be more cost-effective than the additional amount of tax revenue presently collected.

A second reason is the complications that have been written into tax law which discourage both new plans and improvements in existing plans. One treasury official recently said "There is little disagreement that pension law is one of the most complex areas of tax law." This needed to be said. He went on to explain that a "plain English approach" had been adopted "to make the regulations understandable." This was necessary and it was helpful. This official should be applauded, but the next step (of which he is surely aware) is even more difficult, and may never happen.

Infinite Number of Rules

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Reading the proposed regulation for IRC Section 401(a)(4) leaves some room for wonder at the need for such enormous detail. Are simple solutions possible? Or are we dealing with rules to curb perceived or actual abuses that range from the remote, to not likely, to possible, to plausible, etc.? And who can administer such rules? A grid of such rules can never be complete enough and the gaps create uncertainty and the need for more rules. This creates the need for an infinite number of rules which is not possible. Is there any other approach?

Reporting and disclosure are extensive and complex. Even larger companies have difficulty; the cost of administering the programs grows. Benefit design now relates to questions of compliance rather than principally on what may be good practice. Excessive paper work and costs of compliance are seen as burdens, no longer minor in scope.

We seem to be losing sight of the need to encourage retirement benefits. Tax simplification seems to lead to more complications. Could we ever undo the past and start over?

Starting Over

Here are some thoughts on starting over on the actuarial side (not that we could).

- Pension benefit formulas apply uniformly to all employees. At retirement the replacement ratio of plan benefit plus actual primary Social Security benefit divided by final average salary must decrease with increasing salary and be less than 100 percent.
- Test the funding level at each valuation date and make this public information: (a) Unit Credit accrued liability (valuation interest and mortality assumptions) less (b) Market Value of assets, as well as (b) divided by (a). (Final pay plans use current salary, as a proxy, and state so).
- Disclose the relationship between the market value of assets and the amount required to purchase annuities for vested benefits from a life insurance company.
- Employ one of the recognized actuarial funding methods in the regular valuation. Use liberal and conservative actuarial assumptions and fund increases and starting obligations over a 20-year period to determine a range of contributions as a percentage of total payroll. These calculations should use a full set of actuarial assumptions. (The choices of liberal and conservative assumptions are to be discussed in the valuation report and are the actuary's responsibility.)
- Disclose three percentages of total payroll: liberal contribution, conservative contribution, and actual contribution. The last must be between the first two. The maximum contribution is to be 15 percent of total payroll

Conclusion

In establishing a private pension system, the guiding principle should be to keep it simple in every respect and act on behalf of the participants. This is also best for the sponsoring employer and for government.

And everyone involved in the process must realize that someday, if they are fortunate, they will be retirees.

Bob Berin, FSA, AIA , is Managing Director, Chief Actuary for William M. Mercer, Inc. in New York. He is a Vice President of the Society of Actuaries.

As anyone who has ever built anything knows, measurement is critical. As part of the *Retirement 20/20* initiative, we realized early on that we needed to benchmark any proposals that we developed for a new retirement system, as well as the proposals of others and existing systems. Only by benchmarking can we determine the extent to which current systems meet the needs of stakeholders, and how various proposals compare to the status quo and to each other. Measurement is an essential part of the debate.

Attendees at the 2006 *Retirement 20/20* conference—*Building the Foundations for New Retirement Systems*—helped us to understand and enumerate the needs, risks and roles of key stakeholders in a retirement system. We realized that these principles could be used as the basis for our benchmarking tool, which we're calling a *Measurement Framework*. This framework will, we hope, also serve as a tool to help us communicate our findings to pension actuaries and other retirement professionals, as well as other stakeholders (including the media) in order to build grassroots support for our work.

Development of the measurement framework is well underway. We began by using it to evaluate a traditional final-pay single-employer defined benefit plan as well as a traditional defined contribution plan. This was done primarily as a way of testing the framework, and to help stakeholders understand the framework's operation by using it to evaluate well-understood retirement plan designs. We've identified several other retirement system models that we'd like to evaluate with the framework (for example, the TIAA-CREF program in the United States, the Dutch retirement system, the ERISA Industry Committee proposal, and the YMCA Retirement Fund which was recently highlighted in *Plan Sponsor* magazine). It also might be interesting to flesh out the details in Bob Berin's model from 1990 (outlined in the article above) and to use the Measurement Framework to evaluate these early "blank sheet of paper" ideas.

The framework focuses on how well each proposed design addresses the needs, risks and roles for each of the four stakeholder groups: society, individuals, employers, and the markets. The framework focuses in detail on those needs, risks and roles by devoting a section to each stakeholder group. The framework also develops a "summary rating" for each stakeholder group. These four summary rankings are shown in an executive summary, together with ratings related to four of the themes that came out of the 2006 conference and

that we continue to explore:

- Does the plan self-adjust to meet changing economic and demographic conditions?
- Does the plan align stakeholders' roles with their skills?
- Does the plan consider new and emerging norms for work and retirement?
- Does the plan align with markets (use market hedging and pooling mechanisms effectively)?

Additional discussion of these questions and the needs, risk, and roles of stakeholders can be found in the 2006 conference report at *www.retirement2020.soa.org*.

Instead of rating each criteria numerically, we use a five-level color coding system to assess where the plan meets the principle (green), violates the principle (red) or falls somewhere in between (yellow-green, yellow, red-yellow, ranging from better to worse). We're not trying to be scientific with the ratings, but to show directionally whether these proposals meet or don't meet the goals we've identified in the *Retirement 20/20* initiative. One clarification: we're using the framework to evaluate individual designs, be they for employer-sponsored plans, individual savings mechanisms, or social insurance systems. A retirement system as such is a combination of these things. It would be too complicated to try to use the framework to evaluate the system in totality. But, the framework can help us determine which combination of individual designs might do the best job of ensuring a strong retirement system for the 21st century. One thing we've learned in the *Retirement 20/20* journey is there's no single design that can satisfy every stakeholder in every situation. That's why we also intend to develop a "summary of summaries" as the final element of the measurement framework. This will show how different plans compare across the board in meeting the needs of stakeholders and the four principles/questions outlined above. This should help us to identify which combination of designs will do the best job of meeting the retirement needs of tomorrow.

If you're curious how our DB and DC plans fared, the traditional final-pay single-employer DB plans do a much better job of meeting the needs of society and individuals than they do of meeting the needs of employers, and the results with respect to meeting the needs of the markets are mixed. The results for traditional DC plans are mixed for all stakeholders.

We recently instituted an advisory group to give input and suggestions on what we've done so far with the measurement framework and to give us guidance on the best way of using this tool going forward. Volunteers will be involved in evaluating the designs noted above, and the advisory group will suggest additional models to "run through" the framework. We will post results on the *Retirement 20/20* Web site and provide you with updates via the *Pension Section News*, as we make progress in this area.

In the Chairperson's Corner of the January 2008 issue of *PSN*, Martine Sohier stated "the end of the defined benefit era may be what it takes to bring the pendulum back eventually, or to push it to somewhere else—to a system that might be better

able to respond to the evolving needs of today's and tomorrow's workers." As noted above, we understand that it's probably impossible to come up with a single design that will address all or even most of the needs of all stakeholders. Our ultimate goal is to find designs that minimize the amount of "red" and "red-yellow" results in the framework tool, and to offer combinations of elements that form a system that ensures that all needs and risks are satisfactorily addressed for all stakeholders.

In his submission brief to the Ontario Expert Commission on Pensions in October of 2007, Keith Ambachtsheer (founder of KPA Advisory Services, publisher of the Ambachtsheer Letter, and a panelist at the 2007 *Retirement 20/20* conference) talked about the concept of "Moral Capitalism" as it applies to retirement systems:

> Even over 200 years ago, Adam Smith knew that fostering "the public good" would require more than just applying the rule of law and maintaining unfettered free markets in goods, services, capital, and labor. Sometimes intelligent intervention is required. The time has come to apply this moral sentiment to the design and implementation of systems that can reliably provide an adequate level of retirement income to today's and tomorrow's working populations.

As actuaries who understand the concept of risk and are trained at solving problems, we are uniquely qualified to lead this discussion. This is at the core of the *Retirement 20/20* mission. We hope the measurement framework will serve as a cornerstone in accomplishing this purpose.

Please contact Cindy Levering at *cindy_levering@aon.com*, Sandi Kruszenski (Pension Section Chair) at *sandbrd@comcast.net*, or Emily Kessler at *ekessler@soa.org*, if you're interested in working on either the Measurement Framework project or any aspect of *Retirement 20/20*.

Cindy Levering, ASA, EA, MAAA, is a senior vice president with Aon Consulting in Baltimore, Md. She is also co-vice chairperson of Pension Section Council. She can be reached at *cindy_levering@aon.com*.

Retirement 20/20 is the Pension Section's initiative to rethink retirement systems. The goal of *Retirement 20/20* is to consider what's possible, beyond the limitations of what's happened historically or what is in today's tax code. For more information, visit *www.retirement2020.soa.org*.

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ACADEMY/SOA ROUNDTABLE DISCUSSES PUBLIC PENSION PLAN DISCLOSURES

Paul Zorn

Editor's note: *In February, the Academy and Pension Section Council co-sponsored a lively discussion of the role of funding, disclosure and investment for public pension plans. This article reflects the observations of one participant. We encourage other attendees who might have different observations to send them to the Pension Section News for future publication.*

On February 6, 2008, the American Academy of Actuaries and the Society of Actuaries (SOA) co-sponsored a roundtable titled "Public Pension Plan Disclosures: Who Needs to Know What—and Why." Held at New York University, the meeting was attended by over 40 participants representing the actuarial profession, state and local governments, public retirement systems, public employees, legislative and regulatory organizations, credit rating agencies, academics and others. Another 50 professionals attended as audience to the discussion. The following presents the author's observations and interpretations of the roundtable discussion.

Tom Terry, Chairperson of the Academy's Pension Practice Council, moderated the meeting. In his introduction, he noted the meeting's purpose was not so much to debate or seek consensus but rather to give participants an opportunity to listen to each other. He framed the meeting's three central questions as:

1. Who are the users of public pension plan disclosures?
2. What questions are they trying to answer?
3. What information is needed to answer their questions?

As arranged before the meeting, four participants acted as "table setters" to start the discussion. Laurie Hacking, Executive Director of the Minnesota Teachers Retirement Association, spoke about the importance of public pensions in assuring quality public services, especially with regard to public safety and education. She also discussed the related underlying goals of the various stakeholders. For employers, the goals are to attract and retain qualified employees while balancing the affordability and stability of pension costs. For employees, the goals are to ensure adequate and secure benefits related to retirement, disability, and death. For taxpayers, the goals are to assure quality public services while seeking to reduce the overall tax burden. She noted that public plans also contribute to the larger economy by providing $3.2 trillion in financial market capital and $150 billion in annual

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retirement income to state and local economies.

Jeremy Bulow, Professor of Economics at Stanford University's Graduate School of Business, noted that the key issue surrounding pension disclosures is how to solve the "moral hazard" problem – that is, to prevent pressures by various stakeholders from influencing actuaries with regard to their assumptions.

Michael Peskin, Chairperson of the Joint Academy/SOA Pension Finance Task Force, stated that, with regard to sustainable benefits, the key underlying issues include:

1. How much risk should be allowed in a public pension system?
2. How should related costs be measured (especially with regard to the discount rate)?
3. How should the risks related to mismatched assets and liabilities be measured?
4. How can decision-makers be held accountable? He stated that, given the pressures that can be brought to bear by labor, elected officials are at a disadvantage.

Paul Angelo, former Chair of the Academy's Public Plans Subcommittee, asked participants to pay attention to the terminology used in the discussion and cautioned that words like "liabilities", "costs" and "value" mean different things in different contexts. As a result, there are reasons to measure them differently depending on the purpose of the measurement (e.g., plan termination vs. ongoing funding).

Discussion was then opened up to the roundtable participants. Although far-reaching, it primarily revolved around the following topics.

Who, What and Why

Conference participants focused on key stakeholders, and what they need to know about the system. The table below summarizes the views of several conference participants:

STAKEHOLDERS	RELATED INFORMATION
Employers	What do the benefits cost? How will they be paid?
Employees	What are the benefits? Are they secure?
Taxpayers	What do the benefits cost? What is the value I re-ceive for these benefits?
Policy Makers	Are the benefits worth the cost? How do they help attract and retain qualified employees?
Regulators	Does the plan comply with applicable laws and regulations? How would

	benefits be paid if the plan fails?
Debt Holders and Rating Agencies	Do pension obligations limit the ability of the public entity to pay for other debt? Do pension obligations change the risk to debt holders?

Another participant noted that investors are also stakeholders and indicated that holders of governmental general obligation bonds would prefer that the government's pension discount rate reflect the government's credit quality.

Another participant observed that many of the questions related to additional public pension disclosures were addressed in the 1970s during development of the Comprehensive Annual Financial Report (CAFR) for public pension plans. The CAFR requires detailed information about public plan funding, asset allocations, actuarial assumptions, etc. Other participants agreed on the usefulness of the public pension CAFR.

Measuring Liabilities

A significant portion of the discussion focused on the value of disclosing the market value of assets and liabilities for public plans. Generally, this approach combines the accrued benefit obligation (ABO) method with a discount rate based on risk-free bond yields. Currently, the majority of public pension plans use the entry age method combined with a discount rate based on long-term expected investment returns. A portion of the participants favored applying the MVL to public plans for disclosure purposes, while another portion did not. In discussing the advantages of the MVL approach, some participants argued:

- Current use of a discount rate based on expected returns does not factor the cost of investment risk into the calculations. Investment return should not be recognized by the plan until earned.
- Use of a discount rate based on expected returns could lead public plans to take on excessive investment risk to obtain the higher returns.
- If current contributions are not sufficient to cover the cost of risk, increased contributions would be needed in the future, violating the principle of intergenerational equity.

In discussing the disadvantages of the MVL approach, other participants argued:

- The current actuarial methods and assumptions used by public plans are intended to maintain contribution rates as a level percent of pay. Applying the MVL would likely introduce greater volatility into contribution rates, making them more difficult to budget, and resulting in inappropriate intergenerational transfers among taxpayers.
- The MVL was developed for private-sector plans that can, and often do, terminate. Public plans are long-term entities. For long-term entities, it is appropriate to use the long-term expected return for discounting and

disclosure.

- The ABO does not include future salary and service. Applying an ABO measure to government plans would likely result in a pattern of increasing contributions.

Differences between Public and Private Plans

Many participants representing governments and public pension plans stated their belief that governments are fundamentally different from private-sector entities, with one of the key differences being that governments and governmental plans do not terminate. Consequently, it is appropriate for governments to apply measures of pension costs and liabilities that reflect the long-term nature of governments and their pension commitments. Another participant countered that while governments cannot be terminated, their pension plans can.

Another difference between public-sector and private-sector plans is that employee contributions are typically mandatory in public-sector plans, whereas employees rarely contribute to private-sector plans. Several of the participants representing public-sector employees emphasized that these contributions represent deferred wages and effectively give employees a property interest in the benefits.

Moral Hazard

The term “moral hazard” is used by economists to describe the problems that can result when parties to a transaction are insulated from its risk. Several participants expressed concern over the potential moral hazards associated with pension plans, especially with regard to the tensions among stakeholders regarding the use of “excess” plan assets (i.e., plan assets that exceed actuarial accrued liabilities). However, several of the participants observed that changing measures or disclosures alone would not fully address the issue. Another observed that investment experience from 2000 to 2002 has helped reinforce the lesson that “excess assets” should be carefully managed.

Measuring Risk

Several participants noted that a key problem with using a single-point liability measure is that a point measure does not provide information about the range and probability of outcomes. This problem applies to any single point measure. Another participant noted that risk measures showing the likelihood and range of outcomes would be useful although difficult to construct. Still another observed that while investment return volatility is an important source of risk, there are other sources that should be considered as well, including mortality, wage and price inflation, etc.

Impact of Changing Actuarial Standards

Several participants expressed strong concerns about the impact of changing the actuarial standards, noting that the changes would likely create confusion among policy-makers (especially if the actuaries themselves did not agree) and lead to unintended consequences. Moreover, the resulting shocks to public pension systems could put many participants at risk. This would be especially harmful for the 20 percent of public employees (approximately 4 million) who are not covered under Social Security and rely largely on their public pension for

retirement security.

Breakout Group Reports

After the broad discussion, participants divided into three breakout groups to focus on how the issues affect public plan governance, funding, and investments. The following summarizes the groups' reports to the roundtable:

The Governance Group reported discussing the tensions among employers, employees, elected officials, trustees, taxpayers, and experts with regard to public pensions. Although these tensions result from inherent differences in objectives, the group suggested several areas where improvements in information and education could improve governance:

- Better understanding and communication of pension funding principles could reduce pressures to increase benefits or reduce contributions due to "excess" pension assets.
- Better education regarding fiduciary responsibilities could help strengthen the independence of pension trustees.
- Better measures of investment (and other) risks borne by the plan could help officials understand the range and likelihood of potential outcomes. These could include market-related measures, asset/liability studies, and other measures.
- Better understanding of how funding pressures affect stakeholders could be provided by developing plan "stress tests" to simulate the impact of potential risks on future contribution levels and tax rates.

The Funding Group reported discussing the role of disclosures with regard to plan funding. While generally agreeing that disclosure is important, the group also noted that different disclosures are appropriate for different purposes. Moreover, by itself disclosure does not ensure that contributions will follow, regardless of the actuarial cost method used. In addition, some members of the group were concerned about the unintended consequences that might result from a fundamental change in measurement, including the possibility of public plan terminations. In discussing additional information that would be useful with regard to plan funding, the group suggested:

- Information about the degree to which the actuarial assumptions affect the measured liability; and
- Information about the long-term sustainability of benefits.

In commenting on these suggestions, one participant referred to a recent behavioral economics study suggesting that the way information is framed and presented significantly affects the decisions made. He noted that more information is not necessarily better and that some numbers are more important than others.

The Investment Group reported that different investors have different information needs. For municipal bond investors, the cash flows related to pension payouts would be useful and could be discounted at rates deemed appropriate by the investor. For plan investment officers, asset/liability studies would be useful, as well as stochastic simulations and

measures of the probability of failure. For employers and employees, information that protects against the unwarranted use of plan surpluses would be useful. The group also discussed the possibility that information overload might result in the loss of information, and that the MVL might represent “dangerous noise” leading to unnecessary plan terminations.

In the follow-up to this discussion, a question was raised about whether use of the MVL would lead to pressure to invest in bonds. Several participants suggested that fully funded plans might be immunized using an LDI (liability driven investment) strategy. Others supported continued allocation in equity investments. One expressed concern that dedicating a large portion of the portfolio to fixed-income securities would unnecessarily limit the returns earned by public plan investments. Earlier, Laurie Hacking had noted that approximately 65 percent of annual public plan receipts are from investment earnings.

Tom Terry concluded the meeting by thanking the participants and noting that no decisions had been made on these issues. Moreover, any decisions would be made after careful deliberations and possible future group discussions.

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PUBLIC VERSUS PRIVATE SECTOR OPEB ACCOUNTING

Kevin Binder, FSA

The new United States accounting standard (GASB45) requires local and state governments to account for their post-retirement medical and life insurance programs on an accrual basis for the first time. This new standard is creating new demands for actuarial services. Some actuaries who are entering this market are experienced public sector pension actuaries, who have worked with the public sector pension accounting standard GASB27. For these actuaries there are several important differences between pension plans and post-retirement medical plans (referred to as “other post-employment benefits,” or OPEB, in GASB45) that they will need to understand before they can perform GASB45 valuations. However, this article is written for the experienced private sector post-retirement medical plan actuaries with a strong FAS106 background who is now working on GASB45 valuations. For these actuaries there are many similarities between a FAS106 valuation and a GASB45 valuation:

- The underlying benefits are the same.
- Both require accrual accounting.
- Under both FAS106 and GASB45 an annual expense is determined.
- Under both FAS106 and GASB45 the cumulative difference between the expense and the actual amount spent on the benefits is a liability on the entity’s balance sheet. Under FAS106 the cumulative difference is the Accrued Expense. Under GASB45 the cumulative difference is the Net OPEB Obligation (NOO).
- There are separate disclosure requirements.

However, there are so many differences between the FASB and GASB standards that I would recommend that you initially work with an experienced public sector pension actuary who understands public sector accounting.

Some background information might be useful to understand why there are so many differences.

First the GASB and FASB standards are drafted by separate sister organizations, the Governmental Accounting Standards Board (GASB) and the Financial Accounting Standards Board (FASB). Both organizations are under the umbrella of the Financial Accounting Foundation. Businesses or governments are required to follow the applicable standards to be considered to be operating under Generally Accepted Accounting Principles (GAAP).

Why are there separate accounting standards for governments and business in general and for employee benefits in particular? The GASB Web site (*www.gasb.org*) has an excellent article explaining the need for separate accounting standards. The following is paraphrased from the article:

1. Governments do not operate in a competitive marketplace.
2. Governments rarely go bankrupt or are liquidated.
3. Governments do not have equity owners.
4. Governments do not generate income.
5. While both businesses and governments have creditors, government creditors focus on the ability to raise taxes and the cost of activities that could compete for those resources.
6. Finally, taxpayers are concerned with generational equity. That is, future tax payers should not have to pay for today's services.

In short, because governments do not face competition they do not have to focus as much as businesses on the present. A business at any time could be sold or liquidated so its current value needs to be as accurate as possible. However, there is a responsibility to future taxpayers to ensure generational equity.

The authors of the GASB standards are clearly aware of these differences and they are reflected in the GASB45 standard for OPEB benefits (and the GASB27 standard for pensions).

With this in mind here are some of the differences between the FASB and the GASB standards.

1. FAS106 requires the use of the Projected Unit Credit funding method. The GASB permits the use of other funding methods beside the projected unit credit funding method. For example a GASB valuation can use an Entry Age Normal Funding method. The projected unit credit funding is more consistent with a solvency standard. The entry age normal funding method is designed to produce level costs; this goal is very much consistent with the purpose of the GASB standards.

2. FAS106 requires that the discount rate be based on that for high quality bonds. The GASB discount rate used is based on the actuary's best estimate of future investment return. For a trust invested in equities that would be the best estimate of the long-term expected return for the equity market. Because most OPEB plans have not been pre-funded, under the GASB45 the discount rate used depends upon the expected funding level of the plan. (For a more complete discussion of the GASB45 discount rate assumption see my article in the summer 2007 issue of *The Actuary*).

3. Projected unit credit normal costs are calculated differently for FAS106 compared to GASB45. For FAS106, normal costs accumulate between entry and full eligibility for benefits. For GASB45, normal costs accumulate between entry and assumed exit from the plan.

This year, the 2008 Halmstad Prize will be awarded to the best actuarial science paper published in 2006. The selection committee makes its determination taking into account the originality and thoroughness of the ideas expressed in the paper, the readability of the paper, and the timeliness and relevance of the research.

Nominations for papers on pension-related topics are being sought. Please send a brief email that includes the name of the paper, the journal (with volume number) in which it was published, and a few sentences explaining why the paper should be considered to kelley.mckeating@sympatico.ca before June 15, 2008.

Nominations for the 2009 prize (for the best paper published in 2007) are also welcome at this time.

For more information on the Halmstad Prize, click here.

4. Generally, unfunded amounts can be amortized over a period of as long as 30 years. The amortization period is not tied to expected future working lifetime or expected working lifetime to first eligibility for benefits.

5. Generally, GASB amortizations can be as a level percentage of payroll. This can result in negative amortizations where the unfunded amounts actually increase (at least initially) under the amortization schedule. This is not a concern if the amortization payments are approximately the same in real dollars for future taxpayers. Plans that are closed to new entrants cannot amortize as a level percentage of pay.

6. GASB amortization periods can be reset each year. Thus the government can consistently reamortize the unfunded over 30 years, in effect refinancing the mortgage.

7. GASB has no special accounting for special termination programs except for disclosure purposes.

8. GASB disclosures require a schedule of funding progress. The schedule includes for the current valuation and for two of the preceding valuations the accrued liability, the actuarial value of assets, the funding ratio, and the annual covered payroll and the ratio of the unfunded liability to the payroll. The purpose of this schedule is to gauge the plan's progress in managing unfunded liabilities as a percentage of payroll. This exhibit is consistent with the goal of ensuring generational equity.

9. GASB does not require an end of year snapshot disclosure of the funding status of the plan. For a July 1, 2007 fiscal year, the end of the year disclosure will show the results as of the valuation date, which could be as much as 24 months prior to the beginning of the fiscal year.

10. FAS158 has recently required OCI charges for unamortized losses and prior service costs. There is no such GASB requirement.

Finally, there are some differences, which may just have to do with the fact that they have different authors. Or perhaps I just haven't figured out what they have to do with the way governments operate versus companies.

Under the GASB standard if there is a NOO, the final expense includes two additional components.

- Interest on the NOO minus
- The NOO adjustment which is equal to the NOO divided by the amortization factor used for the unfunded liability.

This is more analogous to the treatment of a credit balance in the pre-PPA ERISA funding world.

Finally, while this article focuses on the technical differences

between the GASB and FASB standards (because we are after all technical people), the actuary should also be aware of the difference between business and government in his face-to-face meetings and his communications with government officials and governing bodies.

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WOMEN AND RETIREMENT: GREATER CHALLENGES AND MORE INDIVIDUAL RESPONSIBILITY

Anna Rappaport, FSA

Planning for retirement in North America has become much more challenging as the defined benefit system has declined. We must take more responsibility for ourselves. As we plan, many societal forces affect us. Both men and women are disadvantaged because Americans in particular are not very good savers.

While generally pension plans and Social Security (CPP/QPP/OAS in Canada) use the same formulas for men and women, often the results are different. Women alone are much more likely to be poor or near poor, and women have lower pensions on average. The differences in the economic status of older men and older women come from a number of different factors, including:

- Women's longer life spans;
- The fact that women are more likely to be alone in old age;
- Family decisions about the allocation and use of retirement assets;
- Differences in work histories and earnings;
- Failure to organize a comprehensive system to provide and finance long-term care;
- The fact that women are much more likely than men to need long-term care in an institutional setting;
- The failure of many families to secure adequate life insurance on the main breadwinner, if there is a main breadwinner;
- A Social Security system in the United States that works very well for a single-earner family with a dependent spouse, but much less well for various combinations of dual-earner families;
- The same women who have to work hard as single parents to support children alone are often striving hard to make it in retirement since they had a very difficult time saving.

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Note that the situation for married couples is totally different from that of single persons. A key challenge for the married woman is to remember that she is very likely to be single some day. Planning needs to work for the couple, and for each person when they're no longer a couple.

While there are significant differences in life circumstances between men and women, Society of Actuaries' research shows only very modest differences in risk perceptions with women being more concerned about some risks. A special report on the results of the 2007 Retirement Risk Survey and women will be issued later this year. A report on women and the 2005 survey results is currently available. The full report of the 2007 survey and the 2005 report on women are available on the SOA Web site.

The 2007 research includes two new sets of material that are of particular interest as we think about women. There is a question in the survey which asks whether you will be worse off after the death of your spouse and whether your spouse will be worse off after your death. The results indicate that pre-retirees and retirees have similar expectations for their own financial well-being after their spouse's death or the financial well-being of their spouse after their own death. Two in 10 retirees (22 percent) and pre-retirees (21 percent) feel they will be financially worse off if their spouse were to die first. Only about one in 10 retirees (11 percent) and pre-retirees (8 percent) believe that their spouse will be worse off if they were to die first. Around 60 percent of both groups feel that they will be financially about the same. Several members of the project oversight committee, including me, feel that this is very optimistic and reflects a gap in knowledge. Results, by sex, for this portion of the survey will be included in the upcoming report on women.

The second new area in the 2007 survey focuses on phases of retirement, and looks at change during retirement. A special report on this topic will also be coming out later this year.

The key learnings from the risk surveys are that there are significant gaps in knowledge among Americans, and misperceptions about finances in retirement. This general finding is reinforced by the Employee Benefit Research Institute's annual Retirement Confidence Survey. While this work is from the United States, there is also evidence of similar gaps in other countries. The consequences of these gaps are more severe for women because they live longer. For example, if a couple uses its resources too rapidly due to a lack of knowledge, it is the survivor (after the first death) who is most likely to have a problem. If inflation risk is not considered properly, it is the person who lives the longest who is likely to suffer the consequences. The Committee on Post-Retirement Needs and Risks has issued two reports focusing on an overview of where the knowledge gaps are. These also can be found here.

Is there something new about this topic?

The fundamental issues are unchanged, but they are more important today because of the large number of baby-boomers reaching retirement age, as well as the decline in defined

benefit plans. And, rising health care costs are compounding the challenges. With the increase in personal responsibility, more actuaries are focusing on how individuals can manage on their own.

Although the basic issues are certainly not new, the need to do something about them is greater than ever.

How can actuaries address these issues?

Actuaries are accustomed to thinking "like actuaries." However, there are other, more effective, ways by which one can attack these issues. Diane Savage, CFP, CFC, provides an overview of the issues surrounding women and financial planning in Rumpelstiltskin and Financial Planning.[1]

She takes a different twist, focusing on what should be done to solve the problems. She says:

> *Women need to become assertive financial decision-makers regardless of how little or how much money they earn, their marital status, their work patterns, their social status, or their net worth. It is important that women do something for their own retirement with whatever resources they have available to them. Is it better to arrive at retirement with regrets and no nest egg or to have some regrets and a little nest egg? Arriving at the life stage of retirement may be one of those times when something is better than nothing.*

Savage also provides advice to planners about how to work with and approach women clients. She asks planners to:

- Help clients take responsibility and identify beliefs about personal financial responsibility;
- Work with clients to develop new financial behaviors;
- Integrate them into retirement planning;
- Use a coaching style;
- Find opportunities to work with groups of women.

What decisions do women need to make?

Success in retirement depends on a combination of financial resources and support, dealing with health issues, and having a "life portfolio" or staying engaged in meaningful activities. Here are some of the questions that individuals and their advisors need to ask as they prepare for retirement:

- What financial instruments, retirement benefits, and health care benefits are of special importance to couples in their later lives? To widows? To divorced women?
- What non-financial issues should be considered when planning for later life?
- To what kinds of later life benefits (e.g., retirement, health care) may a woman be entitled as a result of her (or her partner's) employment?
- What factors influence if, when, and how a woman should retire?
- What is the best age (62? 65? Later?) for a woman to commence social security retirement benefits?
- How might a woman's continued employment affect later life planning?

- How do health care issues affect later life planning?

When should women focus on retirement planning?

Retirement planning is an important part of lifetime financial planning. Unfortunately, many people do not start early enough. The best time to start saving is when you have your first real job, and the best idea is to stick with it. Once you've saved a little money, the next step is to learn to invest wisely. In your 30s and 40s, it makes sense to track your savings, invest well, and determine whether you're on track to have a reasonable amount of money when you become ready to retire or phase down. In your late 40s or 50s, it makes sense to do more serious retirement planning, focusing on risk management and how you will make retirement work. The Women at Risk materials discussed later in this article are aimed at this "near retirement" age group, as is Taking the Mystery Out of Retirement Planning, a publication of the U.S. Department of Labor prepared with help from the Actuarial Foundation.

There are three key areas where actuaries can add value:

1. Helping people understand when to retire and when to claim Social Security benefits. While most people claim benefits early, there can be value in claiming them later.[2] When Ron Gebhardstbauer was Pension Fellow of the American Academy of Actuaries, he worked with USA Today to provide some tools to help people see the chances of living long and the increased value if Social Security is claimed later by those who live longer. The USA Today calculator indicates that, for a couple both aged 62, the chance that at least one of them will live to age 95 is 29 percent. It also shows, for a predefined example, how much benefit is lost by those who claim benefits early and live long. In addition to Social Security claiming, there are a number of other issues related to the economic pros and cons of retiring early and late. There is a paper on this topic in the Women at Risk material described below. Actuaries need to focus on how to help people understand and model the financial trade-offs between retiring at different times. For each individual, the right answer is a balance of life and financial issues. Many people want to realize their dreams while they are still energetic enough to enjoy the activities involved.

2. Considering whether, when, and how much to annuitize. A joint publication of the Actuarial Foundation and WISER, called Making Your Money Last a Lifetime, focuses on the questions that people should ask and the pros and cons of annuitization. Many people have asked me "How much should be annuitized?" or "Is there a guideline?" There is no professional advice currently available on which there is consensus. My view is that it is desirable to have a guaranteed life income (or an income stream that will not disappear) equal to one's basic expenses at one's "minimum living standard." I would define this minimum living standard not as living in the house we currently live in, but rather

in the least expensive house in which we would be comfortable. Social Security gets us part of the way there but, for most of us, not the whole way. However, note that about 40 percent of older women living alone have virtually nothing but Social Security, and must manage on what Social Security provides. If we have DB income, Social Security and DB income together may be sufficient. But for those who do not have DB pension income in addition to Social Security, there are serious questions. The Committee on Post-Retirement Needs and Risks has been grappling with this question, and whether there is a pathway to an answer. Papers included in the Needs and Spending in Retirement: Unraveling the Mystery monograph explore the range of needs in retirement considering those that are essential, discretionary, or unpredictable, as well as changing consumption patterns throughout retirement.[3] We continue to look for ways to help advance our knowledge on this topic.

3. Helping people manage risk during retirement, including consideration of a range of risk management products. Individual risk management involves very different concepts than risk management for a group. Actuaries serving as advisors to human resource managers can help them determine their role and how to meet the needs of employees and retirees. Actuaries serving as advisors to financial service companies can help them develop and maintain products and services. Actuaries advising individuals or working in an educational mode can help develop information for individuals.

What are some of the most important knowledge and planning gaps?

Some of the key knowledge and planning gaps include:

- Thinking short term. Many people plan for five years or less when they might live another 30 years or more.
- Failure to focus on widowhood, or what will happen when a couple is no longer a couple.
- Overestimating the value of pensions and personal savings, and underestimating the importance of Social Security.
- Not focusing on the variability of life spans.
- Not planning for shocks such as long term illness and the need for long-term care.

"Spending and Investing in Retirement: Is there a Strategy?" outlines how focus groups organized by the SOA in conjunction with LIMRA reinforced the findings of earlier risk surveys and demonstrated that much of people's planning is short-term. This report, which includes actual quotes from retirees in the focus groups and audio recordings can be found here.

What should actuaries do and how can we help?

Each of us can work to help build awareness of these issues with our clients, employers and the publics that we meet. We can become involved in our communities. Here is a discussion of some materials that may help us to help and an example.

In September 2007, the Joint Task Force on Issues Affecting Women as They Age of the Chicago Bar Association and the Women's Bar Association of Illinois organized an event to help women plan entitled Women at Risk: Timing, Financing and Coping with Retirement. The program was designed to inform women and the professionals who advise and counsel women, about issues relevant to middle and later life planning, particularly as to those issues affecting the decision to retire and the timing of that decision. Through a series of interactive panels, the participants analyzed three hypothetical case studies and discussed the ramifications of various responses to the circumstances faced by each of the case study subjects. The participants were provided with information about resources available to women facing particular risks as they approach retirement. Three actuaries, Julie Durkin, Carol Bogosian, and I, were on the program.

The Actuarial Foundation was a sponsor of the event, and the materials produced can be found on the Actuarial Foundation Web site. The actuaries involved helped connect the organizers to the Actuarial Foundation. The resulting book of materials is transportable and could be used to help educate women or organize seminars elsewhere.

Closing Comments

Many women, particularly those who are alone, spend part of their retirement years poor or near poor. For many of them, their circumstances are much more difficult than earlier in life. As we talk about the new retirement and think about people working longer, we often ignore the fact that few will be able to and would want to work past age 75. As we think about retirement plans and retirement planning, remember that women are the majority among the very old, and that we need to focus on how to help them plan better for these years.

Notes

[1] Published in the Journal of Financial Planning in March 2008. *http://www.fpanet.org/journal/articles/2008_Issues/jfp0308-art3.cfm*

[2] *http://www.usatoday.com/money/perfi/retirement/2008-01-13-turning-62-cover_N.htm*

[3] *http://www.soa.org/news-and-publications/publications/other-publications/monographs /pub-retirement-systems-monographs.aspx*

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TECHNOLOGY—THEN AND NOW

Tom Sablak, FSA

In this, the 20th year of publication for the PSN, we're taking a look back in time by reprinting selected articles from the earliest issues.

Flashback to 1989: "Batman" was a smash at the box office. Radio stations were playing hit after hit from Paula Abdul and Bobby Brown. "Roseanne" was the top-rated TV show. And, the SOA hosted its first-ever teleconference! The topic was pension-related, and the event was reported both in *The Actuary* and in the inaugural issue of the *Pension Section News*. Here's how the teleconference was described at the time:

1,100 View SOA's First Teleconference by Barbara Choyke

More than 1,100 persons at 25 sites across the United States participated in SOA's first teleconference January 26.

The program on "Minimum /Maximum Tax Deductible Contributions" offered participants five hours of core continuing education credits toward the required 10 hours needed to maintain their enrolled status. It was organized in cooperation with the American Academy of Actuaries, American Society of Pension Actuaries, and the Conference of Actuaries in Public Practice.

The planning and production of this educational program took a year. A crew of more than two dozen was at work when the session was broadcast before a live audience at the American Hospital Association's (AHA) headquarters in Chicago. The Society contracted with AHA to have it provide production, logistical, registration, and broadcast support.

Audience members at other sites were able to call in questions to telephone operators who passed the questions on to the moderator. Attendees responding to a questionnaire rated the program quality high.

Those wishing to view this program at home may order a VHS video tape and workbook from the Society. To earn continuing education credits, viewers may submit a test accompanying the video tape.

For more information, contact the Seminar Department.

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For more information on the Halmstad Prize, click here.

Congratulations to the teleconference faculty: Bamet Berin, Chtistopher Bone, Edward Burrows, and James Holland.

The first (pre-Internet) teleconferences were certainly different than today's webcasts. As our reprinted article above explains, the first teleconference took place before a live audience at the American Hospital Association's headquarters in Chicago. Many more participants around the United States dialed in and crowded around speaker phones to soak up the five hours' (yikes!) worth of education on minimum/maximum tax deductible contributions. It took a large number of staff and volunteers to pull it off. The lead time in terms of planning was lengthy.

Times have changed for continuing education, thanks to the Internet. We still use our phones to hook into the audio portion of a webcast presentation, but we now have the ability to view slides in real time on our computers. Only a handful of people—not a crew of 2 dozen!—are needed to run the webcasts. And, since today's webcasts are less of a "production," they can take place more frequently. Most last about an hour to an hour and a half.

The presenters can deliver their material from their own offices or homes. Some webcasts are still designed to handle questions from participants over the phone, although this is rarely done today. Instead, technology permits participants to submit questions electronically via their computers. And of course, participants can still obtain recordings of the webcasts. However, they're now delivered on CD, rather than via clunky video tapes.

Since 1989, the SOA has broadcast hundreds of teleconferences and webcasts for its members. In fact, in the past five years alone, there have been 31 pension-related webcasts by one count. 2006 was (unofficially) the most active year on record, with 11 productions in total, thanks in large part to PPA and accounting reform in the United States. In that five-year span, the SOA has delivered over 7,200 continuing education certificates to participants. It is impossible to get a precise count of the number of people participating in any given webcast. While it's easy to add up the number of registration sites, some (perhaps most) of those registrations are for groups of people who gather in a conference room at work to participate, as opposed to individuals who dial in from their own desks.

The money raised from Pension Section webcasts supports the important projects and initiatives of our section. For that, a big "thank you" goes out to the many volunteers who have shared their time and knowledge over the years.

We hope you enjoyed the reprint from 1989! Perhaps you dialed in to the original teleconference, or better yet, were a part of the live audience. If so, we'd enjoy hearing about your memories. E-mail your reminiscences to our editor, Art Assantes, at *PSN.Editor@pensionedge.com*, and we'll try to print them in a future issue of the *PSN*.

Special thanks to Sue Martz and Carol Lyle at the SOA for digging up the webcast statistics for this article.

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LETTER TO THE EDITOR: OVERHAULING THE PENSION-MEASURING METHOD TO REFLECT FUTURE PAY RAISES

Cicero Limberea CPA

The recent changes in pension accounting standards promulgated in 2006 relate to an old economists' dilemma: whether salary trends can be predicted over a long term horizon. During 2006, the Financial Accounting Standards Board (FASB) issued Statement 158. For fiscal years ending after Dec.15, 2006, it requires all companies to reflect each defined benefit and other posretirement benefit plan's funded status on the company balance sheet against the equity account of other comprehensive income.

FAS 158 does not change net income or comprehensive income for the previous years. Rather, it requires a one-time adjustment to accumulated other comprehensive income (AOCI) in shareholders' equity.

FAS 158 reaffirmed the approach to overhauling pension accounting which would ask companies to include projected salary increases when reporting deficits or surpluses.

FAS 158 amends FAS 87. For nearly 20 years, FAS 87 required companies to show in the footnotes to their financial statements the amount owed to employees based on the projected obligation measure, thus not quantifying right away any future equity impact, and furthermore excluding salary projections.

So what does this change do to corporate balance sheets?

A number of actuarial consulting firms using existing disclosures from 2005 to 2007 estimated a combined pension deficit of about $90 billion. This projection was based on an analysis the expense structures and included projected salary increases for over one hundred large U.S.-based public companies. When they left the estimated salary increases out of the calculation, the deficit dropped to between $10-12 billion.

Does including the expected salary increases in the pension liability on the balance sheet make sense?

Some economists contend that salary increases are cyclical, strongly correlated to consumer price index moves (i.e. inflation

This year, the 2008 Halmstad Prize will be awarded to the best actuarial science paper published in 2006. The selection committee makes its determination taking into account the originality and thoroughness of the ideas expressed in the paper, the readability of the paper, and the timeliness and relevance of the research.

Nominations for papers on pension-related topics are being sought. Please send a brief email that includes the name of the paper, the journal (with volume number) in which it was published, and a few sentences explaining why the paper should be considered to kelley.mckeating@sympatico.ca before June 15, 2008.

Nominations for the 2009 prize (for the best paper published in 2007) are also welcome at this time.

For more information on the Halmstad Prize, click here.

or deflation), and often tied to labor productivity. In addition salary increases are inversely correlated to the marginal product of capital and equipment productivity.[1]

However, other economists contend that salary increases are industry specific and strongly related to bargaining strength, degree of industry protectionism, budgets and tax revenues for public employees, strength of labor unions for blue collar workers and other non-quantifiable market realities.

In response to FASB, numerous public companies have claimed that salary increases indeed aren't guaranteed and therefore the estimates of a constantly growing salary liability should not be included in calculating the pension deficits.

While salary increases in the United States aren't contractually guaranteed, they typically outpace inflation by a small margin over the long term, although the reverse is true sometimes over short time spans.

Salary increases for 2003 in the United States were approximately 3.4 percent, which was the lowest rate in more than 30 years. U.S. employers awarded average pay increases of 3.8 percent in 2007, just slightly more than they granted in 2006, 3.7 percent. The CPI was 2.7 percent in 2007, so the median wage hike exceeded inflation. Pay increases are projected to remain flat at 3.8 percent in 2008. (Source: Economics Research Institute)

This short term pattern proves that business cycles, which reverse over relatively short terms, indeed are related to salary increases.

Thirty years ago, the United States was going through a period of poignant inflation, driven in part by the gas crisis of the early and mid seventies. At that point in time, average raises were 7-10 percent, but inflation in the seventies was 7-8 percent, leaving an effective increase in buying power of 1-2 percent.[2] Through the eighties, the economy improved, inflation dropped to 5-6 percent and salary increases started to trail the inflation rate. In fact, during the eighties, average salary increase rates dropped from 10 percent per year to just over 5 percent per year. In the first half of the 1990's, with the very low U.S. inflation (3-4 percent), those same salary increase rates dropped to about 4-4.25 percent and they stayed there through 2001 and 2002.[3]

The positive evidence over the past 30 years suggests that salary increases are almost certain, thus supporting the claim that their inclusion in the projected obligation is a realistic measure of what a company would expect to pay in future.

Do we need to consider both short term and long term salary impacts?

Estimating cross-industry salary trends over longer periods tends to be complicated by the current credit crunch (i.e. persistence of illiquidity), the financial markets short-term downturn, and emerging industries which display highly volatile

profit margins. All this makes estimating the projected pension liability more realistic if it is split into two components: A liability for employees closer to retirement which is LESS volatile because of LESS uncertainty from business cycles and a more UNstable one for employees further from retirement. The short tenor of the interest rate curve is similarly different than the long term displaying more volatility.

Thus due to the current condition of a credit crunch, the compression of expected returns makes the long term pension liability overstated due to short term conditions. Out of five actuarial valuation reports which I audited in 2008, all five assumed a rate on return on assets which was smaller than estimated salary increases, immediately creating a negative overall return since the rates are not dynamically adjusted yearly.

Are there industry specific issues to consider?

The emerging industries seem to need specific individual guidance: according to a salary study by online skills assessment specialist Brainbench, most IT workers received very little in the way of salary increases from 2002 to 2007, due to large price reductions and margin compression in IT equipment.

Brainbench's salary study is based on data collected from more than 6,000 survey respondents, two-thirds of whom were male. The salary survey covers a variety of different trends, including year-over-year salary increase data from 2001 to 2007; male and female salary levels in key IT disciplines; salary increase rankings on a per-industry basis; the role of IT certifications in salary increases; and the typical size of compensation packages that augment salary increases.

Many IT firms didn't offer additional compensation in 2007, but large organizations (those with more than $1 billion in revenue) and small organizations (less than $1 million) were more likely to offer such compensation. Workers in the computer industry consistently fared better than their colleagues in other industries in terms of salary increases when the IT equipment had better margins, before 2001. Before 2001, workers in health care, education or training, and financial services also fared better than normal.

How are companies' credit ratings being impacted?

While moving benefit obligations on the balance sheet is likely to force many companies to recognize a big liability, there is uncertainty as to whether credit scores will be lowered for such companies, possibly jeopardizing their lending agreements, since the gap between salary increases and existing plan asset returns is primarily influenced by the competitive nature of the companies' sales on a case by case bases, in which case the price increases may outpace inflation by a higher margin than the salaries.

In view of this assumption, I have selected a sample of 25 companies from a list of 35 companies with the largest reported FAS 158 projected pension deficits that were included by the

actuarial consulting firms which estimated the $90 billion combined deficit from 2005 to 2007 in their study. I examined them for ratings changes by the main three ratings companies (i.e., Moody's, Standard and Poor and Fitch). Of the sample, only three of them had been downgraded after the implementation of FAS 158, and for reasons other than the pension liability. Thus, the rating companies are prudent in including the future pension obligation as a right-away downgrade trigger.

Notes

[1] See the neoclassical Solow-Swan steady-state growth model.

[2] Source: Financial Trend Forecaster.

[3] Source: Economics Research Institute.

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