Pension Section News

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Building the
Foundation for New
Retirement Systems

Join Us for another Thought-Provoking Experience at the 2008 Living to 100 Symposium

The Society of Actuaries' Committee on Living to 100 Research Symposia invites you to its third, triennial international symposium on high-age mortality and related issues taking place Jan. 7-9, 2008, in Orlando, Fla.

Actuaries, demographers, gerontologists and other professionals from around the world will be among those presenting:

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- **Enhanced mortality rate and population projections**
- **Implications of an aging population for social, financial, health care and retirement systems.**

The 2008 symposium will feature an increased emphasis on practical material. Come and learn from experts the latest developments and their real-life implications.

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Visit http://livingto100.soa.org **for more details.**

Chairperson's Corner

By Martine Sohier, FSA, FCIA

With the aging of the North American population, there will be more competition for workers as labour shortages gradually increase. Employers will need to focus on attraction and retention strategies. New means to retain older workers will be required. In this context, how will retirement promises make a difference in the chase and retention of talent?

In our global economy, many companies are now looking to attract qualified workers from around the world. What kind of retirement benefits, if any, should companies commit to remain competitive internationally? To best answer this question in a global market, we need to keep ourselves abreast of what is happening in other countries. Has the optimal solution been found somewhere else to address retirement savings accumulation and decumulation issues? What can we learn from others that can help us find the best ways to address the challenges we face in our retirement system? We need to keep an international perspective in mind as we continue to advance in our *Retirement 20/20* initiative.

Retirement 20/20

On April 16th, we published our report on the first *Retirement 20/20* conference, "Building the Foundations for New Retirement Systems", which was held on September 28-29 of last year in Washington, D.C. You can read both the full report and the "headlines" at *www.retirement2020.soa.org*. A summary of the headlines from the conference was also provided to you in January in our first electronic *Pension Section News*.

We are now embarking on our second phase of *Retirement 20/20*. At this stage, we are focusing on the alignment of stakeholders' roles within a retirement system with their skills. Fundamental questions will be addressed through this second phase, such as what responsibilities and risks employers should bear when sponsoring a pension plan. Should we rely on individuals to make the best decisions when it comes to retirement income planning? Should the markets play an increased role in putting forward solutions to enhance the delivery of retirement promises? Our second conference discussing the alignment of roles with skills will be held on September 24 -25, 2007. We are also starting research projects to look at some issues more deeply, including how we can use the markets more effectively in pooling and hedging of retirement risks, and what other possibilities there are for self-adjustment mechanisms in retirement systems. Results of this research will be published in 2008.

The *Pension Section News*

We continuously strive to improve the quality and delivery of the information we provide you. This is why we asked you in the January *Pension Section News* to participate in a brief survey on your preferences for the *Pension Section News* format.

The results of the survey received so far are summarized by Mike Price in this issue.

We have adjusted the format of this edition in accordance with your preferences. We want to thank you for your responses and comments as this brings of a lot of value to the delivery of our *Pension Section News*.

Please contact Emily Kessler, SOA retirement systems staff fellow, at *ekessler@soa.org* , or myself at *martine.sohier@watsonwyatt.com* to provide us with your comments or to let us know if you are interested in getting involved with any of the Pension Section Council projects.

Martine Sohier, Chair of the Pension Section Council, works for Watson Wyatt Worldwide in Toronto, Ontario. She can be reached at *martine.sohier@watsonwyatt.com*.

PPA and 2007 Pension Funding:

What in the World Are We Waiting For?

By Brian C. Donohue, FSA, EA

Concerning the Pension Protection Act (PPA) and certainty, there are two related misconceptions:

Misconception #1: Now that PPA is law, we finally have clarity on pension funding rules.

Misconception #2: PPA extends current rules through 2007. So, if we don't have all the details of the new law, at least this year is clear enough.

There is no doubt that PPA has removed significant legislative uncertainty around pension funding rules. But there are lots of details. And, as discussed below, many unresolved issues relate to near-term funding decisions. In some ways, the rules for 2012 are clearer than for 2007.

Here's the problem: many PPA rules apply based on variants of the Funding Target Attainment Percentage (FTAP) as of January 1 (for calendar-year plans) of the prior year (the "lookback year"). For 2008, the lookback year -- 2007 -- is a pre-PPA year. Here are the rules that may use a 2007 lookback year for 2008:

2007 Funding Target Attainment Percentage (FTAP)	2008 Consequence
< 60 percent funded*	Hard benefit restrictions (hard freeze, no lump sum or shutdown benefits)
< 65 percent funded	At-risk rules, nonqualified deferred compensation funding restrictions
< 70 percent funded*	Hard benefit restrictions (beginning April 1)
< 80 percent funded	Credit balance restrictions
< 80 percent funded*	Soft benefit restrictions (no benefit improvements, 50 percent lump sums)
< 90 percent funded*	Soft benefit restrictions (beginning April 1)
< 100 percent funded	Quarterly contributions

> ** PPA is unclear whether or not 2008 benefit restrictions (e.g., lump sums, improvements, accruals, shutdown benefits) will be subject to a 2007 lookback, let alone how the lookback rules would be applied to 2007. Collectively bargained plans enjoy up to two years delay in the effective date for these restrictions.*

So, for example, in determining whether hard benefit restrictions apply to your plan in 2008, you look at your FTAP *as of Jan. 1, 2007* (for calendar-year plans). In order to avoid hard benefit restrictions in 2008 (or, e.g., "at-risk status," restrictions on lump sums, or funding of nonqualified deferred compensation plans), pension plans will need to hit certain funding targets as of Jan. 1, 2007 (for calendar-year plans). Contributions to hit these targets must be made by Sept. 15, 2007.

The problem is that there *is no FTAP for 2007* -- the rules defining FTAP do not apply until 2008. There are similar percentages defined under current law, such as the "funded current liability percentage." But PPA does not adopt these measures as the basis for the lookback at 2007, but instead instructs IRS to issue guidance as to how the lookback rules apply for 2007.

So, just how will the FTAP be calculated for 2007? There are four areas of uncertainty.

	Old (2007) rule	**New (PPA) rule**
Mortality	New table	New table; Custom option for large employers
Interest rate	Long-term rate/ 4-year smoothing	3-segment yield curve/ 2-year smoothing
Assets	Smoothing of prior 4-years' experience; 80-120 percent corridor	"Averaging" of prior 2-years' experience; 90-110 percent corridor
Credit balance	Included in assets	Subtracted from assets

The key question in each case, in calculating the FTAP for the 2007 lookback year, in applying various restrictions that key off funded percentage, do you use the old rule (for mortality, interest rate, etc.) or the new one? The answer may be different for different items on our four-item list.

Mortality

IRS recently issued regulations governing 2007 mortality. The preamble to the regulation includes the following comment: "The specifications for developing the mortality tables under [PPA] are the

same as the specifications" under current law." So, we can expect the 2007 table to be reasonably similar to what we'll see under PPA.
The big unknown here relates to large employers that submit their own mortality tables for PPA. Will they be able to apply this table to the 2007 FTAP calculation?

Interest rate

Current law uses a long-term corporate bond rate, while PPA uses a three-segment yield curve. In view of the recent flattening of the yield curve, there may not be a lot of difference between using the old (single rate) rule or the new (yield curve) rule for the 2007 lookback year. Applying the yield curve (instead of a single long-term bond rate) to 2007 may result in a 2-3 percent increase in liability for a very short-duration plan, but may produce a slightly lower liability for other plans.

But, there's an (optional) transition rule for the yield curve. In year 1, you calculate interest rates using 1/3rd yield curve and 2/3rds single long-term bond rate. In year 2, you calculate interest rates using 2/3rds yield curve and 1/3rd single long-term bond rate. Is 2007 year 1 or year 0? If it's year 0, then presumably, you would use the old (single rate) rule to determine the plan's interest rate.

Assets

Current law allows smoothing of up to four years of prior asset returns within a corridor of 80-120 percent of market value. PPA reduces this to two years of prior experience "on the basis of the averaging of fair market values" within a 90-110 percent corridor. If this is interpreted as simple averaging rather than averaging of expected values in some fashion, it will produce a value that is biased below market value and will be unappealing to many, possibly most, plan sponsors.

Our immediate concern is: which rule do you apply for the 2007 lookback year? If anything, PPA methodology (market value or something closer to it) will produce a higher asset value than current rules for many plans in 2007, due to healthy asset returns over the past four years.

Credit balances

For many companies, the biggest issue will be, how are credit balances treated in determining the FTAP for 2007 -- are they included in (old rule) or subtracted from (new rule) assets? Sponsors with large credit balances will be especially interested in the resolution of this issue.

Beginning in 2008, plans can (and in some cases must) "burn" a portion of their credit balance to avoid adverse consequences. If lookbacks at 2007 are calculated by subtracting the credit

balance from assets, it would be very troublesome to employers unless they had some ability to "burn," or otherwise agree not to use, their credit balance during 2007.

Some Clarity

Amid all this uncertainty, there are some things we can lock on to for 2007. First, plans that wish to enjoy delayed impact of PPA funding rules will want to ensure they avoid the "deficit reduction contribution" (DRC) for 2007.

Secondly, plans that want to avoid lump sum restrictions to "top-25" employees will need to fund to 110 percent of their 2007 liability.
Both of these calculations will reflect the new mortality published for 2007.

Finally, plans will have one last bite at the "full funding exemption" apple (for the sake of avoiding PBGC variable premiums) during 2007 by ensuring that they fund at least up to the 2006 full funding limitation. This amount, which is based on 2006 valuation results, should be known already for most plans.

What's next

The IRS and Treasury are aware of the urgent need for guidance around 2007 lookback issues and have made this one of their priorities in the months ahead. I am optimistic that plans will have the needed guidance in time to make intelligent September 15 funding decisions- maybe even with a few weeks to spare.

Brian Donohue is a vice president with CCA Strategies in Chicago, Illinois, and a member of the Pension Section Council. He can be reached at *brian.donohue@ccastrategies.com*.

Individual Accounts for Social Security Reform

International Perspectives on the U.S. Debate

by John Turner (*Published by W.E. Upjohn Institute For Employment Research)*

Reviewed by: Steven Siegel, ASA

"Congress did not act last year on my proposal to save Social Security. ..."
–President George W. Bush in his Jan.31, 2006 State of the Union address.

With this chastisement of Congress on the eve of this year's State of the Union address, a year of intense politicking on Social Security Reform came to a fruitless and abrupt end. Intended as perhaps the highest priority on the Bush administration's second term economic agenda, the original proposal and subsequent reformulations met with less than an enthusiastic response from the public. As a result, Social Security Reform has quickly vanished from the daily headlines. Yet, the debate on Social Security solvency remains a crucial one for many Americans who either currently or will in the future rely on Social Security benefits for a significant portion of their financial resources. And with the 2008 presidential election season quickly approaching, the Social Security platforms of leading candidates promise to be among the key determinants of their electability.

Actuaries have a particular vested interest in this issue as demonstrated by a survey issued by the Pension Section's Research Committee last year. Close to 2,400 actuaries responded to this survey seeking their opinion on the long–term solvency of Social Security in the United States and proposals that address it. The survey also revealed that actuaries do not speak in one voice on this issue–opinions in the survey ran the gamut from calls for complete privatization of the system to outright rejection of privatization in any form.

With this mind, I would highly recommend actuaries, who would like to learn more about this issue, read John Turner's excellent book on international perspectives of individual accounts. In clear and concise language, Turner, a senior policy advisor at the AARP Public Policy Institute, explores the first–hand experience of other countries that have implemented, either partially or in full, aspects of social security reform that have been proposed for the U.S. system.

Early on, Turner acknowledges the vast international spectrum of governmental policies for encouraging pension coverage, and then categorizes those policies into four major categories that I found particularly helpful. Using this as a framework, Turner takes the reader through different national systems with an emphasis on the relevance of the experiences of Sweden and the United Kingdom in terms of the most likely types of overall reform approaches.

Turner effectively interweaves the experiences of these countries with the overarching risks of reform that he delineates earlier in the book. This provides a balanced view of the benefits, pitfalls, and lessons of reform that only come from empirical observation. For instance, in the section dealing with the risks of individual management of investments, Turner writes, "Experience with individual accounts as part of social security in Sweden indicates that many employees do not make an investment choice, and thus the structure of the default fund is an important aspect of the system design." The message here is clear: any reform approach that shifts responsibility to individuals must have well–thought out and safe defaults for those motivated to make choices, but not financially sophisticated enough to do so as well as those that are simply negligent. Related to this, I found Turner's discussion and citation of studies exploring the psychological effects of individual accounts insightful for gauging the public's ultimate appetite for reform.

Finally, for those who have relied on the popular media for much of their information, Turner methodically deconstructs a number of myths that have persisted as part of the debate. These myths serve as a cautionary note for how the truth can be obscured for the sake of political expedience. It's worth it to read the book for this section alone.

The U.S. Social Security system has depended on the sage advice and leadership of actuaries since its inception in 1935 with President Franklin Roosevelt's signing the Social Security Act into law. This legacy of actuarial leadership continues today and with the approaching election, it is important to arm yourself with facts to make an informed judgment–no matter where you fall on the political spectrum. Read this book and then decide for yourself.

Steve Siegel is research actuary for the Society of Actuaries. He can be contacted at *ssiegel@soa.org.*

Retirement Plan Design and Investments: Trends in Europe, Insights for North America

By Frank Goasguen, Global Head of Institutional Clients, ABN AMRO Asset Management

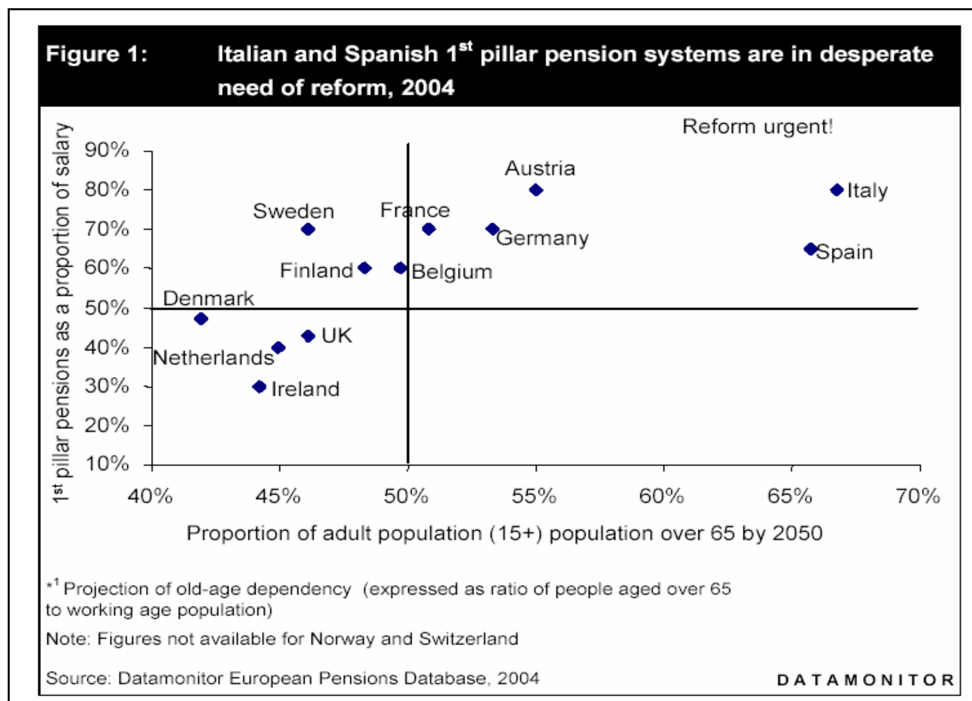
European pension funds face challenges similar to those facing North American plans, so developments in Europe may help U.S. and Canadian plan sponsors find their way to a reasonable resolution of their current problems.

Three Pillars

As in North America, the pension systems in European countries consist of three pillars:

1. State-provided systems
2. Employment-related plans
3. Individual retirement savings

Relative reliance on each of these pillars varies from country to country across the continent. For example, in Switzerland the state system targets a pension of about 30 percent of final salary, while in Italy the state system targets an 80 percent replacement ratio. Combine the Italian state system's high replacement ratio with a high proportion of older workers, and it is not surprising that Italy's 1st pillar system is in urgent need of reform, as shown below:



Reforming the state-provided pillar in many European countries will result in more inflow into the 2nd and 3rd pillars.

Employment-related Plans

Both defined benefit (DB) and defined contribution (DC) arrangements can be found in Europe. Utilization of these designs varies across countries due to different historical factors and social norms. In several of the Eastern European nations that recently joined the European Union, 100 percent of employment-related plans are DC. By contrast, "old Europe" largely favors DB plans.

In total, about € 3.3 trillion (about $4.3 trillion US) is invested in European employment pension funds. The largest asset pool is found in the United Kingdom, at € 1.3 trillion, where major companies tend to have large DB plans. Two relatively small countries, The Netherlands and Switzerland, have large DB assets (€ 489 billion and € 393 billion, respectively) due to their compulsory 2nd pillar pension schemes.

Individual Retirement Savings

Europeans have roughly € 830 billion invested in individual retirement savings. Of this, almost ¾ is found in the United Kingdom, benefiting from favorable tax treatment for personal retirement savings as well as a more equity-oriented culture. Personal savings for retirement are relatively low in Germany and The Netherlands due to strong employment-related systems and less equity-oriented societies, and are also low in Italy and France due to heavy reliance on state systems.

Trends

A recent McKinsey & Company Study ("The Asset Management Industry in 2010") identifies two key trends in the European pension environment:

- A shift from DB plans to DC plans; and
- A shift from a relative performance orientation for investments to an outcome orientation.

For DB plans, these trends imply either a move to become DC plans or a move to change how the DB plans themselves are managed in order to keep them viable. For DC plans these trends imply continued growth as well as an evolution towards investment products that meet member and sponsor goals rather than seeking to track market-based benchmarks.

The remainder of this article considers these trends in more detail.

Managing in the New DB Environment

As suggested above, those DB plans that are not contemplating conversion to DC are changing their investment paradigms to ensure their longer-term viability. Just as in North America, accounting rules and valuation regulations have caused DB plan sponsors to face much higher volatility in their pension expense and balance sheets. Similarly, low long bond yields and a historical reliance on market index tracking have exacerbated this problem. The pension funding crisis is not just a North American phenomenon!

DB pension plans bear risks as a result of interest rate movements. In recent years, European plans have been trying to manage this risk by investing in long duration bonds, cash flow matching portfolios, interest rate swap overlays and swaptions. However, these approaches do not address the issue of equity risk, and can have some serious consequences for the pension expense as well. Consequently some European pension plans are taking a more holistic approach using liability-driven investing (LDI). The challenge for the pension trustees and their investment manager(s) in operating an LDI approach is to construct a portfolio that combines two separate sub-portfolios:

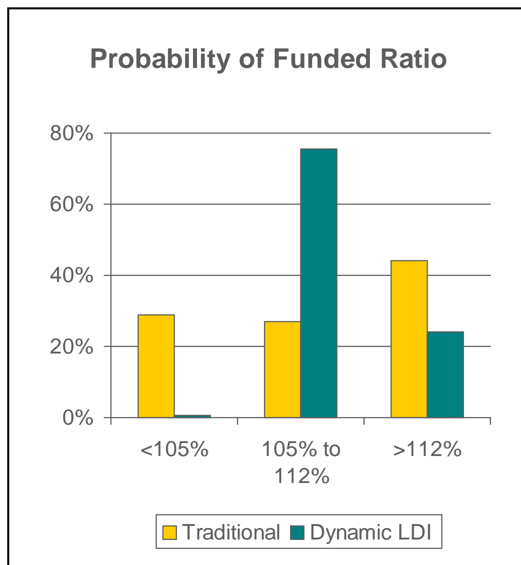
- A portion that is used for hedging purposes relative to the liabilities of the plan; and
- A portion that is used to generate upside potential strong enough to keep the pension expense within reasonable bounds.

The upside portfolio can be created by combining uncorrelated returns from both strategic market exposures (beta) and from active management (alpha). To maximize the upside potential, the opportunity sets can be increased in both the alpha and beta exposures.

It is important to note that LDI is not the same as asset/liability management (ALM) as the latter has been traditionally practiced in Europe and North America. While both ALM and LDI are about linking assets and liabilities, the outcome of an ALM study tends to be a fixed strategic asset allocation. By contrast, LDI provides an opportunity to manage the pension fund portfolio relative

to the liabilities in a dynamic way, taking into account changes to the funded level and risk profile of the plan as frequently as daily (although usually monthly). Dynamic LDI — An Example

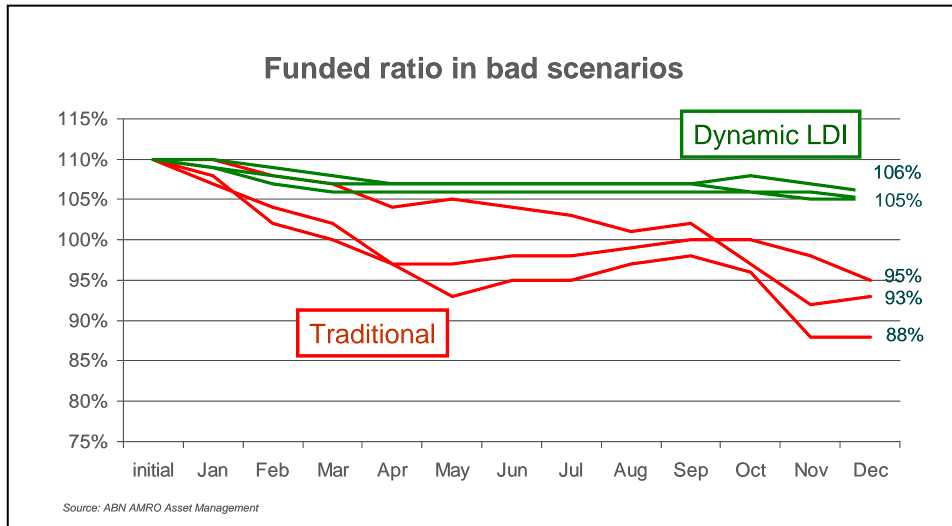
The idea behind a dynamic LDI approach is to increase the commitment to higher-yielding "risky" assets when the funded level is higher, while increasing the commitment to the hedging or "risk-free" portfolio when the funded level is lower. This concept is similar to the constant proportion portfolio insurance approach used in some guaranteed investment products. It is designed to protect the funded ratio in bad times, and to take advantage of good times to build up that ratio. An example of the impact of this dynamic LDI approach in practice is shown below:



Funded Level		
	Traditional	Dynamic LDI
Average	111%	111%
Lower bound 95% confidence	93%	105%
Upper bound 95% confidence	135%	133%

The chart and table compares the probability of the funded ratio of the real-life DB plan in question under two alternate approaches: traditional funding and dynamic LDI. The horizontal axis shows bands of funded ratios (for instance, "105% to 112%") and the vertical axis shows the probability the actual funded ratio will be in the band. Compared to traditional funding, the LDI approach has delivered the same expected funded ratio for the plan (111 percent in this case), but with much less volatility. In particular, it is much more likely the plan will remain fully funded using the dynamic LDI approach.

The ability of dynamic LDI to keep funded ratios within a relatively tight band even in bad markets is illustrated below.



Of course, to properly benefit from dynamic LDI the plan sponsor must ensure very close communication with and between the actuary and the LDI investment manager so that the manager can explicitly take account of the development of the plan's liabilities on an ongoing basis. This close cooperation is visibly developing between some European investment managers and actuarial consultancies. In this fashion, European DB plans intend to maintain and improve their long-term viability.

Outcome-Oriented DC Solutions

The dynamic LDI approach for DB plans is an example of an outcome-oriented approach to DB investing. Instead of focusing on market indices, the focus is on achieving a specific real-world outcome for the DB plan. A similar trend towards an outcome orientation is evident in DC plans in Europe (and elsewhere), as well as in the individual investment area.

In the DC world, outcome-oriented investments include:

- Principal protected investments
- Risk-based lifestyle funds
- Target-date lifecycle funds

- Inflation-indexed investments

According to the McKinsey & Company study mentioned earlier, the fastest growing of these product segments over the last 10 years are the target-date lifecycle funds and the inflation indexed investments. ABN AMRO Asset Management has noted that combinations of outcome-oriented features are also proving popular, such as target-date lifecycle funds that include guarantee provisions.

As more and more of the assets of DC plans (and individual retirement savings) concentrate in the hands of members who are age 55 or more, income generation will assume an ever-greater importance.

In the new market environment that is emerging in Europe, and in North America as well, there will be a great demand for investment solutions that capture the future needs of DC members and individual investors. These include

- Return (to secure a future lifestyle and offset longevity risk)
- Security (to ensure at least a minimum lifestyle and provide peace of mind) and
- Flexibility (to adapt to changes in life situation).

As DC plans evolve to meet these needs, a trend is already becoming visible in some parts of the world that will likely occur in North America as well. Over time, plan providers (whether sponsors themselves or the service providers such as insurance companies) will move to define a carefully selected set of investment options and managers rather than a fund supermarket. This trend is already well advanced in Australia and is increasingly visible elsewhere.

Summary

European pension funds are grappling with similar issues to those facing American and Canadian plans. Proposed solutions include strengthening the DB model, and switching from DB to DC plans. The solution chosen in a specific country seems to depend at least in part on cultural factors. In either case a move towards outcome-oriented investment solutions will intensify.

Frank Goasguen is global head of institutional clients at ABN AMRO Asset Management.

Pension Reform in Jamaica

By Megan Irvine and Cathy Lyn, FIA, FSA

Introduction

The government and private sector of Jamaica have been working hard to enable people who have worked a full career to receive pensions that can at least provide for minimum living requirements in their golden years. This is a worldwide problem and while each country presents unique issues, the sharing of knowledge and strategies may be of general benefit to practitioners in pension systems and consequently the population covered by these systems.

Jamaica has a total population of 2.7 million people. Retirement with an immediate pension can be as early as age 50 years and as late as age 70 years. The average age at death for persons receiving a pension from a pension plan is in the late seventies to early eighties; so retirees need an income for many years after ceasing employment.

The "social security system" is weak but occupational pension funds (private sector) with retirement savings now worth about US$1.5 billion have been established since the 1940s covering about 70,000 private sector workers out of a total workforce of 1 million. A further 130,000 to 180,000 working persons are covered under unfunded government programs for the public sector.

As elsewhere, the population of senior citizens (aged 60 and over) is increasing both in absolute number and as a percentage of the total population and is the fastest growing age group of the population. It is therefore critical to implement long-term measures that allow larger numbers of senior citizens to be financially self-sufficient.

In addition to the benefits to the retirees, more savings could strengthen the economy as these funds provide financing for profitable long-term ventures.

The Present Retirement System

In 1966 The National Insurance Scheme (NIS) was introduced to provide basic pension benefits to a wide cross-section of Jamaicans and their dependents. In spite of these broad-based provisions in the NIS Act (1965), only approximately a third of older persons 60 years and above meet the qualifying criteria and are in receipt of NIS pensions, the majority of whom are women.

Approved Superannuation Funds and Approved Retirement Schemes (for individuals) set up in British-style trusts benefit from preferred tax treatment. Until 2005 the legislative framework governing these funds were provisions in the Income Tax Act primarily dealing with the conditions necessary to qualify for tax exemption on contributions and investment income.

In the private sector there are currently about 800 employer sponsored pension funds covering about 80,000 persons. Within this group there are about 8,000 persons receiving pensions today. However, a high proportion (more than 50 percent) of pensioners still receive pensions that are below the minimum wage of the country (less than US$2,500 per annum).

Small pensions in Jamaica are usually the result of:

- Insufficient savings caused by:
  - Low wages and/or
  - Pensionable earnings that are a fraction of taxable earnings
  - Sporadic or limited participation in pension plans
  - Access to cash refunds of "own contribution" (tax free) when changing jobs thereby losing any accrued benefit for that period of service. The refund is typically used for consumption rather than investment.
  - Falling interest rate environment (which is significant factor since the majority of pension plans are of the defined contribution type)

- High Inflation Rates

  Virtually all plans only guarantee a fixed pension payable for life and do not grant automatic post retirement pension increases. So pensioners can only rely on discretionary ad hoc increases.

In summary, working Jamaicans are unlikely to accumulate enough money to provide an adequate pension at retirement and current pensioners are likely to face increasing difficulties meeting their financial needs as inflation erodes the purchasing power of their pensions.

The New Legislation

The pension reform process in Jamaica has evolved over the past two decades. It accelerated and became a priority after a meltdown of the financial sector in the nineties. This crisis caused the government a huge increase in debt financing to support the sector and led them to institute extensive financial reforms.

In 1999 a foundation document pronounced reform for the Jamaican Pensions system. The objectives included:

1. Ensuring proper arrangements for employees to enable them to receive adequate pension at retirement
2. Reducing dependency of the aged on the state and families
3. Heightening social awareness about the need to prepare for retirement
4. Increasing access to pension arrangements with tax incentives to facilitate self-employed persons and persons in non-pensionable employment to meet this need.
5. Providing for effective governance and supervision of pension arrangement so as to ensure accountability, solvency of funds, and the protection of the plan participants' interests.
6. Introducing minimum benefit standards e.g. vesting and portability
7. Ensuring Transparency
8. Transforming some existing pension arrangements for public sector workers from the partially and non-funded Pay-As-You-Go (PAYG) schemes to fully funded contributory schemes, thereby creating investment opportunities and possible improved benefits to retirees from the sector and their beneficiaries.

The pension reform process is being conducted in stages. The first stage was completed recently by issuing the Pensions (Superannuation Funds and Retirement Scheme) Act 2004 effective 1 March 2005 along with new Regulations, which were passed in 2006. The first stage of the new legislation dealt primarily with:

- Minimum operating standards for Plans with a focus on investments and the trust deed and rules (constitutive documents) of the Plan.
- Registration and Approval of Superannuation Funds and Retirement Schemes, Trustees and Responsible Officers
- Licensing of Administrators and Investment Managers
- Amendments to and Winding-up of Approved Superannuation Funds and Retirement Schemes

This achieves formal supervision addressing matters of governance, operational standardization, transparency, penalties for non-compliance and a mechanism to handle complaints from members.

Will the Legislation Meet the Objectives?

Will this refurbished system ensure employees receive adequate pensions at retirement?

The new legislation introduced a registration process for plans, trustees, investment managers, administrators, and their professional advisors with accompanying registration fees. It contains provisions as to how all these parties should function and tries to replicate the contents of the constitutive documents. It is trying to put "proper arrangements in place" by setting a standard of governance and requiring a substantial amount of detail to be submitted to the regulator.

The cost of submitting and reviewing all this information in a central place is high. The impact of the cost is likely to have a negative impact on benefits paid from these funds (current industry estimate is a reduction of 15 percent over time). This aggravates rather than improves the situation.

Mandatory locking in of members' retirement savings until retirement has been so controversial that this was delayed. This provision was intended to force members to keep their retirement savings intact until they were allowed to start their pension.

The implementation of the locking in, when it occurs, will only apply to future contributions. However, once implemented the impact on benefits is expected to be positive over the long term provided the benefits are not eroded by inflation.

Will the dependency of the aged on the state and families be reduced?

This will depend on whether the cost of regulation and its impact on pension fund management can be contained and the "buy in" of employees saving for retirement (especially against a background of high inflation and limited or no access to cost of living adjustments).

Has social awareness of the need to prepare for retirement been heightened?

Pension reform has been given a lot of publicity by the government and private sector. Also, there is mandatory communication with participants on a regular basis. However given that only about 25 percent of the working population has access to pension arrangements there is a continuing disconnect. Growth of social awareness is likely to take some time but should improve as access improves and if participants see that savings are not depleted by expenses and inflation.

Will access to self employed persons and persons in non-pensionable posts be improved?

The first stage omitted the area of greatest need in the Jamaican retirement system. A decision was made to delay introducing the regulations for Approved Retirement Schemes or personal pension plans until the next stage of legislation. The benefit of allowing the self-employed and persons in non-pensionable employment to make realistic savings earlier far outweighs the benefit to the public of legislating for occupation funds.

Will the new legislation provide for effective governance and supervision of pension arrangement so as to ensure accountability, solvency of funds, and the protection of the plan participants' interests?

Success hinges on a well-crafted Trust Deed and Rules otherwise referred to as the constitutive document and a regulator that enforces the provisions of the trust and the recommendations in the actuarial valuation report.

Newly introduced mechanisms include:

- Mandatory professional indemnity coverage for each of the Investment Manager and Administrator (about US$76,000 coverage minimum) and fidelity guarantee insurances for each Investment Manager (about US$152,000 coverage minimum)

- Detailed prescribed reporting for each of the Administrator, Investment Manager and Trustees (reporting timelines range from 60 to 120 days)

- Detailed report of the Plan's operation (annual report) within 9 months of the Plan's year end

- Changes to the Plan's Trustees, Administrator, Investment Manager or professional advisors where made should be reported within 14 days.

Resources and expertise are scarce in a small developing country like Jamaica. The regulator is not immune to this scarcity and will face difficulty in efficiently analyzing the detailed reports demanded. This challenge will be exacerbated (at least in the near term) by the fact that the reports are not submitted electronically.

At the same time Trustees and participants may be lulled into a false sense of security having accepted the assurance that the regulator is keeping tabs on the health of each plan.

The outcome is that governance standards have been strengthened but the supervision end may not be sufficient to enforce them.

Will transparency be ensured?

Members have the right to information about the operation of the plan (inclusive of annual report to be produced annually) and their level of participation in the decision making process has been increased:

- Nomination of a minimum number of Trustees,
- Approval for all amendments to the constitutive documents except those made for compliance purposes,
- Minimum standards for member communication material (what they should receive and the minimum information to be included)
- Severe penalties for breaches of the 2004 Pensions Act and regulations (fines and/or imprisonment)
- A complaints mechanism so participants can go to the regulator (FSC) as a last resort to resolve their problems.

The introduction of transparency is expected to have positive impact. The main challenge will be the participants' ability to digest and use the information.

Have minimum benefit standards been introduced?

This introduction of minimum benefit standards will be a part of the next stage of legislation and will include vesting, locking in and portability.

When introduced, social awareness will be a key component to translating the objective into a benefit to working Jamaicans. Access to more pension arrangements for working Jamaicans is likely to drive the social awareness so the benefit of the minimum standards is likely to take a few years to emerge.

Will public sector arrangements be able to make the transition from pay as you go or partial funding to full funding?

So far all pension reform has mainly dealt with pension plans set up in the private sector. There are some indications that the public sector has been attempting to move in this direction. Nonetheless public sector issues remain outstanding (at least in the public domain).

Will the Retirement System be Strengthened?

Employers, administrators, investment managers and trustees will be under more scrutiny from the regulator and the participants. This is expected to raise the confidence levels of existing pension savers.

The expenses of operating these plans are a challenge. Following the introduction of the new legislation, employers and trustees are in the process of winding up at least 100 plans, mostly small or dominated by low income workers. The main reason is the increased cost introduced by the new regulations. However, pension reform is weeding out the weak plans and the costs of compliance are giving employers incentive to consolidate pension arrangements for their employees.

There will be a future shift towards Approved Retirement Schemes (ARS) or personal pension plans as employees of small businesses, self-employed persons and persons in non-pensionable posts gain access. This is expected to expand the base of pension savers overall.

Unfortunately, growth is likely to be slow due overall lack of education in the population (generally and particularly in respect of retirement issues). This, coupled with a general distrust of institutions social awareness may be slow to changes. Substantial funds will be required for education.

In the meanwhile, the government is committed to at least biannual reviews of the legislation (once completed) to fix what does not work and fine tune where needed. This is significant as it provides the government and pension industry with a mechanism to respond to unintended negative provisions in the legislation.

Megan Irvine is assistant vice president of Pension Services at Life of Jamaica Limited. She can be reached at *mirvine@life-of-ja.com*. Cathy Lyn is with Duggan Consulting Limited. She can be reached at *clyn@sympatico.ca*. Both are based in Kingston, Jamaica.

What People Expect of a Pension Plan

By Tom Zavist, FSA, EA

When people get what they expect, they are happy. When people do not get what they expect, they get upset. A lot of Americans are upset today with their retirement plans. The Financial Accounting Standards Board (FASB) and Congress are taking action, but their actions may create more problems than they solve. Underlying everything is a substantial disconnect between rule-makers and the public. The public has a more simplistic view of a retirement plan than rule-makers do. Rule-makers need to keep in mind the simplistic way ordinary people think of a retirement plan.

Ordinary people think of money being set aside each year during employment. They imagine an account accumulating and growing—not shrinking—each year of employment. At retirement they imagine this account being available to pay a pension. This describes a cash balance plan more accurately than it describes a traditional pension plan or a defined contribution plan, like a §401(k) plan. Cash balance plans match what laymen think a retirement plan should be, and they are therefore popular. Cash balance plans are popular because they give ordinary people what they expect of a pension plan.

Let us look at this in more detail. The layman does not think in terms of an *accrued benefit*. The layman thinks in terms of a cash account. The layman does not start thinking about monthly annuities until close to retirement. Furthermore, the layman does not anticipate shrinking present value—either through investment losses or through increasing interest rates.

A defined contribution plan, like a §401(k) plan, has an account value expressed in dollars, which appeals to the layman. When the account loses value, however, the layman feels cheated. In the case of self-directed accounts, the layman may move out of an investment category after the losses have happened and thus may chase the market. The layman may stay in cash for years so as to avoid losses altogether. If the employer directs the assets, the layman may blame the employer for any losses.

§401(k) defined contribution plans with self-directed accounts will work properly only if participants are trained to invest. Schools teach students to drive. They need to teach everyone to invest. An appropriate curriculum can be found in the first Chartered Financial Analyst (CFA) exam, or other sources. School is the best place to teach this topic. A page or two of investment education from an employer is not enough. As we switch from defined benefit pension plans to

defined contribution §401(k) plans, we are transferring management of the nation's wealth into the hands of untrained investors. In the long run, untrained investors will be upset with the mismanagement of their assets.

Cash balance plans are popular because they are what laymen expect of a pension plan. Laymen expect to see an account that goes up each year. The layman envisions an employer setting aside money each year and building up a fund to pay for retirement and then providing an annuity from the fund. The layman envisions the retirement annuity and the fund both getting larger with each year of service an employee works for an employer. The layman does not expect the relationship between the fund and the annuity to vary with changing interest rates.

As actuaries, the relationship among interest rate, annuity amount and present value is second nature to us, but the layman does not anticipate this relationship—at least not a varying relationship on account of varying interest rates. No layman expects the lump sum cash-out of an accrued pension benefit to go down from one year to the next because of rising interest rates.

In 1981, long-term corporate interest rates rose to 16 percent. Think about what a spike like this can do to pension plan funding, financial accounting and lump sum cash-outs, when you tie all liabilities to prevailing interest rates. A poorly funded pension plan that is struggling with overwhelming contribution requirements at 5 percent today can be enjoying a contribution holiday at 9 percent. What about 16 percent? 16 percent is not impossible. It happened once. It can happen again. When rising interest rates turn very under-funded pension plans into vastly over-funded pension plans, the public will see it as accounting legerdemain and as the defrauding of ordinary workers rather than as the proper working of the system.

Suppose you were born in 1981, and your pension benefit is worth $5,000 in 2007 at 5 percent. What is it worth at 16 percent? You might be surprised to learn $52. If you are 26 years old, an 11 percent spike in interest rates means you get a penny on the dollar. A spike in interest rates means a windfall for employers and upset employees. Low interest rates, like today, are the reverse. Employers are upset with defined benefit pension plans today because they did not expect large unfunded liabilities on account of low interest rates. Employees will be upset tomorrow when their lump sums decrease because of rising interest rates.

When the Pension Benefit Guaranty Corporation discounts its liabilities using an interest rate less than 5 percent and complains about how under-funded pension plans are, the public gets the impression that employers have somehow pilfered the funds. The public does not understand that pension plan liabilities can swing by a factor of ten on account of changing interest rates (or in the

case of a 26-year-old by a factor of nearly 100). These huge swings are the result of applying theoretical bond pricing models to the valuation of a pension plan. In these models, a pension plan has a longer duration than any available bond, so falling interest rates tend to make pension plans under-funded, and rising interest rates tend to make pension plans over-funded.

Theoreticians have latched onto the accrued benefit as an immutable fixed point, about which the pension plan liabilities must swing madly up and down. The public wants stable pension plan liabilities, but theoreticians who make rules insist on holding the accrued benefit fixed and varying the liabilities.

It does not have to be this way. If Congress were to permit lump sum cash-out rates to be fixed at a single interest rate, *e.g.*, 8 percent, then funding and accounting rules could apply the same interest rate, and everybody would be happy. A pension plan is not a bond traded on a public market. It is a payment arrangement that ought to be what employers and employees expect it to be. Employees would be happy to have a lump sum cash balance that grows at 8 percent interest each year. Employers would be happy to fund on this basis.

The only ones insisting on prevailing interest rates are the rule-makers. The rule-makers started with the lump sum cash-out rates. For many pension plan sponsors these mandated interest rates only applied to small lump sum amounts, so it was a negligible topic for them, but the seed was planted. Later, the rule-makers extended prevailing interest rates to current liability calculations and to pension plan accounting. Now they want to *increase* the volatility due to fluctuating interest rates, by eliminating the use of four-year and five-year averaging. The use of fluctuating interest rates for lump sum payments underlies their mandated use in funding and accounting. The public does not demand this blind adherence to the bond market.

The public expects every pension plan to have a single number that represents the liabilities of the pension plan—a number like the total of all the accounts in a cash balance pension plan. Instead of a single number, rule-makers in Congress and the FASB have given the public a bewildering array of competing liabilities—PVB, UFAAL, EAAL, UCAL, PUCAL, vested current liability, pre-PFEA current liability, post-PFEA current liability, current liability for maximum, gateway current liability, PBGC variable premium liability, EBO, PBO, ABO, VBO, plan termination liability and various categories of §414(l) spin-off liability. Is the public confused? Of course. Are Congress and the FASB confused? Probably, but Congress and the FASB have nobody to blame but themselves for creating this opaque mess.

In an effort to create clarity out of confusion, employers, with the help of consultants, implemented cash balance plans. The public likes cash balance plans, because they are easily understood. Who hampers and interferes with these efforts? Who demands whipsaw effects? Who perceives age discrimination when equal amounts of money are assigned to employees of different ages? Only some district courts. The notion of defining an accrued benefit as an immediate lump sum amount—a cash balance account—which is what the public expects, unsettles the theoretician judges who insist on viewing these plans through the lens of the "accrued benefit". Instead of conforming to the public's expectation of what a pension plan ought to be, some court rulings insist that the frame of reference must be a deferred annuity, with all the consequent confusing array of liabilities and unreasonable volatility year to year.

Rule-makers are out of step with the public. Rule-makers insist on tying pension rules to deferred annuities and fluctuating interest rates. The public does not expect this. Accountants and Congressmen who are bedazzled by bond pricing models and bewitched by yield curves should beware. Laymen do not expect the consequences that result from rules tying everything to fluctuating interest rates.

New funding and accounting rules may alleviate some issues for cash balance plans, but they will make matters worse for traditional annuity plans, and they will increase public unrest. The root of the problem, however, is not in the funding and accounting rules. It is in the lump sum rules. The solution is to permit a single interest rate, *e.g.*, 8 percent, for computing a lump sum cash-out. Funding and accounting can then follow suit and use the same interest rate.

Tom Zavist is vice president and actuary with Stanley Hunt DuPree & Rhine in Greensboro, North Carolina. He can be reached at *tzavist@shdr.com*.

Thirty Years of Continuing Education – What Have we Learned?

By Richard Q. Wendt, FSA, EA, CFA[1]

There is currently a formal proposal by the American Academy of Actuaries (AAA) to adopt mandatory continuing education for actuaries; the SOA Board of Governors, at their March 2007 meeting, approved a motion to proceed with the establishment of a continuing professional development requirement. In addition, the recent CRUSAP report suggested a need for mandatory continuing education. Although many actuaries may believe that mandatory CE is a relatively new issue, requirements affecting thousands of Enrolled Actuaries have actually been in place for about 30 years.[2] What learnings can we take from that substantial body of experience?

In 1974, the Employee Retirement Income Security Act (ERISA) was signed into law. This created a comprehensive scheme for the regulation of corporate defined benefit plans. ERISA introduced the concept of the Enrolled Actuary; only an Enrolled Actuary can choose actuarial assumptions, determine funding requirements and sign Schedule B's.

To become an Enrolled Actuary, candidates need to satisfy significant experience, educational and examination requirements. Once the EA status is achieved, continuing professional education (CPE) requirements apply. Enrolled Actuaries must complete 36 hours of continuing professional education credit during each three-year enrollment cycle. Satisfying the requirements in a cycle qualifies the actuary for enrollment in the following cycle. Subject matter is split into two categories, core - pension funding rules and regulations – and non-core – actuarial topics, investment theory, pension accounting, etc. Core material must comprise at least 18 hours in each cycle. Initial and renewal enrollments are supervised by the Joint Board for the Enrollment of Actuaries (JBEA), a government agency with representatives of the Departments of Treasury and Labor.

The current CPE cycle runs from Jan. 1, 2005, to Dec. 31, 2007. The JBEA previously requested comments on possible modifications to the enrollment and CPE requirements; the AAA, SOA, ASPA, and several actuarial consulting firms submitted comments. I would speculate that, if any CPE changes were to be made, they would not take effect until the cycle starting in 2008.

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[1] The author recently retired from an actuarial consulting firm and does not expect to be subject to any future mandatory continuing education requirements. These comments are based on my personal observations and do not reflect the views of any other party.
[2] In 2004, the SOA stated that there were over 3200 SOA members who were also Enrolled Actuaries.

Given that background, what have we learned from the thousands of Enrolled Actuaries who have been subject to the CPE requirements? The following comments are based on my personal observations:

1. I have found the vast majority of Enrolled Actuaries to be diligent in fulfilling the CPE requirements. Enrolled actuaries monitor their CPE progress and plan to fulfill requirements by the end of each cycle. I have never found indications that actuaries have submitted false reports to the JBEA.
2. It has become standard practice for program listings for national and local actuarial meetings to show the CPE credit expected to be awarded for each session. Meetings with concurrent sessions typically coordinate CPE sessions, so as to avoid conflicts.
3. Attendance at CPE sessions at national actuarial meetings is recorded by submitting attendance cards to a monitor. A small number of actuaries are inattentive at meetings, perhaps sleeping, reading, or doing puzzles. Looking from the podium, audiences generally appear alert and interested.
4. The split between core and non-core subjects is very significant, as EA's typically need to scramble to obtain core credit. The majority of EA's attend more than 36 hours of formal activity, but the excess credit is generally for non-core topics. The determination of whether a session is core is made by the JBEA; there are occasionally changes to announced CPE credits due to comments from the JBEA.
5. Presenters earn quadruple credit, which seems to be a fair tradeoff for the effort involved in preparation. It continues to be difficult to recruit speakers, even with the extra credit.
6. Enrolled actuaries are required by the regulations to retain, for a period of three years, the following supporting documentation regarding CPE:
    a. The name of the sponsoring organization
    b. The location of the program
    c. The title of the program and description of its content
    d. The dates attended
    e. The name of the instructor, discussion leader or speaker
    f. The certificate of completion and/or signed statement of the hours of attendance from the sponsor
    g. The total core and non-core credit hours.

7. The SOA and other actuarial organizations routinely send printed attendance certificates to registrants, based on validated attendance at each session.
8. The triennial reporting requirements to the JBEA are relatively straightforward, assuming that EA's retain the records of attendance and participation.
9. The Joint Board conducts random audits of claims for CPE credit, which includes the review of the documents listed above. However, I have heard of very few actuaries who have been audited.
10. The national Enrolled Actuaries meeting has been held annually at the same hotel in Washington, DC for approximately 30 years. In the early years, it was the most important resource for EA's, as government speakers would announce and explain the new requirements. Over time, the importance of the EA Meeting has diminished somewhat, as employers and other providers have established more cost-effective resources. However, many EA's attend the EA Meeting to earn large blocks of CPE credit in a concentrated period – typically in the last year of the three-year cycle. Attendance at national meetings is expensive in terms of time, travel, and fees. Until recently, edited transcripts of almost all sessions were made available to attendees. As of 2006, transcripts were no longer produced, but EA's may purchase audiotapes of the sessions.
11. Over the last several years, many employers of EA's have started to offer internal programs, using Webcasts and other cost-effective methodologies. This has reduced the number of actuaries who need to attend national or regional meetings in order to obtain CPE credit. In addition, it increases the number of presenters, who may earn quadruple credit. Employers must be approved as educational sponsors by the JBEA.
12. Local offices of actuarial consulting firms offer educational sessions for actuaries in the office, using either resources supplied by corporate headquarters or developed by the presenter. At least three EA's must be in attendance for a session to qualify for CPE credit.
13. The SOA, among other organizations, developed distance-learning programs that allow individual EA's to complete their CPE requirements. EA's who listen to an audiotape and return a questionnaire with answers to subject-related questions can receive CPE credit. Unlike group sessions, where only attendance is required, the distance learning option requires the EA to actively learn and answer questions. I have not come across any EA's who have used this resource.
14. The SOA and other organizations provided additional resources near the end of the 2002-2004 CPE cycle, specifically designed to allow EA's to meet the CPE requirements

for that cycle. These offerings included the SOA's distance learning program and re-presentations of videos of prior educational sessions.

15. Most Enrolled Actuaries engage in significant informal education, including reading news and journal articles, company memos, and performing independent research. This would not qualify for CPE credit.
16. Many Enrolled Actuaries would benefit from education in financial theory, which is not a major part of the pension syllabus and is not considered a core topic.
17. While some claim that mandatory CPE affects the public perception of actuaries, the experience of CPE for Enrolled Actuaries indicates that the public has very little knowledge that such requirements exist.

Based on my personal experience and observations, I would offer the following recommendations:

1. A three-year cycle is superior to an annual requirement, as it both maintains currency of the educational sessions and avoids unnecessary burdens on both the EA and the JBEA. Actuaries may not be able to attend national actuarial meetings in each and every year; a multi-year cycle allows the actuary flexibility in planning meetings and educational sessions.
2. 36 hours of required CPE in a three-year period is sufficient to maintain an appropriate skill level. In 2004, the AAA specifically commented to the JBEA that 36 hours were sufficient for CPE requirements, while the SOA suggested that the proportion of core credit be changed within the 36-hour requirement. ASPA (now known as ASPPA) stated that requirements should be expanded to 45 hours. (See *http://www.irs.gov/taxpros/actuaries/article/0,,id=97436,00.html* for comments submitted to the JBEA in 2004.)
3. The requirement for 18 hours of core credit, with a narrow definition of core subjects, is unduly burdensome for both EA's and educational sponsors. The SOA suggested that more core credit is needed early in the EA's career and less thereafter. Many would prefer the segmentation to be eliminated; otherwise, expansion of the definition of core topics or adoption of the SOA proposal would provide needed flexibility.
4. If CPE requirements were to apply to all actuaries, with sub-categories of required CPE, some central authority would need to determine whether specific sessions fit within designated categories of topics. Creating such a segmented structure for the various actuarial practice areas would be difficult to manage.

5. There should be a multiple of credit awarded for presenting a CPE session. This would not only reflect the higher skill level required for presenters and the additional time spent on preparation, but also encourage actuaries to make presentations.

6. Employers should be expected to continue development of cost-effective educational programs; reliance on traditional providers has diminished somewhat. CPE requirements should facilitate employer participation, as well as participation from educational vendors.

7. The higher the fees charged for educational meetings, the greater will be the incentive for employers and others to provide cost-effective education. CPE may not be overly profitable for actuarial organizations.

8. Record keeping should be streamlined. Ideally, education providers would automatically provide a record of attendance (which might be captured in a centralized, automated data base) and actuaries would have an easily accessed electronic record of their CPE.

9. Adoption of AAA or SOA requirements affecting Enrolled Actuaries should be coordinated with any changes in the JBEA regulations.

A recent survey at www.FutureRisk.org indicated that 90 percent of responding actuaries engaged in continuing education within the last two years. This statistic can be interpreted in two different, and opposite, ways. One interpretation is that 90 percent of actuaries are already participating in continuing education; therefore, making it mandatory would not be a hardship. Another interpretation is that, if 90 percent of actuaries are voluntarily participating in continuing education, then there is little to be gained by imposing mandatory requirements. The interpretation that one prefers is probably more related to the individual's philosophical bent than to objective analysis.

Dick Wendt is based in Philadelphia, Pennsylvania. He can be reached at *actuary@icecoldmail.com*.

Electronic Format is Here to Stay!

By Michael B. Price, ASA, EA

Our readers have spoken.

In the inaugural electronic *Pension Section News* (PSN), issued last January, we included a quick readership survey. We asked four questions and left some space at the end for readers to comment. Here's what the 176 of you who responded had to say.

1. Regarding the PSN, in general, 73 percent of readers said that the PSN was *somewhat or very* important to them. A couple of comments requested more technical information on PPA. One reader suggested fewer issues with more articles.

Check out Brian Donohue's article this time on PPA matters. The PSN editors strive for useful content, without being repetitive of factual information that can be found from consulting firm publications and other sources. The editors welcome any suggestions for topics, and welcome even more, authors who write about interesting technical topics.

2. 45 percent of respondents think all issues should be electronic. 32 percent want both printed and electronic format available. While there are some hard-core fans of printed issues, most respondents are satisfied as long as they can print an article or the entire issue. Some applauded our saving paper and money.

Based on your responses, and the flexibility to publish, the Pension Section Council has decided to go to an electronic-only PSN. The PSN team is working to make the current and archived versions of the PSN easier to print, with fewer steps. You will see continual improvements in this regard, as improvements in technology are available to us.

3. 86 percent of respondents were satisfied with the layout of the January PSN. This, despite the difficulty of some readers clicking back and for the between summaries and articles.

Yes, there were some technical difficulties with the first electronic issue. We are working with SOA IT gurus to iron those things out. Please let the editors know if you discover difficulties navigating an issue, in the future.

4. 79 percent of respondents were satisfied with the practicality and content of the January issue. The focus was on *Retirement 20/20* activities to date.

A couple of readers asked for more content to help “grab” your interest, so that you then click to read the entire article. We will keep this in mind as we balance content and length of the summaries. Some would like more of a variety in articles, others thought focusing on a single topic was just fine. Our approach will be to remain flexible in theme and content, depending on the topic and number of articles for publication.

So, all in all, you liked what you saw. We will keep this process dynamic, as we make adjustments based on your input and suggestions.

Michael B. Price has just wrapped up his term as chair of the Pension Section Communications Team. He is with Watson Wyatt Worldwide in St. Louis, Missouri. He can be reached at *mike.price@watsonwyatt.com*.

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