

### Raising Pressure on Policymakers

*Academy Statement Calls for Social Security Change*

WITH THE SOCIAL SECURITY trust fund facing long-term actuarial imbalance, the Academy took its first advocacy position on a public policy issue in August, urging policymakers to raise the program's retirement age. Tom Terry, Academy vice president for pension issues, and Bruce Schobel, chairperson of the Retirement Security Principles Task Force, unveiled the Academy's first public interest advocacy statement at a news conference at the National Press Club Aug. 4 in Washington.

Citing continually increasing life expectancy in the U.S., the statement asserts that raising the retirement age is a necessary ingredient in whatever combination of solutions policymakers settle on.

"If implemented right, increasing the retirement age could play a very significant role in eliminating Social Security's long-range deficit," Schobel said at the news conference.

The Academy's strategic plan that was passed last fall directed it to use its resources to advocate on issues in the

public interest in which actuaries can provide unique expertise. With the support of the Academy's Public Interest Committee, the Academy's Board of Directors approved the statement in late June. To read the statement in its entirety, go to Pages 4 and 5.



Tom Terry, left, and Bruce Schobel introduce the Academy's statement at an Aug. 4 news conference.

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### Clarity Requested on Proposed Regulations

THE ACADEMY CONTINUED ITS DIALOGUE with the Internal Revenue Service (IRS) this summer, sending three Academy members to testify during two hearings on IRS proposed regulations related to the Pension Protection Act (PPA).

Eli Greenblum, chairperson of the Academy's Multiemployer Plans Subcommittee, and subcommittee member Samuel Stanley asked the IRS in their July 31 testimony for

greater clarity and flexibility in regulations governing the certification of financially distressed multiemployer plans.

Released on April 21, proposed regulations on Section 432 of the Internal Revenue Code would establish the manner in which amortization extensions are treated, including those formerly allowed under Section 412(e) of the code, for plan emergence from critical funding status. The proposed regulations also define the reha-

bilitation period duration as 10 years for a plan in critical status, though some plans have amortization extensions with IRS conditions that project to extend beyond that time frame.

"We really need to have crystal-clear rules as to how emergence from critical status works," Stanley said, echoing other speakers who said actuaries and plan sponsors need additional clarification.

Greenblum requested flex-  
[IRS TESTIMONY, PAGE 3](#) ➔

AMY SULLIVAN

# Modeling Future Costs After PPA

**F**ORECASTING FUTURE PENSION PLAN CONTRIBUTIONS has become more challenging because of the Pension Protection Act (PPA). Interest rate and credit balance utilization assumptions were two forecasting considerations explored during a session of the 2008 Enrolled Actuaries Meeting as presented by Brian O'Neill, a consultant with Towers Perrin, and Bruce Cadenhead, a worldwide partner with Mercer.

The session began with a brief overview of the funding rule changes. O'Neill noted that in the pre-PPA world, shocks would occur when current liability took over as the driver of minimum funding if the forecasting were completed based on accrued liability. Post-PPA, there is only one liability measure, but plan sponsors have both short-term and long-term goals to consider that will affect contribution forecasting. A plan sponsor needs to evaluate the optimal use of its credit balance and company cash in light of its desire to avoid benefit restrictions or at-risk status, minimize volatility, and prevent Pension Benefit Guaranty Corp. premiums.

Starting with the observation that funding strategy is really independent of minimum funding requirements, Cadenhead began a discussion of projecting liabilities for forecasting. He remarked that we can still use the traditional approach for rolling forward liabilities, but the new interest rate structure presents some challenges. Options were presented for choosing the forecasting interest rate, including using forward rates or using an adjustment to the results based on expected interest rate changes. Alternatively, the yield curve could be projected and used with the underlying cash flows. Audience members were reminded that in projecting the yield curve, an economic expansion or recession would produce a different yield curve and that eventually the projected yield curve will flatten out.

Cadenhead said that it would be prudent to make some downward adjustments to the early years as two forces are at work pulling yield curves down in the short term. First, there is a term premium; and second, the further you go out into the future, the higher the default risk.



After a lengthy discussion of projecting the yield curve, a comment from the floor was raised suggesting that it might be better to just use the current yield curve. Cadenhead remarked that he wouldn't necessarily draw that conclusion and moved to a slide showing that the yield curve has changed quite a bit over the past six months.

The session continued with observations regarding additional adjustments that should be made for mortality improvements, lump-sum payments, and other plan-specific items. Then O'Neill moved on to a discussion of credit balance use. He introduced key decision points for plan sponsors and explained how those decisions about the use of credit balance and company funding policy can affect forecasting. Under a sample funding policy, contributions and credit balances were modeled for the next decade looking at four different asset return environments. Ideas for mitigating some of the funding spikes observed in the models were discussed as well as some of the issues that arise when funding is accelerated.

In a more lighthearted moment, Cadenhead commented that he was hopeful he had not left the impression with the audience that we should just give up because this is all so complicated. "If we were all pessimists, we'd probably tell our clients to terminate their plans and just not deal with this," O'Neill said. "Luckily, we're all optimists and trying to learn this stuff." He went on to note that the complexity is something we, as actuaries, need to own, and it is clear that our expertise in this area is going to be very valuable as we move into the future.

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ibility on contribution projection requirements in cases where the contributions to the plan either aren't dictated by collective bargaining agreements or are determined using a level percent-of-payroll funding method. While the preamble specifies that certain contribution projections may use a dollar amount consistent with the previous year, Greenblum said that figure makes less sense than a constant percentage of payroll if the plan's normal costs are projected to increase with payroll and other industry changes over time.

Greenblum's testimony also addressed a potential misunderstanding regarding actuarial standards of practice. The proposed regulation, he said, hinted at a "short and sweet" determination statement for plan certification purposes.

"The certification is a statement of actuarial opinion, and statements of actuarial opinion are governed by our standards of practice very clearly," clarified Greenblum, directing the panel to a practice note released by the subcommittee in December that lists many items that should be included in a formal certification.

There was also discussion between the Academy speakers and the panel about PPA expectations for the actuary in measuring the progress of formal action plans to improve funding—whether actuaries are certifying metrics or actions. Harlan Weller, senior actuary for the Treasury Department's Office of Tax Policy, noted that specific metrics or benchmarks must be tracked in order to prevent potential excise taxes for critical plans. However, Greenblum said that for endangered plans the answer to the question is still open. He also pointed out the difference in actuarial effort required to project a funding percentage versus projecting the funding standard count.

### Evergreen Elections

Less than a week after the multiemployer hearing, Donald Segal, member of the Academy's Pension Committee, testified Aug. 4 at an IRS hearing on minimum required contributions for single-employer defined benefit pension plans. In his testimony, Segal asked the IRS for election flexibility for quarterly contributions.

According to the proposed regulations on Code Section 430 released by the IRS April 11, an election to apply any prefunding balance toward the quarterly contribution requirement must use a specified dollar amount and must be made by the quarterly due date. Segal requested that the regulations be revised to allow an "evergreen election," a single election to use the prefunding balance to pay a quarterly contribution to the extent necessary, without specifying an amount. This election would be valid until revoked. Though the preamble considers the idea, Segal said, the proposed regulations themselves do not allow it.

"We're asking that the IRS, through final regulations or other guidance, make it clear that plan sponsors may rely upon a reasonable interpretation of the statute for 2008 for the quarterly and funding balance purposes—and that plan sponsors who did not make explicit elections during 2008 should not be penalized," Segal said.

One example he used was a frozen plan in which a prefunding balance may have been elected to be applied at a quarterly contribution date, but then the minimum funding requirement was zero once the final valuation was completed. The proposed regulations say that you could apply the prefunding balance—but not in excess of the minimum required contribution. Thus, an inappropriate action has occurred inadvertently.

"It seems that the statute prohibits any election to use more of a funding balance than the amount of the minimum required contribution, and, therefore, this again shows the need for final regulations to provide flexibility with respect to the amount elected or with respect to the time of the election," Segal said.

In response to a question by Weller, Segal clarified the difference between an evergreen election and a deemed election. While an evergreen election would be applied until the plan decides to revoke it, he said that a deemed election would typically specify a timetable to which it applies.

Segal's testimony elaborated on a comment letter the Pension Committee submitted to the IRS on July 15. ▲

## Todisco Named New Pension Fellow

The Academy welcomes new Senior Pension Fellow Frank Todisco, who will serve as a chief spokesperson for public policy retirement issues. Todisco joins the Academy after spending 18 years as a retirement expert at Mercer Human Resource Consulting in New York. Todisco starts his work at the Academy Sept. 8. For a profile of Todisco, check out the September *Actuarial Update*.



# Actuaries Advocate Raising Social Security's Retirement Age

## Overview

The American Academy of Actuaries believes that the time has come for the United States to address Social Security's long-term financial soundness. For two decades, Social Security's trustees have been telling the public—annually—that the system is not in actuarial balance. What does that mean? At some point in the foreseeable future, absent corrective legislation, the program will be unable to pay timely benefits in full.

Over the years, actuaries have evaluated numerous proposals to prevent this from happening. Among the very many options that would alleviate the imbalance, one rises to the top of our list: raising Social Security's retirement age. As life expectancy increases, the percentage of workers' lives spent in retirement continues to grow, while the number of working years stays relatively constant. Inevitably, Social Security's costs will exceed what its scheduled financing will support. This is primarily a demographic problem that demands a demographic solution.

## Social Security needs a course correction

Our Social Security system, enacted in 1935, has certainly withstood the test of time. Having paid benefits to over 100 million retired and disabled workers and their families, Social Security has indisputably had a positive impact on our society. It's also indisputable, however, that the system has required occasional adjustments to continue functioning well. The last time was in 1983, following a period of slow economic growth and very high inflation that had drained the trust fund. Without the 1983 legislation, timely benefit payments could not have been made starting in July 1983. The law



Bruce Schobel points to hypothetical retirement age projections at the Academy news conference.

was changed in April, and just in time.

According to Social Security's 2008 trustees' report, released in March, the program won't face a 1983-type crisis for many years, but the program's cash flow is projected to move into the red in 2017, the first of several critical dates cited by the trustees. While reasonable people can debate the significance of 2017 or even 2041 (the projected date of trust fund exhaustion), the underlying financial picture is not in dispute. Social Security needs a course correction to continue fulfilling its mission.

## Social Security's retirement age should be raised

Some people believe that concerns about Social Security's financial soundness are entirely attributable to the baby boomers, who began claiming Social Security retirement benefits just this year, with millions more to come over the next two decades. But the baby boomers are only part of the problem—and a temporary part. Long after all the baby boomers have departed, Social Security's income will cover only about three-fourths of its cost. This permanent

imbalance is partly attributable to increasing longevity. As beneficiaries live longer, their total expected benefits increase.

Without action, Social Security's income won't keep pace with these ever-increasing benefit obligations. Social Security's retirement age is part of the problem. While Social Security's financial soundness could be restored in many different ways, we believe that any solution package should include increases in the retirement age.

The Social Security Amendments of 1983 raised the normal retirement age from 65 to 67 over three decades. But it's frozen at 67 for all workers born after 1959. We shouldn't stop there. Holding the retirement age constant is a certain prescription for future financial problems. Raising it to reflect increasing longevity would contribute to solving those problems.

The American Academy of Actuaries believes that a financially sound Social Security system must accommodate future increases in longevity. The most direct way to do that would be to extend the currently scheduled increases in Social Security's retirement age. The time to enact this change is now.



## Social Security's problems should be addressed now

Public policymakers sometimes wait until the last minute to take necessary action. But in the case of Social Security, waiting will limit the available options — and tend to force solutions that emphasize sudden changes that are more likely to involve tax increases. The last two times Congress made significant changes to Social Security, in 1977 and 1983, the legislation included near-term and long-term provisions involving both tax increases and reductions in the growth of benefits.

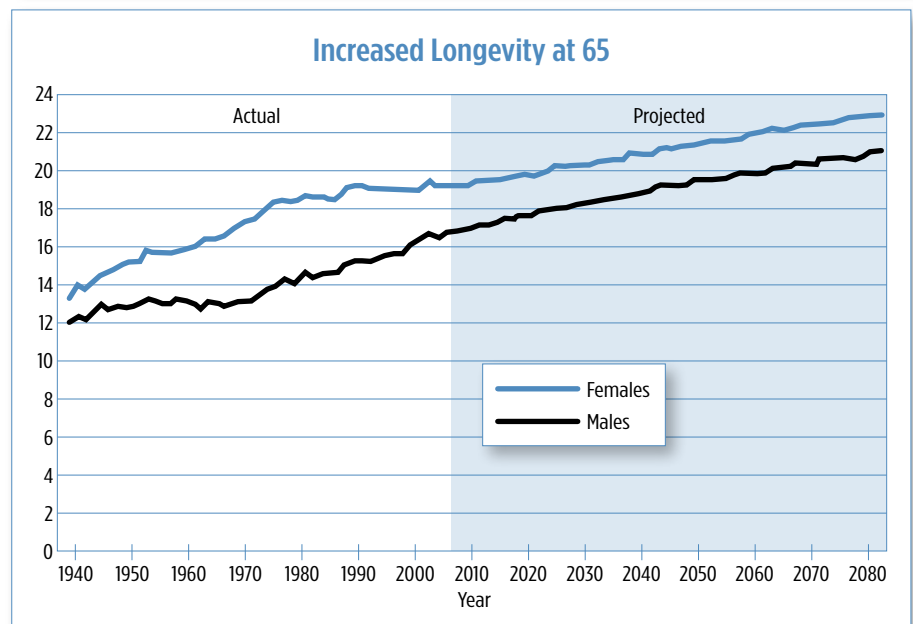
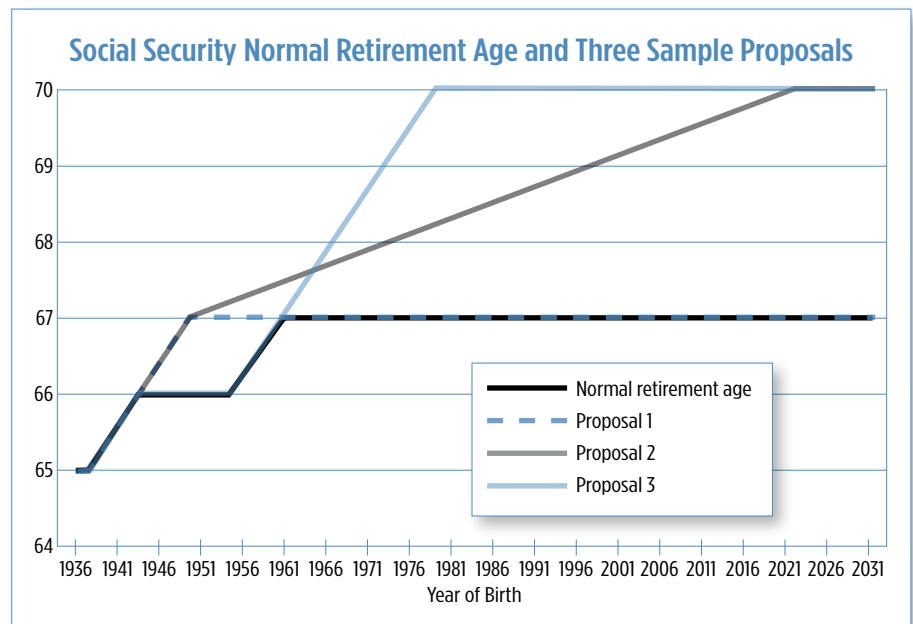
Regardless of the kinds of changes ultimately enacted into law, the sooner policymakers act, the more options they will have. Tax increases could be phased in more gradually, and reductions in benefit growth could be spread across a much larger population of beneficiaries, making individual reductions relatively smaller and less painful. Enacting legislation sooner would also allow individuals sufficient time to modify their own financial planning—adjusting to changes in Social Security.

The American Academy of Actuaries believes that delay will only make the changes ultimately needed to restore Social Security's financial soundness less attractive, more painful, and more precipitous. Timely action can make the solutions more acceptable to all concerned.

The Academy is committed to continuing its thought leadership in this area and stands ready to assist policymakers in their efforts to return the Social Security program to long-term financial soundness. For more information, please contact Steve Sullivan, director of communications, at [Sullivan@actuary.org](mailto:Sullivan@actuary.org) or (202) 223-8196. ▲

Sample proposal	Approximate share of Social Security's long-range deficit <sup>1</sup> eliminated
1. Eliminate the hiatus in the normal retirement age (NRA)—i.e., speed up the increase to age 67	10%
2. Eliminate the hiatus in the NRA—i.e., speed up the increase to age 67—and then increase it by one month every two years until it reaches age 70	35%
3. Keep the current schedule of NRA increases to age 67 but continue increasing it thereafter by two months every year until it reaches age 70	50%

<sup>1</sup>Under the intermediate assumptions of the 2008 OASDI Trustees Report, Social Security's long-range (75-year) actuarial deficit is 1.70 percent of taxable payroll.



Source: 2008 OASDI Trustees Report. The period life expectancy at a given age for a given year represents the average number of years of life remaining if a group of persons at that age were to experience the mortality rates for that year over the course of their remaining lives; 2005 to 2007 are estimated.

## Funding Strategies Under GASB 45

**I**N JUNE 2004, the Governmental Accounting Standards Board (GASB) published GASB Statement No. 45, targeting other post-employment benefits (OPEB) for public employees. Up until this standard, public employers often booked retiree health care costs on a pay-as-you-go (PAYGO) basis without considering that active employees earn a right to this benefit during their working years. The statement requires a valuation performed by an actuary to calculate the value of benefits being earned by current employees, similar to the structure of a defined benefit pension plan.

### Discount Rate Selection and Prefunding

A key component in an actuarial valuation is the discount rate assumption, i.e., the time value of money. According to GASB 45, the discount rate for this purpose needs to be consistent with “investments that are expected to be used to finance the payment of benefits.” Therefore, an employer that establishes a trust and contributes toward satisfying the obligation may recognize a reasonable rate of return based on the trust’s investment policy. For this purpose, 8 percent seems to be the generally accepted assumption for a balanced portfolio. Sponsors that continue funding on a PAYGO basis can reflect a rate of return consistent with investments of their general revenues (short term, low risk) only, a typical assumption being 4 percent or less.

Obviously, funding at a level that completely covers the OPEB liability qualifies for prefunding and for utilizing the applicable discount rate for a funded plan. With most sponsors unable to fully fund upon application of GASB 45, this

leaves a lot of discretion to the actuary. Most have taken the position that contributing the annual required contribution (ARC) or annual OPEB cost (AOC) as determined under GASB 45 is considered prefunding. In the case of the State Teachers Retirement System of Ohio, the discount rate was set at 5.5 percent (i.e., the value between 4 and 8 percent, prorated on the funded ratio and the percent of the ARC contributed each year).

Difficulties with discount rate selection have emerged in the second year for many actuaries. There can be instances in which the plan sponsor indicates a funding policy (even in writing) in the initial year with no follow-through on that commitment. What does the actuary do in year 2? What if the sponsor still indicates it intends to fund? Other abuse includes a high salary-increase-rate assumption. For a percent-pay-based liability method, this results in heavily backloaded liability and cost.

### To Prefund or Not?

Arguments for prefunding are that it is the only guarantee of future benefits and that it enables a sponsor to provide benefits at a lower long-term cost with the exposure to equity investments. Those who oppose prefunding cite the fact that unlike a corporation going out of business or becoming bankrupt, there is no real risk of an inability to pay future benefits. Ultimately, funding on a PAYGO basis results in the lowest current cash outlay and provides for maximum budget flexibility. However, some argue that this is just pushing the expense to future generations.

Practices vary state by state. New Jersey and Pennsylva-

## U.S. House Passes PPA Corrections

*Editor's Note: The following is the text of an alert the Academy sent out on July 14, 2008.*

On July 9, the U.S. House of Representatives unanimously passed the Pension Protection Technical Corrections Act of 2008 (H.R. 6382) by voice vote. The bill makes changes to the Pension Protection Act of 2006 (PPA) and is similar to H.R. 3361, which passed the House by voice vote March 12, 2008. The Senate version, the Pension Protection Technical Corrections Act of 2007 (S. 1974), which is similar but not identical to the House bill, also passed unanimously in the Senate Dec. 19.

The House bill makes changes to defined benefit pension plan rules by amending the Employee Retirement Income Se-

curity Act as well as the Internal Revenue Code (as amended by the Pension Protection Act). One of the major technical corrections of the bill is the clarification of 24-month asset smoothing, a method used for calculating pension fund assets, which can be used by employers when determining their pension funding obligations. This bill’s asset smoothing provisions are an attempt by the House to clarify a heavily debated section of PPA on which the Treasury Department has not provided any official guidance, despite pleas both from within the actuarial community and outside employee benefits groups.

nia, for instance, have opted for a PAYGO approach, while Massachusetts has chosen to fund annually and utilize special revenue sources. Colorado partially funds based on a fixed dollar value rather than on any basis related to actual health care costs of the program.

## Funding Sources

Other than using an employer's general revenue to prefund or to continue to PAYGO, there are some creative approaches to funding these obligations. Special revenue such as tobacco settlement funds or lottery proceeds can be utilized as a one-time startup or ongoing source. Bond issuance/debt funding is a popular sales pitch with bond salesmen. The sponsor can earn investment income at a level much higher than the current borrowing rates. However, there are problems with borrowing to fund, including taking on significant investment risk and trading a "soft" debt for a "hard" debt. Also, not all sponsors have the authority to issue debt. Sponsors have to consider what happens with the funds if nationalized health care becomes a reality. These funds would clearly not go toward the use that was initially intended.

A bill under consideration in the Ohio House of Representatives is intended to provide an ongoing dedicated revenue stream for the teachers' system and its health care stabilization fund. Since the current funding level is only 1 percent of payroll, the proposed changes would increase both employee and employer contributions by 2.5 percent over a five-year period. The resulting 6 percent of payroll annual contribution would be sufficient to fund the program's GASB 45-determined ARC.

## Multiple-Employer Arrangements

There are some benefits to creating a multiple-employer benefit program and trust. Under a cost-sharing plan, one valuation is performed and all employers have the same cost basis; this reduces administrative costs and maintains a level of consistency. However, this can create difficulty in getting all employers to be in agreement. In an agent plan, every employer has flexibility in funding decisions. However, every employer needs to have a separate valuation performed, leading to inconsistency in assumptions, methods, and results.

Ohio's teachers' system is a cost-sharing multiple-employer plan operating at the state level, covering city/local school districts, colleges, universities, and vocational/technical schools (approximately 1,100 employers in total). The plan's OPEB liability is approximately \$12.2 billion as of Jan. 1, 2008, with its health care stabilization fund valued at \$4 billion.

Regardless of the funding vehicle, source of funds, plan design, or size of the employer, GASB 45 has proven necessary to ensure governmental employers fully disclose future obligations to the taxpayers, its creditors, and the general public.

*Editor's Note: This article is a summary of the presentation that Sherry Chan, William Fornia, and Tom Vincente made at the 2008 Enrolled Actuaries Meeting.*

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The bill also:

- Requires that cash balance plans use an interest rate not to exceed that of the market rate of return for the purposes of benefit of accrual.
- Allows current or former commercial airline employees that transfer airline payments to ROTH Individual Retirement Accounts to treat those payments as qualified rollover contributions. (The airline payments were issued by bankrupt commercial airline carriers.)
- Clarifies tax treatment for beneficiaries receiving reimbursements of health care expenses of a deceased plan participant. (The plan must have provided for the reimbursement of the deceased plan participant's beneficiary on or before Jan. 1, 2008.)

The House bill has been forwarded to the Senate. It is uncertain whether the Senate will approve the bill as passed by the House. H.R. 6382 contains a provision, noted above, which is not in the Senate's version of technical corrections. This provision, while tying cash balance plan interest rate assumptions to the market rate of return, allows government pension plans greater variance by allowing state and local laws to govern the interest rate assumption ranges. It also allows small plans, in lump sum payment transactions, to use a fixed rate of 5.5 percent instead of a market rate of return in order to determine whether or not a lump sum payment is in violation of maximum payout rules.

For more information, including the text of H.R. 6382, contact Justin Edwards, the Academy's legislative assistant (edwards@actuary.org).

The Academy's Public Interest Committee organized a public forum on Sept. 4 at the Ronald Reagan Building and International Trade Center in Washington to hear stakeholder views on the disclosure of the market value of assets and liabilities for public pension plans. The committee will use information obtained through this forum to determine if the Academy's Board of Directors should make a statement on the issue in the public interest.

The following panelists were scheduled to speak at the forum:

#### Panel One

- ▶ **Barry Kozak**, associate director of the employee benefits graduate program and adjunct faculty member, the Center for Tax Law and Employee Benefits at the John Marshall Law School in Chicago
- ▶ **Stephen McElhaney**, principal, Mercer Human Resource Consulting in Richmond, Va., speaking on behalf of the Academy's Public Plans Subcommittee
- ▶ **Girard Miller**, senior strategist, PFM Group in Philadelphia
- ▶ **Christian Weller**, senior fellow, Center for American Progress in Washington
- ▶ **David Wilcox**, deputy director, Division of Research and Statistics, Federal Reserve Board in Washington

#### Panel Two

- ▶ **Beth Almeida**, executive director, National Institute on Retirement Security in Washington
- ▶ **Paul Angelo**, senior vice president and actuary, the Segal Co. in San Francisco
- ▶ **Norman Jones**, chief actuary, Gabriel, Roeder, Smith and Co. in Southfield, Mich.
- ▶ **Nancy Kopp**, Maryland state treasurer
- ▶ **Ron Mulvihill**, employee benefits specialist, American Federation of State, County, and Municipal Employees in Washington
- ▶ **Karen Steffen**, principal and consulting actuary, Milliman in Seattle

#### Panel Three

- ▶ **Robert North**, chief actuary, New York City Office of the Actuary
- ▶ **Michael Peskin**, managing director, Morgan Stanley Investment Management in New York
- ▶ **Mark Ruloff**, director, asset allocation, Watson Wyatt Investment Consulting in Arlington, Va.

**Look for coverage of the forum in the October issue of the *Actuarial Update*.**

## Plan Termination: Whether, When, and How?

Hyatt Regency Coconut Point  
Bonita Springs, Fla.

Wednesday, Oct. 29 2:00 p.m. – 6:00 p.m.  
Thursday, Oct. 30 8:00 a.m. – 12:00 p.m.



It's a new and challenging world for defined benefit (DB) plan sponsors. More and more DB clients are asking about an "exit strategy." Following the Academy's and the Conference of Consulting Actuaries' (CCA) annual meetings, the CCA is offering a seminar that will provide important information to help your clients determine and achieve their goals.

Get answers from the experts on a broad range of plan termination issues. Speakers will include actuaries with significant experience in dealing with plan terminations, legal experts, insurance industry experts, and Pension Benefit Guaranty Corp. (PBGC) representatives.

**Speakers will answer questions about plan terminations, such as:**

- ▶ What goes into a truly useful standard termination study?
- ▶ How do you navigate through the minefield of PBGC and Internal Revenue Service rules to complete the standard termination process successfully?
- ▶ What's required for a distress or involuntary termination for strapped clients with underfunded plans?
- ▶ How can clients deal effectively with the liabilities the PBGC pursues, including its stepped-up enforcement of "downsizing liability" in anticipation of a future termination?

Attendees will be eligible to receive EA noncore credit.

**For more information, visit [www.ccactuaries.org/events/am2008/seminars.html](http://www.ccactuaries.org/events/am2008/seminars.html).**