

Making Sure Your Pension Plan Evaluation Passes the Smell Test

IT ALWAYS AMAZES ME HOW MY MOTHER-IN-LAW, Sue Olinzock, puts together her incredible homemade soup. Her care and concern never fail to produce a wonderful batch of soup that my whole family enjoys.

As the senior pension actuary in our firm, I often draw upon my mother-in-law's soup-making skills when instructing actuarial students on the process of putting together a defined benefit pension valuation.

Like a cook, the actuary must carefully bring together a wide variety of ingredients in order to prepare an actuarial valuation. These ingredients include plan document; participant census information; asset information; rules and regulations; actuarial assumptions and methods; and computer software.

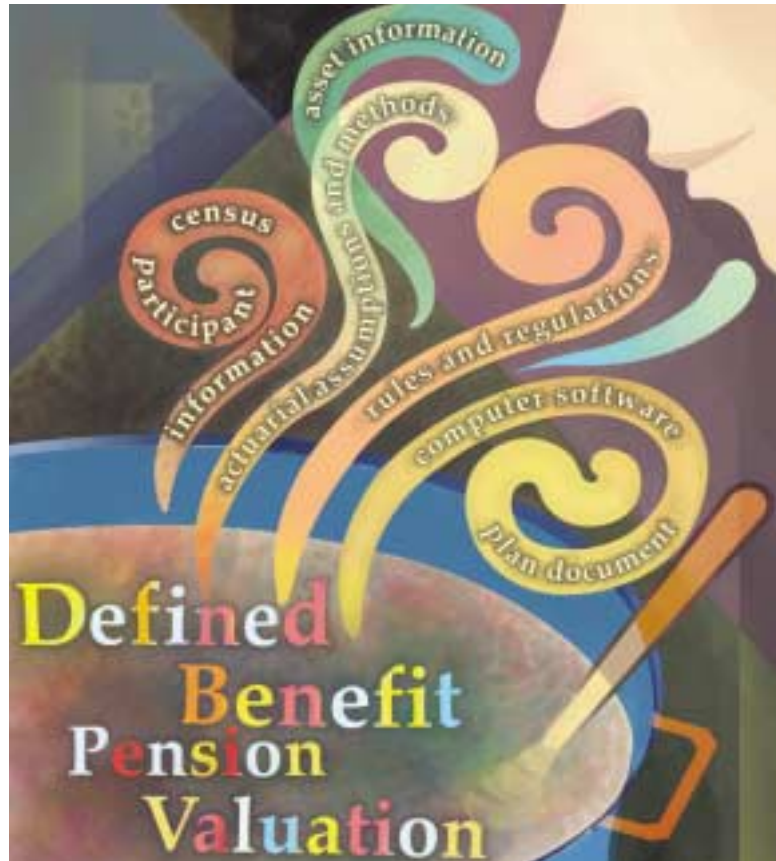
When used correctly and in the proper proportions, these ingredients make for excellent soup. But leave one out, or prepare any one of these ingredients improperly, and you've got a recipe for disaster.

Plan Document

The pension plan document provides the actuary with the legal framework upon which to hang the valuation. Before preparing the actuarial valuation, the actuary must carefully review the plan document to ensure that he or she is familiar with all of the provisions of the plan. Certain features—such as the benefit formula and the service and compensation definitions—are critical in understanding the plan's nuances.

Of special importance to the valuation process is the existence of subsidized early retirement benefits (such as unreduced pensions after 30 years of service), death and disability benefits, as well as enhanced benefits that "pop up" upon disability, lay-off, or plant shutdown. The current climate of mega-mergers and creation of cash balance plans has made the review of the plan document incredibly difficult

MICHAEL L. PISULA IS AN ACTUARY WITH THE CONSULTING FIRM OF D P B & Z INC. IN PITTSBURGH.



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because of the multitude of benefit formulas and lack of clear guidance on how benefits may or may not have been grandfathered after the merger or amendment date.

Actuaries working with governmental plans are faced with the additional challenge of working with plans for which a formal plan document may not exist! Though actuaries aren't required to do so, they should review the current summary plan description (SPD) and any collective bargaining agreements. Carelessly written SPDs and/or inattention to the collective bargaining agreement may create benefit obligations the plan sponsor didn't anticipate or fund.

Fully understanding the terms of the plan document as well as the Internal Revenue Service (IRS) filing and amendment procedures is critical. Currently the IRS has opened up its GUST¹ determination letter process requiring the restatement of all qualified retirement plans. These restatements must

be reviewed carefully since they'll affect future valuations.

For example, a recent plan we were asked to value showed a puzzling set of plan documents, amendments, and re-statements. As our review of the documents and prior valuations concluded, it was our opinion that the prior actuary, because of confusing documents, may not have valued a benefit feature that was "supposed" to have been eliminated from the plan many years ago, potentially understating the plan's liabilities by a factor of two!

Participant Census Information

Like meat and potatoes, the participant census information provides substance to the valuation process, for without participants, there's no need for valuation. Obtaining and updating participant census in this electronic age should, on the surface, be a rather simple operation. The availability of electronic communication, however, masks potential pitfalls in the data collection process.

For example, an employee's date of *hire* may be updated for temporary breaks in service, such as maternity leave, layoff, or short-term disability. In such instances the plan actuary needs to be careful not to update the original date of hire with the re-hire date unless the break warrants such update.

Another potential problem area is the collection of compensation. The plan document defines the *type* of compensation used for benefit accrual purposes. The plan actuary must ensure that the compensation collected, base pay, total pay, or W-2 pay is the appropriate compensation upon which benefits accrue.

Preparing the initial valuation for a new client provides the actuary with a challenge because two sets of data must be collected and reviewed. The data for the prior valuation must be collected from the prior actuary and a new set of data, for the new valuation, requested and collected from the plan sponsor. Inaccurate interpretation of the prior actuary's data or requesting the wrong data (e.g., type of compensation) for the new valuation can be disastrous.

The rules and regulations the actuary must adhere to when putting together a valuation add another layer of legal and regulatory complexity. For minimum funding and maximum tax deduction valuation, the enrolled actuary draws his or her guidance from the Internal Revenue Code with its supporting IRS-issued revenue rulings, notices, and procedures.

For example, while putting the actuarial valuation together for a new client, our review of the retiree data from the prior actuary indicated that all of the retirees had elected a life annuity. Considering this odd, our call to the client requesting confirmation of these benefit elections showed all were receiving benefits in the form of a joint and 50 percent annuity and all spouses were alive.

Asset Information

The third ingredient in the valuation process is the amount of assets the plan owns. The investment gains realized by many plans during the late 1990s creates the potential for complacency when pulling the plan assets into the valuation. Though not required to do so, the actuary should review the plan's investment policy to check that the portfolio meets the guidelines set forth.

The actuary must review the allocation of plan assets between stocks, bonds, and cash to ensure that the allocation is consistent with the investment return assumption as well as emerging liabilities. For example, a plan with a large group of active participants at or near normal retirement entitled to lump-sum payments should be aware of the effect a large number of single-sum distributions will have on the plan sponsor's investment decisions.

A common source of new business for many actuaries comes from investment managers and financial advisers moving plan assets. When performing a valuation for a plan that has transferred funds, it's critical to monitor the paper trail of in-

vestment transfers to ensure that all monies are properly accounted for. The actuary should review the receipts and disbursements of the plan, checking that monthly benefit payments match the expected payments from the retiree data.

For example, while putting together the first valuation for a new client, we were unable to match the benefit payments from the asset statements with the expected benefit payments from the prior actuarial valuation. When told of this mismatch, the client wasn't worried since the benefit payments were correct, but he had "forgotten" to inform the prior actuary of the benefit increases to retirees that were adopted and approved by the board of directors just before the last valuation date.

Finally, the actuary, as part of his or her presentation of the valuation, should make the plan sponsor aware of the Department of Labor (DOL)'s opinions on payment of administrative expenses from plan assets.

Rules and Regulations

The rules and regulations the actuary must adhere to when putting together a valuation add another layer of legal and regulatory complexity. For minimum funding and maximum tax deduction valuations, the enrolled actuary draws his or her guidance from the Internal Revenue Code with its supporting IRS-issued revenue rulings, notices, and procedures. For financial statement valuations, the actuary must look to the statements issued by the Financial Accounting Standards Board. For plan termination valuations,

the actuary's work is directed by the rules and regulations issued by the Pension Benefit Guaranty Corporation (PBGC).

The enrolled actuary is required to stay abreast of the perpetual change in regulations. Following successful completion of their three enrollment examinations, all enrolled actuaries must maintain and document their continuing professional educational requirements to the Joint Board for the Enrollment of Actuaries (JBEA). Assisting the enrolled actuary's search for continuing education credits are the annual meetings sponsored by the Society of Actuaries, the Conference of Consulting Actuaries, and the American Academy of Actuaries as well as the American Society of Pension Actuaries (ASPA). Finally, the enrolled actuary has access to a wide variety of professional newsletters such as the *Enrolled Actuaries Report*, published quarterly by the Academy, and the *Pension Actuary*, published bimonthly by ASPA.

Information overload is an ever present danger, and the actuary must not be lulled into complacency. To minimize this risk, many actuarial consulting firms assign two consultants to each case, offering an internal system of peer review.

On one of our cases, for example, our senior consultant brought to my attention that the client, because of a rapid change in human resource directors, suddenly failed to issue suspension of benefits notices to employees who were working beyond the plan's normal retirement age. Because of this lapse, the plan was required to actuarially increase benefits to those participants not issued the suspension notice. Had this lapse not been caught, the affected participants would have suffered economic losses and the plan sponsor would have faced potential penalties and fines from the IRS and DOL.

Actuarial Assumptions and Methods

Through the choice of actuarial assumptions and methods, the actuary adds a personal touch to the valuation process. Like a chef preparing his entrée, the actuary chooses from a wide selection of actuarial assumptions and cost methods that

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are appropriate for his or her valuation.

Actuarial assumptions include, but are not limited to: the pre- and post-retirement mortality, assumed retirement age and/or rates of retirement, wage increases, employee turnover, rates of disablement, and post-disablement mortality. With the appearance of FAS 87, the Omnibus Budget Reconciliation Act (OBRA 87), and the Retirement Protection Act of 1994, certain restrictions have been placed on the choice of assumptions and actuarial cost methods for minimum funding and financial statement disclosure purposes.

The American Academy of Actuaries is actively involved in establishing standards of practice for selecting economic and noneconomic assumptions, the actuarial cost method, and the asset valuation method—all key elements in the valuation of pension obligations. These standards include:

- ASOP #4—Measuring pension obligations
- ASOP #27—Selection of economic assumptions for measuring pension obligations
- ASOP #35—Selection of demographic and other noneconomic assumptions for measuring pension obligations

The strength of the private pension industry in the United States proves that, in general, the actuary's role in the selection of assumptions and methods is working as it's designed to. Unfortunately, as the role of defined benefit pension plans

diminishes and the number of plans declines, actuaries are faced with the challenge of maintaining their integrity in the choice of assumptions and methods. Though it's easier said than done, we must exercise self-possession to avoid the typical knee-jerk response that satisfies a client's demand for reduced funding or expense. Without this self-restraint we risk not only certain professional and legal liabilities but the possibility of losing the trust and confidence of those we are mandated to serve, the plan participants.

Computer Software

The final component in the valuation process is the computer software. Over the past 18 years I've seen pension valuations advance from ones put together by hand on columnar tablets using annuity rates gleaned from annuity books meticulously tucked away in the chief actuary's office to ones prepared "signature ready" by incredibly sophisticated computer systems designed in concert by professional programmers and actuaries.

In general, the technological changes of our valuation tools have resulted in more accurate and timely work. Unfortunately, as the sophistication of the software has grown, it becomes more difficult to monitor the results of the valuation especially for plans that have a multitude of benefit formulas and/or early retirement subsidies. Like the ominous dentist played by the late Sir Laurence Olivier in *The Marathon Man*, the actuary in his or her review of the valuation software's output must ask the programmers not only the question "Is it safe?", but "Is it right?"!

In sum, the preparation of a defined benefit valuation is a complex process involving many factors and individuals. The actuary's role in this process is critical, ensuring that each phase of the valuation process has been carefully and accurately completed and interpreted. ●

¹ General Agreement on Trade and Tariffs (GATT); Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA); Small Business Job Protection Act of 1996 (SBJPA); Tax Payer Relief Act of 1997 (TRA97).