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PROJECTED BENEFIT ILLUSTRATION STANDARD:

Why We Need It

By Edward E. Burrows

The storm surrounding cash balance conversions has claimed many casualties over the past several years. One of the most painful has been the reputation of pension actuaries. We have been accused of conspiring with our clients to hide the real impact of these conversions from participants. Many of these accusations have been unfounded. But the fact that many observers have accepted them as true makes them just as disastrous to our reputation as if they were true.

Now, buried in the massive Economic Growth and Tax Relief Reconciliation Act of 2001 is a new disclosure requirement. With certain exceptions, pension plan sponsors must notify affected participants of any amendment providing for "a significant reduction in the rate of future benefit accrual." The notice

Do Actuaries Need a Standard for Illustrations?

How much do retirement plan participants need to know about changes in their benefits?

In June 2000, the Actuarial Standards Board (ASB) proposed a controversial new actuarial standard of practice, Projected Benefit Illustrations in Connection with Retirement Plan Amendments.

The proposed standard is intended to provide direction for actuaries who are preparing, reviewing, or advising on the preparation of benefit illustrations used to communicate a retirement plan change to participants. The proposed

standard introduces the concept of an "actuarial opinion of compliance," an actuarial seal of approval indicating that a benefit illustration has been based on generally accepted actuarial principles and that the information in the illustration is comprehensive and fair.

Unfortunately, there has been little or no consensus on the provisions of the standard. To spur debate and encourage more feedback from actuaries, the Pension Committee

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PROJECTED BENEFIT ILLUSTRATION STANDARD:

Well Intended But Ill Advised

By Lawrence J. Sher

Effective and honest communication of benefit programs is an important objective. Employees have a right to understand their programs, and special attention should be given when a plan is changed to assure that the communication is accurate and fair.

Actuaries often play an important role in helping employers develop benefit communications campaigns. And actuaries who are subject to the Code of Professional Conduct already are required to act professionally when providing such assistance in accordance with Precepts 1 and 2. But the ultimate decision as to what and how to communicate rests with the employer, not the actuary.

The fundamental problem with any standardized approach to communicating a plan amendment is that effective and appropriate communication in one situation is often totally ineffective and inappropriate in another. A one-size-fits-all approach is bound to do more harm than good to the very people who are supposed to benefit from the standard—plan participants.

must "allow [participants] to understand the effect of the plan amendment." The notice must be provided within a reasonable time before the effective date of the amendment. The act does not mention cash balance conversions, but it might as well have. These conversions are at the very heart of the motivation for the new requirement.

To underscore the fact that Congress envisioned considerably more than a brief, perfunctory statement, the act permits the exemption of plans covering fewer than 100 participants. Compliance for these smaller plans might be unreasonably costly.

With minor exceptions, the new rule applies to amendments effective on or after June 7, 2001, the date the act was signed. Congress instructed Treasury to issue regulations implementing the new requirement within 90 days.

Nobody really expected that fast a response, but the tight timing underscores the urgency that Congress attaches to the new requirement.

This requirement didn't come as a surprise to anyone familiar with cash balance developments. The Academy Pension Practice Council saw the direction of developments many months ago, when it asked the Actuarial Standards Board to consider a projected benefit illustration standard. Many members of the Practice Council felt that if we were going to have rules regarding disclosure of changes, the profession would be better off participating in the rule making. This was good reasoning then. It remains good reasoning today.

The Actuarial Standards Board issued an exposure draft of the requested standard. It drew mixed reviews. Some com-

Strating Projected Retirement Benefits?

es in their benefits? And what's the best way to tell them about it?

solicited the following exchange. The articles were originally envisioned as complementary pieces discussing the pros and cons of the standard. The authors have given us even more, producing thought-provoking analyses of the nature of disclosure requirements and the inherent difficulties therein.

There's no better time for the opinions of actuaries to be heard. Regulations interpreting the new disclosure rules

will be produced by the Treasury Department soon. Discussion of adequate disclosure of plan changes continues to be a very important, very public debate, one to which actuaries can add a great deal of expertise and experience.

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ASOP Wouldn't Improve Actuaries' Image

Our profession has an obligation to be responsive to public concerns involving actuarial practice. And improving the public perception of actuaries is a laudable goal. In light of the criticisms directed at actuaries during the recent cash balance debate, the issuance of an ASOP on individual benefit projections might provide a short-term boost in the perception of our profession to some outsiders. But such an ASOP could actually do more long-term harm than good both to our profession and to the public.

First, it's not at all clear that there's a real problem with the practice of actuaries in this area. The only evidence of misbehavior is a few quotes of actuaries at EA and other meetings, carefully selected by trial lawyers involved in cash balance litigation. By issuing a standard of practice in reaction to this highly politicized issue, the ASB leaves the public with the impression that it agrees with the criticisms directed at actuaries and at our profession.

Second, our profession has been reacting in other ways that more appropriately address the situation and are befitting of our profession's motto to substitute facts for impressions. For example, the Academy published a brochure on cash balance plans, and its pension committee and staff have been meeting frequently with government officials to explain cash balance conversions and the roles actuaries play. Also, the SOA has published studies and has solicited papers dealing with aspects of cash balance plans. And studies such as those published by Watson Wyatt and Unifi Network have provided the public with real data on cash balance conversions.

Are Benefit Projections Actuarial?

Benefit projections don't involve traditional actuarial principles. The laws of large numbers and the self-correcting aspect of typical actuarial determinations don't apply when it comes to an individual's benefits. Throughout the exposure draft, especially in

mentators saw the draft as a proposal that deserved serious attention and, ultimately, adoption as a final standard. Others saw absolutely no value in the proposal and felt the ASB should remove the entire effort from its agenda.

All of this leaves us at a crossroads. We can stand aside and wait for the regulators to develop their mandatory disclosure rules. Or we can attempt to engage the regulators in a joint effort to develop a set of rules cooperatively.

If we take the latter approach, the current exposure draft is a carefully constructed outline that will serve as an excellent first step in any joint effort. Regulations and the standard could be brought to their final versions concurrently. The regulations could enjoy input from members of the ASB. The standard could enjoy input from the regulators. The regulations could mandate disclosure that is certified by an enrolled actuary. The enrolled actuary would be bound to follow the standard—or justify the deviation.

Before we decide which way to turn, it might be useful to examine the reasons for and against a cooperative effort.

First, the reasons against.

The most often stated reason is that any effort to craft a disclosure approach “in a manner calculated to be understood by the average plan participant” is doomed to failure. And if a project is going to fail, it would be better to let the regulators fail on their own, without help from the private sector. As proof

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that failure is inevitable, the critics offer Appendix 2 of the ASB exposure draft. This is a set of carefully crafted illustrations. It reflects the best efforts of a group of thoughtful and knowledgeable pension actuaries. The critics claim that most participants will be left totally in the dark after reading these carefully constructed disclosures.

Guilty as charged. Instead of “most,” the critics might have said “98 percent.”

But even so, the disclosure will be a powerful tool in accomplishing its objective. The 2 percent who do comprehend

the selection of actuarial assumptions (including baseline assumptions), concepts that make sense in the context of funding a plan are carried over, perhaps inappropriately. For example, in many instances it might make more sense to assume that an individual's pay will increase at the same rate as it has in recent years rather than applying the same baseline rate to all employees.

If the ASB had considered individual benefit projections to be an area warranting a standard, why has such a standard not previously been issued or not even been on the Board's agenda? In this regard, it is interesting to observe that the recent ASOPs on selecting actuarial assumptions (ASOPs 27 and 35) specifically excluded individual benefit projections from their scopes, yet there was no indication in such ASOPs of an intention to fill that gap.

AOC Concept Is Flawed

If the “Actuarial Opinion of Compliance” is important enough to be articulated in an ASOP, compliance should be mandatory, not voluntary. As is the case with all other ASOPs, a standard should cause the actuary who doesn't follow its requirements to disclose and be prepared to justify such a deviation. Moreover, in practice, this ASOP would be irrelevant (other than as a PR document), at least in the short term.

If the ASB had hoped that then pending legislation would require or encourage compliance with an ASOP or some kind of actuarial sign-off, that wish did not come true. The Economic Growth and Tax Relief Reconciliation Act did address disclo-

will have a strong influence on the other 98 percent. For example, if that 2 percent see cash balance transition rules that are reasonable, they'll tell the other 98 percent. If that 2 percent perceive the rules as unreasonable, that's what they'll tell the other 98 percent.

The plan sponsor knows this will happen. The plan sponsor will be very slow to adopt rules that even a small minority of participants will understand are unreasonable. The drafters of the statutory requirement will have accomplished their purpose. In short, the purpose is only partly to ensure disclosure. More important, it's to ensure plan sponsor behavior that's reasonable and responsive to the needs of participants.

The next most commonly stated position of the critics is cost. To be sure, compliance with any meaningful disclosure requirement will not come free. Why, the critics ask, should we be viewed as conspirators in an effort that will increase administrative costs to our clients?

This is a valid concern. However, experience over the years leads to the conclusion that any new rule or any new approach will be perceived initially as unduly complex and costly. Automation does indeed have its startup costs. However, once new rules are in place, they generally turn out to be less burdensome than had originally been feared.

The final reason is difficult to handle, because we're all reluctant to wrestle with it in the open. Some of our clients will

prefer that their participants not understand the implications of plan changes. These clients wish to avoid transition protection they view as too costly. And they're not interested in spotlighting the avoidance. If a requirement conflicts with a client's wishes, the critics ask quietly, why should we go on record as supporting the requirement?

This problem goes to the heart of a basic issue we face as professionals. We have obligations as professionals that may sometimes conflict with our clients' short-term objectives. These obligations do, indeed, include our clients' needs. But they also include the needs of retirement plan participants. Most important, they include the long-term health of our nation's retirement security system.

Now for the reasons favoring a joint effort with the regulators.

The most obvious reason is that a joint effort will produce a better work product. There is precedent for this. In the life insurance field, it recently became apparent that rules were needed covering policy illustrations agents use in their sales efforts. Through a very happy set of coincidences, major players from the regulatory side were predisposed to seek help from the private sector. And major players from the private sector recognized that a solution to the problem couldn't be achieved without definitive regulations.

Working together, the regulators and individuals associated with the ASB brought regulations and a standard forward in

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sure in plan amendments but with no mention of actuarial involvement. While the law left it up to Treasury regulations to spell out the details of the required disclosure, it seems highly unlikely that such regulations would require adherence to an ASOP given the lack of such a mandate in the statute. Therefore, few companies and actuaries would elect to comply with an ASOP in this area unless, of course, the standard closely paralleled the regulations. Actuaries presumably would continue to consult with employers on this work unless and until they become (or sense they will become) vulnerable in litigation for not following the standard.

The fact that the Board would even consider this approach confirms that it believes this type of work isn't uniquely actuarial but rather is a consulting activity that other professionals are capable of doing.

tandem. Participants from both the public and private sectors agree that the end result is far better than would have been possible without the joint effort.

We can do the same thing in the pension field. Particularly at the higher levels, individuals working for Treasury and the IRS are intelligent, conscientious, and extremely hard working. They sometimes suspect our motives—sometimes with reason. But generally their objectives are quite reasonable. They seek an orderly, feasible, and reasonably flexible approach to administration of the law regulating retirement plans. As soon as they become convinced that we have the same objectives, the dialogue becomes productive and cooperative.

So cooperation and joint effort bode well for the quality of the work product. But the advantage of a cooperative effort doesn't end there. An even more powerful argument is the precedent this joint effort can set for future projects. Once the advantages become obvious, this same cooperative approach can be continued into other areas of regulation. Consider, for example, how much better the 401(a)(4) nondiscrimination regulations might have been, if they'd been the product of a joint effort.

With this precedent firmly established, it may become possible to modify many of the bright-line rules we now face. We

need to convince the regulators that our objectives are the same as theirs. We need to convince them that we have an active and effective standards-setting process (the ASB). We need to convince them that we have an active and effective enforcement process (the ABCD).

With all of this accomplished, it may become feasible to replace today's bright-line rules with rules that call upon the pension actuary to exercise sound judgment. The result will mean more sensible administration of the law. It will mean a better environment for the health and growth of private retirement plans. And it will mean a more useful and meaningful role for pension actuaries.

The new disclosure requirements contained in the Economic Growth and Tax Relief Reconciliation Act of 2001 offer us an opportunity. If we seize it aggressively, we may be establishing a new era for pension actuaries—an era in which we regain some element of control over our own ship. With the projected benefit exposure draft, we have a powerful tool to help us launch this new era. ●

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ASOP's Goal Is Unclear

Other than as a response to the perceived public relations problem, it's not clear what the ASOP is attempting to accomplish. By making plan amendments the focus of the proposed ASOP, the ASB has failed to lay the foundation for a thoughtful and coherent standard. Except in the relatively few situations where a choice between plans is offered, the ASOP fails to focus on the objective for providing the information to employees. That lack of focus is apparently why the board is struggling with some fundamental issues (e.g., what information to provide in the illustrations on the preamendment benefits and whether projections provided to the employer should also be subject to the standard).

Any ASOP on benefit illustrations should clearly indicate that the purpose of providing the projections is critical and might provide different requirements depending upon the purpose. What are some of the possible purposes for providing benefit illustrations in connection with a plan amendment where the employee will not be making a choice?

A common response to this question is simply "the employee has a right to know how much worse off he or she might be in the future under the new plan." The main problem with this response is that it fosters an incorrect and dangerous impression that the employee had already become entitled to future pension accruals that are being taken away or curtailed.

Another response to the question is that this information (in-

cluding the wear-away effect) will help the employee determine whether to continue working for the employer and to make any necessary adjustment in savings and retirement planning. While those are laudable goals, merely providing detailed projections and comparisons in connection with a retirement plan amendment will provide little help to employees in achieving those objectives.

If the ASB is truly interested in helping employees understand the value of their benefit and compensation programs, the place to begin would be standards on how to do benefit projections for various defined benefit and defined contribution plan designs. That could then lead into how to compare projected benefits under alternative designs. Plan amendments would then flow more naturally from basic concepts.

Other objectives for providing employees detailed projections are motivated by public policy or politics. These include discouraging employers from amending their plans where some employees might receive lower benefits, encouraging employers to offer choice and other generous "transition" provisions, and providing employees ammunition to stop or reverse the amendment. These ulterior motives likely will backfire on employees because they'll lead to more plan terminations and fewer defined benefit plans. In any event, it's inappropriate for an actuarial standard of practice to implicitly endorse or encourage these kinds of policy and political agendas.

ASOP Would Be Misleading

A standardized approach to projecting benefits under a new plan formula (or even comparing old and new formulas) would be more confusing to employees than helpful. Providing a limited number of projections with only a few assumption combinations won't cover the range of reasonably possible outcomes (which is misleading). Or, if the range is wide, employees would find the information useless. And if an actuary certifies that any particular limited set of projections is reasonable (including the specification of baseline assumptions), it could give employees a false sense of accuracy and reliability.

The actuary, and possibly even the ASB, will be subject to second-guessing (i.e., litigation) when employees claim that they relied on the projections (despite any caveats and disclaimers). And if numerous projections are provided (whether in hard copy or software), most employees will be overwhelmed. In any case, few employers who are communicating the impact of a plan change to their employees would view the model put forth in the exposure draft as appropriate.

Comparisons between the old and new programs should reflect simultaneous changes to other benefit and compensation programs. For example, some employers introduce broad-based stock option programs at the same time as amending their pension plan. To disregard the potential financial impact of the

stock options in comparing the pre- and post-amendment retirement plan would be highly misleading and bias the results against the new program. And merely mentioning the stock options without including them in the numerical projections would be inadequate as well. This illustrates the need to identify the purpose for providing the comparisons.

Recommendations

Now that Congress has passed legislation requiring expanded disclosure in connection with plan amendments, it would seem prudent for the ASB to table this project at least until Treasury regulations are issued. In the meantime, the ASB and Academy pension committees should provide input to the Treasury on possible approaches to carry out the legislative intent. The approach taken in the exposure draft or a variation of it might be one possibility. If the regulations call for numerical projections that leave any leeway for the employer (e.g., assumption choices), the ASB could then reconsider whether an ASOP covering such projections is warranted.

In the future, when the cash balance controversy subsides, the ASB might consider whether a more general standard on individual benefit projections would be appropriate. ●

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