

MERCER

Human Resource Consulting

1166 Avenue of the Americas
New York, NY 10036-2708
212 345 7000 Fax 212 345 7414
www.mercerHR.com

April 27, 2004

Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Subject:

Comments on Tentative Decisions Regarding the Interpretation of Statement 87 for "Cash Balance" Pension Plans

We are writing to follow up on our letter of April 14, concerning the Board's tentative conclusions regarding the interpretation of Statement 87 for "Cash Balance" pension plans and to offer a reasonable, logical, and more consistent alternative for cash balance pension plan accounting.

As the largest global actuarial firm, we are significant providers, consumers, and interpreters of pension plan accounting and disclosure information. We support the Board's continuing efforts to provide financial statement users with meaningful, reliable, relevant, and useful information.

As stated in our April 14 letter, we do not agree with the Board's initial position (as developed at the March 3 and March 31 meetings), which departs significantly from established precedent and practice. We feel that the Board can more effectively improve the quality, consistency and comparability of reported results by issuing an interpretation that preserves and builds on existing principles and practices; maintains a unified and coherent defined benefit accounting model; and which is practical, affordable, and easily implemented by plan sponsors.

In the discussion that follows, we offer six specific suggestions for guidance and a rationale for each that achieves these objectives and avoids the problems of the bifurcated approach currently being considered. We believe these suggestions offer better comparability and consistency than the Board's tentative conclusions.

We welcome the opportunity to review these recommendations (discussed in greater detail below) with the Board or staff.

MERCER

Human Resource Consulting

Page 2

April 27, 2004

Financial Accounting Standards Board

Alternative Interpretation Based on Current Principles

In addition to the issues discussed in our April 14 letter (lack of comparability, inconsistent application, disruptive transitional effects and the possibility of multiple accounting transitions within a relatively short period of time), we believe that implementing the Board's tentative conclusions will require a complex set of detailed rules and interpretations. These would be necessary to define exactly what types of cash balance plans are covered by the interpretation and to explain what to do in a variety of fact patterns.

For example, to date, Board discussion has focused only on "pure" cash balance plans with a specific set of attributes. However, limiting the proposed interpretation in this manner will very likely create an immediate need for additional guidance in a number of areas, including:

- Plans that meet most, but not all of the attributes of cash balance plans as defined by the Board (for example, plans that do not pay lump sums or plans that do not permit employees to access their accounts before retirement age);
- Plans that have both "variable" and "fixed" interest crediting components (such as caps and floors); and
- Plans that have a mix of both traditional defined benefit and cash balance features – either for different groups of employees, or multiple formulas for the same employee. We have included as an Appendix a sampling of some of the types of issues that adoption of the tentative conclusions might raise.

Instead, we offer below an alternative view of cash balance plans (and other hybrid-type plans) which can be relatively easily accommodated by current accounting principles and the current pension accounting model. Our proposal does not split the defined benefit model into two models; thus, it eliminates the need for significant additional implementation guidance. If the pension accounting model is subsequently adjusted, the entire model can be adjusted as a unified whole. We urge the Board to reconsider its position in light of this alternative.

MERCER

Human Resource Consulting

Page 3

April 27, 2004

Financial Accounting Standards Board

Our alternative view takes the following current accounting principles into consideration:

- Cash balance plans are defined benefit plans.
- The substance of a defined benefit plan is the exchange of a promise of a future payment for a year of an employee's service. The amount of the promise is defined by the plan's formula, although it is not known with precision until the payment becomes due; the timing of the actual payment is uncertain.
- The benefit obligation of a defined benefit plan equals the discounted present value of each future estimated payment (times its probability of occurring) attributed to service to date.

(1) Cash balance plans are defined benefit plans.

We agree with the Board's conclusion that cash balance plans are defined benefit pension plans. The benefits to plan participants are defined by a formula, and the employer bears the investment risks of the assets used to finance the obligations. Cash balance plans lack the critical defining elements of defined contribution plans – individual employee accounts that add up to the market value of assets in the trust and the up-front transfer to the employee of the risks associated with the cash used to settle the payment obligations. Regardless of the type of cash balance plan (as defined by the Board at the beginning of this project), the same arguments apply; all cash balance plans should thus be considered as defined benefit plans.

For purposes of this discussion, we accept the working definition of a cash balance plan as agreed to by the Board at the beginning of this project¹, although we believe that our analysis could, if desired, be extended to a broader class of plans.

¹ "A cash balance pension plan is a defined benefit pension plan (as defined in the Glossary of Statement 87) that defines the promised employee benefit by reference to a notional account balance. An employee's notional account balance is increased with periodic notional principal credits and notional fixed and/or variable interest or investment credits, and may be increased for other notional ad hoc credits. Upon separation of employment, for any reason, by a fully vested employee, the employee is entitled to the notional account balance as either a lump sum or an actuarially equivalent annuity either immediately or at a future date. Subject to the terms of the plan or regulatory requirements, an employee may be entitled to a settlement amount greater than the notional account balance due to the crediting of future interest (or investment) credits that are not conditioned upon future service." (FASB Project Update – Interpretation of Statement 87, as of April 2, 2004).

MERCER

Human Resource Consulting

Page 4

April 27, 2004

Financial Accounting Standards Board

(2) *The substance of a defined benefit plan is an exchange of a promise of a future payment for a year of an employee's service. The amount of the promise is defined by the plan's formula, although it is not known with precision until the payment becomes due; the timing of the actual payment is uncertain.*

Estimating the timing and amount of these payments involves several measurement issues:

- **Attribution to years of service.** The first challenge is to determine how the total projected pension benefit should be allocated to an employee's years of service. In many traditional plans, the answer is often readily apparent from the terms of a formula that expresses the benefit as $x\% \times \text{pay} \times \text{years of service}$. Paragraph 42 of Statement 87 provides a practical solution (proration over the applicable service period) for formulas that attribute a disproportionate share of benefits to later years of service.

Cash balance plans do not fit into either of these two groups - the benefits are not expressed as a direct function of years of service and are generally more front-loaded than back-loaded. Determining the attribution pattern for these plans is one area where FASB guidance is needed. Existing principles and guidance would appear to offer two choices:

- (A) Look to the terms of the plan and conclude that the account balance (plus associated future interest credits that are not dependent on future service) is the best representation of benefits attributed to service to date. This approach was endorsed by the Emerging Issues Task Force (EITF) in issue 03-4² for a small subset of cash balance plans, although we find the logic equally compelling for all types of cash balance plans. The current account balance (plus associated future interest credits that are not dependent on future service) is indeed the full amount of the benefit that relates to all past service. Future pay changes will never affect the value of benefits earned for that service.
- (B) Determine that the default position for all plans that do not directly relate benefits to years of service is the projected benefit, allocated on a straight line basis to years of service. (For example, this is the general approach taken for other post-retirement benefits.) We recognize that this approach was specifically rejected by the EITF during last year's discussion around issue 03-4; however, it is a practical approach easily adapted to a variety of situations (even though it is perhaps theoretically imperfect). Adopting this approach would also mean reversing EITF 03-4, a step that the Board may not wish to take.

² Paragraph 6 of the May 15, 2003 Meeting Minutes on EITF 03-4 states: "The benefit promise in the cash balance arrangement [described in paragraph 4] is not pay-related as contemplated by Statement 87 and its related interpretive guidance.... The appropriate cost attribution approach, therefore, is the traditional unit credit method."

Page 5

April 27, 2004

Financial Accounting Standards Board

On balance, we conclude that (A) aligns better with current accounting principles and creates fewer implementation issues. To achieve this result, the Board would need to take the following actions:

- interpret EITF 03-4 to expand its applicability beyond the limited case of the sample plan presented to the EITF;
 - clarify Q&A 50 in the *Guide to Implementation of Statement 87* to indicate that it applies only to the specific case outlined in the question; and
 - determine that cash balance plans are not “pay related” as that term was meant to be applied for purposes of Statement 87, because future pay increases do not affect benefits earned for past service.
- **Uncertainty of time of payment.** The time of payment involves a number of factors, including how long the employee will continue working, when the employee elects to receive the pension amount, the form of payment the employee elects to receive, and how long the employee lives after the pension benefit begins. All of these are routinely estimated using actuarial assumptions such as turnover, retirement age and mortality. These actuarial factors assign a probability for each potential future payment; this process has proven reliable and appropriate for over 17 years of experience under FAS 87 and it applies equally well to all types of defined benefit plans – traditional final pay plans and cash balance plans alike.
- **Uncertainty as to the amount of the payment.** To determine the amount of the payment, the plan sponsor needs to make a number of assumptions, including future service for benefit eligibility, future salary increases, future levels of government-provided benefits or limits, future inflation, and other economic factors. In this regard cash balance plans are no different from traditional defined benefit plans; although instead of future salary and inflation assumptions, they will require a projection of future interest credits. Future interest credits are part of the “expectations of future economic conditions” (Statement 87, paragraph 46) that need to be determined consistently when setting assumptions. In many ways, they are also analogous to “automatic benefit increases specified by the plan (for example, automatic cost of living increases) that are expected to occur,” which are included in the benefit obligations under paragraph 48.

In thinking about future interest credits, it is important to note that what is relevant to the measurement is the estimated amount of future benefit payments, which are dependent, in part, on future economic conditions. Making assumptions about future interest credits *does not* involve trying to project an actual return on any underlying asset (this would be difficult to do in most cases because cash balance interest credits are seldom based on the actual return of any asset).

Page 6

April 27, 2004

Financial Accounting Standards Board

If the Board felt it necessary, it would certainly be appropriate to include as part of an interpretation a clarification of the economic assumptions described in paragraphs 46 and 48 of Statement 87 to specifically include the interest credits in cash balance plans that are not contingent on future services. (Interest credits that are contingent on future service should properly be allocated to Service Cost when earned).

- (3) *The benefit obligation of a defined benefit plan equals the discounted present value of each future estimated payment (times its probability of occurring) attributed to service to date.*

Q&A 61 of the *Implementation Guide* provides useful guidance for selecting the discount rate:

Once the estimated future annuity payments are determined, the discounting process using an explicit approach does not consider anything other than the time value of money for purposes of determining the single sum which, if invested at the measurement date, would generate the necessary cash flows to pay the pension benefits when due.

The purpose of the guidance in paragraph 44 of Statement 87 is to direct the employer to the proper sources for selecting assumed discount rates. Its intent is not necessarily to arrive at a discounted amount that would be the price an insurance company would charge to assume the same pension benefit promise to employees.

Thus, having determined the projected benefit payments by principle (2), all that remains is the selection of a proper discount rate. We assume that the reference to “future annuity payments” is also intended to cover “future lump sum payments,” although the Board could also add a clarifying interpretation to this effect.

The application of this principle to traditional defined benefit plans is well-accepted and understood. We submit that it is similarly straight forward with respect to cash balance plans, although several issues have surfaced in Board discussions that require clarification.

- The guidance on selecting a discount rate, specifically Q&A 61, speaks to a *process* rather than a result – the “benefit obligation” is not the amount needed to actually settle the employer’s benefit promise; rather it is the present value, discounted for the time value of money, of the full array of expected future payments under the employer’s promise. In estimating the time value of money, it is appropriate to take into account an insurer’s process

Page 7

April 27, 2004

Financial Accounting Standards Board

for determining annuity premiums (as well as other economic factors such as the yield on high-grade corporate bonds of the appropriate maturities).

- In informal discussions, at least one insurance carrier has indicated that their pricing model for terminating cash balance plans does indeed include a projection of the notional account balances, discounted with the assumed yield on their bond investment portfolio; we presume many other carriers do the same, because this particular carrier had, on occasion, been underbid by others. We believe that the Board may have been under the impression that pricing models were not constructed in this manner. We do acknowledge, however, that such transactions are rare, either because of underwriting standards or because participants in terminating cash balance plans who, given the option of taking their notional account balance as a lump sum, frequently do so. We also note insurance companies successfully face similar challenges for traditional plans with lump sum options. The buyout pricing reflects the expected payment date of the lump sum, not the amount that would be payable if everyone were to take a lump sum today.
- Although a participant may be entitled to receive a lump sum equal to his account balance upon termination of employment, we do not feel that this is an appropriate measure for the benefit obligation. Most importantly, in order to receive this amount, an employee needs to terminate employment, sacrificing valuable rights (seniority, knowledge, pay level, etc.) to do so. The “walk away” value thus overstates the employer’s *net* obligation for the benefit. In addition, it is contrary to the going-concern notion embedded in all other defined benefit accounting – including many similar situations like early retirement subsidies where the value of the “walk away” benefit might exceed the benefit obligation. We believe that comparability and faithful representation are better enhanced by maintaining a consistent set of principles in the accounting model for all post-retirement benefits.

On the reverse side, of course, the “walk away” principle has been determined to be inappropriate for benefits with little or no vesting, such as retiree medical obligations under Statement 106.

Summary of Recommendations

In summary, we feel the Board can improve the quality, consistency and comparability of reported results with an interpretation that preserves and builds on existing principles and practices, and which is practical, affordable and can be easily implemented by plan sponsors. As outlined above, we suggest the Board take the following specific actions in lieu of the approach outlined in the tentative conclusions:

MERCER

Human Resource Consulting

Page 8

April 27, 2004

Financial Accounting Standards Board

- (i) Re-endorse the idea that cash balance plans are defined benefit plans, and should therefore follow the general defined benefit accounting model.
- (ii) Extend the logic outlined in EITF 03-4 to all cash balance plans
- (iii) Clarify that Q&A 50 of the *Implementation Guide* is limited in scope, and applies only to the example shown in the *Implementation Guide*
- (iv) Indicate that plans where future pay increases do not affect benefits earned for past service are not “pay-related” for purposes of FAS-87
- (v) Clarify paragraphs 46 and 48 of FAS-87 to indicate that cash balance interest credits are either a part of the formula or are “other economic factors” about which it is appropriate for an employer to make assumptions.
- (vi) Clarify Q&A 61 of the *Implementation Guide* to include lump sum payments within the meaning of the term “future annuity payments.”

Our alternative view offers a number of advantages over the Board’s current proposal:

- It preserves comparability amongst all types of cash balance plans (both variable credit and fixed credit), as well as comparability between cash balance plans and other types of defined benefit plans.
- It applies existing principles and standards consistently under a single model; and does not require an extensive amount of implementation guidance to specify scope, application or transition exceptions that would be required with a dual or bifurcated model. The alternative interpretation is also easily adaptable to cash balance plans that include both a cash balance formula and a traditional defined benefit formula for certain groups of plan participants (grandfathered benefits, minimum benefits, etc.).
- Transition would be far less disruptive, as in most cases only the projected benefit obligation would change and not the accumulated benefit obligation, avoiding the illogical result of a simultaneous credit to income and charge to equity (as outlined in our April 14 letter).
- The transition could be easily handled as either an ordinary gain or loss at the next measurement date (similar to and consistent with the transition outlined in EITF 03-4) or as a one time adjustment and would not require a significant modification to existing systems and processes. If the basic defined benefit pension model were subsequently changed, the concerns about multiple transitions would be far less onerous.

MERCER

Human Resource Consulting

Page 9

April 27, 2004

Financial Accounting Standards Board

We welcome the opportunity to review these recommendations with the Board or staff in greater detail.

Sincerely,

A handwritten signature in black ink, appearing to read "Ethan E. Kra". The signature is written in a cursive style with some loops and flourishes.

Ethan E. Kra
Chief Actuary

saa:saa:bsm/fxp

Appendix

Other Technical Questions Raised by the Proposed Interpretation of Statement 87

The following questions outline a sample of several technical implementation and interpretation questions that would need to be addressed if the Board's tentative conclusions on the interpretation of Statement 87 were to be formally adopted. This list is not intended to be exhaustive; it is only meant to provide an overview of the types of issues that may be raised by the Board's tentative conclusion and the resulting separation of the pension accounting model into "cash balance plans" and "other plans."

1. For a pure cash balance plan, how are the interest cost and service cost components of expense determined?
2. Assuming that the interest cost component is the interest credit on the notional account balance ("the increase in the projected benefit obligation due to the passage of time"³), should the interest cost be based on the **assumed** interest credit rate, which is known at the beginning of the year, or the **actual** interest credit rate, which may only be known at the end of the year? Requiring end-of-year assumptions would be a further departure from the current model, and could make it extremely difficult for plans with mixed formulas (see items 3. and 4. below) to complete needed valuations on a timely basis. On the other hand, using assumed rates raises questions about how the assumption should be determined and how to handle differences between the actual credit and the assumed credit.
3. For a cash balance plan that consists of both account balances (*e.g.*, for active employees) and non-account traditional defined benefits (*e.g.*, for retirees and deferred vested employees), would the interest cost need to be determined separately for each employee? If so, what would be the proper disclosure of the assumed discount rate? (Note: current valuation systems and processes would require a substantial amount of re-engineering and re-programming to calculate a separate interest cost for each individual. That calculation is typically performed only after all the liabilities for the plan have been aggregated into a single number).

The following example provides some additional detail:

³ Statement No. 87, paragraph 22

MERCER

Human Resource Consulting

Appendix, page 2

April 27, 2004

Financial Accounting Standards Board

Example 1:

	Participants with Account Balances	Participants with Traditional Annuities	Total Plan, as reported in the financial statements
Benefit Obligation	\$1,000,000	\$1,000,000	\$2,000,000
Interest / Discount Rate ⁴	4.5%	6.5%	
Interest Cost	\$45,000	\$65,000	\$110,000

Would this be reported as an assumed discount rate of 5.5% (\$110,000 / \$2,000,000), or 6.5% for approximately one-half the liability, or just 6.5%?

- For a cash balance plan that provides the greater of a cash balance formula or a traditional defined benefit formula, how should the service cost and interest cost be computed when the formula that applies to an individual can change from one to the other? Because the account balance is a present value, answering this question may require rewriting much of the existing guidance on attribution to take into account the present value of benefits associated with each exit age. Current guidance focuses only on benefits attributable to years of service and not on the present value of those benefits.

Example 2 (cash balance formula has the greater liability at the beginning of the year, traditional defined benefit formula has the greater liability at the end of the year; for simplicity, this illustration assumes a single exit age of 65):

Cash balance plan current crediting rate ⁵ :	4.5%
Traditional defined benefit plan discount rate	6.5%
Account balance beginning of year (greater than traditional PBO)	\$100,000
Traditional PBO, projected to year-end (greater than account balance)	\$116,000

Of the total \$16,000 expected increase in PBO during the year, is the interest cost \$4,500 (\$100,000 × the cash balance credit rate of 4.5%) or \$6,500 (\$100,000 × the traditional discount rate of 6.5%), or something in-between (*i.e.*, the traditional plan discount rate times the beginning of year traditional plan PBO)? What discount rate would an employer report in its year-end financials? Presumably the service cost is \$16,000 minus the amount allocated to interest cost.

The example is similar if the traditional defined benefit formula has the greater PBO at the beginning of the year and the cash balance formula has the greater PBO at the end of the year.

⁴ Appropriate interest credit rate for cash balance plans (see question 2); assumed discount rate for traditional benefits

⁵ Actual or assumed; see question 2.