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IRS Proposes Regulations on § 415 Limits

The following is reprinted from the May/June 2005 issue of Pension & Benefits Update, the Government Finance Officers Association's newsletter on retirement issues. It was written by Paul Zorn, director of governmental research for GRS.

In late May, IRS issued proposed regulations (REG-130241-04) relating to limits on defined benefit (DB) and defined contribution (DC) retirement plans under Internal Revenue Code (IRC) § 415. Many of these limits apply to governmental plans.

The proposed regulations consolidate statutory changes and IRS guidance issued since the regulations were last updated in 1981. In some cases, the proposal substantially modifies prior regulations. If made final, the regulations would become effective for plan years beginning on or after January 1, 2007.

Section 415(c) limits the "annual additions" that can be made to a DC plan participant's account to \$40,000 – indexed to inflation

(\$42,000 in 2005), or 100 percent of the participant's annual compensation, whichever is less. Annual additions include employer and employee contributions and forfeitures but not rollovers from qualified plans.

Also limited by § 415(b) is the benefit that can be provided by a DB plan. The DB benefit is limited to \$160,000 – indexed to inflation (\$170,000 in 2005), or 100 percent of the participant's average compensation for the highest three consecutive years, whichever is less. Although private sector plans are subject to both limits, governmental plans are exempt from the limit related to average compensation for the highest three consecutive years.

Generally, the \$170,000 dollar limit for DB plans applies to the employer-provided portion of the benefit, expressed as a straight-life annuity. For benefits beginning before age 62, the limit is reduced so that the age-adjusted dollar limit is actuarially equivalent to the unreduced dollar limit at age 62.

For participants in state and local government defined benefit plans who are employees of police and fire departments (or former members of the U.S. Armed Forces) with at least 15 years of service, no actuarial reduction to the dollar limit is made for retirement before age 62.

The following clarifications and modifications are just a few of the many made by the proposed regulations:

Adjusting the Form of Benefit for Automatic Fixed COLAs

The proposed regulations clarify that, in determining the value of the DB plan benefit tested against the § 415(b) dollar limit, the actuarial value of a plan's fixed automatic cost-of-living adjustment (COLA) is included in the benefit.

Adjusting the Dollar Limit for Inflation

The IRS increases the § 415 limits periodically based on changes in the Consumer Price Index (CPI). In conjunction with this adjustment, a plan may increase benefits paid to retirees whose benefits were otherwise limited by § 415. The proposed regulations establish a "safe harbor"

under which the benefit may be increased by the ratio of the new § 415 dollar limit (as adjusted for age at benefit commencement) to the prior § 415 limit (similarly adjusted). However, this increase may not exceed the amount that would otherwise be payable under the plan.

Testing Benefits Having Multiple Annuity Starting Dates

The proposed regulations also establish an extremely

Adjusting the 415 Dollar Limit for Inflation. The IRS adjusts the § 415 DB dollar limit for changes in the CPI, rounding the limit to the next lowest multiple of \$5,000. In 2005, the limit is \$170,000.

complicated set of calculations for annuities with “multiple annuity starting dates.” Among other circumstances, these rules would apply when a benefit being paid to a retiree increases due to additional benefit accruals resulting from a return to work or, possibly, as a result of benefit increases due to COLAs.

Overall, the proposed regulations present a complicated framework for DB plans’ tested benefits and DC plans’ annual additions.

A more detailed analysis of the proposed regulations’ key elements is available in the Library section of the GRS web site, under Research Memos.

In conjunction with the increase in the dollar limit, a DB plan may increase benefits that were otherwise restricted by the limit, provided the plan explicitly permits the increase and does so in conformance with the § 415 regulations.

The proposed § 415 regulations clarify that a DB plan may apply the increased DB dollar limit to participants who have begun receiving plan benefits. To do so, the plan must apply either the “safe harbor” rules or the rules related to “multiple annuity starting dates.”

Under the safe harbor rules, the benefit may be increased by the ratio of the new § 415 dollar limit (adjusted for age at benefit commencement) to the prior § 415 dollar limit (similarly adjusted), provided the increase does not exceed the amount that would otherwise be payable under the plan.

Use of the safe harbor is contingent upon the participant having received at least one distribution that satisfies the requirements of § 415(b) before the date that the § 415 limit increase becomes effective.

Public Coalition Comments on Proposed § 415 Regulations

A broad coalition of 11 national associations offered comments to the IRS regarding the proposed § 415 regulations. The coalition includes associations representing state and local retirement systems, government finance officials, teachers, police officers, firefighters, and other government employees. The coalition expressed significant concerns regarding a variety of issues including, but not limited to:

Comment Period

The IRS issued the proposed regulations May 25 and required comments by July 25. Noting that this review period was “extremely cramped” given the complexity of the proposed rules, the coalition requested the IRS to extend the comment deadline until November or December.

Effective Date for Governmental Plans

Amending governmental plans often requires legisla-

tive action, and in some states the legislature only meets every two years. Given that the proposed regulations represent substantially new rules, the coalition requested an extension of the final regulations’ effective date for governmental plans in order to allow the time needed for legislative action.

Treatment of Defined Benefit COLAs

Noting that cost-of-living adjustments (COLAs) play an important role in protecting retirees against inflation, the coalition urged the IRS to reconsider its treatment of COLAs in testing benefits. Under the proposed regulations, the actuarial value of fixed COLAs are included in the value of the benefit that is tested against the § 415 limits for defined benefit plans. As a result, inclusion of the COLA could cause benefits that would otherwise be below the limits to exceed them. The coalition argued that Congress did not intend to

penalize a participant whose benefit was otherwise below the § 415 limits, “merely because the participant is or may be entitled later on to receive COLA increases ... [when] the applicable dollar limits will undoubtedly have risen...” Instead, the coalition suggested that the benefit, as increased, be retested against the applicable § 415 limit at the time of increase.

Multiple Annuity Starting Dates

The coalition expressed “substantial concerns” regarding the rules related to multiple annuity starting dates. It noted that the rules could limit benefits previously paid, even though those benefits had previously passed the applicable § 415 limits. The coalition recommended that the benefits simply be retested against the applicable § 415 limits at the time of increase. The coalition also commented on other issues, including benefits beginning after age 65 and the factors used to value the benefits.

The full text is available at: <http://www.gfoa.org/flc/documents/415comments-PPN.pdf>

Cortex's Self-Assessment Questions for Effective Board Governance. Based on 15 years of working with a large number of retirement systems, Cortex has developed the following questions to assist the Board:

- 1) Does the Board concentrate on policy and oversight or does it have a tendency to get into details? What can be done to keep the Board focused on governance issues?
- 2) Does the retirement system have a board orientation and education program that enables the Board to be effective? Are there ways it could be improved?
- 3) Is the Executive Director's evaluation process fair and objective? Can it be improved?
- 4) Is a strategic planning process in place that ensures the Board sets the right priorities?
- 5) Is an effective selection and evaluation process in place for the investment consultant, actuary, auditor, outside attorney, and other vendors?
- 6) What can be done to ensure the system conforms to "best practice" with regard to structure, staffing, compensation, etc?

Achieving Good Pension Governance

Effective governance is an essential component for the long-term success of public employee retirement systems. With the recent downturn in the investment markets and resulting increases in contributions, it is even more important for retirement system governance to take place within an established framework that leads to objective decisions.

The following interview is with John Por and Tom Iannucci, President and Managing Director, respectively, of Cortex Applied Research in Toronto, Canada. Since 1991, they have consulted on pension governance issues with three dozen U.S. state and local retirement plans.

What does "good governance" mean and why is it important?

Pension trustees govern well when they focus on creating and documenting structures, policies, and practices that lead to systematic, objective decisions. These decisions should recognize the primacy of the fiduciary risk management function, and incorporate the best knowledge available. Without conscious design, good governance will not occur on its own. As an aside, it is conscious design that makes the U.S. Constitution such a remarkable document.

What benefits result from good governance? What costs are likely to be avoided or advantages gained?

Experience suggests that the costs of ineffective governance are around 100 basis points, and can be attributed to a variety of factors, including: excessive and often unrecognized risk taking, a tendency to concentrate on low-impact decisions, insufficient attention to managing costs, and a failure to adequately consider the organizational consequences of investment decisions.

The good news is that these costs can be minimized with effective trustee education and by committing to a governance improvement program. By applying good governance principles, most common mistakes can be avoided. Boards will not only achieve better long-term investment results but will also be able to demonstrate a higher degree of rigor in the exercise of their fiduciary duties. Enhancing one's board governance practices is one of the most critical factors in achieving long-term success.

What changes are likely to occur in the direction and operation of the retirement plan as a result?

The key to effective governance is the trustees' ability

to shift from a "hands-on" operational perspective to a "policy and oversight" perspective. This is difficult, as most trustees are "doers" in their non-trustee life and are unaccustomed to playing strictly an oversight role.

By shifting perspectives, however, pension boards will enhance their effectiveness by:

- Clearly setting the direction of the organization through better priority setting processes;
- Focussing on managing the retirement system as a whole, rather than concentrating only on certain, narrow decisions (such as manager selection);
- Devoting more effort to identifying, understanding and managing risk;
- Developing a set of policies to manage their key risks. (As an aside, some may think that copying policies developed by others will do the job. It will not. Much of the value of policies arises out of the process of discussing and debating policy options.)
- Committing to and engaging in ongoing, relevant education, free from conflicts of interest; and,
- Seeking ongoing improvements through structured, objective evaluation of the performance of the Executive Director and the Board itself.

The essence of good governance is the design and implementation of the various tools that help to accomplish the above shift in perspective. These tools include: ongoing trustee education, monitoring requisite trustee knowledge, delineation and documentation of roles and responsibilities, setting of governance principles and policies, setting priorities annually (as they may shift in light of events), and rigorous reporting and monitoring.

What will happen if good governance is ignored?

Experience suggests that if the plan sponsor begins to perceive that its financial responsibilities to its pension plans are untenable, two things usually happen: somebody will be blamed, and some high profile (although not necessarily effective) remedy will be imposed, such as fiduciary audits, pension reform legislative, a shift toward DC plans, etc. Moreover, the Board's reputation will suffer and confidence in the system will be undermined.

What are the obstacles to achieving good governance?

The human condition is such that questioning or examining current practice provokes considerable discomfort. At the same time, all major improvements in life usually come about as a result of rigorous examination of our practices; usually instigated by the pressures of the marketplace or some acute personal or organizational setback.

Since public pension plans are not really subject to market

Steps to Achieving Effective Board Governance. The general process for achieving effective board governance practices is not different from other processes for achieving administrative improvements:

pressures, trustees need to create their own conditions for change (e.g. board self-assessment, executive director performance evaluation, enhanced investment performance measurement, etc.).

However, there also seems to be a dearth of well-designed, pragmatic tools that can help trustees achieve the above. After years of experience in this area, Cortex has developed specific services and workshops to help meet these needs. *An initial set of board self-assessment questions is shown in the sidebar on page 3.*

Will fiduciary audits likely result in improvements in this area?

"Fiduciary audit" is a term that can mean different things to different people. Usually it is an operational audit for the investment program. Even when a fiduciary audit is initiated, the investment operational aspects are usually given a 75% weight and governance only 25%.

Furthermore, the skill set required to look into investment operations is fundamentally different from the skill set necessary for dealing with board issues. Thus, even if an audit is performed, these issues get a shorter than required shrift.

If a fiduciary audit is initiated, it is crucial that trustees understand and agree on what they are looking for. Thus it is important that trustees dis-

cuss what outcomes they are aiming to achieve, and that the RFP for the audit is clear.

We are sorry to say that this is usually not the case, and thus the improvements of having a fiduciary audit may not be commensurate with the pain and costs they incur.

It would be more effective if the issues of investment operations and those of board governance were not subject to the same RFP. Equally important, the Board should agree in advance as to what they would specifically like to achieve with such an audit, so the RFP can be written accordingly.

How should systems go about ensuring that good governance is in place?

We believe that establishing a gradual program along the lines described earlier would not only address board governance in a more effective way, but also build Board support for this process and ensure continuous improvement and maintenance. This is necessary, as boards can often experience periods of high trustee turnover.

The general process for achieving effective board governance practices is summarized in the sidebar on the right.

- 1) Start with education (usually in the form of a workshop).
- 2) Establish the governance principles that trustees wish to live by.
- 3) Identify the risks they want to manage and establish governance policies for managing the risks.
- 4) Design and implement a process that will enable trustees to see if they are moving toward their goal (monitoring results and compliance).
- 5) Modify the process in light of actual results.

This is a continuous process. Achieving effective governance takes time but can be accomplished. It is a matter of will, patience, and commitment.

Cortex dedicates its efforts to making the necessary tools available for Boards and Executive Directors who want to start this journey. More information is available on its web site at:

<http://www.cortex-consulting.com>

OPEB Case Study. The following case study illustrates the impact of applying different investment return assumptions in the actuarial valuation of a retiree health care plan. As shown, lowering the investment return assumption from 8 percent to 4 percent nearly doubles the required contributions.

A large city has 3,000 active members (including general and public safety employees) and 1,200 retirees.

The employer provides retiree health care and pays 100 percent of the premium for retired members. While allowing access to health care for the retirees' spouses, the employer does not pay their premiums.

Assuming an 8 percent investment return, the employer's annual required contribution (ARC) for this plan is 7 percent of covered payroll for general employees and 10 percent for police and firefighters.

Assuming a 4 percent investment return, the ARC would be 13 percent for general employees and 17 percent for police and firefighters.

This example is based on the circumstances of an actual plan. However, given the complexity and wide variation in retiree health plan designs, the contribution rates above should be viewed as illustrative, rather than as typical.

Advantages of Trusts for Funding Retiree Health Care

Last summer, the Governmental Accounting Standards Board (GASB) approved its new accounting standards for Other Postemployment Benefits (OPEBs), including retiree health care. The standards are presented in two statements:

- *Statement No. 43, Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, which applies to the financial reports of OPEB trusts or equivalent arrangements established to fund the benefits, and
- *Statement No. 45, Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, which applies to the financial reports of governmental employers that sponsor OPEBs.

In June, the GASB published its *Guide to Implementation of GASB Statements 43 and 45*, offering additional OPEB guidance through answers to over 250 questions about the standards.

Overview of the GASB OPEB Standards

OPEBs include retiree health care benefits, whether or not provided separately from a defined benefit pension plan.

OPEBs also include life insurance, disability, and long-term care, but only if provided separately from a defined benefit pension plan.

The GASB's standards require that the long-term cost of retiree health care and other OPEBs be determined using actuarial methods and assumptions applied in essentially the same manner as applied to state and local government pension plans.

Generally, under the standards, an actuarial valuation is done to determine the "annual required contribution" (ARC) that would be necessary to fund the promised benefit, as well as the accrued liability, value of assets, and other related information. The ARC then becomes the basis for reporting financial information about the OPEB benefits in the financial statements of the plan and sponsoring employer(s).

A more detailed explanation of the GASB requirements is provided in a GRS briefing paper on the OPEB standards, available on the GRS web site.

OPEB Trusts and Investment Return Assumptions

The GASB OPEB standards apply specifically to measuring and reporting OPEBs in the

financial reports of sponsoring governmental employers and OPEB plans. The standards do not require the benefits to be prefunded or the funds to be held in trust. Nevertheless, the standards offer significant advantages for doing so.

The first advantage is that if the employer consistently contributes the full ARC and holds the funds in a trust or "equivalent arrangement," the investment return assumption can be higher than could otherwise be used. To qualify as a trust or equivalent arrangement, the employer contributions must be irrevocable, dedicated to providing plan benefits, and legally protected from creditors.

Under the standards, if the assets are held in a trust or equivalent arrangement, and the employer consistently contributes amounts at least equal to the ARC, the assumed investment return may reflect a diversified mix of equity and fixed-income securities. This could be similar to the mix of assets held by governmental pension plans, for which assumed investment returns average about 8 percent.

If the assets are not held in a trust or equivalent arrangement, then the assumed investment return may only reflect the yield on investments available to the employer, such as short-term U.S. Treasury securities. This would occur if the assets were held in the employer's general fund or another fund without the protections described above. At the time of this writing, the annual yield on two-year Treasury securities was about 4 percent.

Use of the higher investment assumption would result in significantly lower annual required contributions, as illustrated in the sidebar on the left of page 5.

Trusts and the Net OPEB Obligation

Another key advantage of holding OPEB assets in a trust or equivalent arrangement is that they can then be counted against the employer's net OPEB obligation.

For governmental employers participating in single and agent OPEB plans, two key OPEB measures are calculated and included in the employer's financial statements:

- The "OPEB cost" is based upon the annual required contribution (ARC) determined by an actuarial valuation conforming to the GASB's requirements. The OPEB cost determines the employer's annual OPEB expense/expenditure shown in the employer's financial statements.

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- The "net OPEB obligation" is the difference between the OPEB cost and the annual employer contributions actually contributed to the OPEB plan, accumulated from the effective date of the OPEB standards. The net OPEB obligation is the basis for determining the OPEB liability (or asset) shown in the employer's financial statements.

Under the standards, in order for an employer's contributions to count against the net OPEB obligation, the funds must either be used to pay benefits or be contributed to a trust or equivalent arrangement.

Employer contributions that are held in the general fund to pre-fund OPEB benefits (or in another fund that does not provide the protections of a trust), will not count against the net OPEB obligation and,

therefore, will not reduce the employer's OPEB accounting liability shown in the financial statements.

Conclusion

Prefunding OPEB benefits and holding the assets in trust will have a significant effect on the measurement of an employer's OPEB liability. Doing so allows a higher interest rate assumption to be applied during the valuation, effectively reducing the long-term liability. Moreover, it allows employer contributions used to pre-fund the benefits to count against the net OPEB obligation.

More detailed information about the GASB OPEB standards and about trusts and other vehicles for pre-funding retiree health benefits can be found on the GRS web site at: www.gabrielroeder.com/opeb.

GRS OFFICES

CHICAGO
20 North Clark Street
Suite 2400
Chicago, IL 60602-4193
(312) 456-9800
(312) 456-9801 Fax

DALLAS
5605 N. MacArthur Boulevard
Suite 870
Irving, TX 75038-2631
(469) 524-0000
(469) 524-0003 Fax

DENVER
4600 S. Ulster Street
Suite 700
Denver, CO 80237-2882
(303) 846-3031
(303) 740-6789 Fax

DETROIT
One Towne Square, Suite 800
Southfield, MI 48076-3723
(800) 521-0498
(248) 799-9000
(248) 799-9020 Fax

FT. LAUDERDALE
301 East Las Olas Boulevard
Suite 200
Ft. Lauderdale, FL 33301-2254
(954) 527-1616
(954) 525-0083 Fax

NORTH/CENTRAL FLORIDA
4880 Newberry Road, Suite 180
Gainesville, FL 32607-2249
(352) 375-3800
(352) 338-1513 Fax

SACRAMENTO
3017 Douglas Boulevard
Suite 300
Roseville, CA 95661-3850
(916) 987-7600
(916) 987-7607 Fax

SAN DIEGO
9171 Towne Center, Suite 440
San Diego, CA 92122-1238
(858) 535-1300
(858) 535-1415 Fax

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www.gabrielroeder.com

Gabriel, Roeder, Smith & Company has provided benefit consulting and actuarial services for public, private, and not-for-profit plan sponsors since 1938. We are dedicated to providing services that encourage sound financing, sensible benefit design, efficient administration, and effective communication of employee benefits.

From our network of offices, we serve over 500 public- and private-sector clients nationwide, including retirement systems, employers, employee organizations, and government agencies. We have worked with many of our clients for more than 30 years - some for more than 60 years. The far-ranging locations of our clients and the long associations we have enjoyed reflect the quality of the services we provide. Services offered by GRS include:

- Pension Plan Valuations and Studies
- GASB 43/45 OPEB Plan Valuations and Studies
- Health Care Consulting
- Retirement Technology Applications
- Plan Administration Services