

# Commentary

BUFFIN PARTNERS INC.

ECONOMIC INVESTMENT AND ACTUARIAL RESEARCH

## Missa Solemnis for Pensions

Cassandra-like, the media report the demise of pensions. They cite as evidence, the decline of defined benefit pension plans, the insolvency of the Pension Benefit Guaranty Corporation, the unsustainability of pension plans in the airline and other industries, deterioration in funded levels of corporate pension plans, the decline in market values of equities, the recent historic fall in interest rates, and mismatching of assets and liabilities. This is a time for real concern, but not time for a *Requiem*. Perhaps a *Missa Solemnis* would be more appropriate. An assessment of the problems of the pension system, accompanied by a solemn prayer for survival, might improve confidence that the system will survive.

Our appeal in Latin is motivated by a keynote speech entitled "Quo Vadis?" given recently to the International Association of Consulting Actuaries by Rod Lester of the World Bank. The classic challenge of "whither goest thou" is an appropriate question for pension professionals. Accountants, auditors, actuaries, attorneys and asset managers should undertake some serious soul-searching and devote time and thought to a *Missa Solemnis* for Pensions.

Why is there a pension-funding crisis? The Employee Retirement Income Security Act of 1974 (ERISA) was intended to protect against the situations the pension system is now experiencing. Pension practitioners act to ensure compliance with rules and regulations of the Internal Revenue Service and Department of Labor. Accountants follow procedures for accounting for pension costs under Financial Accounting Standard 87. Actuaries practice as Enrolled Actuaries under ERISA and follow Actuarial Standards of Practice including #27 entitled "Selection of Economic Assumptions for Measuring Pension Obligations."

Pension professionals, when challenged as to their role in the pension funding cri-

sis, become defensive and cite the *Credo* of law, rules and regulations, accounting and actuarial standards, or even conventional practice, as with asset managers, who perceive their role as achieving performance against a specified benchmark. The problem is that the *Credo* is not necessarily sufficient or appropriate. What is required is less *Credo* and more *Confiteor*, a confession that conventional practice is flawed in many respects. When the Securities and Exchange Commission raises questions about the appropriateness of discount rates used to value pension liabilities, the values ascribed to pension fund assets, and the computation of pension income as a credit to corporate earnings, it may be correct to state that laws, rules, regulations and standards are being complied with, but the real question is "does the framework in which professionals operate make sense in the light of the dubious results it produces and the crisis that has unfolded?"

There are signs that pension professionals are undertaking the necessary soul-searching and *Missa Solemnis* for Pensions. The Conference of Consulting Actuaries honored two papers in October that deserve wider circulation outside the actuarial profession. These two papers are entitled *Fixing the Pension Plan Funding Rules* by Edward Burrows and *Financial Economics and Actuarial Practice* by Tony Day.

The Burrows paper contains a *Confiteor* for pension professionals: "We placed too much emphasis on smoothing year-by-year volatility in contribution requirements. When it became necessary to true-up assumptions for investment return, future pay changes, and mortality, we didn't require immediate recognition of these changes. We permitted grading to the new level, amortizing the difference. We permitted amortization of the inevitable gains and losses that occur as results fluctuate from what we expected. We failed to consider what might happen if business fail-

ure should occur before amortization was complete. When it came to asset value fluctuation, we permitted even more dampening. We permitted amortization of deficits when benefit enhancements outpaced asset buildups. We permitted dampening when benchmark interest rates changed and we told actuaries they didn't have to use even the dampened rates as long as they used rates within broad tolerances of the dampened targets. When some aspect of the world around us changed, we told plan sponsors they needn't recognize the change all at once."

The Day paper offers the following recommendations for change. "The practice of using the discount rates of the underlying assets for valuing liabilities should no longer be considered good practice. Actuaries should be indifferent to the investment strategy of the pension fund. Actuaries should acknowledge the inevitable moral hazards and interest conflicts that arise from the application of actuarial judgment and seek ways to limit their adverse effects. Current market prices and economic values should be respected and it should be realized that other professions own the issue of current value. Actuaries should respect these other views and strive to link long-term models and ideas with accounting practices, current market values and economic realities."

The Burrows *Confiteor* and the Day recommendations together constitute a *Missa Solemnis* for pension professionals that offers hope that the pension system will avoid a *Requiem* and will instead witness a revitalization to the acclaim of *Exsultate Jubilate*.

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