



Letter of Comment No: 7
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Mr. Robert H. Herz, Chairman
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Dear Chairman Herz:

Subject: Discount Rate for Cash Balance Plans

This letter is on behalf of Hewitt Associates LLC. Hewitt is a global provider of benefits, compensation, and human resources services, providing our clients with actuarial, consulting, and outsourcing services. In the United States, we provide actuarial services to a significant number of companies of all sizes. More specifically, we provide actuarial services to over 100 employers that sponsor cash balance pension plans.

Based on the conclusions reached at recent FASB meetings, we have some serious concerns regarding the direction that the FASB is taking with respect to cash balance plans. Our belief is that the interest crediting assumption and discount rate for a cash balance plan should be determined just as these assumptions would be determined for any other defined benefit plan. We believe that the FASB's decisions are based on the incorrect view that the settlement of a cash balance account is accomplished through an investment equal to the account balance yielding the same return as the plan's interest crediting rate. We believe that this concept is incorrect since the interest crediting rates used by cash balance plans are not necessarily available in the investment markets, nor do these crediting rates expose the insurer to the risk that would exist if actual investments were made.

We have outlined below the major reasons that we feel that it is counter to FAS 87 to require that the discount rate be set equal to the interest-crediting rate on cash balance accounts for plans with variable interest credits.

Consistency with FAS 87

Within FAS 87, there is no distinction in the selection of the discount rate based on how the plan's benefit is computed. In fact, the conceptual basis for the accounting standard suggests the opposite.

Mr. Robert H. Herz, Chairman

Page 2

May 4, 2004

It is clear that different designs that result in different projected payment streams could have different discount rates (based on the duration of the liabilities). However, there is no basis in FAS 87 for two plans that provide the same projected benefit stream to have different discount rates based on how the benefits are computed. If a final average pay plan had a projected payout of \$100,000 in each of the next 10 years and a cash balance plan had a projected payout of \$100,000 in each of the next 10 years, the PBO for these two plans should be identical. There is no more uncertainty in developing the cash balance payout stream than for the final average pay payout stream.

Under the approach FASB favors, the PBO for these two types of plans would be different since the cash balance plan would be required to use an artificially low discount rate equal to the interest crediting rate. FASB's rationale for this distinction is that the projected cash flow is irrelevant for a cash balance plan. Instead, the FASB appears to believe that an insurance company could accept a payment equal to the cash balance accounts and invest those assets in an investment that would yield the exact interest crediting rate for an indeterminate period, with no fluctuation in the principal value of the assets. As noted earlier, this type of investment vehicle does not exist.

Thus, despite the practical inability to find this "investment" and the inability for it to perform as it would need to if the FASB's decisions are implemented, cash balance plans will see the PBO related to the cash balance accounts increase by as much as 25 percent from that previously calculated.

One of the guiding principles of FAS 87 was to enhance the comparability of the pension expense and disclosure information among employers. The adoption of an approach like this would reduce that comparability.

Investing to Return the Interest Crediting Rate

We think it is important to emphasize that the cash balance interest-crediting rate is **not** a rate that can typically be replicated in the investment markets. If a cash balance plan had an interest crediting rate that was equal to a money market account daily crediting rate (i.e., an account where the principal is fixed, not variable), it would be true that by investing the balance in the money market fund, an insurer could then settle the obligations for the amount of the cash balance account. However, this type of interest credit is not used in cash balance plans. Further, it is not possible to settle cash balance accounts by "locking-in" the interest crediting rate on assets equal to the account balances. As a result, these plans must apply the provisions of FAS 87 as other defined benefit plans are required to do which requires the use of reasonable assumptions and a specifically determined discount rate.

Mr. Robert H. Herz, Chairman

Page 3

May 4, 2004

Anomalies of the Proposed Approach

There are many reasons why it is inappropriate to implement FASB's proposed approach. The following examples illustrate some of the anomalies and issues in applying this approach that would result:

- Assume that there are two plans that just converted from final average pay formulas to cash balance and that both of these plans have the same opening balances and ongoing pay credits. However, one plan uses a one-year Constant Maturity Treasury (CMT) plus 1 percent interest-crediting rate, while the other plan uses a one-year CMT minus 1 percent interest-crediting rate. Under FASB's proposed approach, these plans would have the same ABO and PBO (since the sum of their account balances would be the same). As time went on, the obligations of these two plans would diverge as actual interest credits caused the balances to grow at different rates. However, during the first few years following the adoption of a cash balance formula, the obligations would look similar and thus the accounting methodology would mask the real differences between the benefit commitments for these plans.
- Consider three plans with the same total cash balance accounts and the following interest credits: 5 percent, 1-year CMT, 1-year CMT but no greater than 5 percent. Under FASB's proposed approach, when the discount rate would have otherwise been selected to be 6.5 percent, the plan that uses the 1-year CMT and the plan that uses the 1-year CMT but not greater than 5 percent interest credits both have the same ABO and PBO—while the plan with a 5 percent interest credit has a lower ABO and PBO (discount rate exceeds interest credit and plan has a fixed interest credit). The equality of the ABO and PBO for the 1-year CMT interest credits with and without the 5 percent ceiling is illogical, and the lower ABO and PBO for the plan with the fixed 5 percent interest credit relative to a Plan with a 5 percent ceiling on the interest credit can't be explained in any rational way (i.e., the plan with the 1-year CMT yield and a 5 percent ceiling will never have an interest credit above 5 percent but will typically have an interest credit that falls below 5 percent).
- Interest credits in cash balance plans are subject to minimums, maximums, annual limits on increases, annual limits on decreases, and also can vary with equity indices. In addition, many of these plans provide the greater of cash balance or final average pay benefits. How would a plan sponsor apply the discount rate to this "better of" the two benefits design?



Mr. Robert H. Herz, Chairman

Page 4

May 4, 2004

As you can see, we are confused by the rationale for an approach that would set the discount rate equal to the interest-crediting rate. We believe that it is a step backwards from the intent of FAS 87 to provide comparability in information. The information is no longer comparable when reviewing financial information for cash balance plans versus the same information for other defined benefit plans. Nor is there comparability when considering the financial information for fixed interest and variable interest credit cash balance plans.

The premise for this accounting is that there are investments that mirror the interest credits. This is a fundamentally flawed premise and clearly fails to consider other important plan design information. As actuaries for over 100 cash balance plans, we would be happy to share information with FASB which we believe will support the inappropriateness of this proposed approach.

Review Before Modifying FAS 87

We and others asked FASB to give this cash balance accounting further review when it had looked like FASB was ready to adopt this position along with confirming the defined benefit nature of cash balance plans and specifying the attribution method for fixed interest rate plans (in EITF 03-4). We had expected that when FASB studied this topic it would be impossible to conclude that the proposed approach made sense. If the only explanation for the proposed approach is that the interest credit can be achieved in the market place as it is defined in the plan and without any adverse market risk, then the basis for FASB's conclusions is without merit.

Although we have heard FASB support this proposed approach with the investment explanation to which we expressed our concerns in prior sections of this letter, we also suspect that FASB is reacting to the fact that this interest crediting rate is a financial assumption. Through FAS 87, the additional disclosures regarding the expected rate of return on assets and other guidance, FASB is defining the other major financial assumptions (discount rate and expected return) to be more "cook-book" driven (i.e., less input from the professionals who typically make long term assumptions and more reliance on benchmarks). To the extent that a reluctance to allow plan sponsors, with assistance from their actuaries, to make reasonable assumptions regarding financial variables is driving FASB's position, the use of a discount rate equal to the interest crediting rate is the wrong answer.



Mr. Robert H. Herz, Chairman

Page 5

May 4, 2004

The expected rate of return on plan assets is built from different assumed returns for different asset classes. Since a bond portfolio is typically a component of the expected rate of return and most cash balance plans use Treasury based yields to determine the interest credit, the expected rate of return already includes a component for these interest crediting rates. Instead of mandating an approach that produces inconsistent results, the FASB should be promoting an approach that recognizes the consistency between the interest crediting rate and the expected rate of return on assets and allows plan sponsors, with assistance from their actuaries, to make reasonable and consistent assumptions regarding the interest crediting rates.

The proposed requirement will have a huge impact on the accounting for plan sponsors of cash balance plans and is contrary to universally accepted approaches for past accounting. We ask that FASB reconsider its position that the discount rate should be set equal to the interest crediting rate.

We would be glad to provide additional information to the FASB and would be glad to discuss any issues with you. You can contact me directly by phone at (781) 314-7647.

Sincerely,

Hewitt Associates LLC

Jeff D. Clymer

JDC:smr

Delivered via email