FAEGRE & BENSON LLP

UNITED STATES | ENGLAND | GERMANY | CHINA

HUBERT V. FORCIER
HForcier@Faegre.Com
612.766.7417

Letter of Comment No: 172
File Reference: AICPA ICG
Date Received: 4/10/05

VIA E-MAIL: spbelcher@FASB.org

Financial Accounting Standards Board
Attention: Steven P. Belcher, Senior Fellow
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Some hybrid, account-based defined benefit pension plans purchase fully benefit responsive stable value funds.
Implications for the FASB Project referenced at http://www.fasb.org/project/stable_value_investments.shtml

Dear Reader:

The minutes of the February 9, 2005 Board Meeting (dated March 2, 2005 and available at http://fasb.org/board_meeting_minutes/02-09-05_svif.pdf) indicate that the Board took the following actions regarding accounting for fully benefit responsive investment contracts by certain investment companies:

> Summary of Decisions Reached:
>
> The Board provided direction for the FASB staff in drafting a proposed FASB Staff Position (FSP) to address issues related to the accounting for certain fully benefit-responsive investment contracts held by certain investment companies. The Board reconfirmed that fair value is the appropriate amount at which to measure all investments and derivatives of an investment company. However, the Board was supportive of contract value accounting being appropriate for fully benefit-responsive investment contracts held by certain entities in limited circumstances coupled with enhanced disclosure of the investment contracts. The Board asked the staff to prepare a draft of the proposed FSP for discussion at a future Board meeting that includes the following:

1. The criteria and limited circumstances under which contract value accounting treatment would be appropriate

2. A description of the enhanced quantitative and qualitative disclosures required if contract value is used.

The Board recommended that the staff utilize guidance in AICPA Statement of Position 94-4, *Reporting of Investment Contracts Held by Health and Welfare Plans and Defined-Contribution Pension Plans*, in drafting the proposed FSP.

The principles described in AICPA SOP 94-4 (generally permitting contract value accounting treatment) apply to stable value funds—provided they are "fully benefit responsive." We note that AICPA SOP 94-4 on its face purports to only deal with fully benefit responsive investment contracts purchased by **defined contribution plans**. We wish to call your attention to the fact that some **defined benefit plans** purchase units of stable value funds that are every bit as fully benefit responsive as any stable value fund purchased by a defined contribution plan. We urge that the proposed FSP the Staff prepares provide the same accounting treatment with respect to a stable value fund that is fully benefit responsive—regardless of whether it is held by a defined contribution plan or by a defined benefit plan.

A. Background: "Full benefit responsiveness" that is provided to defined contribution plans that offer units in a stable value fund as a participant-directed investment option.

Defined contribution plans that purchase units in a fully benefit responsive stable value fund are plans that offer the units of the stable value fund as one of several participant-directed investment options. If a participant elects to have his/her plan account(s) invested in units of the stable value fund—

- The participant's account(s) (or portions thereof) so invested grow at the same rate as the units in the stable value fund grow.

- The stable value fund permits withdrawals at contract value for "participant-initiated withdrawals" from the stable value fund. The withdrawals that can be made at contract value include all participant-initiated transactions that can occur—assuming an ongoing plan. This can include withdrawals for each of the following types of transactions:

  - Distributions following terminations of service in the normal course.[1]

  - In-service withdrawals—for hardship or following a specific number of years of service or the attainment of a specific age.

- Loan disbursements.

- Transfers to other investment options.

  Note: If the other investment option is a "competing fund," an "equity wash" would generally be required. This protects the stable value fund from interest rate disintermediation.

Therefore, if the ongoing plan assumption is appropriate for a plan and the stable value fund is not impaired, contract value accounting is appropriate under AICPA SOP 94-4. Only if an ongoing plan assumption is not appropriate or the stable value fund is impaired is fair market value accounting required.

B. The same "full benefit responsiveness" is provided to some hybrid, account-based defined benefit plans.

Some employers (for example, large professional firms in accounting, law and medicine) have structured their hybrid, account-based defined benefit plans to invest in the units of a fully benefit responsive stable value fund as the sole plan asset. When that structure is used for a hybrid, account-based defined benefit plan, the stable value fund provides the same full benefit responsiveness as described in A above in the case of defined contribution plans. That is, the stable value fund will allow participant-initiated withdrawals at contract value for the following:

1. To pay plan benefits following the participant's termination of service in the normal course or to pay benefits incident to a participant's election of an in-service withdrawal (following the participant's attaining the plan's normal retirement age).[2]

2. To provide for investment option transfers, if the defined benefit plan permits transfers to a defined contribution type account, that, in turn, provides for the type of participant-level investment control described in A above.[3]

A defined benefit plan sponsored by a large professional firm that purchases units in a fully benefit responsive stable value fund is a plan that is designed to match the plan assets to the plan's present value of accrued benefits ("PVAB")—more specifically, the "walk-away PVAB":

"Walk-away PVAB": Hybrid, account-based defined benefit plans almost always provide a lump sum distribution option following any termination of service. When a lump sum is provided (and because of a complex set of rules that apply to tax-qualified and ERISA-covered plans), the lump sum benefit is generally more valuable to the participant than the annuity options that are also provided as forms of distribution. This means that it can be assumed that all participants will elect a lump sum—rather than an annuity. Because it can be assumed that all participants will elect the lump sum, and because large professional firms have as their funding objective to be fully funded on a plan termination basis at the end of each plan year, their plans measure the PVAB on the so-called "walk-away" basis.

Note: Corporate plans are very different. At least absent a FASB requirement that the walk-away valuation rule apply to all plans that offer lump sums,[4] corporate America has almost always valued the PVAB at less than the walk-away amount.[5]

Large professional firms generally have the objective to match plan assets to the walk-away PVAB because if the plan's assets are greater or less than the walk-away PVAB, actuarial investment gains and losses are produced. For example: If (as will frequently be the case) the firm's objective is to have the plan assets produce an intermediate-term bond return, significant actuarial investment gains and losses will be produced.[6] It can be difficult for a professional firm to deal with actuarial investment gains and losses. See Appendix A.

A stable value fund is the perfect solution for the hybrid account-based defined benefit plan of a large professional firm. Over the long term, a stable value fund will produce an intermediate-term bond return—<u>with no more than *de minimis* amounts of actuarial investment gains and losses</u>. Under these plans the accumulating walk-away PVAB grows at a rate of interest equal to the rate of return of the stable value find—by definition, a stable return. Given full benefit responsiveness; no impairment of the stable value fund; and assuming an ongoing plan assumption is appropriate; the PVAB and the contract value are the same. The plan will have purchased an investment (the units of the stable value fund) that it can liquidate to pay the walk-away PVAB. For a more complete description of how these plans are structured, see Appendix B.

C. <u>The use of stable value funds by garden variety defined benefit plans is different</u>.

If a garden variety defined benefit plan purchases units in the stable value fund, it does not acquire participant-initiated contract value withdrawal rights (called "full benefit responsiveness"). The units of the stable value fund are held as one investment among the many that constitute the total plan assets. Almost always there are substantial investments in both equities and in other types of fixed income investments. Therefore, such plans cannot be (and are not) designed to have the units of the stable value fund equal the walk-away PVAB.

At most, stable value funds purchased by garden variety defined benefit plans provide what is sometimes called "contractholder-initiated contract value withdrawal rights" (sometimes simply called "benefit responsiveness" and distinguished from "full benefit responsiveness"). That is, the plan (as the contractholder) has the right to make contract value withdrawals—but that right is subject to the right of the manager of the stable value fund to delay payment for up to anywhere from twelve to twenty-four months (sometimes called a "holdback period"). The manager of the stable value fund will impose a holdback period if market interest rates have risen. The holdback period is designed to protect the stable value fund from interest rate disintermediation.

It appears that most pension professionals are of the view that contract value accounting would not be appropriate for units of a stable value fund held by a garden variety defined benefit plan. See Myers, Differing Views on Defined Benefit Plans Use of Stable Value, Stable Times, Vol. 7, Issue 3, Stable Value Investment Association (*www.stablevalue.org/library/vol7issue3/part2.asp*).[7] The majority view is that, if market interest rates have risen and a holdback period would be imposed on a contractholder-initiated withdrawal, the delayed payout should be discounted back to its present value based on the market interest rates for comparable quality debt instruments with a duration equal to the holdback period.

D. Defined contribution plans that offer units of a stable value fund as a participant-directed investment option and defined benefit plans that are structured to use fully benefit responsive stable value funds may also obtain contractholder-initiated contract value withdrawal rights.

This type of withdrawal (described in C above) would be exercised by the plan in the following circumstances:

1. In the case of mass terminations by participants resulting from such events as plan closings.

2. In the case of a plan termination.

3. In the case of the contractholder's decision to liquidate the stable value fund.

    - For example, in the case of a defined contribution plan, to effect a plan level decision to offer a different stable value fund as the stable interest investment option or to effect a plan level decision to cease offering a stable interest investment option.

    - In the case of a defined benefit plan, to effect a plan level decision to invest in a different stable value fund or in a totally different type of investment.

Participants impacted by contractholder-initiated contract value withdrawals described in 1 and 2 above will almost always have their distributions delayed—if the manager of the stable value fund in fact imposes a holdback period.[8]

E. **<u>In some cases, a defined contribution plan will use a stable value fund in the same way that a garden variety defined benefit plan does.</u>**

In these cases, the plan will, at most, acquire only contractholder-initiated contract value withdrawal rights (as opposed to participant-initiated contract value withdrawal rights). These situations include the following:

1. Some defined contribution plans do not offer participant-level investment control. In these cases, the plan assets are almost always invested in a balanced fund. That balanced fund could use stable value funds in exactly the same way as a garden variety defined benefit plan does. (See C above.) In these cases, the plan would at most acquire contractholder-initiated contract value withdrawals. But it would not acquire participant-initiated contract value withdrawal rights.

2. Defined contribution plans that offer participant-level investment control will frequently offer a balanced fund option. A balanced fund could use a stable value fund in the same way that a garden variety defined benefit plan does. (See C above.) In such cases, the plan would at most acquire contractholder-initiated contract value withdrawals. But it would not acquire participant-initiated contract value withdrawal rights.

F. **<u>Providing contract value reporting for units of a fully benefit responsive stable value fund held by an account-based defined benefit plan is consistent with the objective of the plan's financial statements.</u>**

When a hybrid, account-based defined benefit plan structures its benefits to match the contract value of a fully benefit responsive stable value fund in which it invests, the accounting treatment should be the same as is provided for a defined contribution plan that invests in such a stable value fund. In both cases, the participants are interested in knowing whether (on an ongoing plan basis) the stable value fund will pay the benefits that have been promised when due in the normal course (assuming the stable value fund is not impaired). If some event has occurred that puts contract value liquidity in question, then, of course, different accounting treatment should be applied. But as long as no such event has occurred, contract value accounting best reflects the value of the plan assets.

<u>Conclusion</u>

When a plan (whether it is a defined contribution plan or a hybrid, account-based defined benefit plan) purchases a fully benefit responsive stable value fund, it has purchased an investment that (by definition) will pay the participant's benefit promised in the normal course as of the measurement date—assuming an ongoing plan and no impairment of the

APPENDIX A

Actuarial investment gains and actuarial investment losses are produced by a defined benefit plan when the plan assets produce a rate of return that is different than the rate at which the PVAB grows. Many large professional firms use a cash balance plan format. Under the typical cash balance plan, the walk-away PVAB (the cash balance account) almost always grows at the rate determined by reference to the yield on the 30-year Constant Maturity Treasury, reset periodically—usually annually. Therefore:

- An actuarial investment gain is produced when the assets produce a return that is higher than the yield on the 30-year CMT.
- An actuarial investment loss is produced when the assets produce a return that is less than the yield on the 30-year CMT.

Many large professional firms wish to structure account-based defined benefit plans so that each partner (or shareholder-employee) who is a plan participant pays the cost of his/her benefit. This requires that any actuarial investment gains and losses be allocated among the partners (or shareholder-employees) based on their respective beginning-of-year PVABs.

Dealing with actuarial investment losses is particularly difficult. There is a risk that a partner (shareholder-employee) will receive a windfall benefit; that is, a benefit he/she has not yet fully paid for.

The firm might use what we call a "side agreement" that would obligate a partner (or shareholder-employee) to make a "true-up payment" to the firm equal to the amount of his/her windfall benefit—which the firm would then contribute to the plan to cover the cost of the windfall benefit. But regrettably, a side agreement of that type presents a serious compliance risk. A side agreement of the type described could well violate the Code § 401(a)(26) regulations, which would result in plan disqualification. This issue is discussed at ¶ 6.17[g]of the 2005 Supplement to my book, GUIDE TO CASH BALANCE PLANS.

Gains are less troublesome—but there are very few situations in which an actuarial investment gain cannot be allocated based on the respective beginning-of-year PVAB—unless a side agreement providing for a true-up payment from the firm to the partner (or shareholder-employee) is used. Again, the use of a side agreement providing for this type of true-up payment presents a compliance issue under Code § 401(a)(26).

A Revenue Ruling 185 defined benefit plan (described in Appendix B) avoids all actuarial investment losses—and if the plan assets are invested in a stable value fund—can precisely match the walk-away PVAB to the contract value of the stable value fund at the end of the plan year, when plan benefits become payable.

APPENDIX B

Some professional firms that use stable value funds with full benefit responsiveness structure their plans as cash balance plans. But the type of hybrid, account-based defined benefit plan that most precisely matches the contract value of the units of the stable value fund to the plan's walk-away PVAB is a "Revenue Ruling 185 defined benefit plan"—named for the type of defined benefit plan described in Rev. Rul. 185, 1953-2 CB 202.

Under that type of plan the PVAB (measured on a walk-away basis) grows at an interest rate that is the lesser of:

- The internal rate of return on the plan assets or
- The 30-year CMT, reset periodically, usually annually.

Under this type of structure, there are no actuarial investment losses—and if the plan assets are invested in a stable value fund, only *de minimis* amounts of actuarial investment gains. During the last 20 years, this type of plan would have produced gains in about half of the years—with the highest gain being 1.02%.

Year	*(a) Stable Value Fund return*	*(b) Crediting rate*	*(c) Actuarial investment gain*
1985	na	na	na
1986	8.93%	8.93%	0.00%
1987	7.84%	7.51%	0.33%
1988	8.72%	8.72%	0.00%
1989	9.00%	9.00%	0.00%
1990	9.03%	8.01%	1.01%
1991	8.75%	8.71%	0.05%
1992	7.52%	7.52%	0.00%
1993	7.46%	7.46%	0.00%
1994	6.52%	6.14%	0.37%
1995	6.52%	6.52%	0.00%
1996	6.46%	6.42%	0.04%
1997	6.48%	6.48%	0.00%
1998	6.52%	6.30%	0.22%
1999	6.23%	5.21%	1.02%
2000	6.48%	6.18%	0.30%
2001	6.54%	5.72%	0.82%
2002	5.88%	5.38%	0.50%
2003	4.75%	4.75%	0.00%
2004	4.32%	4.32%	0.00%

The actuarial investment gain for any given year can be expected to be a very tiny fraction of the normal cost for the plan year—and given the full funding limit applicable to tax-qualified plans, the actuarial investment gain would be more than offset by the normal cost for the plan year. Therefore, as of the end of each plan year, the walk-away PVAB and the contract value of the stable value fund are matched.[10] (Note: Under this type of plan, distributions are permitted only as of the end of the plan year—when the plan assets (the contract value of the stable value fund) and the PVAB are matched and participant-initiated contract value withdrawal rights can be exercised.

ENDNOTES

[1] A stable value fund would normally not permit book value withdrawals for plan distributions following a plan termination, or due to early retirement programs and plant closings.

[2] Currently, federal law permits the use of any age as the normal retirement age. See Rev. Rul. 78-120. In November of 2004, Treasury proposed regulations that (if adopted as proposed) would impose a minimum normal retirement age.

[3] For example: Some plans permit what is called a "plan-to-plan transfer" to a 414(k) account within the defined benefit plan. A 414(k) account is a true defined contribution type of account—established as part of the defined benefit plan—but treated as a "separate plan" for many compliance purposes. Under the 414(k) account, the participant would have the same investment options as are offered under the employer's 401(k)/profit sharing plan.

When the defined benefit plan is invested in a stable value fund, the mechanics of the transfer are as follows:

- If a participant elects to have his/her accrued benefit transferred to a 414(k) account, units of the stable value fund equal to the present value of his/her then accrued benefit are transferred in-kind to the 414(k) account.
- After the units of the stable value fund are transferred to the 414(k) account, the participant can direct the investment of the account among the same investment options as are offered under the employer's 401(k)/profit sharing plan. Note: The stable value fund will be one of the investment options under the employer's 401(k)/profit sharing plan.

[4] See discussion at http://www.fasb.org/project/amendment_st87&35.shtml

[5] The following discussion of this issue as it applies to cash balance plans sponsored by corporate America is at ¶3.3 of my book: GUIDE TO CASH BALANCE PLANS (Aspen 2003) (endnote omitted).

> An issue related to the cost issue is the expected investment differential. This is fundamentally an actuarial funding issue, but it also relates to criticisms made by some opponents of cash balance plans. So-called interest rate whipsaw (see chapter 8) has caused employers to set the hypothetical interest credit rate at what seems to many to be a relatively low rate. Employers almost always assume that plan assets will earn more in the future than the plan will have to credit in terms of hypothetical interest credit rates. For purposes of determining the cost of the plan, the spread between the expected return on plan assets and the expected future hypothetical interest credit rates is called the *expected investment differential.* The expected investment differential, in effect, reduces the cost of the plan (when expressed as a percentage of pay) to a value that is lower than the hypothetical pay credits (also expressed as a percentage of pay).
>
> In the Kwasha monograph the concept is explained as follows:
>
> > As with any defined benefit pension plan funding must be predicated on realistic investment expectations and the specific provisions of the plan in question. Where an investment differential can be anticipated, there can be substantial leverage in this assumption. For example, a "5% of pay plan" might require a contribution of only 4% of pay, after a realistic investment differential is taken into account. Discounting for anticipated turnover prior to vesting would further reduce the cost, perhaps to 3 ½% of pay. If, on the other hand, the anticipated investment differential does not materialize, the employer's cost as a percentage of pay will gradually increase. In these respects as regards "actual versus expected" actuarial experience, the funding mirrors that of a traditional plan, with the important addition of a significant new element—the expected investment differential.

[6] See the discussion in the 2005 Supplement to my book, GUIDE TO CASH BALANCE PLANS at ¶6.17[c].

[7] In the referenced article, Mr. Myers states as follows:

> [D]ivision . . . exists within the Stable Value community itself about whether its products are appropriate for defined benefit plans. The debate revolves around accounting rules that make it difficult for those plans to take advantage of the unique book value accounting treatment accorded to Stable Value products . . ..
>
> Prior to changes in accounting rules in 1992, it was common for defined benefit plans to invest in Stable Value products. As recently as the fourth quarter of 1990, such plans accounted for 19 percent of the assets held by Stable Value funds in the Hueler Analytics Pooled Fund Universe . . ..
>
> All that began to change in 1992 after the Financial Accounting Standards Board issued a new accounting rule, FAS 110, which said defined benefit plans had to start valuing all their plan assets at "fair value," meaning market value. Previously, these plans had taken advantage of the book value guarantee embedded in Stable Value

> products to record those investments at book. With the new accounting standard stripping away this volatility-reducing benefit, interest in Stable Value products among defined benefit plans quickly waned. By the fourth quarter of 1993, their share of the assets in the Hueler's pooled fund universe was down to 3.9 percent. Today it's less than 2 percent.
>
> FASB left the accounting rules for defined contribution plans, such as 401(k)s, under the purview of the American Institute of Certified Public Accountants. In 1994, that organization affirmed, in Statement of Position 94-4, that those plans could continue to carry Stable Value Investments at book value. But by ignoring defined benefit plans, some believe that the AICPA implied that those plans should follow FAS 110 and mark their Stable Value assets to market . . ..
>
> Pension plan sponsors who weigh the pros and cons of Stable Value investing and decide they'd like to invest in the sector can still find it challenging, simply because only about half of all Stable Value managers accept defined benefit money in their pooled funds. "Our view is that a defined benefit plan buying into a Stable Value commingled fund is not consistent with the spirit of the guidelines provided by SOP 94-4," says John Axtell, Managing Director at Stable Value manager Deutsch Asset Management. As a result, he says, his firm does not accept investments into its Stable Value funds from defined benefit plans.

[8] As the old saying goes: "You cannot get blood out of a turnip." For example, if a plant closing has occurred, many plan participants will have had their employment terminated and will be eligible to elect lump sum distributions from the typical defined contribution plan. If market interest rates have risen and the manager of a stable value fund imposes a holdback, the plan will not have the cash to pay the distributions until the expiration of the holdback. While there are other options, they are frequently not practical:

1. The units in the stable value fund are non-transferable. While reluctant to do so (because of federal and state securities law concerns), the manager of a stable value fund might be willing to consent to a sale of the units to another plan. But the market for these types of transfers is very thin.
2. The firm might loan cash to the plan to enable the plan to pay the benefits. In this case, the plan sponsor will be repaid when the holdback expires and the plan receives the contract value amount. But the plan sponsor is not obligated to lend the cash to the plan and may not be in a position to do so.

The best plan document drafting practice is to anticipate the possibility that distributions will have to be delayed (to accommodate an orderly liquidation of plan assets—in this case, the orderly liquidation of the units of the stable value fund) and provide that distributions of amounts invested in the stable value fund can be deferred to accommodate this type of orderly liquidation of the stable value fund (with the exception of some distributions that would be required to start; for example, the so-called "minimum required distribution" at age 70 ½ or distributions to beneficiaries).

[9] The mere reference of the accounting question by the AICPA to FASB (by its letter to FASB dated November 26, 2004) resulted in what is believed to be the following: <u>All managers of all stable value funds stopped accepting contributions from defined benefit plans</u>—or at least from defined benefit plans that had not previously been making contributions. It is our expectation that if the FASB position does not expressly provide for contract value accounting for defined benefit plans that purchase stable value funds that are fully benefit responsive, all stable value funds will cease accepting contributions from defined benefit plans—and, indeed, require that such defined benefit plans that have previously purchased units withdraw from the stable value funds.

[10] Note: Under this type of plan, distributions are permitted only as of the end of the plan year—when the plan assets (the contract value of the stable value fund) and the PVAB are matched and participant-initiated contract value withdrawal rights can be exercised.

stable value fund. The units of such a stable value fund are not transferable to third parties. It simply makes sense to value the units of the stable value fund at the contract value for financial reporting purposes.

Whether the plan is a defined contribution plan or an account-based defined benefit plan, the contract value treatment would (should) be subject to the same conditions referenced in the Board's February 9, 2005 decision. These would include the following:

- The criteria and limited conditions under which contract value accounting treatment would be appropriate.

- Enhanced quantitative and qualitative disclosure required if contract value is used.

In our view, it is important that you consider the issues presented in this letter. If FASB does not expressly provide for contract value treatment for defined benefit plans on the same basis as for defined contribution plans, it is expected that the managers of all stable value funds will refuse to accept contributions from defined benefit plans that would wish to purchase fully benefit responsive units[9]—even if (for underwriting reasons) the managers would be willing to provide full benefit responsiveness to such plans. This would mean loss of the best option for a hybrid, account-based defined benefit plan that has a funding policy objective of matching plan assets to the walk-away PVAB. From a policy perspective, it is highly desirable for defined benefit plans to have that option available.

Thank you for your consideration of the issues discussed in this letter. I would be happy to respond to any questions you might have.

Very truly yours,

Hubert V. Forcier

HVF:gowes

Attachments

M1:1190565.03