



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

May 6, 2016

Board of Trustees, Central States, Southeast and Southwest Areas Pension Plan
9377 West Higgins Road
Rosemont, IL 60018

Dear Mr. Nyhan, Mr. Ford, and the Board of Trustees:

On September 25, 2015, you submitted an application to the Secretary of the Treasury (Secretary or Treasury) on behalf of the Board of Trustees of the Central States, Southeast and Southwest Areas Pension Plan (Plan). The application you submitted (Application) requests approval to reduce benefits under the Multiemployer Pension Reform Act of 2014 (Kline-Miller or Act).

As Special Master, appointed by the Secretary, I am writing to notify you of Treasury's decision to deny the Application because the suspension fails to satisfy the statutory criteria for approval of benefit suspensions.

In my role as Special Master, I have reviewed the Application under the terms of Kline-Miller, its implementing regulations, and other applicable law. I also have reviewed numerous comments received on the Application from organizations and individuals. The Application states that the Plan is projected, absent suspension, to become insolvent within ten years, and that, if the Application were approved, approximately 270,000 people would have some portion of their pension benefits reduced beginning in July of this year. Keeping in mind the potential impact on so many people's lives, I have held meetings, including conference calls and a series of public sessions around the country, with a wide range of stakeholders, including Plan representatives and several thousand Plan participants and beneficiaries, as well as others who have commented on the Application.

Under the Act, Treasury, in consultation with the Pension Benefit Guaranty Corporation (PBGC) and the Secretary of Labor (DOL), must approve an application upon finding that the plan is eligible for the benefit suspensions and has satisfied the applicable statutory requirements.¹ The Act requires, among other things, that the proposed benefit suspensions be reasonably estimated to allow the plan to avoid insolvency.² Put another way, a key test for any application under Kline-Miller is whether the proposed benefit suspensions take a plan off the path to insolvency. As described further below, Treasury finds that the Plan's proposed benefit suspensions are not reasonably estimated to allow the Plan to avoid insolvency.

¹ Code § 432(e)(9)(G)(i); 29 U.S.C. § 1085(e)(9)(G)(i).

² "Limitations on Suspension—Any suspension of benefits made by a sponsor pursuant to this paragraph shall be subject to the following limitations: ...Any suspension of benefits in the aggregate... shall be reasonably estimated to achieve... the level that is necessary to avoid insolvency...." Code § 432(e)(9)(D)(iv); 29 U.S.C. § 1085(e)(9)(D)(iv). In the interest of simplicity, all citations below to Kline-Miller will refer only to the Internal Revenue Code even though Treasury's findings and conclusions have been made under both the Internal Revenue Code and the Employee Retirement Income Security Act of 1974, as amended.

Specifically, after reviewing the Application and consulting with PBGC and DOL, Treasury has determined that the suspensions described in the Application fail to satisfy the following three requirements set forth in Kline-Miller:

- that the proposed benefit suspensions, in the aggregate, be reasonably estimated to achieve, but not materially exceed, the level that is necessary to avoid insolvency, because the investment return and entry age assumptions used for this purpose are not reasonable. Code § 432(e)(9)(D)(iv).
- that the proposed benefit suspensions be equitably distributed across the participant and beneficiary population. Code § 432(e)(9)(D)(vi).
- that the notices of proposed benefit suspensions be written so as to be understood by the average plan participant. Code § 439(e)(9)(F).

Treasury's key findings are described below.

FINDINGS

Kline-Miller requires the Secretary of the Treasury to approve, in consultation with PBGC and DOL, an application for suspension of benefits "upon finding that the plan is eligible for the suspensions and has satisfied the criteria of subparagraphs (C), (D), (E), and (F)" of section 432(e)(9) of the Internal Revenue Code, as amended by Kline-Miller.³ The Application fails to satisfy the criteria of subparagraphs (D) and (F), as further described below.

I. Suspension Must Be Reasonably Estimated to Avoid Insolvency

Kline-Miller provides that:

[a]ny suspensions of benefits under a plan, in the aggregate . . . , shall be reasonably estimated to achieve, but not materially exceed, the level that is necessary to avoid insolvency.⁴

To demonstrate that a suspension satisfies this requirement under the regulations implementing this provision, an applicant must use actuarial projections. One type of required projection is a deterministic projection of cash flows, under which the plan's asset balance is projected forward using assumptions regarding the amounts of money coming into the plan (e.g., contributions, withdrawal liability payments, and investment returns) and going out of the plan (e.g., benefit payments and administrative expenses). A second type of projection, required for the largest plans, is a stochastic projection, which also projects the plan's asset balance going forward using assumptions. However, the stochastic projection does not use fixed assumptions for the rate of

³ Code § 432(e)(9)(G)(i).

⁴ Code § 432(e)(9)(D)(iv).

investment return, but instead projects a range of possible outcomes to take into account the variability of investment returns.

Treasury evaluated the assumptions and methods used in the Application based on the regulations. The regulations require that each of the actuarial assumptions or methods, as well as the combination of actuarial assumptions and methods, used for the required actuarial projections be reasonable, taking into account the experience of the plan and reasonable expectations.⁵ In applying the regulations, Treasury referred to guidance provided by the standards of the actuarial profession (primarily Actuarial Standards of Practice (ASOPs) numbers 4, 27 and 35).

The regulations and ASOPs require that, to be reasonable, each of the assumptions or methods must be appropriate for the purposes of these cash flow projections (which means, among other things, that factors specific to these cash flow projections must be taken into account). The ASOPs also require taking into account historical and current economic data that is relevant as of the measurement date and require that assumptions have no significant bias. The actuary also must consider the materiality of the assumptions and the balance between the benefits of using refined assumptions (that is, assumptions that are based upon more extensive and specific study and research) and the cost of using those refinements.

Treasury has concluded that two of the assumptions used for the actuarial projections in the Application are not reasonable.

Investment Return Assumptions Are Not Reasonable

The Application uses a 7.5% annual investment rate of return assumption for the deterministic projections and uses corresponding annual investment rate of return assumptions by asset class as inputs for the stochastic projections.⁶ The Plan has asserted that (1) the 7.5% assumed rate of return is reasonable because it is based on the annual investment rate of return assumptions by asset class that were used as inputs for the stochastic projections,⁷ (2) the annual investment rate of return assumptions by asset class that were used as inputs for the stochastic projections are reasonable because they were selected based on average expected rates of return by asset class over a 50-year future time horizon (the time horizon selected by the Plan as the extended period over which the cash flow projections are required for the Plan under the regulations),⁸ and (3) the common use of a 7.5% investment return assumption for pension plan annual funding valuation purposes further supports the choice of the 7.5% assumption for the deterministic cash flow projections.⁹

⁵ 26 C.F.R. § 1.432(e)(9)-1(d)(5)(iv)(B).

⁶ Application 7.1.22, 7.1.24.

⁷ Thomas C. Nyhan, Executive Director and General Counsel, Central States, Southeast and Southwest Areas Pension Fund, Comment on Central States Pension Plan Application for Benefit Suspension 3 (Mar. 1, 2016), <https://www.regulations.gov/#!documentDetail;D=TREAS-DO-2015-0009-2789> (*Central States Comment Letter*).

⁸ Application 7.1.22, 7.1.24.

⁹ *Central States Comment Letter* 4.

These assumptions are not reasonable because they:

1. are not appropriate for the purpose of the measurement (cash flow projections relating to proposed benefit suspensions under Kline-Miller), taking into account the Plan's negative cash flows and other factors;
2. do not adequately take into account relevant current economic data (that is, appropriate investment forecast data); and
3. have a significant bias in that they are significantly optimistic.

Not Appropriate for the Purpose of the Measurement

To be appropriate for the purpose of the measurement, investment return assumptions must be selected in a manner that takes into account factors specific to the measurement. In this case, considering all of the circumstances, Treasury has determined that the following factors should have been taken into account in the selection of the investment return assumptions:

- the timing of future expected contributions and benefit payments, which—when taken into account—results in the Plan having significant negative cash flow and therefore declining asset levels;
- the greater materiality of asset returns during the earlier years of the cash flow projections because, based on the anticipated pattern and magnitude of change in the level of Plan assets resulting from the timing of future expected contributions and benefit payments, asset levels are projected to be higher during the earlier years of the projections than they are projected to be during the later years (i.e., these projections are extremely sensitive to variations in asset returns in the near term because the same percentage gain or loss has a greater impact if it occurs earlier, when asset levels are higher, than in later years, when asset levels are lower);
- a participant's or beneficiary's¹⁰ loss of benefits (once reduced pursuant to a suspension) is permanent—amounts reduced will not be returned; and
- the fact that the amount of the suspension cannot easily be (and will not automatically be) increased or decreased in a later year if the plan's actual experience proves to be different than projected.

Based on these factors, the investment return assumptions for purposes of these cash flow projections must be developed in a refined manner that reflects and gives appropriate weight to near-term expected rates of return. For this purpose, it is not appropriate to develop investment return assumptions based solely on the time-weighted average expected returns over the long term or based on the assumptions used for other purposes (such as for purposes of determining a plan's minimum funding requirement) if doing so produces materially different results than use of a refined assumption.

Relevant Current Economic Data Not Taken into Account

The investment return assumptions used in the Application do not adequately take into account relevant current economic data. Relevant current economic data (i.e., including near-term

¹⁰ For convenience of reference, participants and beneficiaries are referred to below simply as "participants."

current investment forecast data for each asset class) must be reviewed to determine whether refined investment return assumptions would be expected to produce materially different results.

A review of relevant current economic data clearly demonstrates that refined investment return assumptions that take into account appropriate investment forecast data regarding expected near-term rates of return would be expected to produce materially different results. For example, commenters, as well as the Plan, used the Horizon Survey of investment forecasts of 29 investment professionals for purposes of comparison. In comparison to the Horizon Survey data, the Plan's investment return assumptions are in excess of the 10-year 50th and 75th percentile survey results for *every* asset class. For the Plan's total portfolio, the estimated 10-year average rate of return based on 10-year average expected results for the corresponding asset classes in the Horizon Survey is estimated to be 6.43%—a full 123 basis points less than the 7.66% average annual rate of return for the portfolio based on average expected rates of return for the Plan's asset classes provided by the Plan. The Plan's investment return assumptions also exceed longer-term expected rates of return—the 20-year average expected returns in the Horizon Survey—in every corresponding asset class (and the Plan's 7.5% assumed rate of return is estimated to exceed the 20-year average rate of return for the total portfolio based on 20-year average expected results for the corresponding asset classes in the Horizon Survey).¹¹

Bias

The investment return assumptions used in the Application do not satisfy the requirement that assumptions have no bias (i.e., not be significantly optimistic or pessimistic) outside of narrowly specified circumstances. The assumptions are significantly optimistic, as evidenced by the available relevant investment return forecast data in the Horizon Survey described above, which the Plan cites as supportive of the reasonableness of its investment return assumptions.

Based on the foregoing, Treasury has determined that the investment return assumptions are not reasonable, and therefore the proposed suspension does not satisfy the statutory requirement that it be reasonably estimated to avoid insolvency.

Entry Age Assumption Is Not Reasonable

To project cash flows, an applicant must make an assumption regarding demographic characteristics of plan participants, including the demographic characteristics of employees who replace terminating and retiring workers (i.e., future new entrants to the plan). With the exception of entry age, the Application assumed that in all other respects new entrants would reflect the demographic mix of the participants who entered the Plan during the last full year before the Application was submitted (i.e., 2014) for purposes of other actuarial projections in the Application. However, for entry age, the Plan used a single assumed age (32 years old, the average age at entry for the entire current active workforce) instead of using the demographic mix that it used for other purposes. Assuming a single (relatively young) age of entry enabled

¹¹ The 50th and 75th percentile results derived from the Horizon Survey presented in this paragraph are arithmetic averages (used as inputs for the stochastic projections). The average rates of return for the portfolio in this paragraph are geometric averages (used as the basis for the assumption for the deterministic projections).

the Plan to project effectively zero benefit payments for these new employees for more than 20 years.

The entry age assumption is not reasonable because it:

1. is not appropriate for the purpose of the measurement (cash flow projections relating to proposed benefit suspensions under Kline-Miller), taking into account the Plan's negative cash flows and other factors; and
2. does not take into account relevant historical and current demographic data (that is, data available regarding entry age).

To be appropriate for the purpose of the measurement, the entry age assumption, like the investment return assumptions, must be selected in a manner that takes into account factors specific to the measurement. In addition to the factors described above in the investment return assumptions section, the fact that the anticipated pattern and magnitude of change in the level of Plan assets is extremely sensitive to assumptions (like the entry age assumption) that affect the amount and timing of anticipated benefit payments, particularly during the earlier years of the cash flow projections, should have been taken into account in the selection of the entry age assumption.

The entry age assumption must take into account all of the factors described above, including that it will be used for a cash flow negative plan's solvency determination in the context of a benefit suspension application that will result in benefit reductions that will not be returned and cannot easily be increased or decreased in a later year if future experience differs from expected experience. Based on these factors, the entry age assumption for purposes of these cash flow projections must be developed in a refined manner that reflects and gives appropriate weight to near-term expected cash flows. For this purpose, it is not appropriate to develop an entry age assumption based solely on the average entry age of all participants in a plan that happen to be active as of a certain date if doing so produces materially different results than use of a refined assumption.

The Application's entry age assumption does not appropriately reflect the sensitivity of the cash flow projections to near-term cash flow or the fact that, for purposes of these cash flow projections, the assumption (in this case, an estimate that 100% of new entrants are age 32) materially fails to model anticipated plan experience. In addition, an assumption based on the age at entry of all active participants that remain in the Plan during 2014 is not an appropriate measure of new hire populations over time, because the existing population may exhibit survivorship bias. In other words, older new hires from prior years, who are more likely to have already retired or died, are likely underrepresented in a snapshot of the workforce in a given year. Because older new hires may generate much earlier cash outflows, which can materially affect cash outflows of the Plan as a whole, refined assumptions are required if material to the measurement.

In this case, use of the new entrant profile used for purposes other than entry age—that is, an assumption that new entrants have a demographic mix consistent with recent entrants during the past year—produces materially different results. For example, if this assumption were applied

consistently and the actual distribution of ages of new entrants in 2014¹² were used as the entry age assumption instead of age 32, the proposed suspension would not be estimated to enable the Plan to satisfy the requirement that the suspension be reasonably estimated to achieve, but not materially exceed, the level that is necessary to avoid insolvency. Relevant historical and current demographic data, such as data on the actual entry ages of *all* new entrants to the Plan over any relevant period of time, should have been reviewed and taken into account in the selection of the entry age assumption.

Based on the foregoing, Treasury has determined that the new entrant age assumption is not reasonable, and therefore the proposed suspension does not satisfy the statutory requirement that it be reasonably estimated to avoid insolvency.

II. Suspensions of Benefits Must Be Equitably Distributed

Kline-Miller provides that:

[a]ny suspensions of benefits shall be equitably distributed across the participant and beneficiary population, taking into account factors, with respect to participants and beneficiaries and their benefits”¹³

An application must identify (1) the separate groups of participants and beneficiaries, as defined by the consistent treatment of individuals within each separate group; (2) the relevant factor(s) that were selected by the plan as the basis for the plan’s different treatment of these groups; and (3) how the differences in treatment are based on a reasonable application of the factors selected by the plan.¹⁴

The Application describes an approach to benefit suspensions that would apply several different post-suspension benefit formulas, but it does not adequately explain why certain classes of participants would be placed in a group that is subject to a less favorable post-suspension benefit formula than other participants. An example is provided below.

Application of Special Limitation on Suspension of Benefits

The Application provides that the benefits of some United Parcel Service, Inc. (UPS) participants would be reduced more than the benefits of other UPS participants. Because the Application provides that the UPS-related benefits with the least protection are subject to the greatest reduction, Treasury has concluded that the proposed suspension of benefits is not equitably distributed.

A special provision of Kline-Miller that applies only to certain plans (and which, based on representations in the Application, Treasury will assume applies to this Plan) directs how a suspension of benefits must be applied across certain categories of benefits.¹⁵ Under this provision, and the applicable regulations, benefits directly attributable to a participant’s service

¹² See Application 7.2.51 for general experience regarding the age of new entrants for 2014.

¹³ Code § 432(e)(9)(D)(vi); 26 C.F.R. § 1.432(e)(9)-1(d)(6)(i).

¹⁴ See 26 C.F.R. §§ 1.432(e)(9)-1(d)(6)(i); 1.432(e)(9)-1(g)(1)(iv); Revenue Procedure 2015-34 § 4.04.

¹⁵ See Code § 432(e)(9)(D)(vii); 26 C.F.R. § 1.432(e)(9)-1(d)(8)(ii).

with a particular type of employer cannot be reduced more than other benefits under the Plan are reduced by the suspension. The type of employer that triggers the application of this provision is one that, before the enactment of Kline-Miller, (1) withdrew from the plan in a complete withdrawal, (2) paid the full amount of its withdrawal liability, and (3) pursuant to a collective bargaining agreement, assumed liability for providing benefits to participants and beneficiaries under a separate, single-employer plan sponsored by the employer, in an amount equal to any amount of benefits for these participants and beneficiaries reduced as a result of the financial status of the plan (a make-whole agreement).

The Application identifies UPS as an employer that triggers this special provision because, before Kline-Miller was enacted, UPS withdrew from the Plan in a complete withdrawal, paid the full amount of its withdrawal liability, and, pursuant to a collective bargaining agreement, entered into a make-whole agreement. Although the UPS make-whole agreement applies only to some (and not all) of the benefits attributable to participants' service with UPS, the limitation on benefit reductions under this special statutory provision applies to all benefits attributable to service with the type of employer identified in the statute (in this case, UPS), regardless of whether they are covered by the make-whole agreement.¹⁶

In an attempt to comply with this special provision, the Application divides benefits under the Plan into categories (or tiers) corresponding to the Plan's interpretation of the provision. Benefits covered by the UPS make-whole agreement are referred to as "Tier 3" benefits. Under the Application, some of these Tier 3 benefits would be protected by a 40% cap on the percentage reduction of a participant's pre-suspension benefit. Benefits attributable to service with UPS that are not covered by the make-whole agreement are classified as benefits in a separate category (together with benefits attributable to service with many other employers) and are referred to as "Tier 2" benefits.¹⁷ Under the Application, some of these Tier 2 benefits would receive less protection than Tier 3 benefits insofar as they would only be protected by a 50% cap on the percentage reduction of a participant's pre-suspension benefit.

In dividing participants' benefits in this way, the Plan interpreted the statutory category governing a suspension of benefits directly attributable to a participant's service with UPS to include only those benefits directly attributable to service with UPS that are covered by the make-whole agreement (rather than all benefits directly attributable to service with UPS). This approach can be reconciled with the special provision of Kline-Miller described above because, in accordance with the regulations, no benefits attributable to service with UPS would be reduced more than any other benefits.¹⁸ However, the different treatment of two groups of participants with benefits attributable to service with UPS—a 40% cap for participants with benefits that *are covered* by the UPS make-whole agreement and a less protective 50% cap for participants with benefits that *are not covered* by the make-whole agreement—violates the requirement that the suspension of benefits be equitably distributed.

¹⁶ 26 C.F.R. § 1.432(e)(9)-1(d)(8)(ii)(B).

¹⁷ The Application also includes a category of benefits referred to as "Tier 1" benefits, but that category is not relevant to this analysis.

¹⁸ See 26 C.F.R. § 1.432(e)(9)-1(d)(8)(ii).

As noted above, to satisfy the equitable distribution requirement, an application that treats two groups of participants differently must identify the relevant factor(s) that were selected as the basis for the different treatment and must explain how the differences in treatment are based on a reasonable application of the factors selected. In this case, the only factor identified to explain the different treatment between the two groups of UPS participants is whether a participant is covered by the make-whole agreement. While that factor may be relevant to the different treatment of participants, it was not reasonably applied by the Plan.

Specifically, Treasury has concluded that it is not reasonable to justify larger benefit suspensions for one group of UPS participants based on the fact that those participants are not covered by a make-whole agreement (and therefore are less protected from benefit cuts) than for another group of UPS participants who are covered by a make-whole agreement (and thus are more protected from benefit cuts). Applying a factor in a manner that justifies larger cuts for participants who are otherwise less protected (and therefore stand to receive smaller benefits) is not a reasonable application of the factor.¹⁹

Based on the foregoing, Treasury has determined that the benefit reductions proposed by the Plan are not equitably distributed across the participant and beneficiary population with respect to these separate groups of participants and beneficiaries. As a result, the Application does not satisfy the statutory requirement that benefit reductions be equitably distributed.

III. Notices Must Be Written So As to Be Understood by the Average Plan Participant

Kline-Miller provides that

[n]o suspension of benefits may be made . . . unless notice of such proposed suspension has been given by the plan sponsor . . . to . . . plan participants and beneficiaries . . . [and that **the notice**] **shall be written in a manner so as to be understood by the average plan participant . . .**²⁰

The regulations likewise provide that the notice given must be written in a manner so as to be understood by the average plan participant.²¹ However, Treasury has found that the notices provided to participants in connection with the Application fail to meet this standard because they are, in important respects, not written in a manner so as to be understood by the average plan participant. This is because:

- the notices extensively use technical language without adequate explanation;
- critical terms used in the notices are not defined in the notices but only by cross-reference to other documents (e.g., the Plan document and the rehabilitation plan document); and
- the cross-referenced definitions in those other documents are not understandable to the average plan participant.

¹⁹ See 26 C.F.R. § 1.432(e)(9)-1(d)(6)(iii).

²⁰ Code § 432(e)(9)(F) (emphasis added).

²¹ 26 C.F.R. § 1.432(e)(9)-1(f)(2)(iii).

The least understandable sections in the notices are copied verbatim from the Application. These sections of the notices are essential to fully understanding the proposed reductions of benefits, yet repeatedly use technical terms that are not defined in the notices, but only in other documents that the notices cross-reference but do not attach. For example, one section in the notices describes the rules regarding when a participant can return to work after the suspension is implemented. That section contains a 98-word sentence that includes four critical terms (the definitions of which are not contained in the notices, but rather in cross-referenced documents that are not attached) while describing three general conditions for when the reemployment provision applies and two sets of multi-part conditions that must first be satisfied.

Although pension plan provisions and the terms of proposed benefit reductions may be very complex, Kline-Miller nonetheless requires applicants to take the time and care to explain those proposed reductions in a manner that can be understood by an average plan participant.

Based on the foregoing, Treasury has determined that the notices provided to Plan participants are not sufficient to satisfy the Kline-Miller requirement that notices be written so as to be understood by the average plan participant.

IV. Conclusion

The Application fails to meet the requirements of Kline-Miller for the reasons described above. This notification letter will be made public in order to inform plan participants of the outcome of Treasury's review.

Respectfully,

A handwritten signature in black ink, appearing to read "Ken R. Feinberg", written over the printed name.

Kenneth R. Feinberg
Special Master