

**Memorandum**

NOV 15 1999

Date

*Michael Mangano*From *JG*June Gibbs Brown
Inspector General

Subject

Audit of the Pension Plan at a Terminated Medicare Contractor, Blue Cross and Blue Shield of Massachusetts (A-07-99-02537)

To

Nancy-Ann Min DeParle
Administrator
Health Care Financing Administration

This is to alert you to the issuance on Wednesday, November 17, 1999, of our final audit report. A copy is attached. We identified about \$5.3 million in excess pension assets at Blue Cross and Blue Shield of Massachusetts (Massachusetts) which should be remitted to Medicare because of the closing of the Medicare segment of Massachusetts' pension plan. The report has been provided to your staff for adjudication of the finding.

Massachusetts was a Medicare Parts A and B contractor until their contract was terminated in 1997 and was reimbursed for their Medicare employees' pension costs. Regulations and the Medicare contracts provide, however, that pension gains, which occur when a Medicare segment of a pension plan closes, should be credited to the Medicare program. Accordingly, we are recommending that Massachusetts remit about \$5.3 million representing excess pension assets to the Medicare program.

Our calculation of the amount due the Medicare program was based on the same actuarial assumption used by Massachusetts to determine pension costs and contributions for plan years 1995 through 1998 and was in accordance with Federal Cost Accounting Standards. Massachusetts agreed that Medicare was due a refund because of the pension segment closing, however, their calculation of the amount due was based on a different actuarial assumption than had previously been used to calculate their pension costs. Massachusetts' calculation resulted in a refund of approximately \$3.3 million (about \$2 million less than our recommended refund amount). As indicated above, the Health Care Financing Administration staff will make the final determination.

If you need additional information about this report, please contact Barbara A. Bennett, Regional Inspector General for Audit Services, Region VII, 816-426-3591.

Attachment

Department of Health and Human Services

**OFFICE OF
INSPECTOR GENERAL**

**AUDIT OF THE PENSION PLAN
AT A TERMINATED
MEDICARE CONTRACTOR,
BLUE CROSS AND BLUE SHIELD
OF MASSACHUSETTS**



JUNE GIBBS BROWN
Inspector General

NOVEMBER 1999
A-07-99-02537



Region VII
601 East 12th Street
Room 284A
Kansas City, Missouri 64106

CIN A-07-99-02537

Mr. Gary St. Hilaire
Chief Financial Officer
Blue Cross and Blue Shield of Massachusetts
100 Summer Street, MS 01/31
Boston, Massachusetts 02110-2190

Dear Mr. St. Hilaire:

This report provides the results of an Office of Inspector General (OIG), Office of Audit Services (OAS) review entitled *Audit of the Pension Plan at a Terminated Medicare Contractor, Blue Cross and Blue Shield of Massachusetts*. The purpose of our review was to determine the excess assets that should be remitted to Medicare by Blue Cross and Blue Shield of Massachusetts (Massachusetts) because of the termination of the Medicare contractual relationship in 1997.

We computed excess Medicare pension assets of \$5,270,461 as of January 1, 1998, which Massachusetts should remit to the Federal government. Massachusetts believed that elements of our calculations resulted in an overstatement of the recommended refund. Massachusetts' response is included in its entirety as APPENDIX B. APPENDIX C contains the Health Care Financing Administration (HCFA), Office of the Actuary's comments on Massachusetts' response.

INTRODUCTION

BACKGROUND

Massachusetts administered Medicare Part A and B operations under cost reimbursement contracts until the contractual relationship was terminated in 1997. In claiming costs, contractors were to follow cost reimbursement principles contained in the Federal Procurement Regulations (FPR), which were superseded by the Federal Acquisition Regulations (FAR), the Cost Accounting Standards (CAS), and the Medicare contracts.

Since its inception, Medicare has paid a portion of the annual contributions made by contractors to their pension plans. These payments represented allowable pension costs under the FPR and/or the FAR. In 1980, both the FPR and Medicare contracts incorporated CAS 412 and 413.

The CAS 412 regulates the determination and measurement of the components of pension costs. It also regulates the assignment of pension costs to appropriate accounting periods.

The CAS 413 regulates the valuation of pension assets, allocation of pension costs to segments of an organization, adjustment of pension costs for actuarial gains and losses, and assignment of gains and losses to cost accounting periods.

The HCFA incorporated segmentation requirements into Medicare contracts starting with Fiscal Year 1988. The contractual language specifies segmentation requirements and also provides for the separate identification of the pension assets for a Medicare segment.

The Medicare contract defines a segment, and specifies the methodology for the identification and initial allocation of pension assets to the Medicare segment. Furthermore, the contract requires that the Medicare segment assets be updated for each year after the initial allocation in accordance with CAS 413.

In our report entitled "*Audit of Medicare Contractor's Pension Segmentation, Blue Cross and Blue Shield of Massachusetts*", dated April 12, 1994 (A-07-93-00699), we addressed the computation of the asset fraction, the identification of the segment's assets as of January 1, 1986, and updated the segment's assets to January 1, 1992.

Massachusetts' Medicare Part A and B contracts were terminated effective July 31, 1997. Consequently, the majority of Massachusetts' Medicare segment employees were terminated and the Medicare segment was closed on that date. Contract terminations and segment closings are addressed by CAS at 9904.413-50(c)(12), which states:

"If a segment is closed,....the contractor shall determine the difference between the actuarial accrued liability for the segment and the market value of the assets allocated to the segment, irrespective of whether or not the pension plan is terminated. The difference between the market value of the assets and the actuarial accrued liability for the segment represents an adjustment of previously-determined pension costs.

(i) The determination of the actuarial accrued liability shall be made using the accrued benefit cost method. The actuarial assumptions employed shall be consistent with the current and prior long term assumptions used in the measurement of pension costs....

(iii) The calculation of the difference between the market value of the assets and the actuarial accrued liability shall be made as of the date of the event (e.g. contract termination, plan amendment, plant closure) that caused the closing of the segment... If such a date is not readily determinable, or if its use can result in an inequitable calculation, the contracting parties shall agree on an appropriate date."

Medicare contracts specifically prohibit any profit (gain) from Medicare activities. Therefore, according to the contract, pension gains which occur when a Medicare segment terminates should be credited to the Medicare program. In addition, FAR addresses dispositions of gains in situations such as contract terminations. When excess or surplus assets revert to a contractor as a result of termination of a defined benefit pension plan, or such assets are constructively received by it for any reason, the contractor shall make a refund or give credit to the Government for its equitable share (FAR, section 31.205-6(j)(4)).

OBJECTIVE, SCOPE, AND METHODOLOGY

We made our examination in accordance with generally accepted government auditing standards. Our objective was to determine the amount of excess assets that should be remitted to Medicare as a result of the contract termination and Medicare segment closing. Achieving the objective did not require a review of Massachusetts' internal control structure.

Massachusetts' Medicare contract was terminated and the Medicare segment was closed on July 31, 1997. Massachusetts suggested, and we agreed, that January 1, 1998 would be an appropriate settlement date for the closing of the segment. We therefore reviewed Massachusetts' identification of the Medicare segment and its update of Medicare assets from January 1, 1992 to January 1, 1998.

In performing the review, we used information provided by Watson Wyatt Worldwide, Massachusetts' consulting actuary. The information included liabilities, normal costs, contributions, and earnings. We reviewed Massachusetts' accounting records, pension plan documents, annual actuarial valuation reports, and the Department of Labor/Internal Revenue Service Form 5500s. Using these documents, we verified Massachusetts' update of Medicare segment assets to January 1, 1998. The HCFA pension actuarial staff reviewed our methodology and calculations.

Site work at Massachusetts' corporate offices in Boston, Massachusetts was performed during March 1999. We performed subsequent audit work in our OIG, OAS Jefferson City, Missouri field office.

FINDING AND RECOMMENDATION

When Massachusetts' Medicare segment closed, Medicare's share of the excess pension assets was \$5,270,461 which we are recommending be remitted to HCFA. To determine Medicare's share it was necessary to (1) update segment assets to January 1, 1998, and (2) calculate the actuarial accrued liability for accrued benefits for the segment, and the excess Medicare assets.

Update of Medicare Segment Assets

As of January 1, 1998, Massachusetts identified Medicare segment assets of \$22,847,854. We reviewed Massachusetts' update of Medicare segment assets from January 1, 1992 to

January 1, 1998, and we agree with their identification of the total segment assets. However, Massachusetts' identification of segment assets included an accumulated prepayment credit of \$2,830,400, that resulted from prior years' contributions to the pension plan in excess of the CAS pension costs. Since this prepayment credit was unassigned, and had not been reimbursed by Medicare, we subtracted the credit from the Medicare segment's total assets. Therefore, we determined that the Medicare segment assets were \$20,017,454 as of January 1, 1998 (\$22,847,854 less \$2,830,400).

Calculation of Actuarial Accrued Liability and Excess Medicare Assets

We computed the Medicare actuarial accrued liability for accrued benefits to be \$14,444,375. This amount includes the accrued liability of participants who were in the Medicare segment as of the termination date. After considering the

Medicare segment assets of \$20,017,454, the excess segment assets as of January 1, 1998 were \$5,573,079. However, because the segment was not 100 percent devoted to Medicare operations, only a portion of the excess segment assets are attributable to Medicare.

To arrive at Medicare's share of the excess assets, we calculated the aggregate percentage of the segment to be 94.57 percent (see APPENDIX A). After applying the Medicare percentage of 94.57 to excess segment assets of \$5,573,079, the resulting amount of \$5,270,461 represents the portion attributable to Medicare. Because of the termination of the Medicare contracts, this excess must be remitted to the Federal government.

Recommendation:

We recommend that Massachusetts:

Remit \$5,270,461 to the Health Care Financing Administration.

Auditee Response

Massachusetts did not agree with the appropriateness of the interest rate used to determine the actuarial accrued liability. Massachusetts believed that the 8.75 percent interest rate used in our calculations was not appropriate, and that an interest rate close to the current liability interest rate of 7.17 percent (for 1998 calendar year valuations) was appropriate for determining the actuarial accrued liability for the segment closure calculations. According to Massachusetts, determining the actuarial accrued liability using the current liability rate of 7.17 percent results in a refund of approximately \$3.3 million (about \$2 million less than the recommended refund amount).

OIG Comments

Our comments are summarized in the following paragraph. The HCFA, Office of the Actuary's detailed comments on Massachusetts' response are presented on APPENDIX C.

The actuarial accrued liability used in our segment closure calculations was provided by Massachusetts' actuary, and was computed in accordance with CAS at 9904.413-50(c)(12)(i), which states:

"The determination of the actuarial accrued liability shall be made using the accrued benefit cost method. The actuarial assumptions employed shall be consistent with the current and prior long term assumptions used in the measurement of pension costs..."

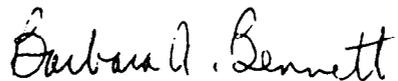
In accordance with the CAS, the 8.75 percent interest assumption used to determine the actuarial accrued liability was the same interest assumption that Massachusetts' actuary used to determine pension costs and contributions for years 1995 through 1998. We found no evidence that Massachusetts or its actuary believed its valuation assumptions were unreasonable.

INSTRUCTIONS FOR AUDITEE RESPONSE

Final determinations as to actions to be taken on all matters reported will be made by the HHS action official identified below. We request that you respond to the recommendation in this report within 30 days from the date of this report to the HHS action official, presenting any comments or additional information that you believe may have a bearing on the final determination.

In accordance with the principles of the Freedom of Information Act (Public Law 90-23), OIG, OAS, reports issued to the Department's grantees and contractors are made available, if requested, to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act which the Department chooses to exercise. (See 45 CFR Part 5).

Sincerely,



Barbara A. Bennett
Regional Inspector General for
Audit Services, Region VII

Enclosures

Page 6 - Mr. Gary St. Hilaire

HHS Action Official:

Mr. George F. Jacobs II
Regional Administrator, Region I
Health Care Financing Administration
John F. Kennedy Federal Building, Room 2325
Boston, Massachusetts 02203-0003

BLUE CROSS AND BLUE SHIELD OF MASSACHUSETTS

CIN A-07-99-02537

**CALCULATION OF MEDICARE SEGMENT'S
AGGREGATE MEDICARE PERCENTAGE**

YEAR	TOTAL SALARIES	MEDICARE SALARIES	MEDICARE PERCENT
1988	\$15,918,856	\$14,915,816	93.70%
1989	\$18,721,633	\$17,495,399	93.45%
1990	\$18,862,738	\$17,837,415	94.56%
1991	\$19,368,506	\$18,283,092	94.40%
1992	\$18,148,029	\$17,289,298	95.27%
1993	\$17,442,542	\$16,544,474	94.85%
1994	\$17,406,518	\$16,432,412	94.40%
1995	\$18,378,961	\$17,519,533	95.32%
1996	\$19,855,115	\$18,535,342	93.35%
1997	\$14,174,755	\$13,741,777	96.95%
Total	\$178,277,653	\$168,594,558	94.57%

$(\$168,594,558 / \$178,277,653 = 94.57\%)$

TEL (617) 832-7704
FAX (617) 832-3355

Gary D. St. Hilaire, CPA
Senior Vice President and
Chief Financial Officer

July 12, 1999

Barbara A. Bennett
Regional Inspector General for Audit Services
Region VII
Room 208A
601 East 12th Street
Kansas City, MO 64106

RE: Audit Report CIN # A-07-99-02537

Dear Ms. Bennett:

Thank you for allowing Blue Cross Blue Shield of Massachusetts (BCBSMA) this opportunity to comment on draft Audit Report CIN: A-07-99-02537. We have reviewed the report with our outside actuary and with counsel. Our comments are set forth below.

In draft Report CIN: A-07-99-02537, you recommended that BCBSMA refund to the Federal government \$5,270,461 of excess pension assets as a result of the termination of BCBSMA's Medicare contract effective January 1, 1998. The recommendation was based upon your understanding of CAS 9904.413-50(c)(12), which provides for an adjustment of previously determined pension costs upon the closing of a segment.

The recommended refund for the Medicare segment was calculated by determining the amount of plan assets associated with the segment and subtracting the accrued actuarial liability of employees and inactive participants associated with the segment. This excess was then multiplied by .9457, the ten-year average of the percentage of Medicare salaries to obtain the amount to remit to the government.

As this letter describes, we believe you should reconsider the conclusions in your draft Audit Report.

Respectfully, BCBSMA does not agree with the appropriateness of the interest rate used to determine the actuarial accrued liability. BCBSMA believes that the 8.75% interest rate assumed by OIG is not appropriate and that an interest rate close to the current liability interest rate of 7.17% (for 1998 calendar year valuations) is appropriate in determining the actuarial accrued liability for the segment closure calculations. Determining the actuarial accrued liability using the current liability rate of 7.17% results in a refund of approximately \$3.3 million.

Our reasoning on this position is as follows:

1. The OIG has stated in the audit report for Blue Cross Blue Shield of Louisiana, dated February 1996, CIN # A-07-95-01121 "Paragraphs CAS 412-40(b)(2) and 50(b)(5) make it clear that the CAS Board intended that reasonable, long-term assumptions based on past performance and future expectations be used."

As of the date of the audit meetings (March 1999) 88% of the accrued liability for the segment is attributed to participants currently receiving benefits. In contrast, for the entire participant group in the retirement plan, about 50% of the actuarial liability is for retired participants.

The duration of the liability for the segment (primarily retired participants) is much shorter than the duration of the liability for the entire retirement plan. In addition, having a significant portion of the segment liability for retirees requires that there be much higher liquidity for plan assets (lower allocation to equities). As of January 1998, the yield on 30-year Treasury securities was 5.81%. Use of a current liability interest rate of 7.17% represents a 136 basis point margin over the highest quality long term fixed income return. We believe the investment return used should reflect the demographics of the segment population. As a result, we do not believe that 8.75% is a reasonable long-term investment return based on past experience and future expectations.

2. The current liability interest rate is a reasonable interest rate to use in valuing the present value of benefits as of any date.

The concept of current liability was introduced by the Tax Reform Act of 1986. The IRS required special calculations (the present value of accrued benefits using a current liability interest rate) in the determination of the annual minimum required contribution. The purpose of introducing the current liability was to ensure that plan sponsors fund their retirement plans at a certain level based on an interest assumption established by the government. Current liability was defined using the accrued benefit cost method and an interest rate that lies within a specified range. That range was 90% to 110% (the 110% has been lowered through the years and in 1998 is 106%) of the weighted 48-month average rate for 30-year Treasury securities.

The IRS recognized that while a higher long term rate of return assumption is appropriate when valuing projected benefits, a long term-rate of return assumption linked to high quality fixed income securities should be used when determining the value of benefits already accrued. The current liability interest rate has been declining in recent years as the general level of interest rates has declined. The current liability rate is a weighted moving average, and as noted above was 136 basis points higher than the yield on 30-year Treasury bonds in January 1998.

Accordingly, we believe that a rate approximating 7.17% is reasonable. The excess return over 30-year Treasury bonds reflects a premium for the portion of the portfolio invested in equities.

3. The return on equity investments has been extraordinary in recent years and this reduces the expectation for equity returns in the future.

Our actuary used an 8.75% investment return assumption for funding valuations between 1995 and 1998 (8.0% was used for the four years prior to 1995). We believe this is why the OIG chose 8.75% as the interest rate to use for the segment closing calculations.

During this four-year period (1995 - 1998) when our actuary used an 8.75% investment return assumption, the Standard and Poors 500 Index average annual return was 33.69%. At the beginning of this period, our actuary was comfortable assuming an average future return of 8.75% based on BCBSMA's investment policy. However, after four years of extraordinary

returns it is no longer reasonable to assume this level of future return. Plan assets already reflect the extraordinary returns earned in the last few years. Management is still having discussions with our actuary about the proper level of the investment return assumption for the 1999 valuation. We know, however, the investment return assumption for the entire plan will not be over 8.0% and could be lower.

It is not reasonable to use an 8.75% investment return to discount the actuarial accrued liability when the asset values already fully reflect the extraordinary returns earned in the trust since 1995. Models prepared by our investment advisor suggest that a long term investment return assumption for our entire plan recognizing our mix of equity and fixed income investments is close to the 8.0% assumption suggested by our actuary.

The segment assets, when considered in isolation, should use an investment return assumption lower than 8.0% because of the shorter duration of the liability and the greater liquidity needs.

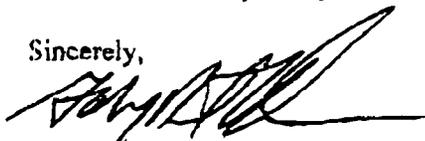
We believe these points are compelling and the 8.75% investment return assumption is not "a reasonable long-term assumption based on past performance and future expectations". We believe an interest rate close to the current liability interest rate of 7.17% is appropriate. In addition, to satisfy the pension obligation, one of the options BCBSMA is considering is the purchase of non-participating, guaranteed annuities for all the Medicare segment benefits (reference: regulation Title 48 CFR 9904.413)

If BCBSMA were to purchase non-participating, guaranteed annuities for all remaining segment liabilities, the annuity purchase cost, discounted to January 1998, would become the segment liability. Our actuary has estimated the cost of annuities to be about \$18,000,000 if the average net return is 6.0% and the insurer assumes average 2.5% increases for the portion of the benefits subject to cost of living increases. 94.57% of the difference between the cost of the annuities and the \$20.0 million segment assets would be remitted to the Federal government.

Under the current finding BCBSMA retains what we believe to be an unacceptable level of investment risk. If we are unable to reach agreement on a mutually acceptable investment rate we may be forced to take steps to protect BCBSMA from this risk through the purchase of annuity contracts.

We request that you give our proposals serious consideration. We welcome the opportunity to have continued discussions with you regarding the segment closing. Please contact either William Cushing (617) 832-5317, or John Fitzgerald (617) 832-5329 regarding the next steps. John has been our primary contact with OIG on this audit.

Sincerely,



Gary D. St. Hilaire, CPA
Executive Vice President and
Chief Financial Officer



MEMORANDUM

September 17, 1999

To: Barbara Bennett
Regional Inspector General

From: Eric H. Shipley
Office of the Actuary

Handwritten signature of Eric H. Shipley in black ink.

Comments on Response by Blue Cross Blue Shield of Massachusetts to OIG Audit Report A-07-99-02537

The purpose of this memorandum is to address the four (4) points raised by Blue Cross Blue Shield of Massachusetts (BCBSMA) in their letter of July 12, 1999 concerning the interest rate used to measure the actuarial accrued liability for purposes of determining the segment closing adjustment in accordance with paragraph 9904.413-50(c)(12) of the Cost Accounting Standards (CAS).

Before I proceed with a discussion of their response, I must correct a patently erroneous statement made by BCBSMA; "We believe this is why the OIG chose 8.75% as the interest rate to use for the segment closing calculations." Neither the OIG auditors nor HCFA's pension actuaries chose the interest assumption. Pursuant to 9904.413-50(c)(12)(i), the auditors requested BCBSMA to provide the actuarial accrued liability calculated using the same interest rate assumption that BCBSMA has represented as their "best-estimate" in accordance with paragraph 904.412-40(b)(2), and has used to determine BCBSMA's pension costs and contributions since 1995¹.

Point # 1: The interest rate used to measure the actuarial accrued liability in accordance with 9904.413-50(c)(12)(ii) should reflect the fact that "the duration of the liability for the segment (primarily retired participants) is much shorter than the duration for the entire retirement plan."

For the BCBSMA pension plan, as for most defined-benefit pension plans, it is true that the duration of the liability for retirees is shorter than the duration of the liability for the entire plan. Current retirees are expected to receive benefit payments for about the next 40 years, although the number of annuitants and the amount of the annual benefit payments will diminish due to mortality over that period of time. For the BCBSMA pension plan, active employees and

¹ Note: this is also the interest rate that their actuary has certified to the IRS as his "best-estimate" in accordance with the Employees Retirement Income Security Act (ERISA.)

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September 17, 1999

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terminated employees with deferred vested benefits on average will not begin to receive benefit payments until they retire 25 years in the future. Once they do retire, they can be expected to receive benefit payments for about the next 45 years, although again the number of annuitants and the amount of the annual benefit payments will diminish due to mortality over that period of time.²

It is also worth noting that the Medicare population is slightly younger than the population of the plan as a whole. For the Medicare segment, retirees have an average age of 69, active employees have an average age of 38, and terminated employees with deferred vested benefits have an average age of 41. Accordingly, the liability duration for the Medicare segment is slightly longer than for the plan's population as a whole.

However, the argument made by BCBSMA is wholly inconsistent with the recent actions taken by them and their actuary. The retiree liability was about 3% of the total liability for 1995 and 1996. In 1997, the retiree liability jumped to 45% of the total and rose to 49% in 1998. The interest assumption was increased to 8.75% in 1995 and has remained unchanged for 1996, 1997, and 1998 despite this change in the proportion of retiree liability. I presume that BCBSMA and their actuary did consider the effect of this change in duration of their liability, and decided to continue to certify to 8.75% as their "best-estimate."³

Point # 2: "The Current Liability interest rate is a reasonable interest rate to use in valuing the present value of benefits as of any date."

BCBSMA argues that the Current Liability, determined in accordance with paragraph (l)(7) of Section 412 of the Internal Revenue Code (IRC § 412(l)(7)), is the appropriate measure of the actuarial accrued liability used to determine the segment closing adjustment in accordance with paragraph 9904.413-50(c)(12) of the CAS.

The Current Liability is determined used the accrued benefit cost method, an interest rate that falls within a permitted range or corridor around a 48 month weighted average of 30-year Treasury Bond yields, and the mortality table prescribed by the Secretary of the Treasury. As the actuary for BCBSMA has noted in his valuation reports, the Current Liability is used "to determine whether a pension plan is sufficiently funded to be exempt from the Deficit Reduction Contribution provisions of the Retirement Protection Act of 1994." The Current Liability is also

² Based on the 1998 actuarial valuation report, retirees have an average age of 70, active employees have an average age of 40, and terminated employees with deferred vested benefits have an average age of 43. The mortality table used to value the plan extends survivorship to age 109.

³ Both Section 412(c)(3)(B) of Internal Revenue Code and paragraph 9904.412-40(b)(2) of the CAS (CAS 412-40(b)(2)) require that actuarial assumptions be established on a "best-estimate" basis. Note that while CAS 412-40(b)(2) refers to the contractor's best-estimate, in practice most contractors rely heavily upon the professional advice of their Enrolled Actuary.

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used to determine the IRC § 412(c)(7) Full Funding Limitation. Both of these uses of the Current Liability are related to a prescribed and standardized measure of the termination liability intended to protect the Pension Benefit Guarantee Corporation (PBGC) in cases where the PBGC must assume a plan's unfunded liability in a "distress termination".⁴

Subparagraph IRC § 412(b)(5)(A), which addresses the interest rate to be used to determine the Current Liability, requires that the interest rate used for minimum funding purposes be "consistent with the rate or rates of interest used under the plan to determine costs." Subdivision IRC § 412(b)(5)(B)(i) requires that the interest rate used to determine the Current Liability differ only if the "rate of interest used under the plan to determine cost is not within the permissible range". And finally, subparagraph IRC § 412(b)(5)(B)(iii), which imposes specific requirements on the interest rate used to determine the Current Liability, acknowledges that this provision is an exception to the general rule concerning interest assumptions used for minimum funding purposes.

Not only are the Current Liability provisions inapplicable to the measurement of a segment closing adjustment, but these provisions are in direct conflict with paragraph 9904.412-40(b)(2) of the CAS.⁵

Point # 3: "The return on equity investments has been extraordinary in recent years and this reduces the expectation for equity returns in the future."

The equity markets have been experiencing a prolonged period of high returns. Conventional wisdom leads many people to expect that equity returns will eventually moderate. I note that the set of actuarial economic assumptions used to value the BCBSMA plan includes a CPI assumption of 3.5% which indicates that the overall set of assumptions is not overstated by the underlying inflation assumption. Conventional wisdom also holds that any fall in the return on equities due to a rise in the annual inflation will be offset or at least mitigated by rising yields on corporate and government securities.

⁴ Similar to a third party insurer, as discussed under Point # 4, the PBGC valuation implicitly charges a "risk premium" to cover any adverse investment results. Furthermore, the unfunded liability assumed by the PBGC can only be covered by Government Securities and therefore the higher returns of corporate equities and bonds are not included in the PBGC interest assumptions.

⁵ IRC § 412(b)(5)(B)(iii): "Assumptions. Notwithstanding subsection (c)(3)(A)(i), the interest rate used under the plan shall be—

- (I) determined without taking into account the experience of the plan and reasonable expectations, but
- (II) consistent with the assumptions which reflect the purchase rates which would be used by insurance companies to satisfy the liabilities under the plan."

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As expected during this period of high equity returns, the BCBSMA pension fund has experienced average investment returns far in excess of the 8.75% interest assumption. Paragraph 9904.412-50(b)(4) of the CAS requires that “[a]ctuarial assumptions shall reflect long-term trends so as to avoid distortions caused by short-term fluctuations.” In fact, as market condition change in the future, it can be anticipated that during some future periods the fund’s investment returns will be less than the assumed 8.75% rate. No evidence has been presented by BCBSMA or their actuary to demonstrate that 8.75% no longer represents their “best-estimate” of the expected net result of future market upturns and downswings.⁶

While their observation is consistent with the conventional wisdom, it does not indicate whether the “best-estimate” actuarial interest assumption used by BCBSMA and its actuary is too high or too low. Nor does this theoretical argument present nearly as compelling a case for the appropriate interest rate, as their consistent representation of 8.75% as their “best-estimate” for 1998 and immediately preceding years.

Point # 4: “If BCBSMA were to purchase non-participating, guaranteed annuities for all remaining segment liabilities, the annuity purchase cost, discounted to January 1, 1998, would become the segment liability.”

The BCBSMA pension plan trustees may elect to irrevocably settle the pension liability for the Medicare segment by purchasing an annuity contract or contracts from an unrelated third party insurer. If such a settlement were to be made, the purchase price of the annuity contract, adjusted for any participation rights, would then be used to determine the liability following the guidance of the last sentence of subparagraph 9904.413-50(c)(12)(i). In such a case, the purchase price might be higher than the actuarial liability determined under the first sentence of subparagraph 9904.413-50(c)(12)(i) because BCBSMA would be paying the third party insurer a profit margin plus a premium to assume all risks of the liability.

By retaining the risks of adverse investment performance, BCBSMA has made a financial decision to manage the ultimate cost of their pension plan and possibly outperform the long-term interest assumption, which in combination with the other assumptions usually has a degree of conservatism. CAS 412 and 413 provide rules for the measurement of pension costs and liabilities that are not dependent on hypothetical financial management decisions that may or may not be made by a contractor. Therefore, unless an annuity is purchased to settle all liabilities, for purposes of measuring the segment closing adjustment, the liability shall be measured using the “best-estimate” long-range interest assumption that is used to fund the plan.

Please contact me at (410)-786-6381 if you have any questions.

⁶ Paragraph 9904.412-40(b)(2) of the Cost Accounting Standard: “Each actuarial assumption used to measure pension cost shall be separately identified and shall represent the contractor’s best estimates of anticipated experience under the plan, taking into account past experience and reasonable expectations.” *{Emphasis added}*

Memo to Barbara Bennett
September 17, 1999

Appendix

Based on the actuarial valuation reports prepared by the actuary for BCBSMA, a comparison of the yield on pension fund assets, the interest and mortality assumptions used to determine the actuarial accrued liability under the cost method used to value costs for CAS purposes and ERISA funding, the Current Liability interest rate and mortality table, and the SFAS 35 Present Value of Accrued Benefits interest rate and mortality table is as follows:

Actuarial Assumptions							
	1992	1993	1994	1995	1996	1997	1998
Mortality Table	86 Projected Experience			83 Group Annuity Mortality			
Post-Retirement COLI <u>1/</u>	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%
Salary Increase	6.00%	6.00%	6.00%	5.50%	5.50%	5.50%	5.50%
Investment Yield							
Annual	8.64%	12.39%	-1.75%	21.74%	11.66%	13.43%	not available
5-Year Average	9.98%	10.37%	7.37%	10.55%	10.27%	11.23%	
10-Year Average	11.41%	10.63%	9.78%	10.27%	10.13%	10.76%	
Interest Assumption: Funding Purposes	8.00%	8.00%	8.00%	8.75%	8.75%	8.75%	8.75%
Lump Sum Valuation			6.50% PBGC	6.50% PBGC	6.50% PBGC	7.25% 83GAM	7.25% 83GAM
Current Liability							
Range Maximum	9.26%	8.88%	8.17%	7.93%	7.62%	7.36%	7.17%
Full Funding Limit	8.25%	8.00%	7.50%	7.00%	7.00%	7.36%	7.17%
IRC § 412(f) Exempt	n/a	n/a	n/a	7.93%	7.62%	7.36%	7.17%
Range Minimum	7.58%	7.25%	6.68%	6.55%	6.35%		6.09%
SFAS 35 PVAB	8.25%	8.00%	7.50%	7.93%	7.62%	7.36%	7.17%
<u>1/</u> 3.00% is the maximum COLI permitted by the plan.							

APPENDIX D

**Massachusetts Blue Cross Blue Shield
Audit of Pension Plan at Terminated Contractor
Audit Report CIN A-07-99-02537**

**LIST OF REGION VII OAS STAFF
WHO CONDUCTED THIS AUDIT**

Greg Tambke, Senior Auditor, Jefferson City

David Imhoff, Auditor, Jefferson City

Jack Morman, Audit Manager, Health Care Audits