May 31, 2012

VIA ELECTRONIC MAIL

ASOP No. 4 Revision
Actuarial Standards Board
1850 M Street, NW, Suite 300
Washington, DC 20036

To Members of the Actuarial Standards Board:

On behalf of Cheiron, Inc. the following are our comments on the proposed changes to ASOP No. 4. We commend the ASB and the Pension Committee for its efforts. Like the Pension Committee, we too have a concern of how terms and disclosures are regarded by non-actuarial readers. Of particular concern is how the terms and disclosures are viewed by lawyers, trustees, and the media. Below we make a number of suggestions that will accomplish the goals of the changes yet avoid placing unnecessary burden on the actuary, or cause other issues for plan sponsors or users.

Definition of Actuarial Cost Method (Paragraph 2.2)
The exposure draft would modify the definition of the term "actuarial cost method" (in section 2.2) to add the words "in advance of the time benefit payments are due." No explanation for this change was provided. This is an unnecessary change to a term that has been used by actuaries for over half a century. Aside from the question of how the additional words should be interpreted, the change may cause problems where the actuary is making calculations in accordance with law. Also, the additional words are not found within the definition of actuarial cost method under the Employee Retirement Income Security Act (ERISA) and its implementing regulations and appear to differentiate from actuarial cost methods as described in those regulations.

To illustrate the potential issue, consider the following hypothetical situation. A new plan is started that provides a funding target (within the meaning of IRC section 430) that will be amortized over seven years. Assume that under the plan terms and under the actuary's reasonable actuarial assumptions, the covered participants will be eligible to take lump sum distributions in two years (and the actuary recommends that the employer contribute more than the required minimum contribution). The actuary makes the required calculations of the minimum funding requirements that incorporate the seven year amortization period. In this case, are the minimum funding standards not considered an Actuarial Cost Method? If the definition is adopted without change, what would the plan actuary be required to disclose?

The term "actuarial cost method" is defined in ERISA section 3(31) and sections 1.412(c)(1)-1(a) and 1.412(c)(3)-1 of the Income Tax Regulations in a manner that does not conform to the proposed change to the definition. Yet, the cited regulations are to be used by enrolled actuaries for making determinations under the minimum funding standards for plans (such as multiemployer plans) that are not subject to the requirements of section 430 of the Internal Revenue Code (Code). However, there is not one prescribed method but rather a choice of methods that may be used for such plans. Any differentiation between the regulatory definition and the definition in ASOP 4 could put the enrolled actuary in a difficult quandary. Rather than change the definition of the term “actuarial cost method,” we suggest that the required disclosures in paragraphs 3.13 address any concerns about an allocation procedure that does not allocate contributions or costs in advance of when benefit payments are due.

Definition of Contribution (Paragraph 2.7)
Just as the word “liability” has a specific meaning to the public at large, so does the word “contribution.” The exposure draft continues the definition of contribution as a “potential payment” to the plan. That definition is contrary to the common meaning used by the public at large, and the accepted meaning used for the amounts reported by the enrolled actuary on a Schedule SB or MB. We suggest that the definition be revised to read “A payment to the plan.” If the committee feels there is a need to have a potential payment concept for use with other definitions, then an additional definition of “calculated contribution” or “calculated payment” could be added.

Definition of Fully Funded and Accompanying Disclosures (Paragraphs 2.12, 2.13 and 4.1(p))
The exposure draft adds new definitions of “fully funded” and “funded status.” Additionally, the exposure draft directs the actuary to make certain disclosures when asserting that the plan is “fully funded” or any similar assertion. The committee expressed the concern that the term may be misinterpreted by non-actuarial readers. While we appreciate the concern expressed by the committee, the changes need to ensure that they do not cause greater misinterpretation and/or unwarranted additional expense for plan sponsors.

First, if the committee is concerned that non-actuarial readers have a different understanding of the term “fully funded,” it is unlikely to help matters by adding a definition to the ASOPs that conflicts with that common understanding even if the definition reflects the common usage among actuaries. Adding the definition of funded status is helpful, and we believe provides the definition needed to address the committee’s concerns for non-actuarial readers when combined with appropriate disclosures in communications.

If the committee believes that a definition of “fully funded” is still warranted, the first sentence of the definition is fine and should be the only sentence needed. Unless there are other requirements for using the phrase “fully funded” other than those in 4.1(p), the second sentence is redundant.

We believe 4.1(p) should be re-written as follows:

p. a description appropriate for the intended users of the communication of the particular measures of plan assets and plan liabilities used to determine the funded status. If the funded status is greater than or equal to 100 percent on these measures, the actuary should accompany this description with the following additional disclosures:

1. The funded status is measured at a particular point in time and is likely to change in the future;
2. The funded status is or is not based on a measure of the estimated cost to settle the benefit obligations; and
3. Additional contributions to the plan may be required.

The actuary should consider similar disclosures when the funded status is less than 100 percent if the actuary believes it would limit misinterpretations by the intended user of the communication.

The risk of misinterpretation is highly dependent on the sophistication and familiarity of the intended user of the actuarial communication to actuarial practices. One level of communication may be required for the corporate finance officer who has managed his or her company's pension plan for many years and another level may be required for a presentation to a public audience for a state retirement system. If the intent is to limit misunderstandings for non-actuarial users, it would be helpful if the ASOP recognized the different levels of communication that may be required.

Any misinterpretation of the term "fully funded" naturally extends to a misinterpretation of "funded status." A statement that a plan is 80 percent funded is naturally interpreted as being 20 percent short of "fully funded." Consequently, it is important to communicate the basis for a funded status measure. We understand the additional importance when a plan is reported as being 100 percent funded or greater, so some additional disclosures are appropriate. However, these additional disclosures should be simple and not impose an additional burden on the actuary. As written, 4.1(p)(1) could be interpreted to require a measurement of the settlement cost that is beyond the scope of work; 4.1(p)(3) requires the development of a judgment that may be beyond the scope of work; and 4.1(4) does not adequately describe when additional contributions may be required. Additional contributions are likely to be required in most circumstances for an ongoing plan even if the plan is more than 100 percent funded based on the present value of projected benefits.

In the structure proposed in the exposure draft, a problem arises when the plan is fully funded for one measure but not for another. For example, a plan may be fully funded for current liability (as defined in the law for a multiemployer plan) but not fully funded for the actuarial accrued liability. What is to be disclosed when the actuarial report states that the assets exceed the current liability as defined in ERISA but is less than the actuarial accrued liability? No mention is made of the term fully funded. The suggested disclosures make no sense in such a situation. Yet, that is not the only example. Current liability is still a concept in the regulations under section 401(a)(4) of the Code, but the plan may have assets that are less than the funding target using the segment rates.

The disclosure that fully funded is a temporary measure presents interpretative problems as well. What is the timeframe (or other measure) of the word "temporary?" Suppose, for example, that a frozen plan has a market value of plan assets that is 200% of the present value of accrued benefits using conservative actuarial assumptions. If the actuary can reasonably project in this situation that there is less than a 1% chance that the assets will fall below the present value of accrued benefits in the next 50 years is the full funding temporary? What about 20 years? What if there is less than a 10% chance?

The disclosure of whether there is a significant risk that the fully funded plan could cease to be fully funded also presents interpretative issues. Who defines significant? The exposure draft does not state that significance is determined by the actuary's judgment. Rather, significant risk is another undefined concept that could spark misinterpretation itself. This is especially the case because the time frame is not specified.

The disclosure that additional contributions to the plan may be required if the plan is fully funded relative to the present value of accrued benefits but not relative to the present value of projected benefits is unnecessary, adds expense for the plan sponsor, and would require even more disclosure as to when there may or may not be the additional contributions. First of all, for a single-employer plan subject to the Pension Protection Act of 2006 (PPA) funding rules, the actuary may not even calculate the present value of projected benefits. Making a statement about the additional contributions seems pointless in that situation. If a statement had to be made, the actuary may then feel compelled or required to make a calculation of the present value of projected benefits so the natural questions of how much, when, etc. can be answered. Furthermore, the actuary would need to point out, as an example, that additional contributions would not be required necessarily if the plan was amended to cease accruals, terminated, or the plan assets earned more than the discount rate used in the calculations. The additional calculations and disclosures will simply add to the expense for the plan sponsor.

<u>Prescribed Assumption or Method (Paragraphs 2.19 and 2.20</u>

The exposure draft adds two definitions that attempt to distinguish when a prescribed assumption or method is set by law from when it is set by another party. Under the exposure draft, an assumption or method is set by another party to the extent that law, regulation, or accounting standards give the other party the responsibility for selecting such an assumption or method. The exposure draft then goes further and states that an assumption or method selected by a governmental entity for a plan that such governmental entity directly or indirectly sponsors is not a prescribed assumption or method set by law.

ASOP 41 requires certain disclosures when an assumption or method is prescribed by law and other disclosures when the assumption or method is set by another party. Specifically, when an assumption or method is prescribed by law, ASOP 41 requires the actuary to disclose the applicable law, the assumption, and confirm that the report was prepared in accordance with the applicable law. In contrast, when an assumption or method is prescribed by another party, the actuary has three choices as to disclosure depending on whether the prescribed assumption does or does not significantly conflict with what the actuary views as a reasonable assumption or if the actuary is unable to judge whether or not the assumption is reasonable (see sections 3.4.4(b) and 4.3 of ASOP 41). No disclosure is required if the actuary believes that the prescribed assumption or method is reasonable for the purpose of the assignment.

Section 4.2(b) of the exposure draft requires that the disclosures of section 4.3 of ASOP 41 should be included for any material assumption or method set by another party, while section 4.2(c) requires the disclosures of section 4.3 of ASOP 41 if the actuary states reliance upon on other sources and thereby disclaims responsibility for any material assumption or method selected by a party other than the actuary. It appears that the reason for the definitions in sections 2.19 and 2.20 is so that the actuary for a governmental plan would be subject to the disclosures of section 4.3 of ASOP 41 when the methods and assumptions are prescribed by a law promulgated by a direct or indirect sponsor of the plan. While we understand the thinking behind the presumed reason, we believe that the exposure draft would require a disclosure even if the actuary believes that the prescribed assumption or method is reasonable for the purposes of the assignment. The goal can be accomplished by a simple requirement that the prescribed methods and assumptions for governmental plans are subject to the disclosure requirements of sections 3.4.4(b) and 4.3 of ASOP 41.[1] Alternatively, sections 4.2(b) and (c) of the exposure draft could be amended to refer to section 3.4.4 of ASOP 41 instead of 4.3. That cross reference would require the actuary to make the disclosures in 4.3 only when the prescribed assumption or method conflicts with what would be reasonable in the actuary's professional judgment, or when the actuary is unable to judge whether or not the assumption is reasonable.

Also, we note that it is not clear whether a method or assumption is prescribed by law or by another party. For example, what if a plan document, law, or regulation provides that the board of trustees will select an assumption or method from a range recommended by the actuary? It would appear that the assumption or method is not set by law, and, arguably the assumption or method is set by another party, however, the actuary would not be disclaiming responsibility under ASOP 41 (unless the selected assumptions, for example, were inconsistent). Given that the actuary has to recommend the assumption or method, is it really set by another party? It would appear that there is shared responsibility.

As another example, consider the situation where the actuary can select the assumption or method, but another party has to approve it. That is much the case for certain automatic changes in funding method under IRS Revenue Procedure 2000-40 where a change cannot go into effect unless the plan administrator agrees with the change. Here too, it is not clear as to who sets the method. Compliance with ASOP 4 (and ASOP 41) would be enhanced if the committee provided guidance in these and similar situations. Alternatively, the standard

[1] Section 3.4.4(a) of ASOP 41 contemplates such a requirement in the last sentence which states "The actuary should also follow the guidance in paragraph (b) below whenever required by another ASOP."

could provide that where there is shared responsibility, the assumptions and methods should be treated as if prescribed by another party.

Other Valuation Issues (Paragraph 3.5.3)
The example in this section refers to an estimate of "economic value." Since the term "economic value" is not defined, we suggest that it be replaced with "Market-Consistent Present Value."

Types of Actuarial Present Values and Associated Disclosure (Paragraphs 3.7, 3.7.1, 3.7.2, 3.7.3 and 4.1(i))
The exposure draft introduces a new section 3.7 entitled "Types of Actuarial Present Values." The terms "Present Values Based on Plan Assets" (section 3.7.1), "Present Values Not Based on Plan Assets" (section 3.7.2), and "Market-Consistent Present Values" (section 3.7.3) are new terms that seek to distinguish values based primarily upon the choice of the discount rate used in the calculations. We believe these terms, as currently defined, will cause confusion, and are not necessary. Furthermore, there are circumstances where the actuary will be called upon to determine a present value that fits in neither category.

A reader may well expect that a "Present Value Based on Plan Assets" will somehow reflect the amount of plan assets, or that a "Present Value Not Based on Plan Assets" represents the value that would be placed if there were no assets. One could easily imagine an attorney requesting the actuary to explain exactly how the present value would change with a small or large change in the amount of plan assets. Better terminology might be "Present Values Based on Anticipated Investment Returns" and "Present Values Based on Market Observations." Under this terminology, discount rates based on "Market Observations" would include averages of market observations over different periods and other adjustments that effectively smooth the fluctuations in observed market interest rates. This terminology is also more consistent with the terminology used in 4.1.1 of the exposure draft of ASOP 27 that requires the actuary to describe whether an economic assumption "represents an estimate of future experience, the actuary's observation of the estimates inherent in financial market data, or a combination thereof."

If the term "Market-Consistent Present Value" is to be defined as "consistent with the price at which expected plan benefit payments would trade in an open market between a knowledgeable seller and a knowledgeable buyer," then it should be clear that not only is the discount rate based on current market observations (no averaging or smoothing), but the other assumptions (including demographic assumptions such as mortality and turnover rates) should include an estimate of the margin for adverse deviation that such a transaction in an open market would require. In addition, the description should stipulate that the knowledgeable seller and knowledgeable buyer have equal credit ratings.

Paragraph 3.7.3(c) refers to an assessment of the "economic value" of a pension plan. This term is not defined, so it is not clear when this paragraph should apply. Either the term "economic value" should be defined, or it should be eliminated from the standard.

There are circumstances where an actuary may well be required to produce a present value of plan liabilities that is a blend of a present value determined using the expected rate of return on plan assets and a present value using a current bond rate. The Government Accounting Standards Board (GASB) released an exposure draft of proposed changes to the determination of expenses for a governmental defined benefit plan. Under the exposure draft, the liability is measured using the expected return on plan assets to the extent current plan assets and future contributions will provide the benefits, and is measured using current bond rates to the extent that benefits will not be provided by current plan assets and future contributions. Such a calculation would produce a liability that is a blend of the two different types of present value under the proposed ASOP.[2] The exposure draft of ASOP 27 also explicitly recognizes this reality in the communication requirements of 4.1.1 described above..

Finally, there is no need to have a separate definition of present values based upon the type of discount rate. If the purpose of this section is just to define different present values based on the type of discount rate used to discount future payments, it seems the distinction belongs in ASOP 27 and not in ASOP 4.

Paragraph 4.1(i) requires the disclosure of the type of actuarial present value and the implications. First, the examples in 4.1(i) should be dropped as they are oversimplified, inappropriate, not balanced in their presentation, fail to recognize all of the competing incentives at play for users of the actuarial present value, and require an assessment of behavior that is clearly beyond the actuary's expertise. To illustrate, the second example might be replaced with the following: "if the actuarial present value is not based on plan assets, the actuary may include a statement that such present values are often volatile from one year to the next and may create incentives to eliminate the defined benefit plan." Recent history provides more support for this incentive than for the one specified in the exposure draft, but either one is speculative and beyond the scope of the actuary's expertise.

Second, the required disclosure should be limited to the type of actuarial present value (and/or discount rate). The implications of the chosen type vary with the purpose of the measurement and are not settled within the actuarial community. It would be appropriate to disclose that higher discount rates produce lower measures of present value or that using a discount rate that changes each year will result in volatile measures of present value. The incentives and behavior that results, however, is not an appropriate actuarial disclosure.

Measuring the Value of Accrued or Vested Benefits (Paragraph 3.10)

The exposure draft would continue the list of factors that an actuary should consider in measuring the value of accrued or vested benefits. However, many of these factors should also be considered when measuring the value of projected benefits. For example, one would expect that plan provisions and applicable law are considered when measuring projected benefits. We assume that the committee does not intend to create an inference to the

[2] We currently expect that the final revisions adopted by GASB will retain the interest rate specification in the exposure draft.

contrary. Thus, we suggest that measurements of all benefits be covered by these factors except that the ones unique to accrued or vested benefits could be treated separately in an appropriate manner.

Assessment of Allocation Procedure and Related Disclosures (Paragraphs 3.13.4, 3.13.5 and 4.1(l))

While the objective of requiring the actuary to assess the implications of the contribution allocation procedure and make appropriate disclosures is important, we have a number of concerns about the proposed requirements. First, some of these assessments may require extensive additional work beyond the scope of the actuary's engagement. This may particularly be the case when new employees receive different benefits than current employees, when the plan sponsor is expected to grow or decline in the future, and when the demographics of a plan are changing due to retirements and new hires. In these cases, perhaps a mandatory disclosure that the contribution allocation procedure has not been assessed by the actuary should suffice.

Second, the primary metrics required by the standard of declining future funded status or increasing future contributions may differ between the short and long-term, and the long-term projections are much less reliable.

Consequently, we suggest that 3.13.4 and 3.13.5 be restricted to an assessment over the short-term (e.g., one to five years). The already required assessment of whether or not the contribution allocation procedure is significantly inconsistent with the plan accumulating adequate assets addresses the long-term concerns. What is missing is the requirement to disclose the short-term expected changes in contribution levels primarily due to the smoothing of assets, the averaging of market observations, or other techniques to control the volatility of contributions. We note, however, that this type of information is just good consulting and is frequently required by our clients. It is not clear what purpose is actually served by adding these requirements to an actuarial standard.

If the Committee is concerned about the consequences of a contribution allocation procedure that perhaps does not rise to the level of required disclosure under paragraphs 3.13.2 or 3.13.3, we think a different approach may be required. One possible approach is to require disclosure if the contribution allocation procedure produces a contribution for the current measurement that is less than normal cost plus interest on the unfunded actuarial accrued liability. While reasonable contribution allocation procedures may fail this test, over time contributions will need to exceed this threshold. Consequently, the disclosure should include whether it is a temporary or permanent feature of the contribution allocation procedure and, if it is temporary, a discussion of when the contribution is expected to exceed the threshold if all actuarial assumptions are met. Note that this discussion can be qualitative so as not to require any additional work from the actuary.

We appreciate the opportunity to comment on the exposure draft. If you have any questions about our comments, or wish additional information, please contact the undersigned at 703-893-1456.

Sincerely,
Cheiron

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