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Pension Committee, Actuarial Standards Board
American Academy of Actuaries

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

May 31, 2012

Subject: Exposure Draft of ASOP No. 4

To members of the Actuarial Standards Board:

Mercer is pleased to provide our response to the proposed revisions of ASOP 4. These comments were prepared with the assistance of Mercer's Actuarial Resource Network, a group of senior actuaries in the Retirement Practice area representing all of the U.S. geographic areas in which Mercer operates, and with input and comments from other senior Mercer actuaries.

We list below several comments regarding the exposure draft for potential revisions to Actuarial Standard of Practice No. 4. Many of our notes relate to clarification, and are not intended to alter the substance of proposed language. Where a change in meaning is desired, the issue is discussed accordingly.

Our suggestions and comments are described below. Suggested additions are **underlined and bold**, and suggested deletions are ~~struck through~~.

Request for Comments
Nine items were mentioned for comment, and we respond specifically to several of those below.

1. *Is the new language regarding the purpose of the measurement clear, sufficient and appropriate? If not, how should the language be changed?*

   No suggestions.

2. *Is the language regarding actuarial present value types clear? Does the language provide actuaries with sufficient freedom to calculate an appropriate present value type? If not, how should the language be changed?*

   We first note that while the language describing "market consistent present value" may be clear, the name itself could be misleading. It is really a "present value based on market

consistent discount rates". Nothing in the proposed standard addresses other inputs to the present value determination, such as demographic probabilities or economic assumptions other than discount rate, which may not be "market consistent" – a term not even defined beyond the scope of discount rates in the proposed standard. We recommend using the more descriptive term "present value calculated with market consistent discount rates."

In addition, 3.7 indicates "[t]he actuary should select ***the*** type of actuarial present value of a pension obligation that is appropriate for the purpose of the measurement (*emphasis added*)." We believe there may be situations where the actuary could reasonably use a combination of the types described in this section. For example, the actuary might select an asset-based present value for the portion of benefits anticipated to be (or currently) funded by specific investments while utilizing a yield curve approach for unfunded benefits.

We suggest that the last sentence of 3.7 be revised to, "The actuary should select the type **or combination of types** of actuarial present value of a pension obligation that is appropriate for the purpose of the measurement."

We are also concerned with the requirement to reflect "payment default risk" for purposes of market-consistent measurements for assessing economic value. Many pension actuaries do not possess the knowledge and skills to assess and quantify the likelihood a plan sponsor will be unable (or unwilling) to fund the plan's obligations. It is also unclear what level of default would be measured: total, or perhaps partial – based on bankruptcy proceedings?

Even if the probabilities of sponsor solvency can be estimated, the risk of default may affect the economic value to different participants to different degrees, depending on timing of payment, priority of claim and underlying guarantees. PBGC guarantees, for example, pose a significant challenge to assessing the actual risk of forfeited benefit payments in a PBGC-covered pension plan. In other situations, state insurance guaranty funds might come into play. Realistically, how would one reflect the probability that various benefits (or portions thereof) would or would not be guaranteed by the PBGC or other party for specific patterns of sponsor insolvency?

In addition, we believe the term "economic value" is neither well defined nor understood. What characteristics distinguish such a measure from other present values? Is it only that economic value reflects payment default risk? Or does it involve the entire range of assumptions including demographic and economic rates? We recommend the discussion of economic value be eliminated pending a fuller definition and vetting of the concept.

3. *Is the disclosure requirement in section 4.1(i) regarding present value measurements clear and appropriate? If not, how can the disclosure language be improved?*

   It is generally not appropriate for the actuary to speculate what "incentives" could be generated by the choice of present value type. As long as the type of present value is clearly documented and described, each reader will be allowed to consider the potential motivations either for selecting that approach or resulting from such a choice.

   If disclosures are necessary, a more factual and objective statement consistent with the expertise of an actuary would be more appropriate. For example, if the present value is asset-based, "**such values: 1) focus on expected investment returns that may or may not be achieved, 2) do not reflect explicitly the volatility associated with future returns, and 3) do not take into account risks and uncertainties inherent in financial markets and in the present values .**" Alternatively, if the actuarial present value uses a market-consistent approach, "**such values: 1) focus on cash flows generated by hypothetical bond portfolios – or discounted by estimated yield curves – that may or may not be representative of securities available for purchase over the duration of plan liabilities, 2) do not reflect explicitly the volatility associated with potential reinvestment rates when plan payments are not exactly matched by cash flows generated by investments, and 3) do not take into account the actual investment policies, sponsor contribution practices, and trust balances for plan assets accumulated to provide benefits.**"

4. *Is the lack of prescribed assumptions for determining a market-consistent present value a deficiency in the proposed standard? If so, what assumptions would you propose?*

   We consider the lack of specific mandates to be a strength of the current draft. Different markets can be appropriate bases for different objectives. The approach should be clearly documented.

5. *Are the expanded definitions and disclosures of cost or contribution allocation procedure clear, sufficient, and appropriate? If not, how should they be changed?*

   Regarding Actuarial Cost Method 3.12(c), we propose one small addition:

   c. **Plan-paid** ~~E~~**e**xpenses should be considered …

6. *Are the revised definitions regarding prescribed assumptions and methods, and the resulting disclosure requirements, clear, sufficient, and appropriate? If not, how should they be changed?*

It appears the disclosures under 4.1(r) only apply to assumptions and methods that are not set "by law" or "by another party". As such, these would be under the actuary's control, so that the reasons behind such changes would be known to the actuary. However, the standard should allow the actuary to not disclose information that is confidential. This leads to the problematic issue of who decides what is confidential, where a principal could take a fairly expansive view regarding sensitive subjects such as shutdown probabilities or salary increases. An actuary might end up providing a relatively vague disclosure, such as, "Actuarial assumptions were updated after a review of recent plan experience and discussions with the plan sponsor to better reflect anticipated future experience." Without clearer examples or guidance we feel the current exposure draft will not likely lead to more useful disclosures than are currently provided.

7. *Are the new definitions regarding funded status, the term fully funded, and the new disclosure requirements, clear, sufficient, and appropriate? If not, how should they be changed?*

   The proposed standard treats "fully funded" and "100% funded" equivalently, and as a bright-line distinction. The additional disclosures appear not to apply where a plan's funded ratio is 99%, even though a reader might interpret the plan as being just 1% short of "fully funded." We do not believe that it makes sense to require additional disclosures solely on account of exceeding this somewhat arbitrary threshold. We believe it would be more appropriate to disclose that any given measure of funded status only reflects assets and liabilities at a fixed point in time, and may not predict whether current resources are sufficient to provide all plan benefits over future time periods.

   Even as proposed, there are a few practical issues around the term "fully funded" that need to be addressed.

   For example, when required by ERISA, an "adjusted funding target attainment percentage" ("AFTAP") certification must show the plan's funded status as a percentage based on the actuarial value of assets (as adjusted) used for minimum funding purposes. If that certified percentage is 100% or higher, it would appear that 4.1(p) requires the actuary to provide a number of additional disclosures. The actuarial value of assets – as used for an AFTAP certification – may or may not reflect: offsets for credit balances, annuity purchases for non-highly compensated participants, accrued contributions made after the valuation date, or earmarked contributions made during the year to allow certain benefits to be accrued or paid. We do not believe the ASOP should require the actuary to append additional disclosure items to such a statutory certification.

Similarly, the "annual funding notice" ("AFN") that must be provided to participants in ERISA plans requires a three-year history of FTAP ratios. The additional disclosures that might be necessary under 4.1(p) (for any ratio of 100% or more) could contradict DOL guidance indicating the notice should not contain additional information that could confuse or mislead participants regarding the notice's requirements.

It is likely that neither document above makes an assertion that the plan is "fully funded". However, these materials could be subject to additional disclosure obligations merely because a ratio or ratios happens to be 100% or higher.

We are also concerned that the requirement to disclose "whether the plan's market value of assets equals or exceeds the estimated cost to settle the benefit obligations" would result in calculations substantially beyond the scope of the assignment. It should be sufficient to disclose the directional effect on funded status of measuring liabilities on a settlement basis without quantifying the impact.

8. *Are the expanded requirements regarding plan provision valuation, including plan provisions that raise special valuation issues, sufficient and appropriate? What additional guidance (or educational material) would be valuable with regard to alternative valuation procedures, such as stochastic modeling, option-pricing techniques, or adjusting assumptions to reflect the asymmetric impact of variations in experience from year to year?*

   The potential impact of asymmetrical liabilities is a significant topic, and we are comfortable with its inclusion in this standard. We offer two suggestions related to the current language contained within the paragraph following 3.5.3(c):

   > For such plan provisions, the actuary should consider using alternative procedures, such as stochastic modeling, option-pricing techniques, or assumptions that are adjusted to reflect the asymmetric impact of variations in experience from year to year. In selecting valuation procedures for such plan provisions, the actuary should use professional judgment based on the purpose of the measurement and other relevant factors. For example, using alternative procedures to capture the impact of asymmetric plan provisions may be appropriate for estimating an economic value. **As another example, an actuary who believes the long term average 30-year Treasury rate will be 4% might select a rate higher than 4% for the assumed rate of increase applied to cash balances that are guaranteed a 30-year Treasury interest rate but not less than 3%.** ~~On the other hand, when determining plan contributions, concerns that certain assumed economic or demographic outcomes may not occur may lead the actuary to ignore asymmetric plan provisions such as shutdown benefits in order to avoid excess funding.~~

We recommend replacing the last sentence as a specific example because current ERISA funding rules require the inclusion of estimated liability for so called "unpredictable contingent event benefits" unless the probability of such events is *de minimis*. Further, an economic example is likely to be more instructive.

9. *Is it appropriate to require the actuary to disclose whether the contribution allocation procedure or the contribution requirements established by contract or law are likely to result in either declining future funded status measures or increasing future contribution requirements? If not, what disclosure responsibility do you feel the actuary has in these scenarios?*

The exposure draft addresses two related forms of this basic issue. In the first form, 3.13.2 and 3.13.3 state, "the actuary should select a contribution allocation procedure that, in the actuary's professional judgment, is consistent with the plan accumulating adequate assets to make benefit payments when due, assuming that all actuarial assumptions will be realized and that the plan sponsor or other contributing entity will make contributions when due" and, "If, in the actuary's professional judgment, such a contribution allocation procedure is significantly inconsistent with the plan accumulating adequate assets to make benefit payments when due, assuming that all actuarial assumptions will be realized and that the plan sponsor or other contributing entity will make contributions when due, the actuary should disclose this in accordance with section 4.1(l)." This level of consistency between the allocation procedure and the ability to fund benefits seems within the role of the actuary.

The second, more stringent form contained in 3.13.4, however, would relate to a much broader range of situations:

> 3.13.4 Assessment of Overall Implications of Contribution Allocation Procedure – Regardless of who selects the contribution allocation procedure, the actuary should assess the expected cost progression implications of the assumptions and methods selected. If the use of such assumptions and methods would be expected to result in either declining future funded status measures or increasing future contribution requirements, such expectation should be disclosed as described in section 4.1(l). For this purpose, contribution increases associated with expected increases in participant compensation should not be considered an increasing future contribution requirement.

Most actuarial valuations do not contain within their scope a forecast of future costs. A valuation is generally a snapshot, measuring funded status at a point in time, and perhaps calculating a contribution amount for the upcoming year based on that snapshot. The criteria in

3.13.4 are significantly different than 3.13.2/3, requiring the actuary to go beyond the valuation project and to forecast results into the future.

Further, the "increasing future contribution requirements" clause is broad enough to encompass many if not most valuations. For example, any funding method with a negative amortization base in place can expect an increase in contributions the year after that base is fully amortized – even if the combined amortizations for the plan are reasonable and greater than zero in all future years. Similarly, any method that recognizes an existing actuarial gain over a period of years – instead of immediately – will likely see an increase in costs once those gains have been fully recognized, or if gains and losses offset in future years as one might expect.

In general, we recommend, deleting 3.13.4 and associated references, and focusing on the type of disclosures contained in 3.13.2/3. We likewise recommend deleting the similarly worded 3.13.5, and modifying 4.1(l) as follows:

l. a statement indicating that the contribution allocation procedure is significantly inconsistent with the plan accumulating adequate assets to make benefit payments when due, if applicable in accordance with section 3.13~~, or a statement regarding the expectation of declining future funding status or increased contribution requirements, if applicable,~~;

We note a few additional items below, not directly related to the nine topics above. Regarding plan provisions,

3.5 Plan Provisions – When measuring pension obligations and determining plan costs or contributions, the actuary should take into account significant plan provisions **known to the actuary** as appropriate for the purpose of the measurement. However, if in the actuary's professional judgment, omitting a significant plan provision is appropriate for the purpose of the measurement, the actuary should disclose the omission in accordance with section 4.1(d).

Section 3.5.3 on Other Valuation Issues is a nice expansion of the discussion in Section 3.10 of the current standard on benefits that vary asymmetrically with future experience.

In 3.14(c) relating to approximations,

c. situations in which the actuary reasonably expects the **amounts being approximated or estimated** ~~benefits being valued~~ to represent only a minor part of the overall pension obligation, cost, or contribution.

Thank you again for the opportunity to comment on this important exposure draft. We are available to provide more information or detail as may be appropriate

Sincerely,

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