Comments of the Proposed Changes to the Actuarial Standard of Practice Number 27 Selection of Economic Assumptions for Measuring Pension Obligations

Comment #13 - April 30, 2011 - 6:04 p.m.

The Actuarial Standards Board

The American Society of Pension Professionals & Actuaries (ASPPA) and the ASPPA College of Pension Actuaries (ACOPA) appreciate this opportunity to comment on the proposed changes to Actuarial Standard of Practice (ASOP) Number 27, *Selection of Economic Assumptions for Measuring Pension Obligations.*

This response to the questions posed in the exposure draft is presented by actuaries who work primarily on small to mid-sized plans, including plans in which a significant portion of the pension obligation is attributable to principal employees.

Comments on the ASB Pension Committee's Questions

Question 1:

Is the language in section 3.1 of ASOP No. 27, indicating that assumptions can be based either on the actuary's estimate of future experience or on the actuary's observation of the estimates inherent in financial market data, clear? Do you agree that either approach produces a reasonable assumption? If not, what change do you suggest?

Response:

Each of the methods can produce a reasonable result for the intended purpose of each of the methods, but a wholly unreasonable result for other purposes. For example, the proposal states that "An assumption based on market observations is reasonable if it fairly reflects current financial market data." This is not an appropriate measurement of reasonableness for calculations relating to the determination of obligations under the Internal Revenue Code (IRC) and the Employee Retirement Income Security Act (ERISA), which require that reasonable *expectations* be considered, and that the assumptions in aggregate be expected to reflect the actuary's "*best estimate of future experience* under the plan". The inconsistency between the proposed ASOP and U.S. pension law is discussed further in Question 3.

We also suggest that, if the dual approach is to be retained, the ASOP elaborate on the concept of "fairly" reflecting financial market data in the reasonableness standard for the market observation approach, advise that this approach is not appropriate for most purposes, and make it clear that the standard is not endorsing past performance as a predictor of future returns.

Question 2:
Section 3 clarifies that there is no explicit link between an investment return assumption and discount rate. Does this create challenges for any existing actuarial processes? If so, please provide a description of the actuarial practice and how the new standard creates a problem. Is the removal of the material in section 3.6.2 of the current standard, which addresses the building-block method and the cash flow matching method, appropriate? Are the examples in section 3.7 of ASOP No. 27 sufficient to communicate the various purposes for which actuaries may need to choose a discount rate?

Response:
We do not agree that the general rule linking investment return and discount rates should no longer apply. The draft itself argues that investment return in many, if not most, cases is the proper expectation for setting a discount rate. The standard should maintain the link, but make it clear that the link depends on the context. Thus, when the assumption is based on the actuary's estimate of future experience, there is no breaking of the link. When the assumption is based on observation of the estimates inherent in financial market data, the link is appropriately broken. Section 3.7 b.-d. could then be presented as examples of when the link is broken.

With regard to the other issues raised in Question 2:

- There was no need to remove the building block approach as it remains applicable and has served the profession well.

- Additional examples of the different purposes would be helpful.

- The current section 3.6.2 provides examples of acceptable methods to develop a best-estimate investment return range. We believe the standard as written provides the actuary with more guidance than the proposed revisions.

- Much like the original section 3.6.2, section 3.7 of the exposure draft provides useful examples of what an actuary should consider in selecting a salary scale. We believe the revisions to this section are worthwhile.

Question 3:
Do you agree that a reasonability standard is an appropriate way to set economic assumptions? If not, why not?

Response:
In the U.S. the vast majority of pension actuarial practice is performed by actuaries who are enrolled to practice under ERISA. For IRC and ERISA purposes, it is not just the

setting of the discount rate for valuation purposes that is governed by law, but rather, their entire assumption setting regimen. IRC Sections 430(h) (1) and 431(c)(3) proscribe the use of actuarial assumptions and methods:

> "(A) each of which is reasonable (taking into account the experience of the plan and reasonable expectations), and
>
> (B) which, in combination, offer the actuary's best estimate of anticipated experience under the plan."

The requirement that the assumptions be "reasonable (taking into account the experience of the plan and reasonable expectations)" is not new. (Prior to enactment of the Pension Protection Act of 2006, the language was found in IRC 412(c).) Case law aligned this reasonable standard with the actuary's best estimate and with that estimate producing a range of acceptable assumptions. We note that the amended statute incorporates this "best estimate" concept. An excerpt from the 9th Circuit Court of Appeals Citrus Valley decision is attached as an example of a well-reasoned opinion in support of the "best estimate" approach. In essence this decision provided that:

- the actuary's best estimate is the appropriate standard with regard to calculations made under the IRC and ERISA;
- the best estimate approach produces a range of acceptable results; and
- since the primary goal is for the ability of the plan to be able to pay benefits when due, a leaning toward the conservative end of the acceptable range is not only allowable , it is preferred under the statutory construction of ERISA.

The proposed ASOP no longer endorses the use of the best-estimate range approach as a reasonable method, even though the best-estimate range approach is contemplated by statute (and as discussed in Question 1 above, the "market observations" basis is not). Furthermore, eliminating the best-estimate range implies that there is a single correct answer in the selection of an assumption. This premise is contradicted in the preamble where 7.2% and 7.4% are both considered to be reasonable results. If the ASB believes the width of the best-estimate range should be reduced, then it should revise the draft with approaches that would narrow the range, not eliminate the range approach.

The proposed change in the ASOP's framework for setting assumptions will require an actuary to caveat their choice of an assumption on the conservative end of the "best estimate" range methodology. In the context of determinations under IRC and ERISA, this not only creates unnecessary and unproductive work, but creates the perception that a desirable outcome – reasonable conservative assumptions – is substandard, similar to an assumption that ignored the standard completely. Given that the proposed revision was not meant to substantially change results, it seems that the benefits of the revision are outweighed by the compliance nightmare it will create.

Question 4:
Do you agree that the guidance on arithmetic and geometric returns is appropriate? Should the consequences of the use of geometric or arithmetic returns be disclosed?

Response:
It is difficult to see any validity in the use of arithmetic returns. The proposed revision to the standard states that the requirement that the assumption be unlikely to produce cumulative gains and losses points to the use of arithmetic returns. This is simply false. The fact that the assumptions look to not producing cumulative gains and losses versus individual annual gains and losses looks to a geometric return rather than arithmetic. If the ASB believes arithmetic returns may be used, then a revised draft should explicitly state when such methodology is appropriate.

Question 5:
Do you agree the guidance in section 3.6.3(d) regarding active investment management is appropriate?

Response:
This proposed language is acceptable.

Question 6:
Is the guidance in section 3.15.6 on the use of expert advice clear and sufficient?

Response:
The actuary must consider the purpose of the economic projection, and should be aware of the economic expectations of other advisors. This may include advice on such items as current annuity market conditions, trends of interest rates, or potential compensation structure changes. The position in 3.15.6 is broad enough to allow for consideration of such positions.

Question 7:
Do you agree that it may be appropriate for the actuary to include conservatism in his or her assumptions? Are the disclosure requirements for a conservative assumption sufficient?

Response:
It is appropriate, and often desirable, to include conservatism in assumptions. Unfortunately the exposure draft encourages actuaries to use more aggressive assumptions by removing the range of acceptable assumptions concept and mandating a disclosure that the assumptions include a margin for conservatism. For a private retirement plan, the actuary is tasked with setting assumptions that help insure the benefits promised under the plan will become a reality. In this context, we disagree with the implied bias toward aggressive or optimistic assumptions.

A degree of conservatism may prove unreasonable just like a degree of optimism could prove unreasonable. The Standard should be drafted to incorporate a requirement that an element of conservatism or optimism must be within the range of reasonability.

Question 8:
Do you agree it is appropriate to require the actuary to provide rationale for assumptions or changes in assumptions? If so, do you agree that the proposed changes represent the appropriate approach?

Response:
We do not agree that the actuary should be required to provide a rationale for each meaningful assumption. First, this type of disclosure is in the realm of ASOP 41. Further, like ASOP 41, it greatly over-reaches. The Standards of Practice are applicable to actuaries working on plans of all sizes. In both this Section of ASOP 27 and in ASOP 41, the ASB and the pension committee appear to have not considered the costs associated with the required disclosures, especially relative to the cost of the underlying assignment.

We believe the detail required in a disclosure should be tempered by the needs of the principal or user and the nature of the assignment. We believe ASOP 41 should be revised to reflect the same consideration.

Other Comments

ACOPA also offers the following comments:

1. Because of statutory requirements for ERISA retirement plans, certain determinations for a plan year may have been made before the effective date of the revised standard (such an AFTAP determination), with final calculations and reporting completed after the effective date. To smooth the transition to a revised standard, the revised ASOP should permit the actuary to apply the revised standards to plan years beginning after the effective date. For example, an actuary could be permitted to apply the new ASOP to determinations for plan years that begin on or after a date that is four months after the revised ASOP is adopted.

2. Section 3.15.5 Subsequent Events. A valuation that determines the minimum required/maximum tax deductible contributions under the IRC is precluded (with a very few exceptions) from recognizing events that occur after the valuation date. We believe the Standard should be drafted to emphasize Subsequent Events should not be recognized when such recognition violates the law.

   In some situations, the actuary may want to recognize a Subsequent Event. Examples include potential plan termination, declining health of a principal or pending merger or acquisition. In such case, the Standard should clearly state that the disclosure is not required if such disclosure would violate confidential or proprietary information.

In summary, we see that some revisions are an improvement over the original standard. However, we believe our comments are substantive and require a second exposure draft.

This letter was prepared by the ASOP 27 Task Force of the ACOPA Intersocietal Committee, Richard A. Block, Chair. The primary authors were Richard A. Block, MSPA; Robert Mitchell, MSPA; Kurt F. Piper, MSPA; and Thomas J. Finnegan, MSPA.

Thank you for your consideration of these comments.

Sincerely,

/s/
Annie Voldman, MSPA, President
ASPPA College of Pension Actuaries

/s/
Judy A. Miller, MSPA
ASPPA Chief of Actuarial Issues

/s/
Joseph A. Nichols, MSPA, President-Elect
ASPPA College of Pension Actuaries

/s/
Richard A. Block, MSPA, Chair
ASOP 27 Task Force

Addendum

Addendum

The 9th Circuit Court of Appeals in its review of). Citrus Valley Estates, 99 T.C. at 465 wrote:

> "The Tax Court rejected the Commissioner's attack and found that the challenged assumptions in each plan were reasonable in the aggregate and represented the actuaries' best estimate of anticipated plan experience in accordance with section 412(c)(3). Citrus Valley Estates, 99 T.C. at 465 (holding that plan contributions were properly deducted). The court recognized that the estimates generally fell on the conservative end of the range of acceptable assumptions, but nonetheless found that the assumptions passed the statutory standard.
>
> The Tax Court premised its findings on the belief that the primary duty of a plan actuary was to calculate a funding pattern that safeguards the ability of the plan to deliver the promised retirement benefit. Given this duty, the Tax Court held that it was appropriate for actuaries to maintain long-term conservative views in selecting actuarial assumptions, because cautious estimates result in higher levels of initial plan funding. Id. at 410 12, 426. The Tax Court noted that an element of actuarial conservatism was especially appropriate for new IDB plans that lack credible experience, as all of the plans in question indisputably did. Id. at 411.
>
> The Commissioner appeals the Tax Court's conclusion. Her challenge is entirely legal. She contends that the Tax Court misconstrued section 412(c)(3) and that as a result the court's findings are "robbed of all vitality." Appellant's Opening Brief in Citrus Valley Estates, Inc. v. Commissioner, 49 F.3d 1410, 1995 U.S. App. LEXIS 4500, *7. She urges the Court to remand the Phoenix Cases for reconsideration in light of what she argues are the correct legal standards. We review de novo the Tax Court's construction of the Code. See Estate of Poletti v. Commissioner, 34 F.3d 742, 745 (9th Cir. 1994).
>
> The essence of the Commissioner's complaint is that by endorsing the use of conservative actuarial assumptions, the Tax Court effectively read the "best estimate" provision out of section 412(c)(3). Although the Tax Court expressly found the "best estimate" provision satisfied in each case, the Commissioner argues that the Tax Court misapprehended the nature of the inquiry. Her position, simply stated, is that an assumption cannot be an actuary's "best estimate" if it reflects a more conservative view of an anticipated plan experience than the actuary believes is likely.

As Commissioner reads section 412(c)(3), not only must assumptions be reasonable in the aggregate, but also they must accurately reflect the actuary's subjective belief about the future. In other words, if a plan actuary selects a set of assumptions that the actuary personally does not believe will come true, the assumptions fail the section 412(c)(3) test, even if they are otherwise reasonable in the aggregate, because they do not reflect the actuary's "best estimate" of anticipated plan experience.

According to the Commissioner, the Tax Court's findings in this case are infirm because the court did not review the challenged assumptions under this substantive "best estimate" standard.

Without a doubt, the language of section 412(c)(3) can be read to support the Commissioner's reading. In addition, given the wide range of reasonable assumptions, requiring actuaries neutrally to pick the most likely result within the range would limit the ability of taxpayers to inflate their contribution deductions. These arguments notwithstanding, we follow the lead of the Second and Fifth Circuits and reject the Commissioner's reading of section 412(c)(3). See Wachtell, Lipton, Rosen & Katz, 26 F.3d at 295-96; Vinson & Elkins, 7 F.3d at 1237-39.

We begin our analysis with the recognition that Congress consciously left the specifics of IDB plan funding in the able hands of professional actuaries. See Vinson & Elkins, 7 F.3d at 1238. Although Congress initially toyed with the idea of legislating mandatory funding assumptions and methods for IDB plans, it quickly rejected the notion as excessively inflexible, even though it understood that giving actuaries room in which to exercise their professional judgment would result in a broad range of funding assumptions. See Vinson & Elkins, 7 F.3d at 1238; see also H.R. Rep. No. 807, 93d Cong., 2d Sess. 27 (1974), reprinted in 1974 U.S.C.C.A.N. 4670, 4694.

We will not disturb this legislative choice to delegate to actuaries an important role in plan funding decisions. Accord, Wachtell, Lipton, Rosen & Katz, 26 F.3d at 295-96 (citing S. Rep. No. 383, 93d Cong., 2d Sess. (1974), reprinted in 1974 U.S.C.C.A.N 4890, 4908 ("The actuarial assumptions made by actuaries in estimating future pension costs are crucial to the application of minimum funding standards for pension plans.")).

We further note that the section 412(c)(3) limitations on actuarial assumptions serve not only as a limit on maximum deductions, but also as a floor for minimum plan funding. This statutory scheme serves the dual but sometimes conflicting goals of guaranteeing adequate plan funding while preventing taxpayer abuse. "Within the range of reasonableness, Congress assigned the task of balancing these goals to actuaries. We will not narrow the statutory gap between the Scylla of underfunding and the Charybdis of tax penalties." Vinson & Elkins, 7 F.3d at 1238. So long as the actuary's funding decisions fall within the range of reasonableness, the substantive provisions of section 412(c)(3) are satisfied.

This means that the "best estimate" provision of section 412(c)(3), properly construed, is essentially procedural in nature. Accord, Wachtell, Lipton, Rosen & Katz, 26 F.3d at 296; Vinson & Elkins, 7 F.3d at 1238. The "best estimate" language is "principally designed to insure that the chosen assumptions actually represent the actuary's own judgment rather than the dictates of plan administrators or sponsors." Wachtell, Lipton, Rosen & Katz, 26 F.3d at 296. The Commissioner does not allege, nor does it appear in the record, that anyone in this case improperly influenced the actuaries' funding decisions.

We therefore hold that the best estimate provision of section 412(c)(3) was satisfied in each of the cases before us. The mere fact that the challenged assumptions fell on the conservative end of the acceptable range does not render them invalid as a matter of law. Conservative assumptions result in a higher level of initial plan funding, which helps ensure that IDB plans will be able to deliver the promised retirement benefit when due, clearly one of ERISA's most important goals. See H.R. Rep. No. 807, 93d Cong., 2d Sess. 8 (1974), reprinted in 1974 U.S.C.C.A.N. 4670 (noting that one objective of ERISA was to ensure that participants "do not lose their benefits as a result . . . [of the] failure of the pension plan to accumulate and retain sufficient funds to meet its obligations"). Although another goal was to prevent tax abuse by wealthy individuals, this concern was addressed primarily by the section 415 limits on the size of IDB plan benefits. See Code 415(b); H.R. Rep. No. 807, 93d Cong., 2d Sess. (1974), reprinted in 1974 U.S.C.C.A.N. 4670, 4702 (remarking that section 415 limits were enacted to prevent abuse of ERISA's favorable tax treatment by highly paid individuals).

Despite what the Commissioner asserts, our decision, faithful to the statutory scheme, does not give actuaries "unfettered liberty" to produce desirable tax results rather than prudent plan funding. First and foremost, plan funding decisions and methods must be reasonable in the aggregate. Code 412(c)(3). In addition, they must represent the actuary's professional judgment, not the tax-motivated wishes of plan sponsors or administrators. Wachtell, Lipton, Rosen & Katz, 26 F.3d at 296; Vinson & Elkins, 7 F.3d at 1238. Finally, plan actuaries must live up to national professional, ethical, and technical standards which help to minimize the risk of untoward advice. n3 Vinson & Elkins, 7 F.3d at 1238-39.

We find no legal error in the Tax Court's analysis under section 412(c)(3). The Commissioner does not separately challenge the factual findings of the Tax Court regarding the challenged assumptions. See Commissioner v. Duberstein, 363 U.S. 278, 289-91, 4 L. Ed. 2d 1218, 80 S. Ct. 1190 (1960) (reviewing factual findings of Tax Court for clear error). The Tax Court's conclusions therefore must stand."