AMERICAN ACADEMY *of* ACTUARIES

May 31, 2012

ASB Comments
Actuarial Standards Board
1850 M Street NW, Suite 300
Washington, DC 20036

Re: Comments on ASOP No. 4, *Measuring Pension Obligations and Determining Pension Plan Costs or Contributions*

To Whom It May Concern:

The American Academy of Actuaries[1] Pension Committee is pleased to present the following comments to the Actuarial Standards Board (ASB) regarding the exposure draft of Actuarial Standard of Practice (ASOP) No. 4, *Measuring Pension Obligations and Determining Pension Plan Costs or Contributions*. The Academy has groups spanning various practice areas that can offer different perspectives on issues. The Academy's Joint Committee on Retiree Health and the Academy/SOA Pension Finance Task Force will each be submitting comments on this Exposure Draft.

Market-Consistent Measure

In January 2012, the ASB issued a discussion draft regarding possible revisions to ASOP No. 4. The discussion draft included a proposal to define market-consistent measures (MCMs) of pension obligations. The proposal established the concept of a market-consistent actuarial present value and then applied that concept to define a specific measurement of a market-consistent actuarial present value of accrued benefits.

The ASB's Pension Committee issued an exposure draft of a proposed revision to ASOP No. 4 in January 2012. The exposure draft takes a large step in the right direction by defining market-consistent present values (MCPVs) as a subset generally of present values and acknowledges that these measures may vary depending on the purpose of the measurement. We applaud the ASB for making this change.

We have concerns, however, about classifying a present value as market consistent merely because the discount rate is determined on a market-consistent basis. This would

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[1] The American Academy of Actuaries is a 17,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

seem to ignore other elements of present values that may or may not be determined on a market-consistent basis. In addition, we believe that basing assumptions on market conditions is an evolving practice and that the single term “market consistent” is too narrow to encompass its many variations.

We believe that a more appropriate classification of present values in Section 3.7 would include three categories:

- *Present values that are discounted with an expected return on plan assets*. This category would be little changed from the current Section 3.7.1.

- *Present values that are discounted based on market pricing of future cash flows.* As detailed below, this category would encompass both obligations based on more strictly market-consistent discount rates (as discussed in the exposure draft) and obligations based on discount rates more generally derived from market observations.

- *Present values based on other discount rates*. This new category also is detailed below.

This focus on the discount rate input suggests that the more appropriate standard in which to elaborate on these distinctions is ASOP No. 27, not ASOP No. 4 (we are making similar remarks in our comments on ASOP No. 27). If the present-value terminology is not changed to include the references to discount rate, we believe that ASOP No. 4 should state clearly that using one particular assumption that is market consistent does not necessarily mean that the present value as a whole is market consistent, and explain the rationale for the terminology that is used in light of this fact.

Terminology

Present values not based on plan assets and MCPVs

In the exposure draft Sections 3.7.1 and 3.7.2 define two types of present values—present values based on plan assets (for which the obligation varies with the allocation and anticipated returns of the assets used to fund it) and present values not based on plan assets (for which the obligation does not vary with the allocation or anticipated returns of the assets used to fund it). As noted above, we recommend retitling and restructuring these sections in a more descriptive manner that (1) focuses on the discount rate, not the present value as a whole, and (2) reflects the fact that discount rates may be market based, i.e., derived from market observations without being strictly market consistent. We note that Section 4.1.1 of ASOP No. 27 requires the actuary to describe whether the discount rate represents an estimate of future experience, an observation of financial market data, or a combination of the two. The terminology for present values should be consistent with the terminology in ASOP No. 27.

Section 3.7.3 introduces the term *market-consistent present value* and further defines MCPVs as a type of present value not based on plan assets. We have several concerns

with this section, some of which already have been noted. We will articulate our concerns and then suggest an approach that addresses them all.

- There is an evolving class of measures that are "market based" and a single term of "market consistent" is not sufficient to describe all of them. In most contexts, discount rates that are not based on plan assets nonetheless are derived from market observations, even if those observations may not be current or rigorous enough to be considered fully market consistent. Examples of such rates are rates that include averaging (PPA rates, for example) or rates that are used for multiple periods before being reexamined.

- A present value should not be labeled as market consistent merely because the discount rate is determined in a manner that reflects current market conditions. Doing so is misleading and could reflect poorly on the profession and subject actuaries to substantial risks. In many situations, the discount rate will be the most important assumption but it is not the only one (for example, inflation, salary scale, cash balance interest-crediting rates, medical trend rates, demographic assumptions, etc.), and these other assumptions may or may not be market consistent.

- The examples in 3.7.3 a–c [additional considerations when calculating MCPVs] are too prescriptive and address only a small portion of the potential measurement purposes for which a market-consistent discount rate might be appropriate.

- From a presentation perspective, it is not clear why MCPVs are a distinct section as opposed to a subsection of 3.7.2. This could be misleading to the reader.

To address these issues we recommend the following changes:

- Section 3.7.1 should be retitled "Present Values that Are Discounted Based on Expected Return on Plan Assets."

- Section 3.7.2 should be retitled "Present Values that Are Discounted Based on Current or Past Market Pricing of Cash Flows," or some other title encompassing the broad range of discount rates that are derived from observations of market interest rates and are consistent with the terminology in ASOP No. 27.

- Section 3.7.3 of the exposure draft should be included as the first subsection of Section 3.7.2, entitled "Present Values Based on Market-Consistent Discount Rates."

- A new subsection within Section 3.7.2, entitled "Present Values Based on Other Market-Derived Discount Rates," should follow. This type of present value would be described as based on discount rates that more generally are derived from market observations, but are not based so specifically on current market conditions on the measurement date that they would be considered market consistent. Examples of such discount rates include rates that average market rates

over a period of time or that were based on market conditions on a date other than the measurement date.

- A new Section 3.7.3 should include present values discounted using any other discount rates, those that are based neither on expected earnings nor on the market-pricing-based discount rates under 3.7.2. Examples of such discount rates include rates that are prescribed, rates stipulated in plan documents, rates used for modeling what future conditions might be, and rates based on a principal's internal measures—such as its cost of capital.

- Finally, Section 3.7 should note that some present values may be based on a combination of discount rates determined under Sections 3.7.1 and 3.7.2 (and possibly even 3.7.3). Examples of such rates may be found in the corporate, multiemployer, and public-sector practices.

- We also recommend deleting the portion of exposure draft 3.7.3 (which under our recommendation would be the first subsection of 3.7.2) beginning with "Additional considerations include…" We believe, however, it is still worthwhile for the ASOP to make clear that when determining a market-consistent discount rate, it might or might not be appropriate to consider payment default risk based on the facts and circumstances of a particular measurement as well as the potential to "make estimates for valuation parameters that cannot be readily observed in the marketplace."

Advancing Practice

Market-consistent measurement is an evolving area of interest. As discussed above, the discount rate is only one element of such measurements. It also is possible to identify other inputs to present-value calculations that can be determined on a market-consistent basis. Although we believe that actuaries should be allowed to consider or perform such measurements as they judge appropriate, we do not feel that practice, knowledge, and tools have advanced sufficiently to warrant their inclusion within an ASOP or to prescribe particular usage. Thought and practice still are evolving in this area and we believe that the most appropriate manner in which to advance this development is through a practice note. The Academy, therefore, will consider developing a practice note that will discuss more thoroughly the issues and approaches for market-consistent measures. We would be happy to discuss with the Pension Committee of the ASB areas to be addressed in such a practice note.

Economic Value

The Transmittal Memorandum, Section 3.5.3 and Section 3.7.3, makes reference to economic value. However, economic value is not defined in the ASOP and might be interpreted in various ways—some of which are substantially different from each other. We recommend that the ASB remove the term entirely, as it is ambiguous and potentially

misleading. If the term is retained then the standard should define it explicitly in Section 2.

Fully Funded

Section 4.1.p requires an actuary who discloses that the plan is fully funded to disclose the specific measures of plan assets and liabilities underlying the determination. The actuary also is required to disclose:

1. Whether the market value of assets is sufficient to settle the obligation,

2. that being fully funded is a point-in-time measurement,

3. whether there is significant risk that the plan may cease to be fully funded, and

4. that additional contributions may be required if the plan is fully funded relative to accrued benefits but not projected benefits.

As discussed in more detail below, we believe the board's concerns could be addressed by replacing these disclosures under 4.1.p with a limited qualitative disclosure, such as the following statement (which could be included in the ASOP as an example):

> "An actuarial valuation is only a snapshot of a plan's estimated financial condition at a particular point in time and is based on the underlying data, assumptions, and methods; it does not predict the plan's future financial condition or its ability to pay benefits in the future. Even though a particular measurement of a plan's assets and its actuarial liabilities may show that the plan is fully funded, some or all of the following may occur: assets may not be sufficient to settle the obligations of the plan now or in the future; the plan may not be fully funded in the future; current or future contributions may be required by law or funding policy."

We recognize the ASB's concerns regarding the potential misunderstanding of fully funded (or a similar measure, such as a ratio that exceeds 100 percent). But we object to the first and fourth disclosure requirements because they might require the calculation of measurements that have not been performed, may not be desired by the principal, and for which the actuary likely would not be compensated. For example:

- The actuary might not know whether the market value of assets is sufficient to settle the obligation. For example, assume an actuary discloses that a particular plan is 105 percent funded on the basis of the liabilities used to determine the plan's minimum funding requirement. If the plan sponsor has not indicated any intent to terminate, the actuary likely will not have measured the plan's liability on a settlement basis. In such an instance, the actuary will be reluctant to make any statement regarding the plan's funded status on a settlement basis because he has no information on which to base a statement (except perhaps that the plan will likely be less well-funded when measured that way). Certainly the actuary can not

and should not make any quantitative assessment without doing additional work that is out of the scope of his or her engagement with the principal.

- The fourth disclosure requirement could be read to require the actuary to make a quantitative assessment of the plan's funded status on a projected basis (even though that assessment itself need not be disclosed). Such an assessment may not be available and may be beyond the scope of the engagement. It is also unclear why the fourth disclosure requirement always should be made, since most often a fully-funded plan is fully funded relative to accrued benefits or liabilities but not relative to projected benefits. In those cases, future contributions not only may be required but are expected to be required. If this requirement is retained, we suggest that Section 4.1.p be clarified to reflect the expected relationship between full funding under the particular measurement being used and the need for future contributions based only on existing, if any, quantitative measurements relative to projected benefits.

Future Assessments and Projections

In several areas (for example, Section 3.13.4, 3.13.5 and 4.1 l), the actuary is required to examine the progression of costs and/or contributions and potentially make certain disclosures based on the results. Such a requirement could require extensive additional work that the principal may not need and for which the principal is not willing to compensate the actuary. We believe that these sections should be revised to state specifically that they do not require that the actuary perform additional calculations that are outside the scope of the engagement with the principal.[2]

In some situations in the ordinary course of the actuary's work, there may be a reason to expect a significant trend of either increasing or decreasing contributions. In such situations it would seem appropriate to disclose this expectation with a qualitative statement. For example, in the case in which the actuarial value of assets is significantly higher than the market value of assets, the actuary may state that this creates an expectation of higher contribution requirements in the future, without being obligated to determine the actual magnitude of the expected increases.

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[2] It is important that these sections of the standard explicitly do not require calculations that are outside of the scope of the engagement with the principal. An example of a situation in which the disclosures in these sections should not apply is when an open-group projection of the liabilities would reveal that emerging demographic trends will result in significantly higher or lower normal costs in future years. The actuary will only be aware of this trend after performing an open-group projection, which frequently is not part of the engagement with the principal. If this situation leads to a required disclosure under the standard, actuaries would need to perform complex projections as part of every valuation in order to comply.

Chosen Actuarial Present Value Type

Section 4.1i requires disclosure of "the type of actuarial present value… and a general description of the implications of the chosen… type." We believe this section should be eliminated for several reasons. First, as noted in our comments on Section 3.7, we believe that it is not appropriate to categorize a present value based solely on the discount rate used to determine it. Disclosing such a categorization would be oversimplified and misleading. This concern is allayed if our comments on Section 3.7 are addressed and the descriptions of the present-value types are modified to make clear that only the discount rate is being categorized rather than the entire present value.

Second, the notions of market-consistent and market-derived liabilities continue to evolve, and the lines between them are still in flux. As a result, actuaries may be reluctant to describe a present value as falling into one of these subcategories. We note that if Section 4.1i is retained, this particular concern could be addressed by specifying that the actuary only need categorize the discount rate as more generally market derived without specifying whether it is market consistent.

Third, the requirement to categorize a present value in situations in which the actuary does not select the assumptions is problematic as it may be interpreted as the actuary endorsing or concurring with the assumption by providing such categorization. We believe, finally, that disclosures required in other portions of this standard as well as by ASOPs No. 27 and No. 41 provide sufficient information to the user.

In the event that this section is retained or moved to ASOP No. 27, we strongly believe that the disclosure should be limited to the type of discount rate and should be required only in situations in which the actuary selects the assumptions used to determine the present value. The requirement to disclose the implications of the type of present value is vague and the sample implications are both speculative and oversimplified (plans often require a variety of measurements with potentially conflicting incentives). The incentives inherent in a particular present-value measurement will vary with the context and purpose of the measurement. Identifying one incentive without identifying other incentives relevant for a particular measurement may be perceived as misleading the user of the information. The likely result of such a requirement is that actuaries easily could be challenged as not meeting the requirement, because particular implications or incentives that were not explained proved to be significant in retrospect. The requirement to disclose implications, particularly about investment policies, seems to go well beyond what we believe the actuary should be required to communicate to a principal or interested party.

Amortization Method

In the request for comments within the exposure draft, items 5 and 9 (Page x) touch on the issue of disclosure with respect to the contribution-allocation procedure. We wish to comment specifically on the amortization method aspect of that procedure. Sections 2.6 and 2.8 provide definitions of these terms. Section 3.13 provides guidance on what the actuary should consider, and what to disclose when selecting and using these procedures.

We are concerned that the only specific guidance on the amortization method is implicit: 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"** (Section 3.13.2). The guidance for mandated methods similarly requires disclosure when the procedure is "significantly inconsistent" with the accumulation of sufficient assets (Section 3.13.2). We suggest that, given the common understanding of the term amortization[3], it would be appropriate for ASOP No. 4 to provide explicit guidance on the selection and evaluation of an amortization method (just as is provided for the actuarial cost method, in Section 3.12). In particular, the standard should provide guidance regarding certain characteristics of an amortization method that should be disclosed. For example:

> "If the amortization method is not anticipated to reduce the unfunded liability (i.e., the unfunded liability is expected to increase because contributions are less than normal cost plus interest on the unfunded liability), OR the unfunded liability is not ever expected to be fully amortized, even if all actuarial assumptions are realized and contributions are made when due, then this fact should be disclosed. These situations can arise under the following amortization methods:
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> 1. The amortization payments in the current year are less than interest on the unfunded liability (typically the case early in the amortization period when payments are a level percentage of an increasing payroll and the amortization period is sufficiently long), OR
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> 2. The amortization period is reset each year to the original period (open or rolling amortization), so that amortization of the liability never is completed."

We believe that these situations should be disclosed. Consideration also should be given as to whether the standard should discourage an actuary from recommending (or selecting) an amortization policy that has BOTH of the features described in 1 and 2 above, since, in that case, the unfunded portion of the liability will be expected to grow rather than be amortized (i.e., there is perpetual negative amortization). Describing this as an amortization method may be misleading, given the common understanding of what amortization means (referenced above).

These disclosures should apply regardless of whether the amortization method is selected by the actuary, prescribed by applicable law, or selected by others.

The Pension Committee appreciates the opportunity to comment on this matter and would be happy to discuss any of these items with you at your convenience. Please contact

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[3] Amortize: to liquidate or extinguish (a mortgage, debt, or other obligation), especially by periodic payments to the creditor or to a sinking fund. www.dictionary.com

Donald Fuerst, the Academy’s senior pension fellow (202-785-7871, fuerst@actuary.org) if you have any questions or would like to discuss these items further.

Sincerely

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