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:

These comments on the exposure draft for Actuarial Standard of Practice No. 4, *Measuring Pension Obligations and Determining Pension Plan Costs or Contributions,* are submitted by the Pension Finance Task Force. In addition to these comments, other comments will be submitted separately by the Academy's Pension Committee and Joint Committee on Retiree Health.

As background, the Pension Finance Task Force is sponsored jointly by the Society of Actuaries and the American Academy of Actuaries[1]. The mission of the task force is threefold:

- To study how basic principles of finance and economics can be incorporated into retirement actuarial practice and used to strengthen retirement systems;
- To educate actuaries, plan sponsors, and other stakeholders on these principles, especially with regard to measuring and understanding risk, cost, and value in retirement systems;
- To provide and assist in formulating views based on sound economic principles for public statements by the profession.

This mission compels us to take significant interest in the development of ASOP No. 4.

Background

Actuarial analyses of pension obligations need to provide a sound basis for understanding the financial nature of future benefit promises. It should be the actuarial profession's duty to lead and to advocate for the best solutions under this overriding objective. Our profession's obligation, therefore, should be to disseminate sound principles and standards of practice that

[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.

support this ultimate goal. We are grateful to the Actuarial Standards Board for its efforts in this important area, and we are pleased to submit these comments for consideration.

Market Consistency

We applaud the inclusion of a definition for "market consistent present value" in the exposure draft and we believe that the Actuarial Standards Board has defined it well. The definition addresses the essence of market consistency while also recognizing that no single approach is best in all situations. Many factors affect the determination of market-consistent values in any specific case, and it would not have been possible to anticipate all possibilities in a more prescriptive definition. The proposed principle-based definition can remain relevant even as the pension plan environment evolves.

Market-consistent values are of critical importance. A properly determined market-consistent value represents the amount at which an obligation would trade without violating the *Law of One Price*. It is consistent with the market values reported for other assets and obligations, enabling comparability and meaningful analysis for all stakeholders. It reflects current economic conditions, such as discount rates used to value similar obligations. It objectively manifests the consensus judgment of market participants. While the results of other valuation approaches can vary widely, market-consistent measurements should fall within a tighter range even if determined using different techniques. Although other values may be of interest to particular parties, these very important qualities apply specifically to market-consistent values.

Depending on the purpose of the measurement, it might be appropriate to reflect the possibility that a payment may not be made in full. Examples in 3.7.3(a) and (b) properly assume no probability of default when determining plan solvency, funded status, and contribution requirements. The example in (c) reflects default risk, but we believe that it is unclear because it relies on "economic value," which has not been defined. More importantly, addressing default risk can be quite complicated. Governmental guarantees (such as those provided by the Pension Benefit Guaranty Corp.) may provide some protection against default. Dedicated assets and the relative seniority of pension debt may provide additional security. We suggest that the ASOP simply acknowledge that an actuary may, for purposes other than those identified in 3.7.3(a) and (b), want to reflect the potential for nonpayment in market-consistent measurements.

We believe that market-consistent values should be determined and disclosed on a regular basis because plan sponsors cannot understand the financial position of the plan without knowledge of a market-consistent measure of the funded status. That is, it would be misleading for plan sponsors never to have a market-consistent measure of the funded status. As a result, we recommend that plan actuaries be required to provide plan sponsors with a funded status based on a market value of assets and a market-consistent value of the liabilities at least annually—more frequently if, in the actuary's judgment, omitting these measurements could mislead the principal or other users of the valuation information. In addition, we believe that the only useful measure of plan solvency is based on a market-consistent present value of the obligation and a market value of assets. A statement of plan solvency on any other basis would be misleading. Note that we see the disclosure asked for in 4.1(o) as providing little value if the amount based on the immediate-gain method is not market-consistent.

To the extent that the phrase "fully funded" is viewed as implying that a plan is fully solvent (i.e., all benefits are payable with no further contributions), additional disclosures that clarify that that is not the case (if indeed it is not the case) should be required.

We recognize that a fully rigorous calculation of market-consistent values can be complicated. For example, many pension plan provisions involve embedded options for which valuation approaches may be difficult or not yet fully developed. (We are aware of the Society of Actuaries' research efforts in this area[3]) At this stage, we believe that a reasonable and practical proxy in most cases is the discounted value of expected cash flows using a market-implied discount rate, modified as necessary in accordance with Sections 3.5.3 and 3.14 of the exposure draft. We believe that this would not represent a significant additional cost or burden for actuaries already performing other valuations for a plan sponsor. We hope that as the actuarial profession and the users of our work increasingly emphasize market-consistent values, such simplifications will cease to be necessary.

Other Comments

We found the definition of "Cost" in section 2.9 to be vague and confusing. It does not seem to encompass measures like net periodic benefit cost defined by ASC 715 or IAS 19. Such measurements are not a portion of plan obligations; they typically include components that depend on assets as well. Section 3.13 also implies that the cost may be influenced by assets, rather than simply representing a portion of plan obligations. The definition of Cost as now written seems to be redundant with the definition of Normal Cost in 2.16.

The use of such terms as "value," "cost," and "liability" has significant implications for the communication of the actuary's work and clarifying these terms within the context of actuarial practice would be useful. This version of ASOP No. 4 may not be the appropriate place to first define these terms for the profession, but clarifying these terms would ensure a better understanding of the actuary's work. Section 3.7.1 uses the phrase "expected return on plan assets." We recommend using "assumed return on plan assets" in its place. We believe that this is more accurate and avoids the dangerously misleading implication that this parameter can be predicted with any degree of accuracy. The label "assumed" more clearly indicates that this is an assumption rather than an objective observation. Similar changes should be made to any other instances of the phrase "expected return on assets."

Section 3.10 addresses the measurement of the value of accrued or vested benefits. These ordinarily would be plan-solvency measures. In the absence of an externally prescribed methodology and assumptions, they should be measured in a market-consistent manner.

Section 4.1(p) specifies items that are to be disclosed for plans described as fully funded. Items (2), (3), and (4) are important not only for fully funded plans. No matter what the funded level, it is important to state that the measurement is at a point in time, that it could change (in either direction), and an indication that it is measured relative to accrued or projected benefits.

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[3] http://www.soa.org/Files/Research/Projects/research-catalogue-survey-report.pdf

Structure of Standards of Practice

We find the collection of Actuarial Standards of Practice to be structurally confusing. The same terms or concepts, or very similar ones, may be defined differently within different standards. Restructuring the entire body of standards is no doubt an extremely complex task, and one that may be difficult to accomplish incrementally. We do not have a concrete proposal in this regard, but we support efforts to develop a streamlined framework with fewer standards and more intuitive connections. We believe that the issuance of the exposure draft for the *Introductory Actuarial Standard of Practice* represents a positive step in clarifying basic definitions that are referenced by many standards. In fact, an explicit reference to this document would be welcome in ASOP No. 4. We believe that many actuaries are not aware that terms such as "should" and "significant" are formally defined within the standards, and instead rely on the general uses of these terms when they are encountered in the standards.

We again thank you for affording us this opportunity to provide feedback on the exposure draft. We would be pleased to provide additional detail on any of these comments. If you have any questions or require further information, please Donald Fuerst, the Academy's senior pension fellow (fuerst@actuary.org; 202-785-7871).

Sincerely,

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