

Comment #15 – 10/20/14 – 11:09 a.m.

Background:

I was impressed with the information you and Rep. Drury provided on the current status of reporting for public pension plans. Essentially the reports are short, do not describe the assumptions well, do not provide sensitivity testing nor a range of results and are often based on assumptions provided by the client. Of special note, a range of investment rates is not tested.

I am a consulting actuary with over 20 years of practice with life insurance company asset adequacy analysis. This includes providing “desk audits” (reviews, not in depth), modeling and performing cash flow testing and auditing and reviewing the work of other actuaries. I am familiar with the extensive standards of practice which govern this.

Thus I am familiar with the way life insurance has statutory reserving assumptions which are formulaic and prescribed and the reserves determined by them are tested by asset adequacy analysis (AAA) in light of the underlying assets. If the formulaic reserves are not adequate, an extra reserve is set up based on this analysis.

Because the general public is not considered qualified to understand this analysis (AAA), the memorandum describing this is considered confidential and to be demanded only by the insurance department, which can review this for reasonableness in light of professional standards. Of course, states also have quinquennial audits, which can be more in depth. Also statutory actuarial statements are reviewed by a CPA auditor, who also can retain actuarial support.

Thus life insurance reserves are reviewed objectively and tested in light of reasonable assumptions. It amazed me that this is not so for public pension plans. How could this have gone on so long?

Solution:

My initial thought is to use the life insurance asset adequacy memorandum as a paradigm and try to transpose it to public pensions. Thus a confidential memorandum would be produced showing the health of the public plan. This would be reviewed by a state insurance department, which would presumably have staff or hire consultants.

For life insurance, usually the analysis is based on surplus projections for various scenarios. For the public plans, I believe more emphasis would be on what contributions are necessary to mature the plans. Presumably this would be based on current policyholders only and not on any new ones.

If a state department reviewed it, there would be some confidentiality of the detail. As a practical matter, this would involve hiring staff and this might become a budget issue. Perhaps consultants could be used and the cost of the consultant would be borne by the company directly or perhaps by some special tax.

Another level of review life insurance companies use is their own CPA who certifies their statement. Such CPAs hire actuarial staff, who can review the work, both the asset adequacy memorandum and other matters, and report to the CPA. If passing extra budget for state staff is an issue, requiring a CPA for a public pension plan and requiring an asset adequacy memorandum which could then be reviewed by the CPA would at least be a step in the right direction. Objective professionalism (“another pair of eyes”) should insure some objectivity.

I do not wish to go into too much detail until the industry scopes out the general approach. For example, in pensions, often the controversial assumption is the interest. Some other assumptions are standard industry assumptions. This might affect how to create professional ASOPs to guide the process.

If a higher interest is used, the required contributions would be lower. This means more money available in the state budget for other projects. Thus if a lower interest rate is used, it must have sufficient credibility to prevent the legislature from trying to use a higher one to cut the contribution.

My consulting practice was built heavily on asset adequacy work for life companies. I am not a pension actuary. I am interested in the public pensions situation because I live in Illinois and would be willing to help if this goes any further.

JIM THOMPSON