SOCIETY OF ACTUARIES

475 N. Martingale Road
Suite 600
Schaumburg, IL 60173
847.706.3500 tel
847.706.3599 fax
www.soa.org

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Via e-mail: comments@actuary.org

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

RE: ASOPs and Public Pension Plan Funding and Accounting

Dear Members of the Actuarial Standards Board.

The Society of Actuaries (SOA) would like to thank the Actuarial Standards Board (ASB) for its Request for Comments – ASOPs and Public Pension Plan Funding and Accounting. We thank the ASB for taking this innovative approach for gathering input on this issue.

The SOA's vision statement references the role that actuaries play in "[measuring and managing] risk to support financial security for individuals, organizations, and the public." Public sector defined benefit pension plans (public sector plans) involve a unique intersection of stakeholders: individuals (who benefit from the plan), sponsoring organizations (state and local government entities that sponsor or participate in plans), plan trustees and administrators who run the plans, and the public (who fund these plans through taxes). The measurement and management of risk in public sector plans is vital to the interests of all of these parties.

Our responses to the questions in the Request for Comments, which begin on page 2, are driven by consideration of the needs of these stakeholders. The responses consider the following environmental factors:

1. Public sector plans are almost unique in that, **there is not typically an independent, third-party regulator governing the funding/solvency of public sector plans,** as contrasted with most other situations where actuaries perform work (e.g., private sector defined benefit pension plans (private sector plans), insurance)**.** While many states do have regulations guiding the funding of public sector plans in that state, time and again governments have set inadequate contribution levels[1] or have decided not to make the recommended contributions.[2]

2. **In the absence of a third-party regulator, there is a misperception that Actuarial Standards of Practice (ASOPs) are de facto regulation governing public sector plan funding.** This is not to say that the ASB should seek to be the regulator of these plans; rather, there is a misperception in the public plan community (i.e., sponsors, trustees, participants) about the role of ASOPs. While the ASB did not create the misperception, there is nothing in the ASOPs that addresses it; for example, the ASOPs do not require actuaries to disclose that ASOPs do not act to regulate the funding of plans.

The fundamental problem is that ASOPs have become subject to misperception. We have seen references that meeting ASOPs ensures that a funding method produces sufficient contributions.[3] But ASOPs were not designed to ensure solvency: they "provide the actuary with an analytical framework for exercising professional judgment, and identify factors that the actuary typically should consider when rendering a particular type of actuarial service." (ASOP 1, paragraph 3.1.4). ASOPs ensure the purchaser of actuarial services (organizations) receive consistent and thorough actuarial work; they are not written to protect the product's end user (e.g. public sector plan participants) or the general public. Contrast this with the role of Financial Accounting Standards, which do have a purpose to protect shareholders and bondholders.[4]

Unfortunately, even sophisticated users of actuarial information may assume ASOPs serve that same role. One disturbing example is that the Government Accounting Standards Board (GASB) has suggested that any permissible discount rate under ASOP 27 is appropriate for accounting purposes.[5] But ASOP 27 was never designed to state what was a permissible discount rate for accounting purposes; it was designed to guide the actuary in the selection of discount rates for numerous purposes, among which could include financial accounting.[6]

3. **Finally, we have noticed significant differences between the funding practices for public and private sector defined benefit plans.** We acknowledge that public plans are different than private sector plans, but the similarities are greater than the differences. While some funding entities are unable to declare bankruptcy, an inability to declare bankruptcy does not diminish the importance of strong risk management practice; these plans have practical limits on their ability to draw on taxpayer resources. We are concerned that we see many public sector plans using practices that have not been used by private sector plans or that have been abandoned by private sector plans around the world.[7] We see public sector plans making choices about risk taking that go against basic risk management principles. For example, public sector plans in the U.S. are unique in that they have taken additional risk as the plans have become more mature, compared to private sector plans in the U.S. and private and public sector plans in Canada, UK and the Netherlands, which have taken less risk as plans have matured.[8]

We have specific response to the questions below, referencing the question numbers in the Request for Comments. We have not provided a response to question 5.

1. *… Is additional guidance needed, beyond that in the recently revised pension ASOPs, regarding appropriate public plan actuarial valuation practice to assist actuaries in performing their work and advising their principal? Why or why not?*

We do believe additional guidance ought to be provided, for the reasons we have previously cited: lack of an independent regulator, a misperception about the role of ASOPs, and the significant differences between funding for private and public sector plans. We provide some examples of possible guidance in the response to question 2.

However, if the ASB elects not to make any changes to the ASOPs that would provide additional guidance, it should consider adding requirements for actuaries to make additional disclosures in communications covering funding of those plans that are not covered by funding/solvency standards set by independent third parties. Such disclosures could note that ASOPs set principles for actuaries in choosing funding assumptions and methodology but do not provide strict guidance for actuaries on whether any particular economic and demographic assumptions or any actuarial method is appropriate or inappropriate for plan funding. Or, alternatively, the disclosures could note that ASOPS are not akin to accounting standards set by the FASB/GASB (which provide strict regulatory oversight on accounting) and as such are not designed to provide specific regulatory oversight to the practice of plan funding.

2. *If yes to question 1, in what areas is additional guidance needed?*

Examples of additional guidance could include the following:

- Guidance as to what constitutes an actuarially sound funding policy. This may be challenging, as there is not universal agreement among the profession on the meaning of "actuarial soundness" in this context. We recommend that such guidance be principle-based (e.g., achieve X) rather than prescriptive (e.g., doing X not Y). For example, a potential principle might be that the funding methodology would be expected to achieve full funding over the average remaining working lifetime of the active participants.
- More specific guidance that limits the practice of public sector plans to practices more akin to where private sector plans are today, or were under previous regulation. The ASB could reference specific private sector plan practices (e.g. asset smoothing periods no longer than 5 years, which was the ERISA standard before PPA). For more principle-based approaches, the ASB could, for example, provide guidance on amortization methods that amortization of any unfunded amounts should not be less than interest on the unfunded (i.e. no negative amortization); separate bases should be established annually for gain/loss, assumption/method changes and plan changes; and/or shorter amortization periods should be used for changes affecting retired populations as opposed to active populations.

3. *If yes to question 1, should that guidance take the form of a separate public plan actuarial valuation standard or be incorporated within the existing ASOPs? Why or why not?*

We believe a separate public plan standard is warranted. Public sector plans and private sector plans simply have different needs from the ASOPs, given the public misperception that the ASOPs are designed to provide a protection to the plan participants and the public (which they are not), and given that actuarial practice for public sector plans today differs significantly. In our view, creating one ASOP that addressed the difference in practice between public sector and private sector plans without providing duplicative (and possibly contradictory) guidance for private sector plans would be extremely difficult, and likely not worth the effort of keeping the standards together.

4. *In general, the ASOPs are principles based and not rules based. As a result, the ASOPs are generally not highly prescriptive. Should the ASOPs related to public plan actuarial valuations be more prescriptive? If so, in what areas?*

We agree that ASOPs should not in general be prescriptive. However, given that public sector plans are not generally regulated by third parties, specific guidance on what the assumptions and methods ought to achieve could be described without dictating contribution levels; we've provided some examples in the answers to question 2.

If the ASB strictly does not wish to provide more specific guidance then it may want to be clear, through requirements for actuaries to make additional disclosures, that ASOPs do not provide sufficient guidance to ensure that all combinations of methods and assumptions create a sound funding policy. This is discussed more in the response to question 1.

6. *The current definition of an "intended user" of an actuarial communication is "any person who the actuary identifies as able to rely on the actuarial findings" … Should the ASOPs require the actuary for public pension plans to perform additional, significant work … that is not requested by the principal if that work provides useful information to individuals who are not intended users? Why or why not? If so, should this requirement be extended to all pension practice areas? Why or why not?*

We believe additional information should be provided in disclosures for public sector plans. Again, there is generally no independent regulator for public sector plans. The actuarial report, and the actuarial information contained in the governmental entities' Comprehensive Annual Financial Report (CAFR) is the only information on the obligations that is reported to the public. These documents typically only give one measure of the obligation.[9] Given the lack of independent, third-party oversight, there should be additional work provided so that the users of the report best understand the risk. This information can be structured in a way to reduce cost and improve decision making.[10] Creating the obligation through ASOPs would create a level playing field for all actuaries and all organizations using actuarial services. Finally, as discussed in our response to question 4, we believe that the regulatory deficiency that creates this need for additional information is best handled through a separate actuarial standard for public sector plans, so we do not believe extension to private sector plans would be appropriate.

We recognize that the ASB may not wish to set such standards. Again, at a minimum, if the ASB decides not to act, it may wish to mandate additional disclosures by actuaries, e.g. that the funding obligation calculated is only one potential estimate of the cost; actual cost will likely vary significantly based on experience and future costs could be significantly higher or lower than the value suggested by this number.

Finally, in closing, we note that the role that actuaries in public plans play is difficult. However, they are the only advisors trained to understand the obligation these plans have taken on. If the actuary does not provide an unbiased measure of the obligation, and a complete assessment of the risk inherent in that obligation, who will? ASOPs can act to specify behavior that benefits the users of actuarial products (e.g. plan participants) and the public by providing actuaries the shield to act to raise the issues to ensure stronger funding of plans. State and local governments may choose to not fund the plans properly, but that choice ought to be made in the context of sound advice and explicit disclosures from their actuary.

Respectfully submitted on behalf of the Society of Actuaries,

Errol Cramer,
President, Society of Actuaries

[1] Most commonly cited examples are plans which set a fixed contribution level regardless of the actual funding of the plan. For example, the City of Chicago's contributions to four city-sponsored systems are set by the Illinois State Legislature at a multiple of the fixed employee contribution rate. The Employees' Retirement System of Texas fixed employee and employer contribution rates as a percentage of payroll; in the 2012 actuarial report, the actuary noted that unless the contribution rate was increased, the unfunded liability was expected to grow indefinitely (the plan would never be fully funded).

[2] Between 2001 and 2012 the percentage of plans receiving at least 90% of the Annual Required Contribution (ARC) under GASB 25/GASB 27 fell from over 85% to just over 60%. While the ARC is not a statutory measure and is for financial reporting purposes only, it has been used as a benchmark for whether public plans are contributing amounts sufficient to fund the benefits. Brainard, Keith. 2013. "Public Fund Survey: Summary of Findings for FY 2012." National Association of State Retirement Administrators and National Council on Teacher Retirement, at http://www.publicfundsurvey.org.

[3] The ASOPs permit amortizations that do not pay down principal, e.g. rolling amortization methods which restart the amortization of the unfunded (surplus) every year. In addition, percent of payroll amortization methods that use long periods can grow the unfunded (surplus) amounts for many years.

[4] Financial Accounting Standards are not generated by accountants' professional bodies (e.g., American Institute of Certified Public Accountants) but by separate accounting standard-setters (e.g., the Financial Accounting Standards Board (FASB)) which are given weight and authority by other regulatory bodies (e.g., the Securities and Exchange Commission (SEC)).

[5] See "GASB's New Pension Standards: Setting the Record Straight" at http://www.gasb.org/cs/ BlobServer?blobkey=id&blobwhere=1175824677340&blobheader=application%2Fpdf&blobcol =urldata&blobtable=MungoBlobs, Q&A 4, paragraph 1).

[6] For private sector plans, FASB's Accounting Standards Codification for retirement benefits (ASC715) provides guidance on how to set discount rates that makes no references to ASOPs in the standard or implementation guides.

[7] For example, public sector plans use rolling period amortization methods and/or percentage of payroll amortization methods (and sometimes will use them in combination). Neither of these practices were ever permissible under ERISA (singly or in combination) for single employer private sector plans. Public sector plans will amortize regular gains/losses (due to asset performance or actual experience over assumptions in the liability) over 30 years; ERISA never permitted gains/losses to be spread a period longer than 15 years.

[8] Andonov, Aleksander, Rob Bauer and Martijn Cremers. 2013 (September). "Pension Fund Asset Allocation and Liability Discount Rates: Camouflage and Reckless Risk Taking by U.S. Public Plans?" Presented at the Federal Reserve Bank of Cleveland Conference, Public Pension Underfunding: Closing the Gaps. Available at http://www.clevelandfed.org/events/2013/pensions/presentation-cremers-andonov-bauer-and-cremers-asset-allocation-and-liability-discount-rates-2013-09-27.pdf. See also *Report of the Blue Ribbon Panel on Public Plan Funding*, Society of Actuaries, 2014, figures 6 and 7, which show an increase in investment in risky assets (figure 6) during the same period that the ratio of actives to annuitants has dropped (figure 7).

[9] With the changes to government accounting standards, some plans now will show liability calculations at two discount rates; however, in contrast, for private sector plans, there are calculations for the funding liability, FAS 35 and two calculations for financial accounting standards.

[10] *Report of the Blue Ribbon Panel on Public Plan Funding*. 2014. Society of Actuaries. Donald J. Boyd and Peter J. Kiernan. 2014. *Strengthening the Security of Public Sector Defined Benefit Plans.* Rockefeller Institute. Available at http://www.rockinst.org/pdf/government_finance/2014-01-Blinken_Report_One.pdf