November 12, 2014

Actuarial Standards Board (ASB)
Request for Comments – ASOPs and Public Pension Plan Funding and Accounting
Via e-mail: comments@actuary.org

To the ASB:

The undersigned, all members of the Society of Actuaries' Blue Ribbon Panel on Public Pension Plan Funding, are pleased to submit the attached response to your Request for Comments –ASOPs and Public Pension Plan Funding and Accounting.

We appreciate the opportunity to offer our thoughts on the public plan issues raised by the ASB. As the Panel's work did not address private pension plan matters we have not commented on questions involving these plans (questions 3., 5., and the last part of question 6.). Detailed responses to the questions are shown below.

1. *Public plan funding and associated actuarial valuations are less uniformly regulated than those of private sector pension plans. Actuaries may be asked by their principal to advise on funding levels. 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?*

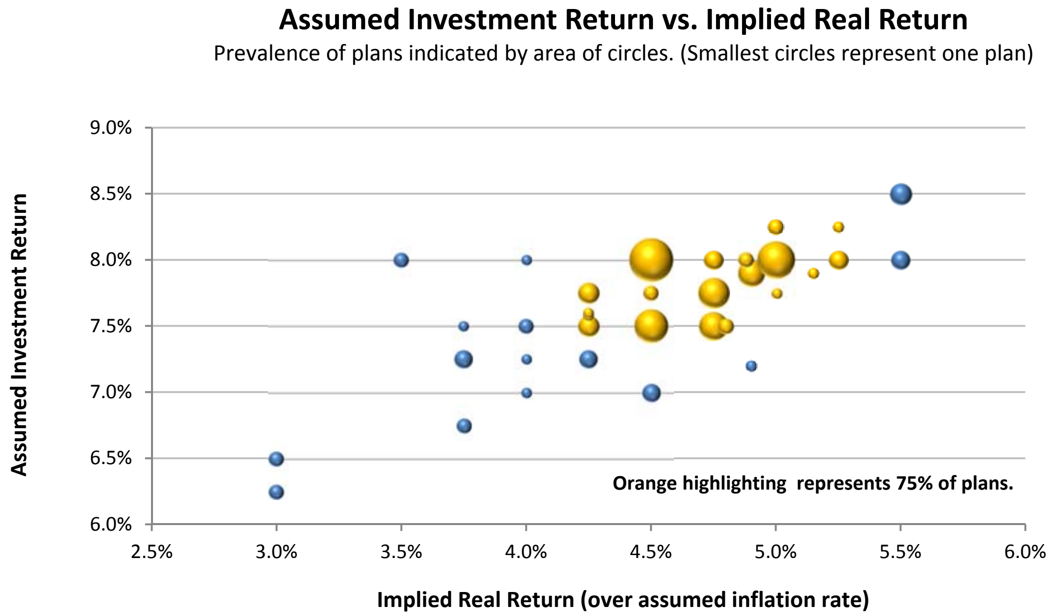
   Yes, additional guidance is needed in several key areas. As noted in the question, public plans are "less uniformly regulated" than private sector plans and, we would add, than nearly every other financial institution. In addition, as many have noted (*Actuarial Funding Policies and Practices for Public Pensions and OPEB Plans,* Conference of Consulting Actuaries (CCA), August 2014), the governance structures of public plans suffer from significant "agency issues" which may prevent trustees from acting in an objective and independent manner. The CCA paper highlights that funding policy should consider that fact that plan governance is influenced by "…agency risk issues associated with the desire of interested parties (agents) to influence the cost calculations in directions viewed as consistent with their particular interests…"

   In the absence of strong independent and objective regulation and oversight, we believe that the actuarial profession must provide more specific guidance to assure that funding calculations more fully support funding objectives, mainly that accumulating funds will be adequate to meet obligations as they come due. Regulators protect consumers by ensuring that the products they buy meet safety standards. For insurance and pensions, the primary concern of insureds and plan participants is that the funding entity – the insurer or the pension fund - has the financial wherewithal to make payment when the time comes. The Blue Ribbon Panel's interviews with and surveys of members of the public plan community indicated that many stakeholders

presumed that actuaries –and Actuarial Standards – existed to ensure this "protection" role was adequately provided.

One hallmark of a "sound system" is the use of mutually agreed upon practices that protect consumers, e.g., in the case of insurers, reserving and capital standards. However, in public plans there is a wide range of practices in use throughout the plan universe, despite relative uniformity of plan structures and investment strategies. And, where we see more consistency, it is around practices that provide a lower level of security to plan participants, e.g., higher assumed real rates of return and longer amortization periods.

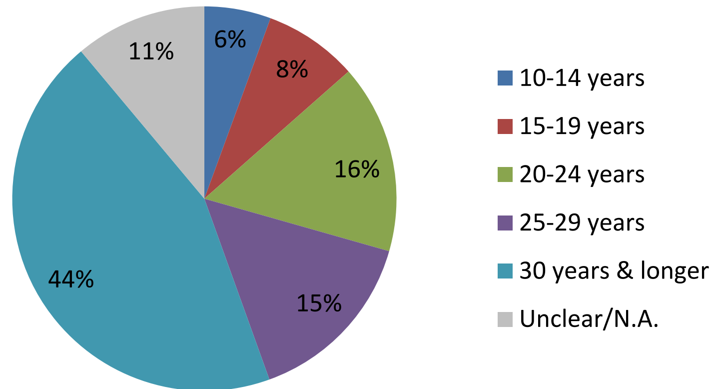
For example, the Public Plans Database (Public Plans Database, 2001-2012, Center for Retirement Research at Boston College and the Center for State and Local Government Excellence) shows the following distribution of assumed asset return assumptions. While differences exist in plans' asset allocations, it is difficult to understand the rationale for real and nominal return expectations to vary up to 350 basis points. To us, this suggests that more guidance is needed for establishing the expected return on asset assumption. More critically, there is a cluster of real return assumptions around 450 to 500 basis points over inflation rates. The Blue Ribbon Panel (BRP) Report concluded that a real rate of return of 350 to 400 basis points was more realistic (*Report of the Blue Ribbon Panel on Public Pension Plan Funding*, Society of Actuaries, 2014, Appendix III, calculation of the standardized contribution discount rate).



Source: Public Plan Database, 126 plans, FY 2011 or 2012

Similarly, the range of amortization methods used as shown in the same Public Plans Database study, suggests that more guidance is needed on the factors considered when determining the amortization period and method. And again, we note that where there is clustering, it is around the longest amortization periods – 30 years or more. Data would suggest that average

future service periods for employees would be closer to 15-20 years (with shorter periods for public safety workers).



Source: Public Plan Database. 126 plans, FY 2011 or 2012.

The range of other practices is also very wide in other areas. This diversity in practice and the clustering of practice around extremes undercuts the credibility of the calculations as many stakeholders cannot understand how such a range of practice can be supported by the facts and circumstances across the plan universe.

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

   We believe that additional guidance is needed in the following areas.

   First, there should be a clear statement of principles providing a defined targeted outcome for funding calculations. Given the complexity of these calculations, we believe that it would be valuable to establish the priority of goals for the funding program being developed. The BRP Report, CCA report and others agree that two of the key priorities are i) adequacy of funding, and ii) maintenance of intergenerational equity. While stable and predictable costs are important, the BRP Report noted that there was a "limited degree to which risky investments can be combined with the goal of stable contributions." (p. 20). The Report discussed at length that often stability and predictability of cost appeared to be the rationale for using methods that failed the first two goals. Establishing clear funding principles and agreeing on their priority will help to ensure assumptions and methods are selected appropriately.

   Key to a statement of principles should be the recognition of the uncertainties facing plans. Funding calculations are commonly completed using assumptions that do not recognize the inherent uncertainty and volatility of economic and non-economic experience. The failure to

recognize volatility and uncertainty in funding calculations, although apparently required by current ASOPs (ASOP 27, 3.8.3.c: considerations for setting return assumptions include: "Investment volatility: plans investing heavily in those asset classes characterized by high variability of returns may be required to liquidate those assets at depressed values to meet benefit obligations. Other investment risks may also be present, such as default risk or the risk of bankruptcy of the issuer."), creates a strong bias for consistent underfunding. When the experience element is by nature not likely to manifest stable or level outcomes, this volatility must be recognized in the assumptions and calculations.

As capital markets and other factors are likely to remain highly unpredictable and volatile, supportable contribution recommendations must be accompanied by a risk analysis of economic scenarios other than the 'best estimate' outcome. Although ASOPs seem to require this work at present (ASOP 35, 3.3.4 related to non-economic assumptions), it is not clear that practice commonly includes such analysis. Without this work, the actuary will not be able to conclude that the recommended contribution is consistent with achieving an adequacy principle. Scenario testing and stress testing should be required.

Given the need to recognize uncertainty, the importance of risk analysis, and the range of assumptions in common use and the relatively similar portfolio constructions across plans, we believe that more guidance is needed for setting the asset return assumption. Specifically:

- Assumptions should be demonstrably achievable 50% of the time. The Panel's review of the basis for assumed returns suggested that return assumptions are often set at a level other than the median expected return.
- Funding calculations should recognize that annual returns will be volatile and will emerge above and below the compound return over the investment horizon. Approaches to recognizing the cost of this volatility might include reducing average annual returns to recognize the impact of variability over the investment time horizon, using stochastic modeling methods or using select and ultimate type assumptions. Other approaches may also be viable.

We believe that as professionals actuaries should take clear responsibility for their work and recommendations, whether explicit or implied. We strongly believe that the actuary should be required to provide his/her opinion that the assumptions and methods are reasonable and consistent with achieving the funding principles established.

Other areas where more guidance is needed include:

- Cost methods – some methods do not result in funding programs that meet most observers' view of appropriate funding principles, e.g., maintenance of intergenerational equity. The range of acceptable methods should be narrowed so that likely outcomes will be consistent with reasonable funding objectives.

- Asset smoothing – modern financial modeling and forecasting methods suggest that this technique has outlived its usefulness and we suggest that it be replaced by more transparent approaches to contribution management.
- Demographic assumptions – stronger requirements to recognize likely future trends in experience, e.g., mortality improvement, should be adopted to avoid an additional bias for underfunding.
- Amortization periods – stronger guidance, including achieving the intergenerational equity goal, should be provided. This will improve funding and avoid a major bias for underfunding.

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 understand that a complex and changing environment is best addressed with principles based guidance. However, we note that the current guidance does not articulate any principles and does not frame the method and assumption decisions within the context of maintaining consistency with such principles. Hence, above we call for principles to be established.

   Nonetheless, under most if not all principle based systems, certain practices are a priori determined to be inconsistent with principles or inadequate to meet the principle; in such cases, those 'boundaries', beyond which it is more likely than not that principles will not be met, should be clearly established. Using assumptions and methods outside those boundaries should be permitted only if fully supported by strong arguments by the actuary.

   Areas in which such boundaries exist include matters such as not recognizing volatility in asset return assumptions, failure to provide for prospective mortality improvements and the use of amortization periods that extend well beyond current employee remaining service lives.

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" (ASOP No. 41, Actuarial Communications, section 2.7). Should the ASOPs require the actuary for public pension plans to perform additional, significant work (which would be incorporated in the guidance provided in the ASOPs) that is not requested by the principal if that work provides useful information to individuals who are not intended users? Why or why not?*

   For public plans, the work of the actuary is, for the most part, not a privileged communication between actuary and client. The actuary's work is in the public realm. The BRP's interviews and research indicated that the actuary's work product is presented in meetings that are typically open (others can attend beyond trustees) and the actuarial report is usually publicly available, commonly on the web site of the sponsoring jurisdiction. Similarly, publically available Comprehensive Annual Financial Reports (CAFRs) typically include an actuarial section on the

plan and its costs and include information that is often taken directly from the actuarial report. Actuaries in the public sphere cannot pretend that their work only has one audience, plan trustees, and seek to arbitrarily exclude other stakeholders' access or to otherwise not address the needs of this broader group of stakeholders.

In the context of public pension plan work, the actuary must, as a practical matter, be recognized as providing objective, independent and professional information to all the stakeholders in the plan. The actuary's work, including plan valuations, experience studies and other analyses are publically available to everyone, not just those whom the actuary may define as a legitimate and 'intended' user. Attempting to exclude any party that uses this publically available information from the legitimate user category will ultimately fail, in our opinion. Further, and more importantly, such a practice detracts from the professionalism and credibility of the information. We urge that the profession recognize its obligation to the public in this work and view all stakeholders as appropriate users.

In this context, the BRP Report recommend that additional disclosures be provided in the actuarial report to highlight information about plan finances and contribution recommendations that can be understood by all stakeholders. To that end, we recommend that actuarial reports include the calculation and disclosure of i) the plan liability and normal cost at the risk free rate, and ii) the standardized benchmark contribution, both as defined in our report on funding.

Questions and requests for further information should be addressed to Robert Stein, steinro2@aol.com or (646) 812-1130 (cell).

Sincerely yours,

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