Larry Pollack
313-580-4464 (mobile)
pollacklarry22@gmail.com

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Sent via email to comments@actuary.org

ASB Comments
American Academy of Actuaries
1850 M Street, NW, Suite 300
Washington, DC 20036

To the Actuarial Standards Board:

This letter is in response to your request for input as to whether additional guidance is needed for actuarial work related to public pension plans, and is structured as answers to the questions asked. The views expressed here are my own and do not represent the views of my employer or any groups with which I am affiliated.

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?**

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

   Stricter standards are needed for public plans, for several reasons, among which:

   a) There is a disconnect between public plan practices and the principles of economics, which has the potential to harm (and may have already harmed) the reputation of the actuarial profession among other finance professionals, in academia, and maybe even with the public. While there are elements of corporate practice that also diverge from economic principles, corporate practices are generally more in accordance with those principles.

   b) Actuarial practices criticized by experts outside the profession, and in academia, generally satisfy Actuarial Standards of Practice (ASOPs). This should be a major concern to the ASB and all members of the profession.

   c) Many high-profile public plans are severely underfunded, naturally leading to questions regarding the soundness of the actuarial services provided.

   d) The currently different practices lead to differences in the way that financial health is commonly assessed and understood (or misunderstood).

      Public plans are generally considered to be getting healthier if actual asset returns exceed the target asset return, equal to the discount rate. Corporate plans are viewed in terms of GAAP funded status. By these criteria, during a period where market interest rates decrease 100 bps and equities perform well, a public plan may show improving health, whereas an *identical plan* (same liabilities and assets, including investments) sponsored by a corporation could show deterioration, which would align with an assessment in accordance with economic principles.

The difference in perspective is largely the result of different actuarial practices, especially discount rates. Public plan actuaries generally use an expected-return discount rate – resulting in what could fairly be called an "investment-driven liability" – that is mostly unresponsive to changes in market interest rates. Corporate plan actuaries use a discount rate based on the market price of promised cash flows. A discount rate difference of three to four percentage points, well in line with current respective practices, could result in the corporate plan reported liability exceeding the public plan liability by over 50% -- taking, for example, a 75% funded ratio down to 50% or lower.

To sum up: The reported financial health of two identical, and identically funded, plans could be significantly at variance just because of different sponsorship, and correspondingly different actuarial practices, all ASOP-compliant. Combined with the fact that public plan practice is so out of line with economic principles, the disparate actuarial measurement and reporting between public and corporate plans is something the ASB should be seriously thinking about.

e) The public plan use of investment-driven liability, endorsed by ASOP 27, creates incentives to take investment risk. In contrast, liability-driven investment (LDI) and "de-risking" are current watchwords in the corporate plan world. The ASB should carefully consider the appropriateness of actuarial standards of practice that incentivize higher levels of public plan risk.

f) There are types of benefits unique to public plans (e.g., DROPs, thirteenth checks), and, I understand, there is significant variance among public plan actuaries in the valuation of these provisions, which suggests that additional standards may be appropriate.

g) The lack of prescriptiveness in the public plan arena and actuaries' status as experts leads to actuaries making non-actuarial recommendations, standards for which (including communications) warrant serious consideration by the ASB. For example, the calculation of the value of promised benefits is actuarial. The selection of an amortization schedule by which to pay for the unfunded liability calculated by an actuary is policy, but may be significantly influenced by the advice of an actuary.

h) Many defenders of current public plan practices outside the profession point to actuarial standards of practice as justification for current practices, which creates a responsibility for the ASB to make sure standards are sufficiently high. In the corporate world, with significant outside regulation and oversight (e.g., GAAP accounting standards policed by corporate auditors), one rarely hears those outside the profession reference ASOPs as a significant driver of practice.

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?**

   There should be a separate standard. While it shouldn't matter substantively whether or not there is a separate standard, there are sufficient meaningful differences in practice to warrant one.

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?**

   The standards should be prescriptive enough to ensure practice in accordance with sound principles.

5. **The ASOPs have provided guidance that has been applicable to all areas of practice in the pension community (for example, private sector, multiemployer, public sector). If you believe that additional**

guidance is needed for public plan actuarial valuations, should any of that additional guidance also apply to nonpublic sector plans? Why or why not?

Multiemployer plans present many of the same issues as public plans, so some of the same standards should apply. Also, some of the changes that are needed to improve public plan practices would be beneficial if applied to corporate plan practice. It therefore would be appropriate to apply relevant parts of any additional standards to multiemployer and corporate plans. However, public plan practice has an urgent need for reform. The issuance of additional standards for public plans should not be delayed to contemplate their possible application to other practice areas.

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? If so, should this requirement be extended to all pension practice areas? Why or why not?**

   The code of professional conduct defines "principal" as "a client or employer of the Actuary." The economic definition of principal is someone with skin in the game. In a public pension plan context, the real (economic) principals are taxpayers, plan participants, the users of government services, and bond holders. The people who determine which actuary is hired are usually agents, often several degrees removed from their principals. Actuaries are agents hired by other agents.

   Actuarial standards of practice should align the definition of an actuary's "principal" with the economic definition. The funds used to pay the actuary come from true economic principals. These principals have the right to be well informed, either directly, by reading actuarial reports, or indirectly, through third parties (e.g., journalists), to make sure their agents, including actuaries, are acting in the principals' best interests.

   The "additional" work required to allow true principals to be fully informed may be "significant," just as it is "additional, significant work" to perform a valuation in the first place vs. not performing one. The proper question is whether the work is necessary to allow the true principals access to information sufficient to judge the actions of their agents and assess the extent of their economic burden. The true principals should be "able to rely on the actuarial findings" to satisfy these purposes, and thus would appear to fall under the definition of "intended user."

   Applying the same standards to corporate plans probably wouldn't result in much "additional" work, because disclosure standards, from sources other than the ASOPs, are fairly extensive. For multiemployer plans, the work may be additional and significant, but similar standards should apply nonetheless.

Thank you for the opportunity to express my views.

Sincerely,

Larry Pollack, FSA, EA, MAAA