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AMERICAN ACADEMY *of* ACTUARIES

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May 29, 2015

Actuarial Standards Board  
1850 M Street NW, Suite 300  
Washington, DC 20036-4601

**Re: Proposed ASOP – Assessment and Disclosure of Risk**

Members of the Actuarial Standards Board:

On behalf of the American Academy of Actuaries<sup>1</sup> Public Plans Subcommittee I appreciate the opportunity to provide comments in response to the Actuarial Standards Board (ASB) exposure draft on the *Assessment and Disclosure of Risk Associated with Measuring Pension Obligations and Determining Pension Plan Contributions*. The Public Plans Subcommittee provides independent and objective analysis, advice and education to stakeholders of state and local government employee benefit plans with respect to funding, financial reporting, managing financial risks and plan design. The Subcommittee also develops issue briefs, and practice notes for Academy membership.

**Introduction to Comments**

We appreciate the efforts of the ASB to develop an ASOP addressing the assessment and disclosure of risk associated with the funding of pension plans. While many public pension plans routinely perform projections under a variety of scenarios and/or discuss risks related to the plans, others do not. Given the uncertainty inherent in these plans, we believe it is appropriate to raise the minimum requirements to include assessments and disclosures of risks related to the funding of pension plans, and we appreciate the leadership the ASB is providing by issuing this exposure draft and the prior discussion draft. Our comments on the exposure draft are intended to support the issuance of such a standard and focus the prospective standard to where it would be most useful.

We note that the proposed standard specifically does not require the actuary to evaluate the ability of the plan sponsor to make contributions when due. As actuaries, we do not

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<sup>1</sup> The American Academy of Actuaries is an 18,500+ 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.

have the necessary expertise to make such an evaluation, so we fully support the current position of the standard. Yet, we must also recognize that the health of the pension plan cannot be completely separated from the health of the plan sponsor and the health of the plan sponsor is a key risk to the plan. In cases where promised pension benefits were not paid, the health of the plan sponsor has been an issue. An actuarial standard on the assessment and disclosure of risk should not completely ignore the health of the plan sponsor. While we may not be able to evaluate whether a plan sponsor is or will be able or willing to make a certain level of contributions, we can provide information illustrating the risks if the sponsor does not make the contributions or the growth or stability of the basis on which contributions are made is not as anticipated. Thus we can provide information so that others can assess whether or not the sponsor would be able or willing to make the necessary contributions.

Finally, we have some concerns that the “bright lines” in the proposed standard are not appropriate for all situations, while also being concerned that simply relying on professional judgment might permit a range of practice that is too wide. In our comments, we suggest continued reliance on professional judgment, but with some additional guidance on factors that actuaries should consider in exercising that professional judgment.

### **Responses to Specific Requests for Comment**

- 1. The discussion draft that preceded this proposed ASOP indicated that a risk assessment should be performed for substantially all pension assignments. The exposure draft has limited the assessment to funding valuations, as defined in section 2.1. Do you believe this limitation is appropriate? Why or why not? If not, what other types of valuations should include risk assessments?*

The proposed requirement in the discussion draft to perform a risk assessment for substantially all pension assignments was far too broad. A risk assessment is not needed for many pension assignments. The proposed limitation to funding valuations captures the pension assignment that is focused on current and future contributions needed to pay for the benefits, which is where a risk assessment is most appropriate, but it may be important to perform a risk assessment for other assignments as well. In particular, we suggest that the measurement of funding requirements for a proposed benefit change might need a risk assessment if the proposed benefit change is significant. These may be the most critical types of assignments requiring actuarial input on risk assessment.

To accomplish this addition, we suggest the definition of “Funding Valuation” in Section 2.1 be amended to read as follows:

“A measurement of pension obligations performed by the actuary either on a periodic basis or as part of the evaluation of a material change to the plan that the plan sponsor may use to determine plan contributions or the benefit levels supportable by specified contribution levels.”

2. *Does the language in the exposure draft provide sufficient guidance to actuaries performing risk assessment work? If not, what additional guidance should be provided?*

The exposure draft provides guidance on:

- Risks to be assessed (3.2),
- Assumptions for assessment of risk (3.3),
- Methods for assessment of risk (3.4),
- Assessment of risk (3.5), and
- Quantitative assessment of risk for large plans (3.7).

While the guidance is very helpful, we believe some additional guidance should be provided. We suggest additional guidance for assumptions in our responses below to question 4, for the assessment of risk in question 5, and for the quantitative assessment of risk in questions 7, 8 and 9.

In Section 3.2, we suggest the addition of two items to the list of risks that may have a material effect on the plan's financial condition:

- (1) contribution **risk** (i.e., the **risk** that the plan's funding policy is not consistent with an actuarially determined contribution or that actual contributions are not made in accordance with the plan's funding policy); and
- (2) growth or demographic **risk** (i.e., the risk that materially adverse changes occur in the anticipated number of covered employees, contribution base, or relevant demographic distributions).

We understand that these risks would fall into the "other significant risks" category, but the purpose of adding them specifically to the list is to make sure actuaries specifically consider them. No actuary would be required to do anything just because an item is on the list if the actuary doesn't believe it would have a material effect on the plan's condition. However, when applicable, our experience has shown that these two items do have a material impact that warrants specific inclusion on the list.

Contribution risk has been a significant issue particularly with public sector plans. In some cases, there may be a statutory contribution rate that the legislative body is unwilling to increase to an appropriate level. In other cases, competing budget needs have taken an apparent priority over contributions to the pension perhaps reflecting on the ability or willingness of the plan sponsor to make the contribution. Over time, these plans are more likely to be poorly funded.

Actuarial funding methods typically assume the future is relatively stable. The majority of public plans, for example, amortize the unfunded actuarial liability assuming a level of payroll growth that extends 15 or more years into the future. Declines in the level of payroll growth due to a short-term drop or a long and steady decline can have significant adverse impacts on a pension plan. Similar problems can occur in multi-employer plans when the covered hours worked

decline and single employer plans when the revenues of the plan sponsor decline. Consequently, one of the risks actuaries should consider assessing is that the growth, maturity or other demographic characteristics of the plan will not be as anticipated. The appropriate measure may vary by type of plan, but there is a significant risk if the assumed base of support for the contributions to the plan is diminished in the future.

We believe the guidance provided in the exposure draft as to methods of assessment of risk is sufficient.

3. *Is the language in the exposure draft sufficiently flexible to allow for new developments in this area of actuarial practice?*

Yes, we believe the language is sufficiently flexible.

4. *Do you agree that the guidance in section 3.3 regarding assumptions used for the assessment of risk should include moderately adverse but plausible outcomes? If no, what guidance would you propose?*

While we agree that the assumptions should include moderately adverse but plausible outcomes, we are concerned that the language in section 3.3 (“should reflect”) may be interpreted to limit assumptions to only those that are moderately adverse, however that is defined by the actuary. Depending on the situation, it can be useful to also illustrate scenarios that are more than moderately adverse. We suggest that the last sentence of the first paragraph of section 3.3 be changed to read:

“Assumptions used for assessment of **risk** should include moderately adverse but plausible outcomes, but may also include more extreme adverse scenarios, particularly for illustrative purposes.”

5. *As discussed in section 3.5, for a funding valuation of a plan, the actuary should perform a risk assessment, which may be quantitative, qualitative, or both. Should the guidance require the actuary to use professional judgment in choosing which type of assessment (quantitative, qualitative, or both) to use? For example, if an actuary believes a quantitative assessment should be performed, do you believe providing a qualitative assessment instead of a quantitative assessment should be considered appropriate actuarial practice?*

The actuary should be required to use professional judgment in choosing which type of assessment to use. If the actuary believes a quantitative assessment should be performed, the principal (or any other party) should not be able to insist on a qualitative assessment instead without the actuary making appropriate disclosures that in his or her professional judgment a quantitative assessment should be performed. Without such a requirement to use professional judgment, the cases where a quantitative assessment is *most* needed may only receive a qualitative assessment.

As described in our response to question 7 below, however, additional guidance should also be provided on the exercise of that professional judgment.

6. *Plan maturity measures have been included as a potential disclosure item to assist intended users in understanding the risks associated with the plan. Are there additional measures that may be disclosed that are significant to understanding the risks of the plan? If yes, what measures would you recommend as a disclosure item?*

We appreciate the inclusion of these measures in the standard and have found the first two (with a minor modification) particularly useful in explaining the varying risks from plan to plan. Some caution is in order, however, when using these measures for closed or frozen plans as the appropriate conclusions may be very different.

Similar to the first measure, we suggest the addition of the ratio of the actuarial liability to payroll. The assets-to-payroll ratio is useful for understanding the sensitivity to investment returns given the current funded status. The actuarial liability-to-payroll ratio provides similar information for a plan that is 100% funded and is also useful for understanding the sensitivity of the plan to assumption changes or liability gains and losses.

Finally, we suggest the second measure be changed from the ratio of retired to active liability to the ratio of retired to total liability. While these are just variations of the same statistic, we have found it more directly useful for trustees to understand, for example, that 60% of the liability is attributable to retirees as opposed to the liability for retirees is 150% of the liability for actives.

7. *Do you agree with the use of a threshold for requiring mandatory quantitative assessment that is based on the actuary's professional judgment? If not, what threshold do you believe should be used?*

As noted in our response to question 5, we believe the determination of the appropriate type of risk assessment should be based on professional judgment. We go even further to propose that the frequency of the quantitative assessment and the details of the quantitative assessment, including the appropriate length of any projection period and the level of quantitative assessment appropriate for the circumstances, fall within the province of professional judgment and should not be defined by any prescribed "bright lines" that might be appropriate for some situations, but inappropriate for other situations.

However, the exercise of professional judgment in these areas should be guided by principles and factors incorporated into the ASOP to direct and constrain practice as deemed appropriate by the ASB. We suggest that the ASB consider including the following factors to guide the professional judgment as to the type and extent of an appropriate risk assessment:

- The purpose of the risk assessment;
- The information needed by the intended users to perform their duties to the plan;
- The size of the plan relative to the size of the plan sponsor;
- The size of any unfunded liability relative to the size of the plan sponsor;
- The size of any actuarially determined contributions relative to the size of the plan sponsor;
- The time since the last risk assessment was performed;
- Significant changes since the last risk assessment was performed;
- The risk profile of the plan’s investment policy and practices;
- Plan maturity measures;
- Funded status; and
- Sponsor’s historical ability or willingness to make actuarially determined contributions.

There could be other appropriate factors to consider, and we would encourage the ASB to define those factors.

8. *Do you believe that the term “large plan” in section 3.7 is sufficiently clear that an actuary will be able to apply it in practice? If not, what clarification would you suggest? Are there other characteristics that should be specified in determining “large plan”?*

We do not believe the term “large plan” is clear at all, and we do not believe that the size of the plan alone is the appropriate criteria for determining when a quantitative analysis should be performed. As suggested in our response to the previous question, there are a number of factors that should be considered, but in particular, the size of the plan relative to the size of the plan sponsor is critical. A plan with \$500 million in liability or assets could be considered quite large for one plan sponsor while it could represent a rounding error for the sponsor of another plan. Simply focusing on the size of the plan without reference to the size of the sponsor can be misleading in the context of assessing risk.

9. *Is every five years an appropriate period for performing a mandatory quantitative assessment for a “large plan” in the absence of significant changes, as described in section 3.7?*

There is no appropriate bright line for the frequency of quantitative assessments or the length of the projections needed in the assessment. Providing these bright lines is likely to cause practice to conform to the bright line as opposed to truly applying professional judgment to the needs of a particular situation.

While the standard requires a frequency of “at least every five years,” we are concerned the standard will be interpreted as indicating that five years is generally an appropriate interval, and it will be more difficult for actuaries to perform a quantitative analysis more frequently when the actuary believes the situation warrants it. Similarly, under the current wording, we expect risk assessments to

recur every 10 years, whether or not that is the appropriate period, and requiring 10 years could inhibit actuaries from providing simple risk assessments on a more frequent regular basis. For example, it may be useful to routinely convey the impact of an investment loss in one year of 10% on the next year's (or the next five years') contributions. But, if the standard requires 10 years, this information might be omitted until a "full" quantitative assessment is performed at the prescribed frequency. We believe the profession, our clients, and other users of our reports would be better served by a more frequent discussion of risk with simple quantitative measures than only providing a quantitative assessment once every five years.

We believe the best way to achieve the objectives of this standard is to rely on professional judgment instead of conforming to prescribed "bright lines" and to provide more extensive guidance on how that professional judgment should be exercised. The bright lines may be appealing for forcing a minimum level of compliance, but they are also likely to have unintended consequences inhibiting, in particular, more frequent simple quantitative measures. We have suggested specific factors that we believe should be added to the standard to provide the needed guidance to direct professional judgment for whether a quantitative or qualitative assessment should be provided, the frequency of quantitative assessments, and the duration of projections. These factors include, in particular, an emphasis on the size of the plan relative to its sponsor as opposed to the current focus on just the size of the plan. We believe this change is critical to ensuring quantitative risk assessments are performed when they are most needed.

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The American Academy of Actuaries Public Plans Subcommittee appreciates the opportunity to provide these comments and if anything in our comments is not clear, I or another member of the Subcommittee would be happy to discuss any of these items with you at your convenience. Please contact Matthew Mulling, pension policy analyst ([mulling@actuary.org](mailto:mulling@actuary.org); 202-223-8196) if you have any questions or would like to discuss these items further.

Sincerely,

William R. Hallmark, MAAA, ASA, EA, FCA  
Chairperson, Public Plans Subcommittee  
American Academy of Actuaries