

**California Actuarial Advisory Panel**



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May 27, 2015

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

RE: Response to Proposed Risk Assessment ASOP Questions

The California Actuarial Advisory Panel (CAAP) supports the ongoing improvement of Actuarial Standards of Practice (ASOPs) and appreciates the opportunity to provide input to the Actuarial Standard Board (ASB) on the issue of assessment and disclosure of risk associated with measuring pension obligations and determining pension plan contributions.

The CAAP was created with the passage of California Senate Bill 1123 in 2008 and consists of eight public sector actuaries appointed by public officeholders and agencies. Pursuant to California Government Code section 7507.2(2):

“... the panel shall provide impartial and independent information on pensions, other post-employment benefits, and best practices to public agencies....”

This letter provides our comments to the proposed ASOP on risk assessment. In general, we want to note the CAAP believes ASOPs should be principles based rather than being prescriptive. Many of the comments provided in this letter are derived from this general philosophy.

Our comments are provided by answering the nine questions that were included in the exposure draft document.

**Question 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?

### **CAAP Answer to Question 1**

We believe this standard of practice should be broader and cover more than pension funding valuations. If performing a risk assessment is deemed necessary for a pension funding valuation, it could be as important to do one for cost studies where an employer is considering modifying the benefit structure for its employees. If it is deemed necessary to perform a risk assessment for a funding valuation, then why wait until a benefit design has been implemented to perform a risk assessment? Under the proposed ASOP language, an actuary would not be required to perform a risk assessment of a benefit change until after the benefit change has been implemented and the actuary performs the next funding valuation.

Similarly, this standard should be broader and apply also to Other Post Employment Benefit (OPEB) funding and/or financial reporting valuations, considering their similarities to pension valuations. We want to note that as currently worded, it would be difficult to simply add OPEB valuations to the scope of this ASOP without modifying other sections. This issue will be addressed as part of other comments we are submitting later in this letter related to section 3.7 of the draft ASOP.

### **Question 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?

### **CAAP Answer to Question 2**

As stated earlier, the CAAP supports that ASOPs should be principles based rather than being prescriptive. The examples of risk to be assessed in section 3.2 provide guidance but we believe additional examples should be provided. Since we support broadening the application of the ASOP to OPEB valuations, adding a health care trend rates risk to the list under 3.2 would be appropriate as well. We believe it is also appropriate to add embedded option risk (e.g. gain sharing provisions and cash balance interest rate crediting) to the list of examples of risks.

All the risks listed in the current version of the ASOP are related to actuarial assumptions. We believe risks related to funding policy should be added. This should include the risk of the plan sponsor's willingness to contribute the actuarially determined funding contribution and the risk associated with the funding policy's implications on future expected plan contributions and funded status as detailed in ASOP 4 sections 3.14.2 and

4.1(m). Even though one could argue that these last two risks could fall under section 3.2.e., we believe listing them separately is more appropriate.

**Question 3**

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

**CAAP Answer to Question 3**

We believe the language of the draft ASOP provides sufficient flexibility to allow for new developments in the area of risk assessment.

**Question 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?

**CAAP Answer to Question 4**

We agree with the guidance provided in section 3.3 when it comes to deterministic projections. We think the guidance is reasonable for deterministic projections and that it should not require inclusion of tail occurrences, which have a very low likelihood of occurring. However, when using stochastic modeling to perform a risk assessment, it is appropriate to reflect the likelihood of tail events. The language of the proposed ASOP should be modified to reflect this distinction.

**Question 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?

**CAAP Answer to Question 5**

Yes, we believe the actuary should use professional judgment in determining the type of risk assessment that should be performed for the plan. We recommend however that the wording of the first paragraph be modified slightly. The first sentence should be modified by using the word "provide" instead of "perform". As suggested, the new sentence would read as follows:

“For a funding valuation of a plan, the actuary should provide a risk assessment, which may be quantitative, qualitative, or both.”

We also recommend that the wording of the second paragraph of section 3.5 be re-written. As currently worded, the intent of this paragraph is unclear.

We recommend the last paragraph of section 3.5 be modified to make clear the actuary may rely or make reference to a report the actuary or another party has produced. As currently written, the ASOP could be interpreted as not allowing an actuary to rely on a separate report the actuary has produced. The same wording appears in section 3.7 and should be changed as well.

#### **Question 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?

#### **CAAP Answer to Question 6**

Yes. We believe that the ratio of the actuarial accrued liability to payroll is also an important indicator, along with the ratio of market value of assets to payroll included in the current draft ASOP. The ratio of liability to payroll is a good indicator of the plan's volatility caused by the plan demographics or the benefit structure and a good indicator of what the market value of assets to payroll ratio would be if the plan were to be fully funded. The ratio of liability to payroll is also a good indicator of sensitivity to experience gains and losses and to assumption changes such as the discount rate and mortality.

#### **Question 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?

#### **CAAP Answer to Question 7**

We agree the decision as to whether or not to provide a quantitative risk assessment should be based on the actuary's judgment. We recommend the wording of the first paragraph of section 3.7 be changed from “the actuary should perform” to “the actuary should consider performing” a quantitative risk assessment. As currently written, section 3.7 deviates

from the opinion that the ASOPs should be principles based rather than prescriptive.

**Question 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”?

**CAAP Answer to Question 8**

As stated in CAAP Answer to Question 7, the decision as to whether or not to provide a risk assessment should be based on the actuary’s judgment. For this reason, when an actuary uses his or her judgment to determine if a risk assessment should be performed, the size of plan may not be the only factor that should be considered. A better threshold may be the materiality or impact of the risk.

We believe the ASOP should not include the four factors listed to describe what a large plan is. We propose that only the first sentence of paragraph four should remain since the intent is to leave the determination to the actuary’s judgment.

**Question 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?

**CAAP Answer to Question 9**

To ensure this ASOP remains principles based, section 3.7 should not include any specific time period over which a risk assessment should be produced and also should not dictate the frequency of such assessments. We propose the wording be changed to say that when performing a risk assessment that the results should be projected over a period long enough to be reasonably sufficient to illustrate the risk being assessed. Prescribing a period of at least ten years goes against an ASOP being principles based. Similarly, the requirement for a risk assessment to be performed at least every five years should be removed. We propose the wording be changed to say that a risk assessment should be performed periodically and leave the determination of the appropriate frequency to the actuary’s professional judgment.

The changes we propose for section 3.7 would also make it easier to broaden the impact of this ASOP beyond funding valuations for pension plans as we stated earlier in our comments.

**Conclusion**

The CAAP supports adding an ASOP on the topic of assessment of risk. However, such standard of practice should be principles based and avoid imposing prescriptive requirements on actuaries, as stated in our comments.

Improvements to ASOPs should result in better actuarial work and be responsive to the needs of the public. We believe application of this standard of practice should be broader and not be limited to pension funding valuations.

Thank you for considering our responses and please do not hesitate to contact us if you have any questions.

Sincerely,

A handwritten signature in black ink, appearing to read 'Paul Angelo', with a stylized, flowing script.

Paul Angelo  
Chair, California Actuarial Advisory Panel

cc: Panel members  
John Bartel, Vice Chair  
Ian Altman  
David Driscoll  
Leslie Finertie  
David Lamoureux  
Rick Reed  
Graham Schmidt