



July 25, 2018

ASB Comments

American Academy of Actuaries

By email: comments@actuary.org

Re: ASB Actuarial Standards of Practice No. 4 Exposure Draft

Dear Members of the Actuarial Standards Board:

We are writing on behalf of our members, who are the directors, administrators, managers, and trustees of public retirement systems throughout the United States. These systems hold more than \$4.0 trillion in trust to provide pension and other benefits on behalf of more than 24 million working and retired employees of state and local government in the United States.

Public pension plans operate in a highly visible environment, overseen by elected governmental bodies at the state and local level and subject to scrutiny by the media and various stakeholder groups. These plans also are subject to constitutional, statutory, and case laws that create a clearly defined legal framework that governs the accrual and protection of pension benefits. We support the appropriate, meaningful, and understandable disclosure of the funded status and contribution requirements of public retirement plans so that stakeholders fully understand the nature, extent, and potential variability of the pension obligations.

For these reasons, the accuracy, clarity, and integrity of actuarial calculations and disclosures are vital to the ability of public pension plans to fulfill their legal responsibilities, and actuarial requirements and standards of practice are a matter of great relevance to us. We appreciate the opportunity to submit comments in response to the Exposure Draft of Actuarial Standards of Practice (ASOP) No. 4.

Following are our specific concerns about the exposure draft.

Comment 1: ASOP 51 already provides a robust framework for the assessment of risk, and the Investment Risk Defeasement Measure (IRDM) is a poor measure of risk

We believe that any guidance on the examination and assessment of investment risk belongs in ASOP 51, *Assessment and Disclosure of Risk Associated with Measuring Pension Obligations and Determining Pension Plan Contributions*, which already contains principles-based guidance on evaluating pension plans' investment risks. ASOP 51 was specifically written to measure and report on pension plan risk, and already provides a robust framework for assessing investment and other risks inherent in funding plan benefits. ASOP 51 specifies investment risk as the first example of risk an actuary should identify and assess, and provides the framework, methods, and considerations for identifying and assessing investment risks.

By contrast, the prescribed IRDM in the proposed revision of ASOP 4 is not an effective measure of the investment risk in funding a plan. In fact, the prescribed IRDM is actually a measure of the liabilities of the plan for benefits accrued to-date, if the future investment risk is eliminated by investing the fund in assets with an expected yield equal to current bond yields. Because the IRDM is based on different

assumptions and a different funding method than those used in most public pension funding valuations, this proposed metric is neither an effective nor a useful measure of the investment risk in funding ongoing benefit accruals. Moreover, the proposed IRDM does not provide a basis to assess the impact of investment risk inherent in the plan's asset allocation – which could result in higher or lower future contribution requirements. Investment risk can and should be measured and assessed as part of ASOP 51.

The appropriate measure for determining the cost to defease the investment risk of a plan would need to be one based on the same cost method that is used for funding. ASOP 51 recognized this and includes language stating that if the actuary were to assess plan liabilities using a lower discount rate, that it be done on a basis consistent with the basis used to assess the plan on-going liabilities. The language of ASOP 51, Section 3.4 says: "... a comparison of an actuarial present value using a discount rate derived from minimal-risk investments to a corresponding actuarial present value from the funding valuation or pricing valuation."

Per the proposed new Section 3.11 of ASOP 4, other assumptions used in the calculation of the IRDM are to be those used in the funding valuation or "based on estimates inherent in market data, in accordance with ASOPs Nos. 27 and 35." However, there may be no market data on other assumptions and the other assumptions used in the funding valuation or inherent in market data may be wholly inappropriate in the context of defeasing liabilities. This may force the actuary to decide whether to adhere to Section 3.11 of the proposed revision to ASOP 4, or to the consistent assumption provisions in Section 3.12 of ASOP 27 and Section 3.7 of ASOP 35.

ASOP 51 deliberately and appropriately does not include mandatory quantitative risk assessments, nor does it require a specific one. Instead, ASOP 51 suggests various methods for assessment of risk. Many of the methods listed in ASOP 51 would be more generally applicable than the proposed IRDM.

Meanwhile, as discussed above, calculating and reporting both an IRDM and complying with ASOP 51 inevitably will lead to misinterpretation, misuse, and confusion.

Comment 2: The intended purpose and application of an IRDM is unclear, particularly for risk-sharing plans

We are unaware of an instance in which such a number has actually been used by a public pension plan. How does the ASB perceive the IRDM being used by decision makers? What would a public pension trustee do with this information? What action would or should a public pension trustee take based on learning the plan's IRDM?

As an example, consider a public pension plan with \$7 billion in assets and \$10 billion in actuarial accrued liability, measured at a discount rate of 7.0 percent. Suppose the IRDM measure is \$15 billion. What does a trustee do with that information? The measure provides no information about the affordability about the possible consequences of the plan's investment risks. The only clear conclusion a trustee could draw is that if the plan had another \$8 billion in assets, the plan could immunize its obligations with very safe investments. That information is likely to be of limited interest to trustees and certainly doesn't warrant a mandatory disclosure. Moreover, as discussed later in this letter, we know

that some will use (or misuse) that information, characterizing it as “the one true number,” to accuse public pension plans of keeping two sets of books, etc.

For plans with risk-sharing or variable benefit features, it is highly likely that other funding valuation assumptions regarding variations in benefit features would be inconsistent with defeasement or with investment returns equal to yields of a bond portfolio and therefore violate Section 3.12 of ASOP 27 or Section 3.7 of ASOP 35. No guidance is provided for such situations.

The meaning and utility of the IRDM is even more ambiguous in cases of risk-sharing pension plans in which benefits are determined partly by external factors. For example, some public pension plans pay a cost-of-living adjustment that is based on the plan’s funding level or on the fund’s investment performance relative to some benchmark. An IRDM calculated on the basis of a Treasury bill return for a plan whose COLA is based on returns above a certain threshold, for example, would produce a particularly nebulous number. Similarly, some plans pay a COLA if investment returns exceed the plan’s assumed rate of investment return. If the IRDM requires that the actuary assume an investment return of a low-risk bond rate of say, 3.0 percent, investment risk may remain but the IRDM would not represent the amount of assets needed to “defease” the investment risk as is implied by the name and stated objective in the standard. Such an outcome would reasonably be considered to be misleading.

Considering the large and growing number of risk-sharing elements that are embedded in public pension plan designs, we believe this to be an especially troublesome matter.

Comment 3: The IRDM has limited relevance to public plans.

As prescribed, the IRDM is a settlement value, also known as the risk-free version of the so-called market value of liabilities (MVL). We would note that during the most recent round of reviews of ASOPs 4 and 27, the ASB considered, and ultimately declined, to define an MVL, electing instead to focus on the purpose of the measurement. We believe that guidance to be both appropriate and sufficient, especially in conjunction with the new ASOP 51 on risk assessments.

Because interest rates and bond yields are fluid and can be volatile, determining a measure based on a spot-price, and contending that it “effectively” defeases the investment risk of a large public pension plan with perdurable future cash flows, not only is unrealistic, but also produces a measure that has no relevance to the plan’s funding valuation and that does not consider the plan’s legal environment.

Most public pension plans are legally obligated to pay promised benefits, and public plan sponsors in many or most cases are forbidden from withdrawing from the plan. In addition, a growing number of public pension plans contain risk-sharing elements. We believe these facts render moot the meaning, relevance and utility of a mandatory public pension settlement value, or an MVL.

If a requirement to calculate an IRDM is to be established, we would suggest that such a requirement should be a) limited to those plans whose employers are legally permitted to withdraw; and b) contained in an advisory letter, similar to a management letter used by auditing professionals, and not within the contents of the valuation. In some cases, statutes specify that the purpose of actuarial valuations is to calculate contribution rates. Providing the information in an advisory letter separate

from a valuation still informs policy makers, but will not come into conflict or confusion with such statutes. For plans whose employers lack such authority, the IRDM has limited relevance.

Comment 4: Requiring pension plans to pay for the calculation of a value that, in many cases, is of marginal utility, is unreasonable and may violate public pension fiduciary duties.

An Investment Risk Defeasement Measure reflects the cost of nullifying or abrogating a pension benefit. Yet public employers in many states are prohibited from leaving, or disaffiliating, from the retirement system that provides pension benefits to their employees. For public pension plans whose employers are legally obligated to pay promised benefits and to continue to provide benefits in the future, calculating an IRDM is a mere academic exercise that offers little to no practical value. As shown in results of a [NASRA survey on policies governing employer disaffiliation from statewide retirement systems](#) public pension obligations in many instances must not only be paid, but also must be allowed to continue to accrue for plan participants who continue to work.

A requirement that a public pension plan must pay an actuary to calculate a value that is based on an event that is in contradiction of the laws governing the plan, not only is a waste of limited public pension assets, but also may require public retirement system trustees and administrators to violate their fiduciary duties, particularly the requirement that they operate solely in the interest of plan participants. Moreover, an actuary in such cases may be unable to affirm in good faith the reasonableness and consistency of actuarial calculations that include the IRDM.

A mandated IRDM in a funding valuation would be interpreted as an endorsement of a measure that is frequently misrepresented as “the one true answer” of the condition and cost of a public pension plan. Such a mandate, for the mere purpose of satisfying those with an interest in this number, is neither good actuarial nor public policy. Moreover, requiring a retirement system to pay for such a calculation is a misuse of public pension assets. Entities that want a settlement/MVL number have demonstrated in recent years that they can independently produce estimates of such liabilities for their purposes.

Comment 5: The Investment Risk Defeasement Measure conflicts with the actuarial standard that standards should not be prescriptive

ASOP 1 states:

The ASOPs are principles-based and do not attempt to dictate every step and decision in an actuarial assignment. Generally, ASOPs are not narrowly prescriptive and neither dictate a single approach nor mandate a particular outcome. Rather, ASOPs 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. The ASOPs allow for the actuary to use professional judgment when selecting methods and assumptions, conducting an analysis, and reaching a conclusion, and recognize that actuaries can reasonably reach different conclusions when faced with the same facts.

By directing the actuary to calculate an IRDM, and by prescribing how the IRDM is to be calculated, Section 3.11 of the ASOP 4 Exposure Draft conflicts directly with ASOP 1 that “ASOPs are not narrowly prescriptive and neither dictate a single approach nor mandate a particular outcome.” Section 3.11 is

wholly prescriptive; it leaves no room for professional judgment on the part of the actuary; and it dictates a single approach.

Public pension plans rely on professional actuaries to employ their professional training, knowledge, and judgment to fairly and accurately assess the condition and cost of the plans our members oversee. A requirement that these actuaries conduct a calculation using a prescribed formulaic process, including factors that in many cases are irrelevant to plans' legal and operating environment, contradicts both the letter and spirit of ASOP 1.

Comment 6: The Investment Risk Defeasement Measure conflicts with the actuarial Code of Professional Conduct in two ways: that actuarial communications should be clear and appropriate to the circumstances and its intended audience, and that actuarial services should not mislead.

Precept 4 of the Code of Professional Conduct, promulgated by the American Academy of Actuaries, states:

An Actuary who issues an Actuarial Communication shall take appropriate steps to ensure that the Actuarial Communication is clear and appropriate to the circumstances and its intended audience and satisfies applicable standards of practice.

Precept 8 of the Code of Professional Conduct states:

An Actuary who performs Actuarial Services shall take reasonable steps to ensure that such services are not used to mislead other parties. ... The Actuary should recognize the risks of misquotation, misinterpretation, or other misuse of the Actuarial Communication and should therefore take reasonable steps to present the Actuarial Communication clearly and fairly and to include, as appropriate, limitations on the distribution and utilization of the Actuarial Communication.

As described above, a public pension obligation measure that is based on a discount rate using US Treasury yields or a settlement value is not, in many instances, appropriate to the circumstances and its intended audience. Likewise, we believe that such a measure will be used to mislead stakeholders—policymakers, the media, pension plan participants, and the general public—about the condition of the pension plan. The IRDM seems to invite precisely the type of misuse that Precepts 4 and 8 are intended to avoid.

The IRDM can be expected to be used to mischaracterize the condition of public pension plans. An abundance of evidence demonstrates that a measure based on a discount rate using US Treasury yields or settlement value routinely has been cited as the “true” measure of the funding condition of public pension plans, despite the fact that many of these plans cannot legally terminate, are obligated to pay promised benefits, and are sponsored by states and other entities that are essentially perpetual. Such evidence includes published news accounts [in the appendix to this letter] quoting adherents to financial economics, who reject conventional public pension funding measures and instead assert that the actual measure of public pension plan funding is based on US Treasuries and settlement values.

In recent years, following the onset of new public sector accounting standards and the establishment by some bond ratings agencies of proprietary methods for valuing pension obligations, multiple

measurements of public pension plans have become more common and have received more attention. These metrics have led to confusion and selective use, rather than the clarity and consensus we believe is provided by using a measurement of public pension plans based on their long-term expected investment return in compliance with public sector accounting standards and longstanding practice. Requiring the actuary to calculate and communicate a defeasement liability in connection with the funding valuation will increase the number of “official” funding liability measures, and will exacerbate the problems of confusion and misuse. The burden of explaining to legislators, plan sponsors and other stakeholders the purported meaning and limited usefulness of the IRDM will fall on our members-- public retirement system directors and their staff and trustees.

In addition, requiring disclosure of an IRDM simply to satisfy those who are interested in such a number, is not good public policy. As public pension plans are subject to open meetings and open records laws, no reasonable steps are available to actuaries who perform actuarial analyses to preclude such misuse as required by Precept 8. Any disclaimers or conditions prepared by the actuary on the appropriate use of the IRDM undoubtedly will be left behind when that value is used to misrepresent the plan’s funding requirements.

Comment 7: Requiring calculation of an IRDM may be a result of the ASB not following its traditional processes for proposing ASOP modifications

Because the ASB did not adhere to its traditional process for proposing changes to ASOPs, we are concerned about the outcome of the process the ASB used, as that process resulted in what we believe to be a flawed proposal, i.e., a requirement to calculate the IRDM. Although we are not professional actuaries and we do not wish to tell the ASB how to conduct its business, as consumers of professional actuarial services, we are affected by the process ASB uses to make decisions. Because we believe the proposal to require an IRDM is flawed, and in consideration of this proposal’s potential consequences, we would prefer that the ASB follow its traditional due diligence in modifying its standards.

Based on previous exposure drafts and on the ASB’s Procedures Manual, our understanding is that the ASB’s Pension Committee typically drafts new guidance related to pension plans. Accordingly, it would have been reasonable to expect that the Pension Committee would have reviewed the responses to the ASB’s July 2014 Request for Comment, and that, based on that review, the Pension Committee would have formulated and drafted any proposed changes to the ASOPs. Instead, we understand that the ASB appointed a Pension Task Force made up of just a few actuaries to review the responses. The Pension Task Force report included several “suggestions,” including the IRDM disclosure requirement. The ASB then directed the Pension Committee to draft these suggestions as a new standard, in effect replacing the role of the larger and more representative Pension Committee with the smaller and less representative Pension Task Force.

As a result, the outcome of the Request for Comments, namely, to require the IRDM, was determined not by the broader consensus of the Pension Committee, but rather by the particular individuals selected for the Task Force. Moreover, at the same time the Pension Task Force was considering suggestions for changes, the ASB was also finalizing and adopting ASOP 51 regarding the identification and assessment of risk. If the IRDM requirement is indeed a risk measure and is considered to be so essential to be uniquely prescribed, we wonder why was it excluded from ASOP 51? ASOP 51 was only

recently adopted and is yet to be effective. Funding valuations subject to ASOP 51 are likely to include meaningful, relevant discussions of investment and other risks inherent in funding a pension plan. We believe it would be prudent for the ASB to observe actuarial practice under ASOP 51 prior to mandating a measurement of questionable risk-assessment value that is likely to be misrepresented by non-actuaries.

We would respectfully suggest that the ASB consider the comments articulated in this letter and issue a revised exposure draft from the Pension Committee, to eliminate a required IRDM, or at least to restrict an IRDM as described in Comment 3.

Once again, we want to express our appreciation for the opportunity to convey our concerns about this proposal. On behalf of our many members and their millions of plan participants, thousands of public employers, and other public pension plan stakeholders, we appreciate your consideration of our views.

Sincerely,

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Appendix

News Articles Citing a Financial Economics Value for Unfunded Public Pension Liabilities

1. <http://altondailynews.com/news/details.cfm?id=227001#.WAeeNSQ7Jrc>
2. <http://nj1015.com/nj-pension-shortfall-amounts-to-26000-for-every-resident-group-claims/>
3. <http://www.investors.com/politics/editorials/the-looming-pension-crisis-of-state-and-local-governments/>
4. <http://www.zerohedge.com/news/2016-10-10/2-simple-charts-show-which-state-pensions-are-most-likely-enforce-benefit-cuts>
5. http://www.ahwatukee.com/news/article_5a6e37b4-76ab-11e6-bb3a-bbc3f68b22dc.html
6. <http://www.forbes.com/sites/pensionresearchcouncil/2015/08/25/unfunded-pension-debts-of-u-s-states-still-exceed-3-trillion/#2ca16dbe69f0>
7. <http://www.capoliticalreview.com/capoliticalnewsandviews/actuaries-real-calpers-unfunded-liability-is-946-billion-when-will-it-collapse/>
8. <http://watchdog.org/207217/pension-texas-ers/>
9. http://www.pionline.com/article/20140709/ONLINE/140709890&utm_source=friend_refer&utm_medium=email&cslet=UnhOY2ILRDILUEtWK2lvK3VyL0dPTzIxb3U3a3NXekdNYk09
10. <http://seekingalpha.com/article/4005269-defined-benefit-might-risky-defined-contribution>
11. <http://on.wsj.com/2dOBlow>
12. http://www.pionline.com/article/20151228/PRINT/312289998&utm_source=friend_refer&utm_medium=email&cslet=UnhOY2ILSDhMZkNVK2pVaXY3amNVdk5xcE96cnVHekhNQT09
13. <https://www.cnbc.com/2016/04/11/pension-pipe-dreams-put-taxpayers-on-hook-analysis.html>
14. <https://www.brookings.edu/opinions/teacher-salary-hikes-face-major-headwinds-politics-and-pension-underfunding/>
15. <https://www.forbes.com/sites/oliviergarret/2017/06/09/the-disturbing-trend-that-will-end-in-a-full-fledged-pension-crisis/#741e40346620>
16. <https://www.ft.com/content/c9966bea-fcd8-11e5-b5f5-070dca6d0a0d>
17. <https://www.forbes.com/sites/jeffreybrown/2012/02/29/the-risk-of-ignoring-risk-the-case-of-pensions/#66b82228bac6>
18. https://www.al.com/opinion/index.ssf/2016/05/further_reforms_are_needed_for.html
19. <http://freebeacon.com/issues/unfunded-liabilities-state-public-pensions-top-6-trillion-2017/>
20. https://www.moody.com/research/Moodys-Net-pension-liabilities-continue-rising-for-42-of-50--PR_377106
21. <https://www.illinoispolicy.org/moodys-downgrades-illinois-to-1-notch-above-junk-warns-state-pension-liabilities-top-250b/>
22. <https://www.valuwalk.com/2017/06/pension-unfunded-liabilities/>