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July 30, 2018

ASOP No. 4 Revision
Actuarial Standards Board
1850 M Street, NW, Suite 300
Washington, DC 20036

Dear Actuarial Standards Board Members:

The plans that I currently serve as Actuary are all public plans. My comments, therefore, are entirely from that perspective. In addition, they are my own personal opinions.

Comments on Section 3.11 Investment Risk Defeasement Measure (IRDM):

If the IRDM is intended to be some type of quantification of risk, it belongs in ASOP 51. Our standards will look disorganized otherwise. If it is not intended to be a risk measure, then given the title of ASOP 4, I would have to conclude that it is a measurement of a pension obligation. In that case, I would suggest that it be renamed accordingly and perhaps redefined if necessary.

Getting into specifics, I find the definition of IRDM to be too prescriptive to be compatible with ASOP 1 Section 3.1.4. I think that because of the significant structural diversity of pension plans, particularly of public plans, the actuary needs much more flexibility in calculating an appropriate IRDM than the current ASOP 4 draft provides. Some particular points follow.

- I presume that, by “unit credit actuarial cost method”, the drafters mean the Traditional Unit Credit method without salary projection “TUC”. All of the plans that I work on are final average pay plans. The CCA White paper on funding policies classifies the TUC method as an unacceptable funding method for final average pay plans. I think most practitioners would agree with that classification. The public will find it contradictory that one actuarial body classifies a method as “unacceptable”, while another mandates its use. In my opinion, the IRDM calculation as defined in ASOP 4 is, in the case of a final average pay plan, a hybrid between an ongoing plan calculation and a plan termination calculation. The application of funding assumptions in 3.11d is suggestive of a calculation related to an ongoing plan. The lack of salary projection is suggestive of a plan termination calculation. In other words, by mandating a calculation without salary projection, the ASOP is mandating inconsistent use of assumptions. It is likely that some users will view the IRDM as a plan termination calculation when it is not. Other users may think that it measures defeasement of accrued benefit investment risk when it does not (because most users at least in the public space conceive accrued benefits as being based upon final average pay).

- There are cases wherein the method specified in ASOP 4 for the IRDM calculation produces an incorrect result. The Wisconsin Retirement System has an optional variable annuity program. By statute, assets in the program are invested in a portfolio that is 100% common stock. Active members can invest a portion of their mandatory contributions in the variable program. At time of retirement, an individual's variable account value is annuitized at 5% interest and valuation mortality. By statute, retirees in the program receive annual benefit increases or decreases that are entirely dependent on the performance of the portfolio in which the assets are invested (again, by statute, it is a 100% equity portfolio). Investment return above a 5% threshold rate results in a benefit increase approximately equal to the percentage difference between the earned rate and 5%. Investment return below 5% results in a similarly calculated benefit reduction. (In fact, the benefit change is calculated based on the ratio of total retiree assets at market value to total retiree liabilities measured at 5%, which has the effect of pooling mortality experience). This plan has no significant investment risk because all investment results flow directly to the retirees. I think that the IRDM for such a plan should either be \$0 or an undefined concept. I think that if I were to calculate the IRDM based on treasury yields, a positive and incorrect value for the IRDM would result. Furthermore, if the plan fiduciaries attempted to defease risk by investing in treasuries (although the statute does not permit that), the act of doing so would either change benefits or add investment risk. Retirees would be entitled to benefit changes based upon the difference between the treasury yield and the statutory portfolio yield.
- There can also be cases wherein the IRDM as defined in ASOP 4 is mathematically correct, but not appropriate given the facts and circumstances of the situation. It is common for an agent multiple employer plan to permit employers to withdraw from the plan. In many cases, liabilities for accrued benefits for retirees and existing employees remain with the plan, while future service benefits for existing employees, and all benefits for new employees, are covered by a replacement plan. In such cases, the actuary should be permitted to calculate an IRDM based upon conditions applicable to a potential withdrawal. Those conditions could differ from plan to plan. Agent Multiple Employer Plan A might freeze accrued benefits based on current pays when an employer withdraws, while Plan B might pay accrued benefits in the future based upon future pays but based upon service only up to the withdrawal date. In the Plan A situation, the IRDM as defined might produce a pretty good result. Regardless of the actual withdrawal liability that is charged to the withdrawing employer, the IRDM would inform all parties of the amount of investment risk that is involved. In the plan B situation, the IRDM as presently defined would be misleading and confusing. For example, in such a case, the IRDM might be calculated as \$80 Million based upon frozen pays and other ASOP 4 methods, but the Plan B Actuary would want to report the IRDM as \$100 Million based upon projected pays. Publishing both calculations would be confusing and misleading and could lead to disagreement between the plan and the withdrawing employer regarding the actual amount of the withdrawal liability. Therefore, the Plan B Actuary would want to omit the IRDM as defined in ASOP 4 from the report and replace it with a calculation that is more appropriate. I think therefore that the standard should permit the calculation to be based upon projected pay and other

assumptions and methods compatible with the operation of the plan, if, in the actuary's professional judgement, doing so is appropriate.

- I think that the actuary should be permitted to express the IRDM based upon the actuarial cost method used in the funding valuation. I think, in fact, that a calculation involving the present value of benefits (PVB) would provide a much more complete picture of risk than does the IRDM as currently defined.
- I recognize the pressure from the financial community to report a single measure of liability for all plans, the "MVL." Several rating agencies and various "Think Tanks" are already using various algorithms to calculate an approximation to a single measure, although I don't know that they are all marking to current interest rates. To the extent that unintended users of financial statements have a means of generating approximations to numbers that they either need or want, I don't see a need for a change in standards that requires the plan actuary to calculate a number for them, and the plan to pay for the calculation. If unintended users want an actual scientific IRDM calculation as opposed to an approximation, they could certainly engage an actuary to calculate one for them. A change in standard would not be required for that to occur.

In conclusion, I would like to see the IRDM requirement moved to ASOP 51 and defined in a principles-based manner in accordance with ASOP 51 Section 3.4.

Comments on Section 3.14 Amortization Method:

There are several problems with this section.

- As written, I think this section would not apply if someone other than the actuary selected the method. Is that the intention? Either way, clarifying language would be helpful.
- Section 3.14 as written would permit 100-year level \$ funding of unfunded liabilities. Assuming that is not the intention of the drafters, some type of correction needs to be made. The problem seems to relate to the use of the word "or" in the third line.
- The section is probably intended to relate to amortization of unfunded liabilities, and not to amortization of surplus (i.e. of an overfunded liability). It should clearly say so. I don't think there is any need for the amortization of surplus to exceed nominal interest, for example. I think taking a credit of half the interest on surplus against the normal cost should be an acceptable method. Actually, I think that in many cases, surplus should be held as a reserve for adverse deviation and not used to reduce employer contributions.
- I think there can be circumstances in which an amortization schedule that calls for payments to increase more rapidly than payroll is not only acceptable, but necessary. For example, a poorly funded plan may need to ramp up contribution income rapidly in order to avoid insolvency, but it may not be possible for the plan sponsor to contribute at the ultimate rate in the first several years of the schedule. I don't see anything wrong with a contribution rate that increases faster than payroll for several years until it reaches an ultimate level, or even until the end of the amortization period. The plan will have more money in that case than if the rate increases at only the payroll growth rate for several years and then jumps to the ultimate level all at once. I am aware of one agent multiple employer plan that applies an

amortization schedule to severely underfunded agencies that decreases two years per year instead of one year per year. Because of the “should” language in Section 3.14, an actuary who believes that contributions need to increase faster than payroll in a particular situation would have to disclose that the recommendation to do so is a deviation from actuarial standards. Such disclosure could make it more difficult than it already is to get the needed funding from the plan sponsor. I also work for a cost sharing multiple employer plan that, by statute, require new employers entering the plan to pay off their initial liability based on a schedule of contributions that increases 5% per year. I don’t see anything wrong with that either. Everyone knows and understands at the outset, what the deal is.

- The payroll in some plans can be a very small portion of the employer’s total financial resources. For example, consider a State Highway Patrol plan with a \$100 Million covered payroll in a state where the total payroll covered by all plans is \$16 Billion. A requirement that contributions in such a plan increase no faster than the plan’s covered pay seems unnecessary to me.
- Section 3.14 b. iii. seems to contemplate layered amortization bases. Consequently, Section 3.14 should explicitly say whether its requirements are to apply to each layer separately or to the sum of all layers. I don’t think the latter is actually possible, so I think the former must be the intention of the drafters. The ASOP should be clear on this point.
- Section 3.14 seems to imply that all the bases have to be closed including gain loss bases. That should be made clear if it is the intention. Personally, I don’t see a problem with a rolling gain loss base over a sufficiently short period and often suggest it as a simplification, particularly in agent multiple employer plans, wherein it might be necessary to track and explain tens of thousands of bases.
- In situations wherein there is a mix of credit and charge bases, a plan can have an unfunded liability and end up getting a credit against the normal cost due to the structure of the bases (or the opposite could occur). This appears to comply with Section 3.14, but I think that in many cases it is unreasonable, if not outright harmful. Permitting this in the ASOP could be a matter of reputational risk for the profession.

I am concerned that dealing with all of the above may result in an overly prescriptive ASOP that is not in keeping with ASOP 1, Section 3.1.4. One possibility might be to replace all of Section 3.14 with a simple statement along the following lines:

“If the actuary selects or recommends or applies an amortization method, the method should be compatible with the plan accumulating assets sufficient to pay benefits when due and it should fund the plan’s unfunded liabilities within a reasonable period of time considering relevant facts and circumstances.”

Comments on Section 3.16 Output Smoothing Method:

I think that output smoothing, depending on how it is implemented, can be a preferred alternative to the use of asset smoothing, largely because output smoothing methods can be much more transparent to plans and their sponsors than asset smoothing methods. I think that output smoothing in conjunction with asset smoothing, which Section 3.16 seems to be intended to allow,

is a complex issue. It is very easy for the combination to result in an excessive amount of smoothing that is not at all transparent to intended users. If the intention of this section is to allow the result of output smoothing to be termed an ADC, I think that it should only be permitted as an alternative to asset smoothing. If this suggestion is not taken, I would then suggest inclusion of a statement along the following lines:

“3.16 d. If the actuary selects an output smoothing method that is used in conjunction with asset smoothing, the actuary should consider whether or not the total amount of smoothing is reasonable.”

Comments on Section 3.19 Implications of Contribution Allocation Procedure or Funding Policy:

The exclusion for valuations that include a prescribed assumption or method set by law is new. I do not understand the reason for this exclusion. It seems to me that fiduciaries of private plans should also understand the implications of the funding policy.

Comments on Section 3.20 Reasonable Actuarially Determined Contribution:

The exclusion related to a prescribed assumption or method set by law basically excludes private plans from this requirement. In the unlikely event that a funding valuation for a private sector plan produced a result that was not a reasonable ADC, I would think that the fiduciaries would be well served by the disclosure of a reasonable ADC.

Regarding 3.20g, I believe that many public sector practitioners ignore the time lag between the measurement date and the contribution date when preparing funding valuations. This may be because doing so can be viewed as a relatively benign form of output smoothing. In periods when contribution rates are falling, ignoring the lag slows down the rate of decline. When rates are rising it slows down the rate of increase. I think that if a requirement to take the time lag into account is to enter the standard, a Practice Note on the subject would be helpful. There are several topics that would need to be addressed, including but not limited to:

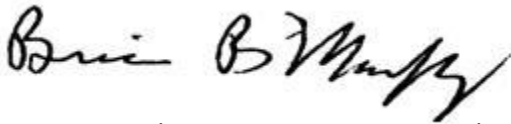
- Contributions expected to be received between the measurement date and the contribution date.
- Recognition of assumed return during the period.
- The effect of the asset smoothing method, in other words, the effect of the unrolling of asset gain/loss bases during the lag period.
- Calculation of the Normal Cost and UAL contribution when more than one Plan Tier is involved. For example, suppose a plan has introduced a new tier and that on the measurement date there are no people in the new tier. By the time the contribution date arrives, there will be people in the new tier. What is the appropriate normal cost for the contribution period? Is it to be based solely on the old tier (perhaps with an interest adjustment), or is it based on some expectation of the proportion of people that will be in each tier on the contribution date?

Comments on Section 3.21 Gain and Loss Analysis:

The first sentence combines the word “should” with an “unless” clause. It would be simpler to replace “should perform” with “should consider performing” and dropping the “unless” clause. What is the intention of the drafters if a spread gain method is used in the valuation?

Thank you for considering my comments.

Sincerely

A handwritten signature in black ink that reads "Brian B. Murphy". The signature is written in a cursive style with a large, stylized "M" at the end.

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