



Public Plans Community

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July 27, 2018

ASB Comments

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

Re: Comments on ASOP 4 Regarding IRDM

Members of the Actuarial Standards Board:

The attached comments were developed through the coordinated efforts of members of the Conference of Consulting Actuaries' (CCA) Public Plans Community and are being submitted to the ASB by the Steering Committee of the CCA Public Plans Community. However, these comments do not necessarily reflect the views of the CCA, the CCA's members, or any employers of CCA members, and should not be construed in any way as being endorsed by any of the aforementioned parties.

The members of the CCA Public Plans Community represent a broad cross section of public-sector actuaries whose extensive experience with public plans provides the framework for our response. The membership includes over 50 leading actuaries whose firms are responsible for cost and liability measurements for the majority of public sector retirement systems. We believe the overall response reflects a substantial consensus among the actuaries who provide valuation and consulting services to public pension plans.

Paul Angelo, FSA, FCA, MAAA, EA (By Direction)

Chair of the Public Plans Community on behalf of the Public Plans Community Steering Committee

Public Plans Community Steering Committee

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

Dear Board Members:

We, the Steering Committee of the Public Plans Community of the Conference of Consulting Actuaries¹, have reviewed the recently released exposure draft of a proposed revision to Actuarial Standard of Practice (ASOP) No. 4, *Measuring Pension Obligations and Determining Pension Plan Costs or Contributions*. We offer the following comments on **Section 3.11** of the proposed standard:

1. For several reasons, we believe that the “Investment Risk Defeasement Measure” (hereinafter referred to as the “IRDM”) as defined in Section 3.11 is seriously flawed as a generally applicable measure of investment risk:
 - a. The proposed metric is to be based on the unit credit cost method, which for public sector retirement systems is rarely used for funding valuations and is never used for financial reporting valuations. This means that the IRDM presents these systems’ liabilities – and hence their risks – in a fundamentally different way from the cost methods that they use for funding and financial reporting, all of which consider the effect of future salary increases on the liability attributed to participants’ past service. As a result, the IRDM and the funding liability for a public retirement system will differ for reasons that have nothing to do with investment risk. We note that a more appropriate IRDM-style measure of investment risk is already found in Section 3.4 of ASOP No. 51 which states:

“Methods may include, but are not limited to scenario tests, sensitivity tests, stochastic modeling, stress tests, and 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” (emphasis added).
 - b. We believe it is important for pension plan trustees to understand the implications and consequences of assuming investment risk, and we believe the most important measures to help them understand these implications and consequences are the stress tests, scenario tests, sensitivity tests and stochastic modeling described in ASOP 51. In contrast, as a measure of

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“investment risk,” the IRDM is deficient in that it only attempts to assess the cost of avoiding investment risk. The cost of avoiding investment risk is only of practical interest to plan trustees once they have concluded that the implications and potential consequences may be unaffordable. Making the IRDM mandatory may actually undermine the importance of the measures described in ASOP 51 that quantify the implications and potential consequences of risk, none of which ASOP 51 mandates.

- c. We note that many pension plans now contain plan design features that mitigate investment risk, such as establishing benefit accruals based on actual investment returns. The IRDM, as defined in the exposure draft, does not reflect such plan features, and so cannot assess the investment risk for such plans. The IRDM also cannot assess the risk of a pension plan that pays benefits through variable annuity contracts.
 - d. The IRDM, as its name suggests, focuses singularly on investment risk and not on other aspects of plan experience (e.g., improving longevity, retirements occurring earlier than projected using assumptions based on past experience due to unforeseen changes in sponsors’ financial circumstances, etc.). This provides a decidedly narrow picture of a plan’s risk that seems inconsistent with the more complete approach to risk assessment that is embodied in ASOP No. 51, *Assessment and Disclosure of Risk Associated with Measuring Pension Obligations and Determining Pension Plan Contributions*.
2. Additionally, the incorporation of the IRDM in the exposure draft as a required disclosure in all actuarial valuations presents a number of problems in terms of consistency with the operating policies of the Actuarial Standards Board and with other standards it has promulgated.
- a. In requiring disclosure of a metric using particular methods and assumptions, the Actuarial Standards Board is deviating in a significant way from the principle that Standards of Practice should be principles-based rather than prescriptive in defining appropriate actuarial practice. The proposed requirements of Section 3.11 are in direct conflict with ASOP 1, Section 3.1.4 which says:

“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.”
 - b. In our opinion, a robust examination of investment risk – or any other risk – faced by a pension plan most logically belongs in ASOP No. 51, *Assessment and Disclosure of Risk Associated with Measuring Pension Obligations and Determining Pension Plan Contributions*. In fact, ASOP No. 51 already contains principles-based guidance to evaluating pension plans’ investment risks. ASOP No. 51 appropriately does not prescribe one method for assessing risk and instead suggests various methods for assessment of risk that focus on possible outcomes, including scenario tests, stress tests and stochastic modeling. Any of these would be more generally applicable than the proposed theoretical cost to defease a plan’s investment risk.
 - c. ASOPs Nos. 4, 27 and 35 emphasize that a primary consideration in the selection of actuarial methods and assumptions is the purpose of the measurement. The discount rates mandated for

use in the calculation of the IRDM do not produce a number that is useful in assessing and managing ongoing investment risk. Moreover, the mandated use of the unit credit (i.e., accrued benefit) cost method, together with the use of current market interest rates, implies that the most useful and commonly understood purpose of the IRDM is as an estimate of the cost of settling the obligation for accrued benefits, and not as an investment-risk measure.²

Identifying the primary purpose of the IRDM as a settlement measure is important because it limits its relevance, particularly for public sector retirement systems. In many jurisdictions in the United States it is legally impermissible, outside of bankruptcy, for public retirement systems to freeze benefit accruals or to settle obligations in the manner represented by the IRDM calculation. The presentation of such a metric in actuarial reports prepared for such retirement systems would immediately incur the risk of misuse and/or misinterpretation by others. This could present a significant burden for actuaries signing such reports in terms of their responsibilities under Precept 8 of the *Code of Professional Conduct* and create more general reputational risk problems for the actuarial profession.³

For these reasons, the ASB should remove the requirement that the actuary “should calculate and disclose” any such settlement metric – by whatever name – as part of an ongoing funding valuation. At most the guidance should state that the actuary “should consider calculating and disclosing” such a value. Furthermore, if any “should calculate and disclose” guidance is retained it should apply only for plans where there is an established practice and procedure for engaging in a settlement transaction and only for those plan sponsors for whom the retirement system’s legal framework allows for such settlements.

3. Finally, we urge the ASB to acknowledge that the IRDM, in addition to being a settlement measure, is also the value known in the financial economic literature as the “Solvency Value”⁴, and to consider the policy implications of making that value a universally required disclosure.
 - a. We recognize that the disclosure of the IRDM would satisfy the demands of some readers of actuarial reports, who find that solvency/settlement-type values are useful for their purposes. However, these entities have demonstrated that they can produce estimates of such settlement values for their purposes independently. We believe that it is preferable for them to continue to do so, as they are neither principals nor intended users of the valuation actuary’s work product.
 - b. We remind the ASB that in 2008 the ASB was asked by the American Academy of Actuaries to “develop standards for consistently measuring the economic value of pension plan liabilities” (here “economic value” is another term for the solvency/settlement value). After an exhaustive

² The functional purpose of the IRDM as a settlement measure also calls into question the guidance in Section 3.11(d), which says the IRDM should use the same demographic assumptions as used in the funding valuation. In practice, settlement values often should use different demographic assumptions, specifically retirement rates, to reflect the curtailment of future benefit accruals.

³ Even in a bankruptcy proceeding, the presentation of a settlement value could affect the outcome of the bankruptcy process in a way that is both unnecessary and unintended, and result in a settlement more extreme than is called for by the facts and circumstances.

⁴ A common reference for this is the “Pension Actuary’s Guide to Financial Economics,” Joint AAA/SOA Task Force on Financial Economics and the Actuarial Model, 2006. In addition, the February 2016 “Report of the Pension Task Force of the Actuarial Standards Board” refers to the IRDM as the Solvency Value. Note we are not proposing that the ASB use the Solvency Value terminology, but only that you acknowledge that this is an established purpose for the value defined as the IRDM in the Exposure Draft.

review of ASOPs Nos. 4 and 27, the ASB in 2013 declined to develop such standards, choosing instead to focus on the “purpose of the measurement”. We understand that the ASB may now feel it is appropriate to provide such guidance, and we believe the IRDM as defined would fulfill the Academy’s request in most circumstances. However, the Academy specifically did not ask the ASB to require disclosure of a solvency/settlement value. We concur with that Academy position and urge the ASB to limit its new guidance to defining a solvency/settlement value, without requiring its disclosure.

- c. Finally, we urge the ASB to consider that requiring a solvency/settlement value disclosure characterized as a risk measure will itself incur a reputational risk for the profession. As discussed above, the IRDM is of questionable value taken solely as a risk measure. This impairs the credibility of the proposed standard – and by extension all actuarial standards -- because the IRDM’s limited merits as a risk measure cannot justify its required disclosure in all pension valuations. As plans realize and then explain to stakeholders that the disclosure is required by the ASB but is of limited practical value for their plans, the value of other required disclosures may also be questioned and the credibility of the ASB and the ASOPs may suffer.

For these reasons, we urge the ASB to confine its guidance to defining a solvency/settlement value, and leave its disclosure to the professional judgement of the valuation actuary. As noted above, the only situation where it might be appropriate to require such a disclosure would be where settlement is an established practice, in which case the disclosed value should be the actual settlement value determined under the terms of the plan.

We appreciate the opportunity to provide feedback on the proposed revisions to ASOP No. 4 and would be happy to discuss our comments in greater detail.

Sincerely,

Members of the Conference of Consulting Actuaries Public Plans Community Steering Committee

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