July 27, 2018

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

RE: ASB COMMENTS

Dear Sir/Madam:

The Segal Group (Segal) is pleased to comment on the exposure draft of a proposed revision of ASOP No. 4, *Measuring Pension Obligations and Determining Pension Plan Costs or Contributions*. Segal is a major consulting firm providing actuarial services to all types of pension plans, with special expertise in the multiemployer and public sector areas. We have identified several concerns and places where further revisions would clarify the requirements and improve their practicality (make them easier to satisfy), while maintaining the spirit of the principles included in the proposed revision.

Our comments include responses to the questions asked in the cover memo as well as comments on specific sections of the exposure draft.

**Responses to Questions**

Our responses to the questions asked by the ASB are shown below:

1. **Section 3.11, Investment Risk Defeasement Measure**, requires the calculation and disclosure of an investment risk defeasement measure when the actuary is performing a funding valuation. The guidance allows for discount rates to be based upon either U.S. Treasury yields or yields of fixed income debt securities that receive one of the two highest ratings given by a recognized ratings agency. Are these discount rate choices appropriate? If not, what rate choice would you suggest?

   We believe that ASB should clarify the purpose of this measure, as in many situations investment risk cannot be “defeased” in any practical sense, and there is widespread concern with possible misuse of this measure. Please see our expanded comments below...
on section 3.11. As to the specific questions posed, we believe that the standard should be less prescriptive, so that additional choices are available.

2. Under certain circumstances, section 3.20, Reasonable Actuarially Determined Contribution, requires the actuary to calculate and disclose a reasonable actuarially determined contribution. Do the conditions in this section describe an appropriate contribution allocation procedure for this purpose? If not, what changes would you suggest?

We support the requirement for this calculation and disclosure. However, as discussed in our comments on section 3.20(b), we believe that certain potential restrictions on the actuarial cost method are not needed in light of restrictions on the contribution allocation procedure. See also proposed language below in section 3.14 on amortization methods.

Comments on Specific Sections of the Exposure Draft of the Proposed Revision

Our detailed concerns with respect to the exposure draft of the proposed revision include the following:

▶ Section 2: Definitions

To be consistent with market-consistent present value, and because this would be a major change that many plans and actuaries find challenging and unnecessary, we suggest that investment risk defeasement measure (IRDM) be defined in section 2. The first sentence of the definition could be “An obligation measure that reflects the cost of effectively defeasing the investment risk of the plan.” As discussed below with respect to Section 3.11, more guidance is needed on the purpose of this measurement; that purpose should also be expressed in the definition (as for example is the case with the Section 2.11 definition of funding valuation). Section 3.11 would then start as follows: “If the actuary is performing a funding valuation, the actuary should calculate and disclose an investment risk defeasement measure.”

Throughout this exposure draft, we found the interconnections among contribution allocation procedure, output smoothing method, and actuarially determined contribution confusing, especially since “The output smoothing method may be a component of the contribution allocation procedure or may be applied to the results of a contribution allocation procedure.” We suggest that what is intended in different sections of the proposed standard could be made clearer if a new term, smoothed contribution, is defined. The definition could be “A potential payment to the plan as determined after applying an output smoothing method to the actuarially determined contribution. It may or may not be the amount actually paid by the plan sponsor or other contributing entity.” This definition parallels the definition of actuarially determined contribution and, as discussed below, would make the language in section 3.16 and other places easier to understand.

In addition, it may be clearer if actuarially determined contribution is defined without reference to an output smoothing method. For the purpose of these comments, we have not
assumed any change in its definition but please consider whether such a change would improve the clarity of the ASOP.

- Section 2.12: The definition of a **Funding Valuation** might be interpreted to include a benefit payment projection provided by the actuary for a SERP that is funded on a pay-as-you-go basis. We do not believe that this was intended, nor is this appropriate. This should be clarified.

- Section 2.18: The definition of **output smoothing method** in the exposure draft is limited to a **contribution allocation procedure**, but this should also apply to a **cost allocation procedure** (Section 2.9) for purposes of determining a **periodic cost**.

  This definition also includes several references to “contributions.” This is inconsistent with the definition of **contribution allocation procedure** and its references to an **actuarially determined contribution**. An **actuarially determined contribution** is a “potential payment to the plan…It may or may not be the amount actually paid by the plan sponsor or other contributing entity.” We suggest that the language be changed to reference either the **actuarially determined contribution, periodic cost**, or “a potential payment to the plan.”

- Section 3.11: Further to the comment in Section 2 above (the proposed addition of a definition of **investment risk defeasement measure**), the proposed standard does not provide clear guidance to the actuary on the purpose of calculating the investment risk defeasement measure; this is especially of concern when the investment risk cannot be “defeased” in any practical sense, given statutory or market constraints.

  The ASB should provide a better rationale for this measure, enabling the actuary to clarify what it represents, and what it does not represent. Many believe that the measure will provide information on the amount of investment risk being taken by the plan; however, for some plans there will be no comparable obligation measure to evaluate that particular level of risk. For instance, many public sector plans do not otherwise calculate a measurement of the benefits accrued to date under the unit credit liability method. If the purpose is as just described, to provide internal comparability the standard should allow the defeasement measure to be determined as the actuarial accrued liability based on the cost allocation method being used to fund the plan.

  Given widespread concerns in the public plans sector with possible misunderstanding and misuse of the defeasement measure, by both intended users and other parties (see Precept 8), the standard should:

  - encourage, if not require, some type of disclosure about the purpose of the measure and to further acknowledge (if appropriate) that the investment risk cannot be defeased.

  - consider whether to allow this disclosure to appear in a side letter provided to all intended users, rather than in the main body of the actuarial report on the results of
the funding valuation, to allow for a full explanation of the measure and its limitations.

We also believe that, if the ASB is intent on retaining this section, it should be far less prescriptive and take into account the possibility of using other approaches that in the actuary’s professional judgment are consistent with the purpose of this measurement. This revision could potentially reduce both the amount of additional work required and the possibility of confusion for the user. One approach to implementing this suggestion would be to revise the end of (c) along the following lines.

“Examples of discount rates that the actuary could use include:

1. U.S. Treasury yields;
2. “Current Liability” discount rates;
3. rates at which the pension obligation can be effectively settled. The actuary may use yields of fixed-income debt securities that receive one of the two highest ratings given by a recognized ratings agency;
4. rates published by the PBGC for plan terminations;
5. non-stabilized HATFA (ERISA single-employer funding) corporate bond segment rates; or
6. rates implicit in an annuity purchase quote from an insurance company.”

Finally, if the pension plan has investment risk-sharing features (e.g., variable annuity, benefits linked to a market index, etc.), then the assumed discount rate and the economic assumptions underlying the assumed benefits payable should be consistent in accordance with ASOP No. 27, Section 3.12. An investment risk defeasement measure may not be meaningful for a true variable pension plan, and may have limited application to other designs with investment-risk sharing features. Additional guidance to the actuary would be useful for these situations.

Section 3.11(d): We found this subsection to be confusing. We suggest the following, structured to be more parallel with the language in section 3.10:

“d. assumptions other than the discount rates described in 3.11(c) should be reasonable assumptions that, in the actuary’s professional judgment, are either those used in the funding valuation or those based on the actuary’s observations of the estimates inherent in market data, or a combination thereof, in accordance with the guidance in ASOP Nos. 27 and 35 and taking into account the purpose of the measurement.”

Section 3.14: We believe that an amortization method selected by the actuary should always be designed to fully amortize the unfunded actuarial accrued liability within a
reasonable time period. We think this is especially important given the new requirement to calculate and disclose a **reasonable actuarially determined contribution**. We therefore suggest that this section be revised along the following lines:

“If the actuary selects an **amortization method**, the actuary should select an **amortization method** that fully amortizes the unfunded **actuarial accrued liability** within a reasonable time period and that meets at least one of the following conditions:

a. the payments do not increase;

b. the payments do not increase more rapidly than expected covered payroll; or

c. the payments exceed nominal interest on the unfunded **actuarial accrued liability**.

For purposes of determining a reasonable time period, the actuary should consider factors such as the following:

i. the length of time until amortization payments exceed nominal interest on the unfunded **actuarial accrued liability**;

ii. the duration of the **actuarial accrued liability**;

iii. the source of the unfunded **actuarial accrued liability** or change in the unfunded **actuarial accrued liability**; and

iv. the **funded status** of the plan or period to plan insolvency, if applicable.”

We also note that the cost methodology used to determine annual accounting expense under U.S. GAAP (FASB ASC 715) may not meet the conditions of this section (e.g., due to the standard gain/loss corridor or due to different interest rates on liabilities vs assets), leading to a position that the methodology is unreasonable. Since these requirements only apply when the actuary selects the methods, this may not affect a plan that is subject to GAAP. Please clarify whether the actuary would be able to select the GAAP methodology to develop an annual cost for a plan that is not subject to GAAP.

Section 3.16: We suggest that the wording of this section be clarified to take into account the proposed definition of **smoothed contribution**. We note that further clarification could be achieved if the definition of **actuarially determined contribution** were changed to exclude reference to an **output smoothing method**. In the absence of that latter change, the wording could be as follows:

“If the actuary selects an **output smoothing method**, the actuary should select an **output smoothing method** that results in a reasonable relationship between the **smoothed**
contribution and the actuarially determined contribution (prior to the application of any output smoothing method). A reasonable relationship includes the following:

a. the output smoothing method produces a smoothed contribution that falls within a reasonable range around the corresponding actuarially determined contribution (prior to the application of any output smoothing method);

b. any differences between the smoothed contribution and the actuarially determined contribution (prior to the application of any output smoothing method) are recognized within a reasonable period of time; and

c. the output smoothing method is not expected to systematically produce smoothed contributions less than the actuarially determined contribution (prior to the application of any output smoothing method).”

Section 3.18: We believe that this section should be expanded to take into account the possibility that the actuary selects both a contribution allocation procedure and an output smoothing method. When selecting both, the actuary should ensure that, in the actuary’s professional judgment, the combination is consistent with the plan accumulating adequate assets to make benefit payments when due, assuming that all actuarial assumptions will be realized and that the plan sponsor or other contributing entity will make actuarially determined contributions (after applying any output smoothing method) when due.

Section 3.19: In the current ASOP No. 4, the corresponding section 3.14.2 does not include the phrase “that does not include a prescribed assumption or method set by law.” One potential interpretation of the revised language is: if the actuary is performing a funding valuation for a qualified private sector plan using a contribution allocation procedure that produces a range of values from the ERISA minimum required contribution to the maximum tax-deductible amount, then the actuary does not need to “qualitatively assess the implications… on the plan’s expected future contributions and funded status” because that funding valuation would include a prescribed assumption or method set by law.

For single-employer ERISA plans, the mortality assumption, the discount rates and the unit credit actuarial cost method clearly meet the definition of prescribed assumption or method set by law. For multiemployer ERISA plans, the current liability assumptions that are used for a relatively minor portion of the funding determination and the set of actuarial cost methods that are permissible for this purpose could appear to also meet the definition of prescribed assumption or method set by law. The meaning of this Section needs to be clarified as to whether it applies even for relatively minor or limited prescriptive aspects of the assumptions or methods.

The issue of whether or not the remainder of section 3.19 applies would also affect the disclosure requirements under sections 4.1(y) and 4.1(z).

Section 3.20: Segal commends the ASB for proposing that the actuary should calculate and disclose a Reasonable Actuarially Determined Contribution (RADC) when performing a
funding valuation, except when it includes a prescribed assumption or method set by law. However, as this is the same conditional clause as in section 3.19, we see the same issues as outlined in our comments on that section.

For a plan using a prescribed basis for a contribution allocation procedure that wants to consider an alternative approach in between the ERISA minimum and maximum levels, it appears that (at least one of) the funding alternatives provided by the actuary would need to meet the RADC requirements. The standard should clarify that point – as applied to all types of plans.

The following paragraphs provide examples of concerns as to meeting the RADC requirements.

The single-employer ERISA minimum contribution basis does not appear to meet the RADC conditions due to the use of “stabilized” interest rates. It is unclear whether use of “non-stabilized” 24-month average interest rates would be considered “reasonable” as a basis for developing RADC options for an ERISA plan – we believe that should be permitted. These types of issues should be clarified.

Consider also a plan that is not subject to ERISA, but the sponsor wants to develop a contribution approach along similar lines. We believe that the actuary should be able to select the single-employer ERISA methodology (using non-stabilized bond rates, with appropriate adjustments in lieu of credit balance elections) for this plan.

Section 3.20(b): We believe that the proposed restriction on “an actuarial cost method with individual attribution” should be clarified. In addition, it may be that this or other potential restrictions are not needed, especially in light of the changes we propose above to improve Section 3.14.

Specifically, for plans that have various types of retirement benefit accruals (flat-dollar or percentage of contributions, and those that associate various percentages of salary for service rendered during certain time periods), the calculation of normal cost under the entry age normal actuarial cost method may be based on the current level of benefits that is applicable to each employee (i.e. based on that employee’s current accrual rate, not that for a “replacement life”). This is commonly used and provides for a more stable contribution allocation, which is especially beneficial for plans funded by fixed contribution rates. Section 3.17(c) of the exposure draft notes that “stability or predictability of periodic costs or actuarially determined contributions” is one of the factors that should be taken into consideration. It is important to distinguish these methods from an “ultimate entry age” approach that bases the normal cost for an employee on a hypothetical replacement, potentially in a new (and far different) tier of benefits. We therefore suggest that this language could be modified as follows:

“If an actuarial cost method is used, it should be consistent with section 3.13. If an actuarial cost method with individual attribution is used, each participant’s normal cost
should be based on the plan provisions applicable to that participant. This could be based on a member’s historical accrual rate pattern or on that member’s current accrual rate as if it had always been in effect.”

- Section 3.20(f): We suggest that this could be shortened, as follows: “the contribution allocation procedure should be consistent with section 3.18.”

- Section 4.1(y): We suggest that this should be prefaced by “if applicable,” similar to 4.1(z) as section 3.19 leads to both these disclosure requirements.

- Section 4.1(aa): There is a requirement to disclose the reasonable actuarially determined contribution and corresponding funded status in accordance with section 3.20. We believe these values are also subject to the same disclosure requirements that would apply to the underlying funding valuation. These would include sections 4.1(k) through 4.1(t) and maybe others as well. We suggest this be clarified.

- Section 4.4: We suggest that this section be amended to be consistent with the corresponding section in ASOP Nos. 27 and 35.

Please contact us if you wish to discuss any of these views.

Sincerely,

Eli Greenblum FSA, MAAA, EA
Senior Vice President & Chief Actuary