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July 31, 2018

Submitted via email to comments@actuary.org

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

Re: Comments on Exposure Drafts of Proposed Revisions to ASOP Nos. 4, 27, and 35

Members of the Actuarial Standards Board:

We would like to thank the Actuarial Standards Board (ASB) and the Pension Committee of the ASB for the effort that went into the proposed revisions to Actuarial Standard of Practice (ASOP) Nos. 4, 27, and 35. We appreciate the opportunity to provide our comments.

Who We Are

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance.

Introduction

The proposed revisions to ASOP No. 4 would provide additional guidance to actuaries in a number of areas, including:

- Selection of actuarial assumptions (section 3.8)
- Selection of amortization methods (section 3.14)
- Selection of output smoothing methods (section 3.16)
- Selection of a cost or contribution allocation procedure (section 3.17)
- Calculation of a reasonable actuarially determined contribution (section 3.20)
- Gain/loss analysis (section 3.21)

In general, we are comfortable with the proposed revisions in these specific areas, as well as the corresponding revisions to the communication requirements in section 4.1 of ASOP No. 4. However, we recommend clarifying the requirements regarding the calculation of a reasonable actuarially determined contribution, as discussed further below.

In addition to these changes, the proposed revisions to ASOP No. 4 would also introduce a requirement that, when performing a funding valuation, an actuary must calculate and disclose an Investment Risk Defeasement Measure (IRDM). We have several concerns with this proposed requirement, which are discussed in the following section.

The proposed revisions to ASOP Nos. 27 and 35 would provide additional guidance to actuaries regarding:

- Phase-in of changes in assumptions (section 3.6.3 of ASOP No. 27 and section 3.4 of ASOP No. 35)
- Review of assumptions (section 3.13 of ASOP No. 27 and section 3.8 of ASOP No. 35)
- Rationale for assumptions (section 4.1.2 of ASOP Nos. 27 and 35)

In addition, the proposed revisions to ASOP No. 35 would provide additional guidance regarding the selection of mortality assumptions. We believe these proposed revisions to ASOP Nos. 27 and 35 are appropriate, and do not recommend any changes to the Exposure Drafts.

Investment Risk Defeasement Measure

The proposed revisions to ASOP No. 4 would require the calculation and disclosure of an IRDM, an "obligation measure to reflect the cost of effectively defeasing the investment risk of the plan." This would be determined using a discount rate based on Treasury or high quality corporate bond yields, and would reflect benefits earned as of the measurement date.

Some economists and actuaries believe that such a defeasement measure represents the "true cost" of a defined benefit promise, and that its disclosure should therefore be mandated. Some further assert that the disclosure of an IRDM may have helped avoid the challenges facing many state and local public pension plans, in the United States and elsewhere, by leading taxpayers and legislators to make better decisions about benefit levels and funding policies. However, we do not believe that such a disclosure on its own would be sufficient to achieve this result, and we are concerned that the addition of an IRDM in actuarial reports will create greater confusion as the intended users of the reports and other interested parties attempt to understand the implications of this measure.

In many cases, the IRDM will be far larger than amounts currently reported as Actuarial Accrued Liabilities for public pension plans. We expect that stakeholders will then need to reconcile two critical observations:

1) Were a plan to attempt to defease investment risk by investing in the specified risk-free or low-risk securities, it would be very difficult in many cases for the plan to pay the full amount of benefits promised using only existing plan assets, even if benefit accruals were immediately frozen.
2) On the other hand, if a plan were to maintain its existing investment policy and fund benefits according to a reasonable contribution policy, it would have a significantly greater chance of paying all promised benefits in most cases. It would also generally have a much higher probability of paying amounts already accrued.

As a result, many stakeholders may conclude that the IRDM is of limited utility. Some could even draw an erroneous conclusion that defeasement or de-risking of any kind could jeopardize benefit security.

Investment Risk Should Be Considered within a Broader Context

We agree that there is a need for stakeholders to develop a deeper understanding of the various risks faced by pension systems. ASOP No. 51 has given the actuarial profession a much-needed push to better measure and disclose risk. Even before the new ASOP was finalized, many actuaries and firms, including those serving a number of large public sector plans, have restructured their reports to prominently discuss funding issues using clear language and well-supported recommendations. Unfortunately, such disclosures may not always be understood or taken into consideration by all stakeholders. Addition of the IRDM, ostensibly intended to quantify risk, would instead introduce an entirely new and competing framework for understanding risk, one which we suspect will be relevant for only a small group of users. We do not believe such disclosures by themselves will have a meaningful impact on the management of these plans, but will merely underscore the point that reduction or elimination of investment risk will generally be unaffordable for many plans, even if they are immediately frozen. Disclosure of an IRDM, to the extent an actuary believes it is relevant to understanding risk, should be made within the broader context of the actuary's risk assessment under ASOP No. 51 rather than as a required, stand-alone measurement in a funding valuation report. As a stand-alone measurement, the IRDM would be unrelated to any other number in the report, or to any recommended contribution amount or funding policy. Such a disclosure would inevitably lead to confusion without further extensive disclosure by the actuary of what the IRDM represents and why it is being included.

Potential Disparity in Calculation of IRDM

We also note that the adoption of the IRDM, as currently defined, may not provide useful information even for those stakeholders who seek to understand the cost to defease a plan's obligations using low-risk investments. The proposed definition points to the use of a discount rate based on Treasury yields or the yields on high quality corporate bonds. Under current market conditions, Treasury yields and AA or AAA corporate bond yields could differ by 100 basis points or more. For long-duration public pension obligations, such a disparity could lead to a difference in the calculated value of the IRDM of 20 percent or more. Inevitably, there will be controversy over which basis should be considered more appropriate, with some actuaries and users preferring one basis over the other. Again, the result will be confusion rather than clarity, distracting stakeholders from the very real challenges of funding these plans to meet the promised benefits. If the IRDM requirement is retained, it should be accompanied by language indicating that the calculation of the IRDM could vary widely based on the specific assumptions used, in order to minimize such confusion.

Discount Rates Used in Determining IRDM

The ASB has also asked for comments on the appropriateness of using Treasury or high-quality corporate bond rates in determining the IRDM. We would note here that actuaries of U.S. and Canadian corporate defined benefit pension plans already disclose a range of obligation measures which might qualify as "defeasement measures." To the extent the current concept of the IRDM is retained, we believe that actuaries should be permitted to comply with the disclosure requirement by simply citing which of these measures, in their view, best qualifies as a “defeasement measure” and why. For example, plan sponsors reporting under U.S. Generally Accepted Accounting Principles are required by Accounting Standards Codification Topic 715 to disclose an Accumulated Benefit Obligation (ABO), which reflects benefits accrued as of the measurement date and a discount rate based on high quality corporate bond yields. We believe an actuary could reasonably conclude that the ABO meets the requirements of an IRDM, and it would be helpful for the standard to state this more explicitly.

Further, we believe that the discount rate requirements should be loosened to accommodate existing unsmoothed corporate bond yield curves specified under the Pension Protection Act. Many actuarial reports already contain a wide range of funding measures, and, as noted above, we believe the addition of another measure of liability on a different basis from any other in the report will not help sponsors manage these plans more effectively.

As further support for the unsmoothed PPA yield curve, we note that only a very small minority of sponsors have chosen to invest their pension assets in anything resembling a true defeasement portfolio. Even plan sponsors that have chosen to effectively de-risk their pension plans typically employ fixed income portfolios that are diversified across a range of credit quality. Similarly, insurance companies usually invest only a small portion of the assets backing pension and annuity obligations in risk-free Treasuries. The use of Treasury yields or even AA-AAA corporate bond yields to calculate a defeasement measure therefore implies a form of defeasement which is in reality rarely employed. The unsmoothed corporate bond yield curves specified under the Pension Protection Act reflect the U.S. Treasury Department’s High Quality Market (HQM) yields. The HQM yields reflect a broader range (from A to AAA) of credit qualities, and therefore represent a better approximation of an actual defeasement portfolio yield while still being based on only high quality bonds.

We would also note that the definition of an IRDM refers to “discount rates consistent with market yields for a hypothetical bond portfolio,” but does not explicitly refer to the potential use of a spot yield curve. While we believe the definition as currently drafted could be interpreted as allowing the use of a spot yield curve derived from bond data, rather than a hypothetical portfolio of actual bonds, it would be helpful to clarify this.

Finally, we note that Governmental Accounting Standards Board (GASB) Statement No. 75 allows for the use of a “…yield or index rate for 20-year, tax-exempt general obligation municipal bonds with an average rating of AA/Aa or higher (or equivalent quality on another rating scale)…” in certain circumstances. To the extent that this yield is more relevant to the financing of many public pension plans than a corporate bond curve, we believe its use should be permitted in the IRDM determination.

IRDM Requirement and Unfunded Plans

As proposed, the IRDM requirement would apply to all funding valuations. We note that the definition of a “funding valuation” includes measurements performed to determine plan contributions or to evaluate the adequacy of specified contribution levels. It is our understanding that this definition is intended to capture situations where benefits to be paid in future years are pre-funded through assets segregated in a trust or other vehicle that is not accessible by the plan sponsor’s general creditors.

We believe that valuations performed for plans with pay-as-you-go funding policies (such as nonqualified plans) or that are funded using vehicles not truly segregated from the plan sponsor's general assets (such as a rabbi trust) should not require the calculation of an IRDM, as the IRDM would essentially be meaningless for these plans. To the extent that the IRDM requirement is retained, it would be helpful for the final standard to clarify this.

Calculation of a Reasonable Actuarially Determined Contribution

The proposed revisions to ASOP No. 4 would require that, if the actuary is performing a funding valuation that does not include a prescribed assumption or method set by law, the actuary must calculate a reasonable actuarially determined contribution that meets certain requirements. There are many situations in which public sector plans or other plans not subject to the Employee Retirement Income Security Act do not have a legally prescribed assumption or method for determining contributions. In such situations, the plan sponsor may consult with the actuary to select reasonable assumptions and an appropriate contribution allocation procedure. We believe that the proposed section 3.20 of ASOP No. 4 should be clarified to indicate that, in such situations, the actuary is not required to perform any additional calculations, provided that the actuary believes the conditions in section 3.20 are satisfied by the assumptions and methods agreed to in consultation with the plan sponsor.

Closing

Aon appreciates the opportunity to submit these comments regarding the proposed revisions to ASOP Nos. 4, 27, and 35. While we believe that the proposed revisions to ASOP Nos. 27 and 35 are appropriate and would represent an improvement over current standards, we believe that certain changes to the proposed revisions to ASOP No. 4 as described above would reduce (though likely not eliminate) unnecessary confusion. Furthermore, we believe the IRDM is of limited utility as a standalone disclosure item in a funding valuation report, and that if this requirement is implemented, it should be made a provision of ASOP No. 51 rather than ASOP No. 4.

If you have any questions regarding these comments, please contact the undersigned at the telephone number or email address provided below.

Sincerely,

Aon

Eric A. Keener

Eric A. Keener
FSA, EA, MAAA
Senior Partner and Chief Actuary, U.S. Retirement
(203) 523-8454
eric.keener@aon.com