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

RE: Proposed Revisions to ASOP 4

To the Members of the Actuarial Standards Board:

The Board of Trustees of the Omaha School Employees' Retirement System (Trustees or OSERS) thanks the Actuarial Standards Board for this opportunity to comment on the proposed revisions to ASOP 4. We recognize these revisions are rooted in the context of a perceived need for additional guidance for public retirement plans. As a public pension plan having served its membership for over 100 years, we have expended tremendous effort over the years working toward educating our members, the plan sponsor, the Nebraska Unicameral and the general public about appropriately funding our retirement plan. From this experience we have some observations that we believe may be of value in helping to shape ASOPs that can best advance the education of the public on pension plans.

Prescriptive or Principle-Based?

Before dealing with some specific items in the proposed revisions, we believe there are two broad issues that need to be addressed. The first of these is to note that many of the proposed changes for ASOP 4 are somewhat prescriptive, rather than being primarily principle-based. Generally, our actuaries have prided themselves in being professionals and being able to exercise appropriate judgment in applying the core principles of their profession. We have witnessed our actuaries holding steadfast to the ideal of conducting their work as professionals following these core principals.

The challenge in moving to a more prescriptive model in ASOP 4 is that there are now significantly more details that must be provided. No longer can the ASOP language call on the actuary to consider a course of action – now it must describe that course of action in a way that can fit all situations. All public pension plans are not alike. If the underlying prescriptive requirement is not based on a principle, it becomes very difficult, and perhaps impossible, to simply use professional judgment to fill in the missing steps. The point being, in order to be prescriptive and handle the wide range of real-world practice in the world of public pension plans, it may well take hundreds of pages rather than just a few paragraphs to provide adequate guidance.

Most public retirement systems currently require that an actuary they engage be a member of one of the actuarial organizations that subscribe to the Code of Professional Conduct and the Actuarial Standards of Practice, ensuring that they have someone who acts in a professional capacity. If the ASOPs for public plans become more prescriptive, at some point does the question raise whether the need and cost for professional actuaries remain necessary and will public pension plans begin to opt to engage someone who

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can calculate the numbers they need without including the additional ASOP-compliance information they don't need or want, reducing the influence the profession has in this area.

Limited Application

A second broad observation is that much of the new material in the proposed ASOP 4 revision may not apply to the majority of public pension plans. Section 3.20 does not apply when there is a prescribed assumption or method set by law, thereby excluding ERISA plans. Likewise, sections 3.14, 3.16, and 3.17 will not be applicable for ERISA plans because these methods are selected via federal laws and regulations. Of course, ERISA valuations performed by individuals who are only Enrolled Actuaries are already exempt from complying with any ASOPs. Another category of plans to which many of these new provisions would not seem to apply are unfunded plans. Because there is no intent to fund them formally, there would not technically be a funding valuation or the need for cost allocation procedures. Thus, many of these new sections really only apply to funded church and public plans.

At first glance, this may appear reasonable, under the presumption that if there are not already requirements for determining funding requirements, an actuary should follow reasonable procedures in setting these. Many public plans have controlling legislation that dictates much of what an actuary may do but because these rules are set by the states that established the retirement systems, the prescribed assumptions and methods exception of the ASOPs appear not apply.

Effectively, the ASOPs have set up a system whereby federally-set standards, some of which may have been legislated as a matter of delaying pension contributions to increase current tax revenues, are being presumed to be sufficient, while similar standards passed by state legislatures are deemed otherwise. It is not clear why the ASB should anticipate that officials elected to national offices will write legislation that is superior to that written by officials elected to state offices, who are more in tuned with the intricacies and nuisances of their respective plan. One size does not fit all. We recognize there are some high-profile public plans where elected officials have chosen to delay funding, perhaps even against the advice of the systems' actuaries, but we also recognize the PBGC has concerns about future finances, suggesting that the funding methods that are mandated for ERISA plans may have weaknesses as well. Excluding plans from the ASOP proposals solely because of the type of legislative body writing the rules does not appear to be exercising fiduciary responsibility.

There may be an argument that state legislators cannot objectively write funding rules for plans they establish, control, and fund. However, the plan provisions, the funding requirements, and significant information about the operations and funding progress of these systems are readily available to the public. If legislators are not behaving responsibly in the eyes of the public, the public will ultimately vote them out of office and select new legislators.

Section 3.11 - Defeasment

We next wish to address some specific issues where we believe the proposed revisions should be adjusted. First, we note that Section 3.11 requires that an actuary "calculate and disclose an obligation measure of effectively defeasing the investment risk" when performing a funding valuation. There are then some prescriptive elements of this calculation listed, including the valuing benefits accrued as of the measurement date, the cost method, and a discount rate to be selected from one of two specific sources.

Many public plans have adopted benefit provisions that mitigate the employer risk by adjusting the member benefits based on such measures as asset performance or plan funded ratio. A common example is a COLA or 13th check that is payable when the plan reaches a certain funding threshold. Another example is the use

of a variable interest crediting rate tied to recent investment returns or other economic measurements. In either of these examples, the benefits are based to some degree on actual asset performance. If investment risk is eliminated by purchasing Treasuries, the expected return will be significantly lower, reducing benefits. The proposed language for the investment risk defeasement cost is not clear as to how to proceed. Should the actuary assume that the benefits will not be reduced (simply changing the discount rate in a computer program) leading to a model which has inconsistent assumptions? Or should the actuary reduce the projected benefit payments, thereby leading to a calculated risk defeasement measure that actually contains a combination of investment risk reduction and benefit cuts? This is not simply a technical issue to be addressed – there will be other variants and odd situations that will arise, requiring more and more technical modifications.

Further, the described goal of this measure is to find the cost to “effectively” defease the investment risk. However, the discount rates described in 3.11.c are related to methods that are not capable of actually defeasing the investment risk. The use of current treasury rates as the discount rate suggest an investment strategy build solely on fixed income and not the realistic inclusion of other public investment vehicles. A simple illustration should demonstrate: Suppose retirement boards had been guided to implement a strategy based upon treasury yields in 1980. Retirement board trustees would have purchased bonds that lined up with projected cash flows for the next 30 years, and then purchased some 30-year Treasuries with the coupons removed that we intended to reinvest in 2010 to cover the remaining 40-60 years of payments that would still be due. However, in 2010, interest rates were significantly lower and so retirement boards would have found they did not have enough money to make the benefit payments. The risk was not “effectively” defeased because some (substantial) risk remained. Of course, we all knew in 1980 that interest rates were high and that such levels were not likely to continue. We feel much more confident in 2018 buying bonds to defease the risk, because rates are not likely to be much lower in 2048 than they are now. But, if rates are higher in 2048 (even if still below historic averages), plans would have more money than was needed. Thus, there still remains a risk –too much money. The plan sponsor has given up some other use of that money in the meantime. It does not appear the stated goal of this section is being accomplished, but is instead suggesting plan sponsors and retirement boards demonstrate capabilities to predict interest rates well past our lifetimes.

We also note that while the goal of this disclosure calls for defeasing investment risk, one of the options (3.11.c.2) is to determine the cost of settling pension obligation, thereby eliminating all risks. While investment risk is usually the largest, there is an inconsistency between the stated intent and the method to measure it. If this method is allowed, we suggest that the actuary be further required to disclose which risks are being eliminated so that users will not be misled. Quantifying the cost of eliminating risks may indeed be valuable (and certainly is something actuaries will be considering under ASOP 51), so it is not clear why only one of those risks be identified in ASOP 4.

Section 3.11 is stated to be applicable to funding valuations. As a practical matter for public plans, of course, any study of proposed changes to benefits or funding policies are still going to require an analysis be performed on this basis as well, since the decision makers will need to know the implications of any proposed changes for the risk defeasement cost to be disclosed. It should be emphasized that this measure will be guiding decisions and will be higher profile than just a simple disclosure in a report.

While the cost to defease investment risk may be of interest to some, we anticipate that it will not be a useful measure for many public retirement systems. After all, it reflects an action that cannot be implemented by most plans. Most public plans are open to new members and many are prohibited from

reducing future benefits for anyone who is currently in the plan. Attempting to defease the risk on a hypothetical benefit for a mid-career employee is purely an academic construct – and probably irresponsible at best. The accounting effort to actually carry out such a task would be incredibly challenging. Of course, as noted earlier, there are not financial instruments available that can actually defease the risk over the 80-100 years of remaining payouts expected to be made to current members. Further, these plans are investing in diverse portfolios designed to take an appropriate level of risk so as to provide benefits at a lower cost than could be managed in the absence of risk. In fact, the trustees of the plan are required by law to be prudent, and it is doubtful that a “no risk” investment portfolio would be deemed prudent.

The Nebraska Legislature has foreseen the wisdom to set prudent investment guidelines for OSERS and other Nebraska public pension plans to use as guidance. For OSERS specifically Neb. Rev. Stat. § 79-9,111 states:

79-9,111.

Employees retirement system; investments; board of trustees; powers and duties; state investment officer; powers and duties.

The board of trustees shall invest the funds of the retirement system in investments of the nature which individuals of prudence, discretion, and intelligence acquire or retain in dealing with the property of another. Such investments shall not be made for speculation but for investment, considering the probable safety of their capital as well as the probable income to be derived. The board of trustees shall not purchase investments on margin or enter into any futures contract or other contract obligation which requires the payment of margin or enter into any similar contractual arrangement which may result in losses in excess of the amount paid or deposited with respect to such investment or contract, unless such transaction constitutes a hedging transaction or is incurred for the purpose of portfolio or risk management for the funds and investments of the system. Prior to January 1, 2017, the board of trustees may write covered call options or put options. Prior to January 1, 2017, the board of trustees shall establish written guidelines for any such option, purchase, or contract obligation. Any such option, purchase, or contract obligation shall be governed by the prudent investment rule stated in this section for investment of the funds of the system. The board of trustees may lend any security if cash, United States Government obligations, or United States Government agency obligations with a market value equal to or exceeding the market value of the security lent are received as collateral. Prior to January 1, 2017, if shares of stock are purchased under this section, all proxies may be voted by the board of trustees prior to January 1, 2017. As of January 1, 2017, the funds of the retirement system shall be invested solely by the council and the state investment officer in accordance with the Nebraska State Funds Investment Act. The state investment officer may lend securities and vote proxies in accordance with the standard set forth in section [72-1246](#).

Thus, actuaries will be required to disclose a cost of an action that is not legal without further legislative action, not possible, nor desirable. We realize that some other disclosures may not be useful or appreciated by all plan sponsors, but such information tends to alert the plan sponsor of potential problems that they should know about. This disclosure, however, does not in most situations give the sponsor any useful information since there is no opportunity to actually defease risk. Additionally, the work required of the actuary to disclose the defeasement risk will be at a cost to the plan members, the very individuals who are

the public servants contributing to these plans. Additional cost have a fiscal impact on the funding of plans. We question how such a requirement benefits anyone beyond answering some academic curiosities.

The final concern we have with Section 3.11 is that this measure may not be fully understood by those who see the number. While actuarial reports for corporate plans are presented to CFOs, human resource managers, and others in similar positions, public plan actuarial reports are placed on retirement system web sites for public download and viewing, presented to legislative committees, and written about in the media. While it is fully possible to explain to corporate senior management the nuances of unit credit versus entry age normal and funding discount rates versus risk-defeased yield curves, the general public may not be as familiar with these concepts. While the general public is not a direct intended user of these actuarial reports, those of us who serve in this area are quite cognizant that the broad public is an indirect user.

Because most public retirement systems, including OSERS, must make their valuation reports available to the public, the presence of two sets of numbers can be easily misunderstood or intentionally misused. Publicly presenting two sets of numbers will allow those with an agenda to eliminate public retirement plans to future public servants the opportunity to say that the higher number is the “true” liability. As we have heard in the past, they will be able to assert that actuaries are perhaps being dishonest in providing the calculation used for plan funding purposes. Apart from this intentional misuse, it would certainly be an easy argument that “actuaries make up all these numbers – look how different these two numbers are”. These are mis-representations that have been spouted in recent years.

We strongly believe that this section 3.11 should include an “actuary shall consider” clause to provide for discretion when the issuance of additional disclosures will create confusion and/or mis-represent the consequences of an action that is prohibited at the current moment. In light of the ASOP 51 suggestion of a measure such as this as being an option, it appears section 3.11 could be eliminated altogether.

Section 3.16

The proposed language for this section should be modified to allow for a contribution rate to remain above the actuarially determined contribution for an indefinite time. The language in 3.16.a seems to prevent the smoothed rate from being too much higher, which should provide protection against unreasonable intergenerational equity issues. We do not see any reason that a smoothing method should be compelled to be lowered.

Section 3.20

This section applies for funding valuations when there is not a prescribed method or assumption set by law. In the real world, many, if not most, public plans have some additional legislative requirements for setting a method or assumption, but these requirements may not meet the definition of “prescribed assumption or method set by law” as defined in ASOP 4. Frequently, the legislative methods will nonetheless meet the requirements of this section, so that the actuary need only show one set of contribution numbers.

Our trustees understand the actuary is to disclose if a funding policy will not accumulate sufficient assets to pay the benefits of the plan. Ultimately, this is the central issue at stake. If there is a policy in place that will accumulate sufficient assets, there is little apparent value in providing an alternate measurement of a contribution rate. We believe that the requirements of 3.20 should be applicable only if the actuary has reason to believe that the current funding policy is inconsistent with accumulating sufficient assets. In that situation, the additional information serves to illustrate the needed change in contributions to fund the promised benefits, information which would be needed by the plan sponsor.

Section 3.20.g calls for the reflection of timing between the measurement date and the contribution date. For public retirement systems with multiple tiers (where successive tiers usually have lower benefits and normal cost rates) where the contribution rate is determined as of a measurement date a year or two before the implementation of the rate, this may add a great deal of complexity for very little value. The requirement, as written, does not allow for the actuary to exercise judgment regarding the significance of the factors involved. May the actuary ignore the anticipated reduction in normal cost rate of a few basis points? Must the actuary reflect that school district payroll is not exactly uniform throughout the year? May materiality be considered? In on-going plans, such differences are frequently inconsequential when compared to the probable variation in population size, payroll experience, and the like. This provision should be restated to include the phrase “The actuary should consider...” so as to avoid prescribing a high level of detail which will only serve to increase the complexity of the calculation with little impact on the result and further lend more confusion to the general public.

Concluding Thoughts

It is our understanding these proposed changes were made in response to the Pension Task Force, which in turn was formed in response to concerns about public sector pension plans. The implication seems to be that the additional requirements of these ASOPs will somehow provide actuaries with the guidance that is needed to help them act in a way that leads to changes in how public pension systems are valued, funded, designed, or presented. As we reflect over the past decade or so, there have been major shifts that have occurred with public retirement plans:

- the distribution of investment return assumption has shifted significantly lower
- the mortality assumptions of many systems has moved to a generational mortality basis
- contribution rates for employers have increased in most systems, and members have increased contributions in many cases, as well
- in Nebraska, the state also contributes to the OSERS plan and that rate has increased over the years
- benefit provisions for new hires (and for future accruals where legal) have been reduced or adjusted to share risk
- contribution determination methods have been developed to help move toward fully funding on-going plans, with some systems targeting funded ratios in excess of 100%
- the practice (inadvertently prompted by accounting standards) of an open 30-year level percentage of payroll amortization method appears to be disappearing
- the level of detail provided to board members and the general public has increased significantly

Through all of this, we see actuaries playing a significant role in helping public policy-makers make these changes. This does not suggest that actuaries are unsure of what to do and needing additional guidance, but rather that actuaries are able to work from the existing principles of the ASOPs to help advance the practice and solve problems.

What is not clear is that any of these proposed changes will cause law-makers to suddenly realize that they must make changes to public policy and choose pension funding over school funding. They may believe their role as elected officials is to serve the citizens who elected them by guiding public policy and making the challenging choices about how limited resources are to be allocated to best serve the public over time. And they may be right.

The Board of Trustees of the Omaha School Employees' Retirement System would strongly encourage more deliberation and discussion before implementing any changes.

Respectfully,

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