

COMMENT 12, JULY 31, 2008

TO: Actuarial Standards Board (ASB)

FROM: James S. Rubie, F.S.A., F.C.A., M.A.A.A.

RE: Request for Comments – Actuarial Standard of Practice (ASOP) No. 27

DATE: July 31, 2008

By way of introduction, I have been in the actuarial profession for 41 years and involved in retirement plan consulting for the last 37 years, with an emphasis on public sector plans. In recent years, I have been heavily involved in reviewing the work of other actuaries in the public sector, both for retirement and OPEB.

A common, pervasive practice with the larger public retirement systems is to amortize the Unfunded Actuarial Accrued Liability (UAAL) as a level percentage of future compensation over a period of years. The amortization period may be open or closed. It is not uncommon to see a state retirement system amortizing its UAAL over an open 30 years. This is a method sanctioned by the Governmental Accounting Standards Board (GASB). While I have questions as to how such a practice cannot but result in an inter-generational transfer of liability, the issue at hand is the selection of economic assumptions for measuring pension obligations. My comments therefore are directed at the selection of the rate of increase in future covered compensation.

What I have observed as the typical assumption is that the rate of increase in total covered compensation is equal to the ultimate rate of increase in individual compensation. For example, if the individual salary increase assumption consists of age-related rates from 9% at age 20 decreasing to 4.5% at age 55 and higher, the typical assumption as to the rate of increase in future covered compensation is 4.5%. I seldom see any support or explanation in the actuarial valuation reports for the components of or the basis for the rate of increase assumption – inflation, productivity growth, merit scale, longevity or growth in the active population. There well may be support for the assumption in a separate report, but I seldom find it in the actuarial valuation reports.

We have made open-group projections of future covered compensation, for a current population, using the individual salary increase rates and holding the active population static, with new entrants having similar demographics to recent new entrants. Such projections show a rate of growth in the total covered compensation that is less than the ultimate rate of increase assumed for individuals. From such an analysis, it can be inferred that an assumed rate of increase in total covered compensation equal to the ultimate rate of increase in compensation for individuals must have an implicit assumption of growth in the active population.

Another observation is that in a large percentage of the reports I have reviewed, where there is a history of the total covered compensation, the assumed rate exceeds the

compounded annual rate of increase for the last five or more years. In other words, there does not appear to be a basis for the assumption in the recent experience of the plan.

There is danger to the actuarial profession in the use of an assumption that is unrealistically high. The use of the level percentage of payroll amortization method results in negative amortization of the UAAL. If an open period of amortization is also used, there is perpetual negative amortization. The plan sponsor may think that the UAAL is being amortized, but sees it increase every year, unless there are actuarial gains. If the assumption of the rate of increase in covered compensation is too high, the UAAL will increase even more. At some point, the size of the UAAL is questioned. How did it get so big, when we have been paying the actuarially required contribution every year? Part of the blame will be placed on the actuary, who used unrealistically high assumptions about the rate of growth in covered compensation.

GASB in its "Guide to Implementation of GASB Statements 43 and 45 on Other Postemployment Benefits," provides guidance on the basis for the assumed rate of increase in covered payroll in Q & A 99. "For purposes of applying level percentage of payroll amortization, covered compensation may be assumed to increase over time as a result of the effect of inflation on general salary levels only." This of course is limited to reporting under GASB Statements 25, 27, 43 and 45. Furthermore, it would appear that many actuarial reports indicate that an assumption is being used that does not meet GASB's guidance. While I certainly do not advocate having GASB set standards for the selection of actuarial assumptions, there does not seem to be an explicit standard with respect to this assumption in ASOP 27. A similar assumption might be made for funding policy purposes, which could take into account more components, in particular growth in the active participant group. This is an assumption that I believe the ASB should explicitly address.

The actuarial profession would be well-served, if the ASB addressed acceptable methods for selecting this assumption, such as a building block approach. Since this assumption can have a demographic element, there may be some overlap here with ASOP 35. In my opinion, when an assumption is made about the rate of increase in future covered compensation, the actuary should (a) derive that assumption on a basis similar to and consistent with that used to develop the rates of individual compensation increases, and (b) disclose any demographic component used to develop the assumption.

These comments represent my personal views, and are not necessarily the views of my employer. Please feel free to contact me, if you have any questions or wish to discuss my comments further.