AMERICAN ACADEMY of ACTUARIES

October 3, 2012

California Actuarial Advisors Panel
P.O. Box 942850
Sacramento, CA 94250-5872

Subject: **Model Actuarial Funding Policies and Practices for Public Pension and OPEB Plans**

To the California Actuarial Advisors Panel (CAAP):

We are writing on behalf of the Public Plans Subcommittee of the American Academy of Actuaries[1] Pension Practice Council pursuant to the Request for Comments on Discussion Draft – Version 9c, *Model Actuarial Funding Policies and Practices (MAFPP) for Public Pension and OPEB Plans*.

We thank you for the opportunity to comment. We are pleased that the CAAP has undertaken the work to develop the Model Actuarial Funding Policies and Practices for Public Pension and OPEB Plans. Our comments are limited to the purpose, scope and general policy objectives. The Pension Practice Council intends to work on a practice note on funding policies for public plans, and, thus, we reserve our comments on specific elements of funding policies and practices until the Academy's process for the practice note is complete. At this time, the subcommittee is neither approving nor disapproving of the specific elements and rankings of the model actuarial funding policies and practices.

Purpose and Scope

- Because CAAP's authority is limited to California[2], the MAFPP should be limited to public pension plans in California. The subcommittee recommends that any references to applicability or potential applicability outside of CAAP's jurisdiction be removed.

- Given the established connection between accounting and funding, it would be appropriate to explain to the reader the historic context, including the use by public plans of GASB 25 and 27 Annual Required Contribution (ARC) parameters as a de facto funding standard in the past. With the adoption of GASB 67 and 68 as replacements for GASB 25 and 27, accounting has been differentiated from funding. The proposed draft should not intend to comment on or provide an alternative to GASB's financial reporting standards; rather, it should seek to fill the void created by the elimination of the ARC parameters to provide guidance for the funding of public defined benefit plans in the State of California.

[1] The American Academy of Actuaries is a 17,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

[2] CAAP was created by passage of Senate Bill 1123 pursuant to (California) Government Code § 7507.2.

- The MAFPP does not adequately address all of the funding policies and practices for other post-employment benefit (OPEB) plans. The subcommittee recommends that the MAFPP specifically be limited to public pension plans. In addition, the scope should be limited to ongoing public pension plans (i.e., plans whose members earn future accruals and that are open to new hires). While MAFPP makes some attempt to address the differences for closed plans, the topic requires consideration of many factors that are beyond the scope of this proposed draft.

- We note that the MAFPP would categorize the current Pension Protection Act (PPA) funding method (traditional unit credit) as "unacceptable". This seems politically sensitive and potentially highly charged. We therefore suggest that the scope clarify that the MAFPP specifically applies to a level cost model where the discount rate is based on the expected return on assets (and PPA is a different model based on funding toward a settlement obligation with discount rates based on corporate bond yields). The reasons to use a level cost model in the public sector versus the PPA model in the private sector are probably beyond the scope of what should be contained in the MAFPP.

- The model should clearly state its intended audience. If the model is written for an audience beyond actuaries familiar with the subject, we believe that the language will need to be modified appropriately for a non-actuarial readership. Even if it is intended only for actuaries, as noted in some of our other comments, it is important to keep in mind that nonetheless others outside the intended audience will want to use the document. We recommend CAAP take steps to ensure that a non-actuarial reader does not unintentionally misconstrue the document.

- The Subcommittee believes that the funding policy should specifically exclude certain actuarial calculations such as the method for setting purchase of service rates and the cost of gain sharing benefits.

- We recommend that the limitations of the model be clearly highlighted, preferably in a format such as bullet form (and in a box) on the first page. In addition, the limitations should be included on any summary pages and the category grid.

- The MAFPP does not appear to consider certain benefit structures such as those where a portion of the benefit depends on market investment returns or those where the benefit is the greater of two or more formulas. Either the scope should be limited excluding such benefit structures or additional practices should be added including considerations such as balancing the desire for a level percent of pay normal cost with the goal that the actuarial accrued liability always equal or exceed the present value of accumulated benefits.

- We appreciate that it may be useful to have five categories of practice for purposes of discussion of funding policies and practices. However, we recommend CAAP consider limiting the number of categories to three when the final MAFPP is issued. The three categories should include: acceptable practices, acceptable practices under certain circumstances, and not acceptable practices.

- The "Purpose and Scope" section should reference the prominent roles of the Actuarial Standards Board and the Actuarial Standards of Practice Especially if the CAAP intends that the model is supplementary guidance to creating a funding policy that is in compliance with Actuarial Standards of Practice.

- We recommend that the model include a description of the context for funding policy within a larger policy framework. Ideally, a funding policy would be coordinated with investment policy, benefit policy, and governance structure (as any or all of these may influence funding policy).

General Policy Objectives

- The subcommittee recommends that general policy objective 1, benefit security, should consist only of the first sentence. The second sentence is a conclusion drawn from the objective and others may reach a different conclusion.

- Related to general policy objective 1, we believe that there should be an objective to accumulate the expected cost of benefits by the time a member leaves employment. We note that this objective is included in the actuarial cost method objectives, but it is of such importance that it should also be included in the general policy objectives.

- The current general policy objectives 2 and 3 appear to actually be results of the underlying objectives of intergenerational and period-to-period equity. We suggest stating and discussing the underlying objectives as the general policy objectives instead of relegating them to the subsequent discussion within the document. In addition, the objective of intergenerational equity, as described, appears to only affect the allocation of costs for active employees. The objective of period-to-period equity would argue for lengthy amortization and smoothing of gains and losses on inactive liabilities. The discussion of intergenerational equity should address the intergenerational equity issues associated with gains and losses on benefits for inactive members who are not providing services to current taxpayers. To what extent should current versus future taxpayers be expected to pay for shortages attributable to a prior generation?

- General policy objective 5 – it is unclear what "asymmetric nature of pension plan governance" means. This objective appears to be a consideration of benefit security (addressed in objective 1) as opposed to a separate objective. We recommend that CAAP clarify the intent of objective 5.

- The discussion of balancing objectives should include all of the objectives, and not just generally policy objectives 2 and 3. The current discussion makes it appear that objectives 1 and 4 do not play a role in the balancing act.

Thank you for your consideration of these comments. We would be pleased to discuss these with you in more detail. Please contact David Goldfarb, the Academy's pension policy analyst (202-785-7868, goldfarb@actuary.org) if you have any questions.

Sincerely,

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Chair, Public Plans Subcommittee