AMERICAN ACADEMY of ACTUARIES

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Assessment and Disclosure of Risk
Actuarial Standards Board
1850 M Street NW, Suite 300
Washington, DC 20036-4601

Re: ASB COMMENTS - Comments on Proposed Actuarial Standard of Practice on Assessment and Disclosure of Risk Associated with Measuring Pension Obligations and Determining Pension Plan Contributions

Members of the Actuarial Standards Board:

The American Academy of Actuaries[1] Pension Committee respectfully asks for your consideration of our comments related to the Exposure Draft (ED) of the Proposed Actuarial Standard of Practice (ASOP) related to the Assessment and Disclosure of Risk Associated with Measuring Pension Obligations and Determining Pension Plan Contributions.

We agree that pension risk is an important topic and clearly one where actuaries have substantial expertise. While we agree that practice in this area can be improved, we believe that new standards should reflect practical considerations such as the degree of change from current practices. Actuarial practice as well as stakeholder understanding of pension risk assessment and disclosure might not be sufficiently developed to warrant a set of prescriptive rules, but instead would be better supported by general principles. These principles should provide meaningful information for substantially all pension actuarial valuations used for funding purposes but flexible enough to permit actuarial practice to develop and to engender stakeholder acceptance. Part of this flexibility should allow for the actuary to exercise judgment in determining the level of detail and degree of quantification for any risk assessment.

For example, sophisticated risk assessments are useful in many situations, but in some cases simple approximations could be equally useful and therefore more appropriate than expensive, detailed analysis. As noted in section 3.5, risk assessments should be tailored to the particular circumstances and should focus on the issues that are most concerning to

[1] The American Academy of Actuaries is an 18,500+ 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.

the actuary and for which the actuary regards as significant issues affecting the Principal (the "potential deviations in significant actuarial measurements"). As discussed below, we question whether quantitative risk assessments should be mandated at this time.

The risks required to be considered by the draft ASOP include those "risks that may have a material effect on the plan's financial condition." This phrase can be reasonably interpreted in a manner producing a list of risks that is quite extensive, potentially including asset returns, changes in interest rate environment, mortality/longevity, numbers of future new entrants, termination and retirement rates, option election experience, occurrence of layoffs, plant shutdowns or similar events, plan changes, etc. In addition, the actuary would appear to be required to consider various combinations of these events, and that these events could occur together or at different points in the projection period. Further, the actuary must also determine for each of these events what represents moderately adverse but plausible outcomes – where "plausible" in particular could be subject to a wide variety of interpretations. If each risk were taken singly, as we interpret the proposed ASOP to require, the potential number of scenarios to be modeled and issues to consider is extraordinarily large. This will likely result in information overload for the intended user and may well impose an unreasonable cost burden.

Rather than prescribe a detailed risk assessment process, the ASOP should clarify that the actuary should be able to focus on a few representative risks. For such representative risks, possibly in combination, the actuary might illustrate the volatility of future contributions, and possible trends in plan solvency levels. Actuarial judgment (which includes the actuary's assessment of the Principal's needs) should be used to determine whether the risk assessment should be made by assuming these events occur at the valuation date or whether longer periods of time should be used.

Currently Existing Guidance

The recent revisions to ASOPs No. 4, 6, 27, 35 and 41 significantly enhanced the required disclosure of types of risks associated with pension funding. In particular, actuaries must point out that future actuarial measurements may differ significantly from the current measurements, and the example given in ASOP 4 of an appropriate disclosure includes the reasons future actuarial measurements may differ. These qualitative disclosures provide the user notice that risk may need to be further considered and we question the usefulness of requiring additional related disclosures that may not substantially improve understanding beyond the current disclosures.

Section 2.7 of ASOP 1 acknowledges the importance of considering practical issues in deciding whether to expand the scope of an assignment:

"A professional assignment frequently requires the actuary to adopt a course of action that is likely to yield an appropriate result without being unnecessarily time-consuming, elaborate, or costly relative to the principal's needs. Thus, it is appropriate for the actuary, exercising professional judgment, to decide that the circumstances surrounding a particular assignment are such that it would not be necessary to undertake a particular task."

The risk ASOP should consider the costs of requiring an actuary to perform substantial additional work outside the scope of the assignment, and the role of actuarial judgment, by explicitly including language such as section 2.7 of ASOP 1. Also, as discussed in our response to question 5, requiring a disclosure that the Principal directed the actuary not to perform a risk assessment could help encourage the Principal to engage the actuary to perform such analysis.

Application to U.S. Tax Qualified Pension Plans (ERISA Plans)

Single Employer Plans
Single employer pension plans are governed by the 2006 Pension Protection Act, which has legally-prescribed assumptions for interest and mortality. The proposed ASOP should clarify whether the actuary is required to consider the risk of future changes in these prescribed assumptions. The ASOP should also clarify whether a risk assessment is required for governmental filings and participant notices where a particular presentation format is mandated or encouraged by the government.

Multiemployer Pension Plans
Multiemployer pension plans are jointly governed by a board of trustees representing management (employers) and labor (participants). These plans already have their own requirements under Internal Revenue Code (IRC) §432 for projecting results beyond the current valuation year to certify whether the plan would be in "Endangered" or "Critical" status (or "Critical and Declining" status under the Multiemployer Pension Reform Act (MPRA) of 2014. While IRC §432 does not mandate the modeling of various risks or alternate assumptions as part of these projections, it is common practice for a plan's trustees to request alternate scenarios to be modeled by the actuary in connection with developing Funding Improvement or Rehabilitation Plans. In addition to valuing the current year's assets and liabilities, the actuary must also project results for the 6 succeeding plan years. If a plan is certified as being in Endangered or Critical status, the plan must adopt a Funding Improvement Plan (if Endangered) or Rehabilitation plan (if Critical). The Funding Improvement or Rehabilitation plans need to be projected out for 10 or 15 year periods, and can sometimes become longer than that in practice. Until actuarial practice is further developed and stakeholder acceptance of such practice is garnered, we ask that any proposed application of risk assessment for multiemployer plans be coordinated with the existing scope of multiemployer plan valuation practices.

Responses to Specific Requests for Comments

Our specific responses to the stated questions are as follows:

1. **The discussion draft that preceded this proposed ASOP indicated that a risk assessment should be performed for substantially all pension assignments. The exposure draft has limited the assessment to funding valuations, as defined in section 2.1. Do you believe this limitation is appropriate? Why or why not? If not, what other types of valuations should include risk assessments?**

We support the narrowing of the scope of required assessments. As discussed throughout this letter, we would support further loosening of requirements for assessments while agreeing that risk assessments or disclosures regarding risk should be encouraged in many situations.

2. **Does the language in the exposure draft provide sufficient guidance to actuaries performing risk assessment work? If not, what additional guidance should be provided?**

This standard requires risk assessment work, and in doing so focuses much more on expanding the scope of what an actuary is required to do than on the considerations involved when doing such work. However, the guidance provided is not sufficient to clearly define the expanded scope of work. Some of the difficulties that are discussed in greater detail below include the meanings of "moderately adverse" and "plausible," the clarity and appropriateness of the large plan distinction, the risks to be assessed, and what must be done to assess the risks.

As discussed above, we agree that pension risk is an important topic and clearly one where actuaries have substantial expertise. We believe that this standard should focus on providing guidance to actuaries performing risk assessments.

3. **Is the language in the exposure draft sufficiently flexible to allow for new developments in this area of actuarial practice?**

Yes. The exposure draft does not require specific approaches to risk assessment work; Section 3.4 provides only examples of methods that may be used.

4. **Do you agree that the guidance in section 3.3 regarding assumptions used for the assessment of risk should include moderately adverse but plausible outcomes? If no, what guidance would you propose?**

The draft ASOP should be clarified so that there is flexibility to interpret this in any reasonable manner. For a risk assessment, it is unnecessary to identify the precise level of probability. For example, showing the effect of plausible changes in the key assumptions should be sufficient to allow the user to understand the effects of changes of different magnitude without having to assign a probability to any particular set of changes occurring. For considering events that potentially have a significantly different effect depending on whether a threshold is met, it might be more illuminating to consider a scenario that illustrates the possibility of an adverse outcome rather than focusing on how likely the event is. Judgment might also be needed in determining the appropriate approach; for example, “What is a moderately adverse but reasonably plausible outcome?” is a very different type of risk assessment than “What is the estimated likelihood of a catastrophic outcome?” Either (or both) questions could be appropriate given a particular set of circumstances.

5. **As discussed in section 3.5, for a funding valuation of a plan, the actuary should perform a risk assessment, which may be quantitative, qualitative, or both. Should the guidance require the actuary to use professional judgment**

in choosing which type of assessment (quantitative, qualitative, or both) to use? For example, if an actuary believes a quantitative assessment should be performed, do you believe providing a qualitative assessment instead of a quantitative assessment should be considered appropriate actuarial practice?

Yes, we believe it is appropriate to leave the determination of which type of risk assessment is appropriate for a given circumstance to the professional judgment of the actuary. An actuary might believe that a plan sponsor should have a number of risk assessments performed, including reviews of plan documents, plan administration, asset management, the financial volatility that the plan poses to the organization, etc. However, the plan sponsor could have a different view of the significance of these risks than the actuary does. Not performing an assessment the actuary thinks is advisable does not necessarily represent inappropriate actuarial practice. The actuary should have ongoing discussions with the plan sponsor regarding the sponsor's approach to managing risk in the pension plan. Such discussions can inform the actuary of existing risk measurements being performed by the sponsor or its other consultants. This would allow coordination of risk assessment between the actuary and the sponsor. Section 3.5 allows the actuary to rely on separate reports that the actuary has not produced, if the report is consistent with what the actuary would have produced.

Quantitative risk assessments can vary in detail and sophistication, from simple approximations to large, complicated and expensive projects; discussions with the plan sponsor will inform the actuarial judgment as to which is more appropriate to the circumstances. However, while the actuary can recommend them if the actuary believes they are warranted, the actuary cannot force the plan sponsor to engage the actuary in such efforts.

If the actuary believes a quantitative risk assessment is clearly called for but, at the request of the Principal, such an assessment is not performed the actuary's report should disclose this. Such disclosures could be effective motivation for a plan sponsor to request a risk assessment rather than have explicit documentation in their valuation report that the plan's fiduciaries chose not to investigate potential risks. In this case, the actuary should still consider inclusion of a qualitative risk assessment as an alternative to the more expansive quantitative assessment rejected by the Principal.

6. **Plan maturity measures have been included as a potential disclosure item to assist intended users in understanding the risks associated with the plan. Are there additional measures that may be disclosed that are significant to understanding the risks of the plan? If yes, what measures would you recommend as a disclosure item?**

We believe the examples listed are generally sufficient as examples; however, an additional ratio commonly used by public plan actuaries is the ratio of total actuarial accrued liability to payroll, so it might be appropriate to include that in the examples. Beyond that, we do not have additional ones to suggest. However, we believe that any specific plan maturity measure is not necessarily relevant or appropriate in a given situation, and thus we request that the standard retain its required disclosures only for those plan maturity measures that "the actuary believes are significant to understanding the risks associated with the plan" and also clarify that there are other ways of explaining the risks without showing these measures.

7. **Do you agree with the use of a threshold for requiring mandatory quantitative assessment that is based on the actuary's professional judgment? If not, what threshold do you believe should be used?**

Yes, we think any threshold should be left to the professional judgment of the actuary, in consideration of the available facts and circumstances. It would be helpful to include guidelines that illustrate when a quantitative risk assessment should be encouraged.

8. **Do you believe that the term "large plan" in section 3.7 is sufficiently clear that an actuary will be able to apply it in practice? If not, what clarification would you suggest? Are there other characteristics that should be specified in determining "large plan"?**

No, we do not believe it is sufficiently clear if that intention is to provide prescriptive rules of application. It might be sufficiently clear if the intention is that a "large plan" is to be recognized subjectively, and that different actuaries will come to different conclusions about what a large plan is. We recommend that latter approach. However, if prescriptive rules are needed in this area, the ASOP should give examples of the order of magnitude that the ASB considers to be large. For instance, it would be helpful to know if the ASB considers a large plan to be approximately 10,000 participants rather than 1,000 participants.

Another factor that could influence an actuary's judgment on whether a plan is a "large" plan is the size of the plan relative to the plan sponsor. A large plan could pose little risk to its sponsor (because of the sponsor's large size), and a small plan might pose a significant risk to its sponsor, due to its size relative to the sponsor. The ASOP should include the use of plan assets and liabilities as percentages of total company payroll (not the payroll of plan participants) and as a percentage of revenue, if available, as other factors to consider when determining whether a plan is large. (However, if the plan participants are intended users of the actuarial report, relative size might not be a relevant factor. Even if the plan is small relative to the sponsor, there could be risk to the participants if the company is or could become insolvent and unable to contribute to the plan.)

This section is perhaps implicitly acknowledging that the benefits of a risk assessment should be balanced against its costs. The ASOP should clarify that cost-benefit is a factor that could be considered in the actuary's judgment.

9. Is every five years an appropriate period for performing a mandatory quantitative assessment for a "large plan" in the absence of significant changes, as described in section 3.7?

Should the standard require a mandatory quantitative assessment, we do not believe it should be required more frequently than every five years, assuming no significant changes. With respect to significant changes, we suggest that the standard provide examples of factors that are and are not considered in making this determination. For instance, consistent with Section 3.2, we would not expect the actuary to assess any change in the likelihood of contributions actually being made to the plan.

Additional Specific Comments

Section 1.4 (Effective Date) - The effective date of four months after adoption is not sufficient for major changes in the required work for a funding valuation. We note that the current ASOP 4, with comparatively minor changes in what the actuary is required to do, became effective a year after adoption. Actuaries would need more time to make changes to report formats and valuation programs. These changes, and any additional fees associated with these changes, will need to be discussed with plan sponsors in advance. In addition, it is not clear when a quantitative risk assessment would be required for a large plan that had not had one performed in the past. Immediately, since one was not done within the preceding five years? Within the five-year period beginning on the effective date? While we do not believe this exercise should be required, we note that it is a significant undertaking, and thus we suggest the latter approach if this requirement is retained in the ASOP.

Section 2.1 (Definition of Funding Valuation) - The definition is not clear as to whether study/pricing work (e.g., determining the effects on funding of proposed plan changes) is included. We believe including such work in the definition would be counterproductive, and request clarification that it is not included, unless the proposed changes are either explicitly related to the risk assessment or likely to have a significant effect on the assessment. Such studies/pricings typically refer to the results of an annual valuation, which would have any required risk discussions included.

Section 2.2 (Definition of Risk) – In one view, there is no "potential of future deviation of actual results from expectations derived from actuarial assumptions" in the typical funding valuation of a pension plan, as the "actual results" are the current year's required contributions, which will not change if the actuarial assumptions are not realized. Only future years' required contributions (which are "actual results" of future valuations) are affected, and thus this definition of risk implicitly requires additional "results" be developed (projected future year contributions) from which the effect of deviations of results from actuarial assumptions can be measured. Is the intent to effectively require future year projections on top of the base valuation for the year? This is of course true for large plans under the draft ASOP where 10-year projections are required, but is it true for all plans regardless of size, even for plans for which a qualitative risk assessment is being done?

If so, in order to quantify any risk associated with “future deviations”, the actuary would first need to perform future years' contribution projections if it is the case assumptions are realized before the effect of experience different than assumed or changes in assumptions could be analyzed. In the absence of simplifying or approximation techniques, such baseline projections may well, on their own, be more expensive to perform than the required valuation to determine the current year's required contributions, and that is before the additional work to (i) determine the risks to model, the methodology to use when modeling, and the parameters and assumptions for such modeling, (ii) perform such modeling and (iii) formulate the presentation of the results. As discussed in our response to question 8, actuarial judgment is needed to appropriately balance the costs and benefits of a risk assessment. As such, we believe that it would be problematic to have a standard in effect that would require these projections.

Section 3.1 (Overview) - This section indicates that more guidance is needed because "a user of the measurement may not understand the effects of future experience differing from the assumptions used." The current ASOPs that apply to pension measurements already require disclosure of the fact that assumptions might not be realized, and that future results will differ as a result. In particular, ASOP 4 section 4.1r requires:

> r. a statement, appropriate for the intended users, indicating that future measurements (for example, of pension obligations, periodic costs, actuarially determined contributions, or funded status as applicable) may differ significantly from the current measurement. For example, a statement such as the following could be applicable: "Future actuarial measurements may differ significantly from the current measurements presented in this report due to such factors as the following: plan experience differing from that anticipated by the economic or demographic assumptions; changes in economic or demographic assumptions; increases or decreases expected as part of the natural operation of the methodology used for these measurements (such as the end of an amortization period or additional cost or contribution requirements based on the plan's funded status); and changes in plan provisions or applicable law.”

We believe that such currently required disclosure, along with other requirements in ASOPs 27 & 35 (ASOP 27 section 3.5.5 and ASOP 35 Section 3.10.5) to disclose the effects of changes in circumstances on assumptions, and the requirement in ASOP 41 Section 4.1.3.d to disclose "any cautions about risk and uncertainty" already provide sufficient notice to users of the effects of future experience differing from the assumptions used and changes in circumstances.

The exposure draft allows for a qualitative assessment. It is unclear how such a qualitative assessment would differ from or provide more useful information than is already provided by the currently required disclosures.

We also note that this section refers to a "user" rather than an "intended user." The term "user" is not defined in this draft ASOP or in ASOP 41, and could include a whole host of unspecified parties other than the plan sponsor. We believe this should be narrowed to "intended user."

Section 3.2 (Risks to be Assessed) - We believe that the reference to the actuary not being required to evaluate "the ability of the plan sponsor or other contributing entity to make contributions" should be changed to "the ability or willingness of the plan sponsor or other contributing entity to make contributions," or, perhaps more to the point, to "the likelihood that contributions will be made." However, an actuary should explicitly acknowledge that this risk has not been considered, and if appropriate under the circumstances, provide a brief description of the circumstances beyond an intended user’s control which could lead to the risk occurring. (These situations are most likely to arise in multiemployer or public sector situations, where the sponsor does not always have complete control over the amount of contributions.)

There are many ways to categorize and communicate the various risks. The list of risks shown in Section 3.2 of the draft ASOP is one approach for an actuary to consider, but we note that there can be overlap among investment risk, interest rate risk, and asset/liability mismatch. Other approaches may also emerge over time, for example, by considering the possibility of each key assumption not being met, or by presenting asset/liability mismatch as part of another approach to looking at interest rate risk and investment risk together.

Also, Section 3.2 indicates that the actuary should identify risks that may have a material effect on the plan's financial condition; however, "financial condition" of the plan is not defined. Again, this could be acceptable if the definition can be left to individual judgment and interpretation; however, if more guidance is needed, must the actuary consider all of the following: the possibility of a higher unfunded liability, a lower funding ratio, benefits that are restricted from being paid from the plan because a low funding ratio (e.g., Section 436 benefit restrictions), and higher contribution levels? In addition, as discussed previously, the potential breadth of the risks to be considered is quite substantial. The ASOP should be clarified to endorse flexibility and meaningful information so that it does not suggest a level of comprehensiveness that would be not useful for the reasons previously stated and result in information overload for the intended user.

Section 3.3 (Assumptions for Assessment of Risk) - This section requires that assumptions used for the assessment of risk "should reflect moderately adverse but plausible outcomes." The reference to "adverse" does not appear in the definition of Risk or in Section 3.2 (Risks to be Assessed). If the risk to be considered is limited to bad outcomes, that needs to be made clearer before Section 3.3.

Section 3.4 (Methods for Assessment of Risk) - This section allows for a variety of methods in assessing risk, including stress tests, scenario tests, sensitivity tests, and stochastic modeling. Unfortunately, other sections seem to be written with only some of these methods in mind. We also note that Section 3.5 indicates that the assessment may be qualitative, but Section 3.4 focuses only on quantitative assessments. It would be more helpful if Section 3.4 addressed qualitative assessments, or perhaps degrees of complexity in quantitative assessments as well, in order both to make it clearer that in many cases only qualitative assessments are required and to also provide some guidance as to what is intended for a qualitative assessment.

Section 3.4 specifically allows for stochastic modeling. However, Section 3.3 says: "Assumptions used for assessment of risk should reflect moderately adverse but plausible outcomes." That statement does not apply to stochastic modeling, as stochastic modeling considers a wide range of risks.

Section 3.6 (Plan Maturity Measures) - Section 3.6 indicates that "the actuary should calculate and disclose plan maturity measures that the actuary believes are significant to understanding the risks associated with the plan." It should also be acknowledged that while these measures may be one way of explaining the risks, it is perfectly acceptable to communicate the risks using other methods.

Section 3.7 (Quantitative Assessment of Risk for Large Plans) - This section is requiring a very significant actuarial exercise to be performed at least once every five years, or more frequently if the actuary judges that significant changes have occurred such that an update is required. We note that it is not unusual for the funded status of a pension plan to vary greatly, and it is possible that a change in funded status, even though significant in and of itself, might not necessarily make "the results of a prior risk assessment inappropriate." Thus, despite significant changes in underlying actual results, a prior quantitative analysis may still be valid in that it shows the volatility inherent in the future results. If this requirement is retained, we suggest that the standard include some guidance on making this determination.

The standard requires 10-year projections of obligations and costs to be used as a baseline, along with a potentially large number of scenarios to be modeled based on combinations of various deviations from experience. In addition, each scenario could require the need to illustrate 10 annual contributions plus the funding level in year 10. The ASOP should discuss the considerations in culling down the large number of possible results in a meaningful and cost-effective manner.

The 10-year illustration requirement appears particularly inconsistent with the spirit of ASOPs as principles-based rather than attempting to dictate every step and decision in an actuarial assignment. By focusing on just this requirement many other considerations involved in a risk assessment that are of much more importance could be overlooked.

Conclusion

We appreciate the Actuarial Standards Board giving consideration to these comments. We recognize that pension risk is an important topic and clearly one where actuaries have substantial expertise. However, we believe that it is too early to require a comprehensive, formulaic assessment and disclosure of pension risk for substantially all pension actuarial valuations used for funding purposes in light of current state of actuarial practice and without stakeholder expectations being addressed. Our view is that a standard focusing instead on providing principles and additional guidance on the considerations involved in assessing risk would be more useful and result in greater practice improvement in this area.

Please contact Matthew Mulling, the Academy's pension policy analyst at (202)-785-7868 or mulling@actuary.org if you have any questions or would like to arrange a convenient time to discuss these comments further.

Respectfully submitted,

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