AMERICAN ACADEMY *of* ACTUARIES

May 31, 2013

ASOP No. 4 Revision
Actuarial Standards Board
1850 M Street, NW, Suite 300
Washington, DC 20036

Re: **Comments on ASOP No. 4, *Measuring Pension Obligations and Determining Pension Plan Costs or Contributions***

Members of the Actuarial Standards Board:

The American Academy of Actuaries[1] Pension Committee applauds the Actuarial Standards Board (ASB) for the thoughtful approach being taken in revising Actuarial Standard of Practice (ASOP) No. 4, *Measuring Pension Obligations and Determining Pension Plan Costs or Contributions*. We believe the second exposure draft is a substantial improvement over the first and we appreciate that it incorporates many of the comments we made regarding the first exposure draft. We are pleased to present the following comments to the ASB regarding the second exposure draft.

Output Smoothing

There is discussion within the actuarial community over whether it is better to smooth inputs or outputs in order to control the volatility of contributions. The Society of Actuaries recently issued a report, "Observations on Input and Output Smoothing Methods," and we are aware of the current use of output smoothing methods (e.g., a collar method that restricts the annual change in the contribution rate) for some large public pension plans. The current draft of ASOP 4 appears to be silent about these methods. While it may be premature to provide any significant guidance on output smoothing methods, we believe ASOP 4 should at least include them within the discussion of "allocation procedures" and the related required disclosures. The definition of "contribution allocation procedure" in paragraph 2.8 is probably broad enough to include output smoothing methods without specifically mentioning them. However, paragraphs 3.14 and 4.1(k) should specifically reference output smoothing methods, so they are not otherwise omitted from the required descriptions and disclosures related to allocation procedures.

[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.

1850 M Street NW Suite 300 Washington, DC 20036 Telephone 202 223 8196 Facsimile 202 872 1948 www.actuary.org

We suggest the following language change (in bold) to paragraph 3.14 to accomplish this objective:

> 3.14 Allocation Procedure – A cost allocation procedure or contribution allocation procedure typically combines an actuarial cost method, an asset valuation method, and an amortization method to determine the plan cost or contribution for the period. **A contribution allocation procedure may also employ output smoothing methods to control the volatility of contributions.** When selecting a cost …

With respect to paragraph 4.1(k), the discussion of disclosures that follows includes suggested language incorporating all of our comments, including those regarding output smoothing.

Disclosures

Paragraph 4.1(k)

Paragraph 4.1(k) requires the actuary to disclose (when relevant and material) a description of the contribution allocation procedure, with an additional disclosure if the unfunded actuarial accrued liability (UAAL) is expected to increase at any time during the amortization period.

Identifying an increasing UAAL over the entire amortization period may be difficult for any plan that uses multiple amortization bases. We suggest that a qualitative description of the operation of the method in general may be more appropriate, combined with a quantitative statement about the immediate net amortization payment.

For example, under typical assumptions, 20-year level-percent-of-pay amortization has negative amortization for about three years, meaning that the UAAL for each layer will increase before it starts to decrease. Making any sort of qualitative assessment of the progression of the UAAL is not typically done and could require significant additional work, particularly when there are many amortization layers with varying original and remaining amortization periods.

However, we note that it would be reasonably easy and informative to:

(1) state that each new UAAL layer will grow for a few years before declining, and

(2) disclose whether the current net amortization payment is sufficient to cover the interest on the UAAL (thereby keeping the UAAL from increasing). However, we believe the assessment of whether the UAAL increases should be made on the entire contribution allocation procedure as discussed below. Such a disclosure may be better incorporated in paragraph 4.1(m).

Accordingly, we suggest paragraph 4.1(k) be modified to read as follows:

k. a description of the cost allocation procedure or contribution allocation procedure including a description of the **actuarial cost method, asset valuation method,** amortization methods**, output smoothing methods,** and any pay-as-you-go funding (i.e., the intended payment by the plan sponsor of some or all benefits when due). **The description of the amortization methods used in a contribution allocation procedure should include an additional disclosure if the principal of any individual amortization base is expected to increase at any time during the amortization period (sometimes described as negative amortization), or if the principal is never expected to be fully paid (for example, if the amortization period is reset each year).** For purposes of this section, the actuary should assume that all contributions will be made when due.

Further, we believe the intent of paragraph 4.1(k) in the exposure draft was to require disclosures for plans with negative amortization, but that it was not intended to (nor should it) require additional disclosures for plans using cost and contribution allocation procedures that are prescribed by law as defined in paragraph 2.20 (including approaches that are chosen from among prescribed options). For example, expected future changes in PPA segment rates, either due to the expansion of the MAP-21 corridors or due to the operation of 24-month or 25-year averages, should not require disclosures under this section, even if they are anticipated to lead to increases in the UAAL. To the extent the requirement to identify an increasing UAAL remains in paragraph 4.1(k), it should be made clear that the statement that "the actuary should assume that all assumptions will be realized" should be, when applied to PPA interest rates, interpreted as meaning the effective interest rate should be assumed to remain unchanged.

Paragraph 4.1(m)

Under paragraph 4.1(m), the actuary is required to disclose the qualitative assessment required under paragraph 3.14.2 of the impact of the plan's contribution allocation procedure on future expected plan contributions and the plan's funded status. For any contribution allocation procedure that produces a range of values, the actuary is required to further disclose his or her understanding of the sponsor's funding policy as used to make the qualitative assessment.

With respect to the implications for future contributions for private plans, we reiterate the view expressed above under 4.1(k). Specifically, the operation of prescribed approaches, such as PPA segment rates, should not be factored into this disclosure because the disclosure should be focused on the allocation procedure rather than the rules under which this procedure must operate. The statement contained in 4.1(k) in the exposure draft that "the actuary should assume that all assumptions will be realized" should be included in this section with the clarification that it means that assumptions will remain the same. For example, when applied to PPA interest rates, it should be clear it means the effective interest rate remains unchanged for the purpose of determining future implications.

We are pleased with the removal of projected quantitative assessments of the implications of the contribution policy, but we believe that some short-term quantitative assessments

would be beneficial, particularly for public and multiemployer plans. We believe these assessments would be simple to produce.

For methods that are not prescribed by law (as defined in paragraph 2.20), we suggest that 4.1(m) be expanded (or another subparagraph added) to require a disclosure when the contribution resulting from the contribution allocation procedure, sponsor funding policy, or the amount of contribution set by contract or law, is less than sufficient to cover the normal cost plus interest on the unfunded actuarial accrued liability. We suspect that while many plans in the public sector would be required to make this disclosure, there will be significant variation in the degree to which the UAAL would be expected to increase. Accordingly, we suggest that, when required, this disclosure include the dollar amount and percentage by which the UAAL is expected to increase in the next year (excluding the effect of asset smoothing, which is addressed as a separate disclosure in the next paragraph).

For plans that use a smoothed actuarial value of assets to determine the contributions to the plan, we recommend a separate disclosure of such difference, as well as the amount of that difference that is scheduled to be recognized in the actuarial value (and thus the UAAL) in the next year. However, we believe the additional disclosure should not be required whenever the difference between actuarial and market value does not exceed a modest threshold. We suggest a threshold of 10 percent in order to exempt the modest differences produced by single employer PPA compliant approaches.

We believe that, taken together, these disclosures will allow an evaluation of the overall effect of the contribution policy for the next year as well as the separate effects of the asset smoothing method and the other elements of the contribution allocation procedure.

Paragraph 4.1(s)

Paragraph 4.1(s) requires a description of changes in assumptions and methods from the immediately preceding measurement period and, for those assumptions not set by law or another party, an explanation of the information and analysis that led to the change.

We believe it should be sufficient for the purposes of making the required disclosure to state that the change was based on guidance from the principal or plan sponsor (e.g., anticipated changes in pay practice or workforce planning) or to reference a separate document that contains this rationale. We believe this is essential because the reasons for changes may be confidential and required disclosure of such information may prevent principals from using or being forthcoming with actuaries. The ASOP should be clarified to explicitly permit such approaches.

Definitions

Section 1.1, *Purpose*, defines the term “plan” as referring to a defined benefit pension plan. We recommend the term be explicitly defined in the Definitions section of the ASOP. (Further, the ASOP is not consistent in this usage, as it uses the term “pension plan” occasionally throughout the remainder of the document.)

We recommend the definitions for Actuarial Present Value (2.3) and Actuarial Present Value of Projected Benefits (2.4) be revised to explicitly incorporate discounting, since it is so integral to the concept of a present value.

We recommend the definitions for Contribution Allocation Procedure (2.8) and Cost Allocation Procedure (2.10) be revised to include mention of an asset valuation method and an amortization method, so that these procedures include an actuarial cost method, an asset valuation method, and an amortization method. Note that paragraph 3.14 states this explicitly. The definitions should be revised to be consistent with paragraph 3.14.

The definition of Market-Consistent Present Value (2.14) describes a level of purity that is rarely achieved in practice. We recommend the standard acknowledge this by noting that the degree of market consistency might vary among the different assumptions used in the measurement. In addition, we suggest that the first sentence of paragraph 2.14 be changed to read, "An actuarial present value that is **estimated to be** consistent with …" to emphasize the judgment involved in such a measurement.

Further, the *General Procedures* (3.2(l)) requires the actuary to select a cost/ contribution allocation procedure. But the procedures separately require the actuary to select an actuarial cost method (3.2(k)) and an asset valuation method (3.2(g)). We recommend the *General Procedures* be revised to explicitly require the selection of all three components of a cost/contribution allocation procedure (actuarial cost method, asset valuation method, amortization method) or, alternatively, that the actuary simply be required to select a cost/contribution allocation method (based on the revised definition suggested above).

Other Suggestions

The first and fourth bullets in the Background section on pages v and vi reference the term "economic value," but do not define it. This term is not well-defined within the actuarial community and should be avoided in the document, even in casual use outside of the standard itself. We believe its use in the Background section is as a synonym for "market-consistent present value," which is defined within the ASOP. We recommend the use of the latter term for consistency and clarity.

We recommend that the third sentence in the paragraph following the itemized list in paragraph 3.5.3, *Other Valuation Issues*, be revised to read "For example, if the purpose of the measurement is to estimate a market-consistent present value of the plan **benefits**, using alternative procedures to capture the impact of asymmetric plan provisions may be appropriate." Plan provisions do not have present values; only the *benefits* determined in accordance with plan provisions have present values.

We also noted two strictly typographical and formatting errors:

1. Paragraph 3.5.1, *Adopted Changes in Plan Provisions* is missing a closing parenthesis after "legally binding authority."
2. The first and second paragraphs on p. 12 (part of paragraph 3.14.1 following the bullets) should be indented to line up with the text "Examples of such circumstances

include the following" that precedes the bullets.

Finally, we support the ASB's efforts to coordinate ASOPs No. 4 and No. 6. Consequently, we encourage the ASB not to finalize ASOP No. 4 before considering any related comments on ASOP No. 6.

The Pension Committee appreciates the opportunity to comment on this matter and would be happy to discuss any of these items with you at your convenience. Please contact David Goldfarb, the Academy's pension policy analyst (202-785-7868, goldfarb@actuary.org), if you have any questions or would like to discuss these items further.

Sincerely,

Michael F. Pollack, FSA, MAAA, EA, FCA
Chairperson, Pension Committee
American Academy of Actuaries