AMERICAN ACADEMY *of* ACTUARIES

*Objective. Independent. Effective.*™

October 15, 2021

Actuarial Standards Board
1850 M Street NW, Suite 300
Washington, DC 20036
Via email to comments@actuary.org

**Re: ASB Comments—Comments on Third Exposure Draft of ASOP No. 4**

Members of the Actuarial Standards Board:

The Pension Committee, Multiemployer Plans Committee, and Public Plans Committee of the American Academy of Actuaries[1] present the following comments to the Actuarial Standards Board (ASB) regarding the third exposure draft of Actuarial Standard of Practice No. 4, *Measuring Pension Obligations and Determining Pension Costs or Contributions* (ASOP No. 4). We believe much good work has been done to improve the clarity of the proposed ASOP revision. Nevertheless, we are providing the following comments on the current exposure draft in the format you requested below. Note that recommended new text has been underlined.

**I. Identification:**

| Name of Commentator / Company |
|---|
| Pension Committee, Multiemployer Plans Committee, and Public Plans Committee of the American Academy of Actuaries |

**II. ASB Questions (If Any). Responses to any transmittal memorandum questions should be entered below.**

| Question No. | Commentator Response |
|---|---|
| | N/A |

**III. Specific Recommendations:**

| Section #<br>(e.g. 3.2.a) | Commentator Recommendation<br>(Please provide recommended wording for any suggested changes) | Commentator Rationale<br>(Support for the recommendation) |
|---|---|---|

[1] The American Academy of Actuaries is a 19,500-member professional association whose mission is to serve the public and the U.S. actuarial profession. For more than 50 years, the Academy has assisted 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.

| 2.8 | Change second sentence to "The procedure uses an **actuarial cost method** and may use an asset valuation method, an **amortization method**, and/or an **output smoothing method**." | We suggest changing "or" to "and/or" because the procedure may use one, two, or three of the listed items, not just one as is implied by the use of the word "or." |
|---|---|---|
| 2.9 | Change second sentence to "The procedure uses an **actuarial cost method**, and may use an asset valuation method and/or an **amortization method**." | We suggest changing "or" to "and/or" because the procedure may use one or both of the listed items, not just one as is implied by the use of the word "or." |
| 3.4.3 | Change last sentence to "When adjusting obligations from a prior **measurement date**, the actuary should consider using revised assumptions to determine the obligations if appropriate for the purpose of the measurement." | We think it is important to clarify that the actuary should only use revised assumptions when adjusting obligations if that is appropriate for the purpose of the measurement. |
| 3.11 | Change fourth paragraph of section 3.11 to "When plan provisions create pension obligations that are difficult to appropriately measure using traditional valuation procedures, such as benefits affected by actual investment returns, movements in a market index, or other similar factors, the actuary should consider using alternative valuation procedures such as those described under section 3.5.3, including the use of alternative discount rates if indicated by such procedures, to calculate the low-default-risk obligation measure of those benefits earned or costs accrued as of the measurement date." | One of the foundational reasons financial economics argues traditional pension obligations should be valued using low-default-risk fixed income securities as a reference portfolio is that fixed benefits result in predictable cash flows. Hence, risk to the participants and sponsor of a traditional pension plan would be minimized if its assets were invested in such a portfolio with expected cash flow matching the plan's expected benefit payments. However, if benefit amounts are linked to a market index (e.g., the S&P 500), a low-default-risk fixed income reference portfolio will not match the characteristics of the benefit payments. Investing in such a portfolio, rather than in the underlying market index, would increase the risk to the participants and sponsor of such a plan. Financial economics argues that the reference portfolio for such a market-indexed plan should be, in this example, the S&P 500. Moreover, we believe an obligation measure for such a plan based on discount rates derived from low-default-risk fixed income securities would be meaningless or potentially very misleading to intended users. Therefore, we think it is crucial for the actuary to be able to use alternative discount rates indicated by the procedures in section 3.5.3 to determine a meaningful low-default-risk obligation measure.<br><br>Rather than tying adjustments to specific market indices, many variable plans simply adjust benefits based on the plan's actual return on assets. In either situation, the portfolio used to determine benefit adjustments is the more appropriate reference portfolio, and the expected return on that portfolio is the theoretically appropriate discount rate (as long as the same rate of return is also reflected in determining benefit adjustments). While it is often true that a similar benefit obligation may be produced using high-quality bond yields in place of the expected return for purposes of both adjusting future |

| | | benefits and for discounting the resulting benefit cash flows, there is no compelling reason to make these offsetting adjustments. Requiring the use of bond yields in this situation could result in the provision of misleading information to intended users about the characteristics of the obligation and may, depending on plan provisions, distort results.<br><br>In practice, benefit adjustments for most variable plans are not solely determined by returns on a market index or a plan's own assets, but also impose some sort of minimum benefit or adjustment and may include maximum adjustments as well. In such situations, the plan may have characteristics of both traditional and variable benefits. A forthcoming practice note from the American Academy of Actuaries will discuss valuation techniques that may be used in these situations. To produce a meaningful obligation measure, the actuary should have the flexibility to select a discount rate in a manner that is consistent with the characteristics of the benefits, the purpose of the measurement, and the other assumptions used to project these benefits.<br><br>The current language is not clear as to whether the actuary has the flexibility to appropriately value a market-indexed plan design or the other variations discussed above. As a result, some actuaries may produce measures for such plans using alternative discount rates and explain the meaning of those measures. However, other actuaries may produce measures for such plans using discount rates derived from low-default-risk fixed income securities to value variable benefits that are not indexed based on the same low-default-risk fixed income securities. In this case, to comply with section 4.1(o)(5), the actuary needs to explain to the intended user that the low-default-risk obligation measure has no real meaning for the particular plan design. A third option is for actuaries to elect to deviate from the guidance of the standard so as not to spend time to produce a misleading measure, for which the intended user will most likely not want to pay. Clarifying that the actuary has the flexibility to choose appropriate discount rates and related assumptions for variable plan designs will result in the disclosure of a more consistent and meaningful low-default-risk obligation measure for variable benefit designs. |
|---|---|---|
| 3.11 | Delete the fifth paragraph of section 3.11 "~~For purposes of this obligation measure, the actuary should take into account the effect, if any, of the discount rate or discount rates selected on the~~ | As currently written, the fifth paragraph of section 3.11 adds more confusion than clarity for actuaries who value variable benefit plans. Changing the discount rate does not usually alter |

| | | |
|---|---|---|
| | ~~pattern of benefits expected to be paid in the future, such as in a variable annuity plan.~~"<br><br>However, if you do not want to delete this fifth paragraph of section 3.11, change it to "For purposes of this obligation measure, the actuary may ~~should~~ take into account the effect, if any, of investing plan assets in low-default-risk fixed income securities ~~the discount rate or discount rates selected,~~ on the pattern of benefits expected to be paid in the future, such as in a variable annuity plan." | the pattern of expected benefits unless it also changes how the assets are invested, the expected return on assets, or the stochastically projected distribution of expected investment returns. Requiring the actuary to assume the assets are invested differently than they are currently invested may be reasonable for some plan designs; however, it would be inappropriate for other designs under which benefits do not vary based on the return on plan assets, but instead are linked to a market index or actual returns compared to a fixed rate. In order to produce something meaningful for all difficult-to-measure plan designs, actuaries need the flexibility to treat different types of designs differently, as discussed in section 3.5.3.<br><br>We believe the change to the wording we propose in the prior item for the fourth paragraph of section 3.11 both clarifies how to measure obligations of these plans and provides a meaningful low-default-risk obligation measure so that the confusing fifth paragraph in section 3.11 is **not needed and we believe it should be deleted**.<br><br>However, if you decide not to take our suggested change to the fourth paragraph of section 3.11 or want to keep this fifth paragraph of section 3.11, we think it is important to clarify the intent and provide some flexibility for the actuary to make an appropriate measurement. Instead of referring to changes in the discount rate, which in and of itself do not change the pattern of benefits, we think the fifth paragraph of section 3.11 needs to refer to changing the investment of plan assets to the low-default-risk fixed income securities on which the discount rate is based. In addition, the requirement that the actuary "should" take this change in investments into account needs to be changed to "may" so that actuaries have the flexibility to refrain from making this assumption where they believe it would be inappropriate. For example, if a cash balance plan's benefits are indexed to changes in the S&P 500, it is inappropriate to assume plan assets are invested in fixed income securities. |
| 3.19(b) | "estimate how long before ~~any~~ the plan's expected future contributions as determined by the **contribution allocation procedure** or the plan's funding policy ~~is~~ are expected to exceed the **normal cost**, plus interest on the unfunded **actuarial accrued liability**, if applicable;" | Based on the response to our comments on the second exposure draft, we understand the intent of this section is to assess the contribution allocation procedure or funding policy that is used to determine the plan's expected future contributions. However, the current wording only makes that clear in section 3.19(a). Sections 3.19(b), (c), and (d) do not use the same wording, making it appear that the actuary is able to choose |

| | | |
|---|---|---|
| | | to assess any amount within the range of actuarially determined contributions or determined by the plan's funding policy, even if that is not the amount expected to be contributed to the plan. To address this, we suggest the addition of the same phrase as appears in section 3.19(a), "the plan's expected future contributions," to sections 3.19(b), (c), and (d) to clarify the basis on which the estimates described in those sections should be made. |
| 3.19(c) | "estimate the period over which the plan's expected future contributions as determined by the **contribution allocation procedure** or funding policy are expected to fully amortize the unfunded **actuarial accrued liability**, if any~~, is expected to be fully amortized~~; and" | We believe section 3.19 (c) also needs further clarity. To address this, we suggest adding wording parallel to that in section 3.19(a) to make it clear that the estimate is to be based on the plan's expected future contributions and not a hypothetical amount that may not be expected to be contributed to the plan. |
| 3.19(d) | "assess whether the plan's expected future contributions as determined by the **contribution allocation procedure** or funding policy ~~is~~ are significantly inconsistent with the plan accumulating assets adequate to make benefit payments when due, and estimate the approximate time until assets are depleted." | As with the prior two items, we suggest revising section 3.19(d) to make it clear that the assessment is on the plan's expected future contributions and not on a hypothetical amount that may not be expected to be contributed to the plan. |
| 3.21(b) | Change first sentence to: "the ~~if an~~ **actuarial cost method** ~~is~~ used~~, it~~ should be consistent with section 3.13." | The definition in section 2.8 states that a contribution allocation procedure necessarily uses an actuarial cost method. Therefore, we think section 3.21 should not say "if an actuarial cost method is used" because by definition it must be used. |
| 4.1 | Change first sentence to "When issuing an actuarial report to which this standard applies, the actuary should refer to ASOP Nos. 23, 27, 35, 41, 44, ~~and~~ 51, and 56." | To be complete, the listed ASOPs should include the disclosure requirements of ASOP No. 56, which is expected to be applicable to most (if not all) work covered by ASOP No. 4. |
| 4.1(k) | Change first sentence to "a description of known changes in significant assumptions and methods from those used in the immediately preceding measurement prepared for a similar purpose." | Changes are being suggested to this item so ASOP No. 4 is consistent with the requirements that recently took effect in section 4.1.3 of both ASOP Nos. 27 and 35. Those standards only require disclosure of information about the *significant* assumptions and methods, which is also consistent with providing a more brief and pertinent explanation of changes to the plan's circumstances. |

## IV. General Recommendations (If Any):

| Commentator Recommendation<br>(Identify relevant sections when possible) | Commentator Rationale<br>(Support for the recommendation) |
|---|---|
| N/A | |

**V. Signature:**

| Commentator Signature | Date |
|---|---|
| See below | October 15, 2021 |

*******************

We appreciate the ASB giving consideration to these comments. Please contact Philip Maguire, the Academy's pension policy analyst (maguire@actuary.org; 202-223-7868), if you have any questions or would like to arrange a convenient time to discuss this matter further.

Respectfully submitted,

Bruce Cadenhead, MAAA, FSA, FCA, EA
Chairperson, Pension Committee
American Academy of Actuaries

Christian Benjaminson, MAAA, FSA, EA
Chairperson, Multiemployer Plans Committee
American Academy of Actuaries

Todd Tauzer, MAAA, FSA, CERA
Chairperson, Public Plans Committee
American Academy of Actuaries