AMERICAN ACADEMY *of* ACTUARIES

October 4, 2004

2nd Exposure Draft: Asset Valuation Methods
Actuarial Standards Board
1100 Seventeenth Street, NW, 7th Floor
Washington, DC 20036-4601

Re: Comments on the 2nd Exposure Draft of the Proposed ASOP: "Selection and Use of Asset Valuation Methods for Pension Valuations"

Ladies and Gentlemen:

On behalf of the American Academy of Actuaries'[1] Pension Committee, I am pleased to offer comments on the 2nd Exposure Draft of the Proposed Actuarial Standard of Practice, "Selection and Use of Asset Valuation Methods for Pension Valuations" (the "*2nd Exposure Draft*").

We appreciate the opportunity to comment on this proposed ASOP; it has generated a lot of discussion among our committee members, which has led to both consensus as well as debate.

We welcome the *2nd Exposure Draft's* added emphasis on disclosures and suggest a number of situations below in which the imposition of further disclosure requirements should be considered by the ASB. We also commend the ASB for providing criteria for identifying "significant systematic bias" in §3.3 of the *2nd Exposure Draft*.

We do have certain concerns about the ASB's response to a "significant division within the profession regarding the use of asset valuation methods,[2] which has led to elimination of guidance for determining the "reasonableness" or "acceptability" of *any* asset valuation method (AVM) that a pension actuary might use (or "select"); the 2nd *Exposure Draft* provides no criteria that an AVM should meet in order to be considered "reasonable" or "acceptable" — nor does it identify any AVM that the ASB considers to be such.

Rather than eliminating several items of useful guidance (e.g., the first paragraph of §3.2.4), many committee members felt that the ASOP would be of more value to pension actuaries if it provided more guidance – particularly with respect to a number of specific issues the pension actuary may be faced with in determining the market value of assets. A meaningful number of our comments below are intended to do so.

Limited Guidance for Selecting "Reasonable" or "Acceptable" AVMs

By failing to provide a standard of "acceptability" for *any* asset valuation method,[3] the *2nd Exposure Draft* provides no support to *any* actuarial practice – not only those who choose to deal with an assignment in a

[1] The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States. In addition to setting qualification standards and standards of actuarial practice, a major purpose of the Academy is to act as the public information organization for the profession. The Academy is nonpartisan and assists the public policy process through the presentation of clear actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal and state elected officials, regulators and congressional staff, comments on proposed federal and state regulations and legislation, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualifications and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

[2] "Those who believe that market value of assets … is the only appropriate value … and should be required or strongly encouraged as a best practice" vs. "those who use a variety of AVM's other than market value", e.g. that the AVM used should "depend on the purpose and nature of the measurement" or note that "market value may overstate the value that could be realized on forced liquidation of assets upon plan termination", etc. See pages **v** and **vi** of the *Initial Exposure Draft.*

[3] And somewhat less "guidance" than the *Initial Exposure Draft* provided regarding matters to be considered in certain situations, etc.

“specialized” or overly aggressive manner – should his/her work product be challenged in a lawsuit. Each and every pension actuary will have the full burden of defending what he or she has done and will not be able to support the “reasonableness” or “suitability” of the actions taken by pointing out that the actuarial work done meets all of the criteria set forth in this ASOP. The *2nd Exposure Draft* merely allows the actuary to assert that everything he or she has done has met the profession’s *disclosure* standards, not that it has met *any* professional criteria of “reasonableness,” etc.

Limiting the *2nd Exposure Draft* to setting *disclosure* standards – without providing or suggesting *any* criteria for determining the “reasonableness” or “acceptability” of *any* AVM that a pension actuary might use (or “select”) – raises important questions: does the *2nd Exposure Draft* rise to the level of a *Standard of Practice* without such criteria? How effective will disclosure be in preventing improper use of “significant(ly) systematic(ally) bias(ed)” AVMs?

Comment 1: Determination of Market Value - *Permitting* Adjustment for Potential Selling or Other Liquidating Costs

We believe this ASOP should address the question of whether or not the AVM should reflect potential selling costs (i.e. brokerage commissions, finders fees, professional fees, surrender, or liquidation charges) that would presumably be incurred in connection with any sale of assets. We recommend permitting, *but not requiring,* the actuary, in his/her judgment, to adjust market values to reflect these costs in determining market values.

In considering this issue, we believe this ASOP would provide more guidance to the actuary if it characterized the items that should be considered (e.g., whether a plan termination is likely in the near future, whether anticipated short-term liquidity requirements are likely to exceed anticipated near-term plan sponsor contributions to the plan, the nature and magnitude of potential selling costs, the magnitude and materiality of the adjustment, etc.) and indicated that the actuary’s judgment should govern his/her choice. Neither the *Initial Exposure Draft* nor the *2nd Exposure Draft* provided any guidance on this score.

Comment 2: Assets That Are Difficult to Value - Provide Guidance to the Actuary When Establishing the Market Value of Insurance or Annuity Contracts

We believe this ASOP should specifically address the calculation of market values of insurance contracts containing surrender charges (rear-end loads and/or market value adjustments). Neither §3.4 of the *Initial Exposure Draft* nor §3.5 of the *2nd Exposure Draft* provides guidance on this issue, nor does either suggest that the actuary has any special competence to deal with this – although many pension actuaries are quite skilled in this area.

The common approaches are to use the contract value or the contract value minus the surrender charges (assuming the contract is liquidated on the measurement date). If the market value is considered to be the latter, then the proposed ASOP should consider whether using contract value for the actuarial value of assets is appropriate, since failure to allow this would introduce (systematic) bias.

We believe this ASOP would provide more useful guidance to the actuary if it dealt with this matter separately from “other” difficult-to-value asset issues (e.g., in a separate sentence or sub-section of §3.5) and set forth the matters an actuary should *consider* (e.g., whether a plan termination is likely in the near future, whether anticipated short-term liquidity requirements are likely to exceed anticipated near-range plan sponsor contributions to the plan, the nature and magnitude of such back-end loads and/or market value adjustments, the magnitude and materiality of the adjustment, etc.) when developing a method for establishing the market value of such assets. As with comment 1, we recommend permitting, *but not requiring,* the actuary, in his or her judgment, to reflect these costs in determining market values provided that they disclose the factors that attribute to their valuation of the contract.

Comment 3: "Assets That Are Difficult to Value" - Other Situations

By dealing separately with "potential selling costs" associated with many asset classes and the back-end loads/market value adjustments found in insurance or annuity contracts as separate issues (discussed in comments 1 and 2 above), this ASOP could provide better guidance for the actuaries who must deal with "other" difficult-to-value assets, which could range from commercial real estate holdings to estimating oil or other mineral reserves. A separate sub-section of §3.5 could be crafted for dealing with the "all other" category.

This section should acknowledge the typical pension actuary's limited training in these matters and emphasize the desirability of (disclosed) reliance on auditor's reports *whenever available*; the guidance should, we believe, emphasize the fact that the approaches set forth in §3.5 are appropriate only if no auditor or other independent expert's report is available (if then). We suggest including language along the following lines in §3.5 in the final version of this ASOP:

> "The typical pension actuary has little training in this area and cannot reasonably hold himself out as skilled and professionally qualified in many of these matters. Accordingly, the best guidance this ASOP can provide the actuary is to rely on the treatment accorded to these assets by the plan's auditor whenever an auditor's report is available (unless the actuary is skilled in this area), and to state this reliance in the actuarial report.
>
> If no auditor's report is available, it may be necessary for the actuary to assess certain difficult-to-value assets. In such circumstances, it may be appropriate for the actuary to consider the availability of appraisals by qualified independent experts, recent sales of similar assets, the present value of reasonably expected future cash flows or other methods that may be appropriate and available at reasonable cost."

The actuary's report that sets forth the asset valuation should, of course, identify his or her reliance on other sources in accordance with *Section 3.1.6: Reliance on Other Sources* of *ASOP No. 41 Actuarial Communications*.

Comment 4: This ASOP Should Alert the Actuary to the Potential Use of Frequent Changes in AVM to Bias the Year-to-year Development of Asset Values

Section 3.6 of the *Initial Exposure Draft* noted that a pattern of frequent changes in AVM over time, each of which is unbiased, could systematically overstate or understate the value of assets and produce *de facto* bias; for example, if a smoothing method is used when the rate of return has been less than assumed, and a market value restart is effected whenever the rate of return has been higher than assumed, the long-term effect is a bias in the *de facto* asset valuation method that will have a tendency to value assets in excess of market value. Such bias would not be identified if only the current asset valuation method is considered.

We believe that language along the lines of the preceding paragraph should be added to §3.3 of the ASOP to advise the actuary that a pattern of frequent changes in AVM[4] could have the effect of producing the equivalent of bias.

Comment 5: Actuaries Should be Advised of the Potential Interaction of this ASOP with ASOP 27

We recommend adding a comment regarding the interaction of this ASOP with ASOP 27 when an assumed rate of return (or discount rate) is selected for valuation purposes. The comment would point out that if the actuary's best estimate of the rate of return on market value of plan assets is x percent, then the expected rate of return *on the actuarial value of assets* should be modified appropriately so as to reflect this difference if the *actuarial value of assets* differs from their market value.

[4] Whether recommended or chosen by the actuary or by another party.

Comment 6: Include "Asset Values" in the Definition of "Actuarial Valuation" as Used in this ASOP

Section 2.1 of the *2nd Exposure Draft* defines actuarial valuation for purposes of the proposed ASOP as "the determination, as of a measurement date, of relevant plan obligations and, when applicable, contributions or costs."

Ironically, this definition fails to include asset valuation; we suggest "asset values," be inserted immediately before the word "contributions."

Comment 7: Whose Interests, etc. Should Be Taken into Account by the Actuary?

Section 3.2.2 "*Objectives of the Principal*," as revised in the *2nd Exposure Draft*, indicates that the actuary should "consider the objectives of the principal to the extent such objectives have been communicated to the actuary" and that the actuary should consider "the purpose of the measurement" and "the actuary's responsibilities under the Code of Professional Conduct."

We feel the guidance provided by this section of the ASOP should be broadened to indicate that the actuary, when choosing the AVM (or advising the principal in making such a choice) should *also*:

- take cognizance of the principal's prerogatives regarding the choice of AVM under applicable regulations and statutes;
- be aware of the range of considerations that may be relevant, such as the interests of plan participants and their beneficiaries and the actuary's legal responsibility to these individuals; *and*
- inform the principal of the potential interests of other parties that might be affected by the choice of AVM (e.g., the PBGC and the stockholders and creditors of the plan sponsor).

We believe §3.2.2 should again be retitled, this time as "*Objectives of the Principal and the Interests of Plan Participants and Others*," to call attention to the wide range of parties that can be affected by (or rely upon) the actuary's work as applicable.

We suggest revising the text essentially as follows:

"In choosing the AVM (or advising the principal in making such a choice) the actuary should consider, in addition to the objectives of the principal such as a desire for stable or predictable contributions or costs, the principal's prerogatives under applicable regulations and statutes; the purpose and nature of the assignment; and take cognizance of the interests of plan participants, their beneficiaries, and the actuary's legal responsibility to these individuals; the actuary's responsibilities under the *Code of Professional Conduct*; and, where applicable, the interests of the stockholders and creditors of the principal and the Pension Benefit Guaranty Corporation. Furthermore, the actuary should explain to the principal the implications of the choice of AVM on these other parties."

[The expanded range of matters to be considered could be set forth as a suitably sequenced listing presented in "bullet" form for ease of comprehension.]

Comment 8: Disclosing the Market Value of Significant Classes of Assets

Section 4.1.3 calls for disclosure of the market value of each significant class when an asset valuation method other than market value is used.

- Some committee members dislike disclosure of the market value of assets by each significant class as being needlessly burdensome and leading to inconsistencies since it is required only when provided to the actuary;

- Other committee members, who believe that readers of actuarial reports would benefit from disclosure of the market value of assets by class, feel that such disclosure would be useful in all situations (i.e., not only when the asset valuation method used is market value).

Comment 9: Changes in Asset Valuation Method

Section 4.1.4 of the *2nd Exposure Draft* (and the *Initial Exposure Draft*) requires the actuary to disclose any changes "in the Asset Valuation Methods from the method(s) previously used for the same measurement purpose" and "the general effects" of any such changes. The committee believes the ASOP should provide specific guidance as to how far back the actuary should look (e.g., to the immediately preceding asset valuation, five years, etc.) to decide whether disclosing the change in method is necessary.

We believe this section of the ASOP should require the actuary to disclose AVM changes for a number of years following each such change. This would tell users of actuarial reports how recently and how frequently asset valuation methods have been changed, and would help them consider whether or not frequent AVM changes could have produced *de facto* bias in the results of the actuarial valuation.

We thank you for this opportunity to share our thoughts on the exposure draft. If you have any specific questions, please contact Heather Jerbi, the American Academy of Actuaries' pension policy analyst, at 202-223-8196 if you have any questions or would like more information.

Sincerely,

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American Academy of Actuaries