Comments on Second Exposure Draft of ASOP No. 4

From: Patrick Kinlaw, FSA, EA, MAAA
To: Actuarial Standards Board (ASB)
Date: July 29, 2020

Dear Members of the ASB:

Thank you for the opportunity to comment on the Second Exposure Draft of Actuarial Standard of Practice (ASOP) No. 4. I am an actuary experienced with both public-sector retirement systems and single-employer private plans. I currently serve as staff actuary and Director of Policy, Planning, and Compliance at the North Carolina Retirement Systems. The comments in this letter are my own and do not reflect the views of any governmental entity, organization, or company.

I have reviewed the seven comment letters available on the ASB's website through July 27, 2020, and appreciate the quality of comments representing a range of viewpoints. As applied to private plans, I agree with the comments submitted by Willis Towers Watson (dated July 1, 2020). As applied to public retirement systems, I agree with the comments submitted by the Conference of Consulting Actuaries' Public Plans Community (dated July 22, 2020) except for certain aspects of part 3.a.[1]

The Second Exposure Draft reflects a number of improvements resulting from the thoughtful work of the ASB and its Pension Committee. I agree with other commenters that the modifications to what is now the low-default risk obligation measure (LDROM) are helpful. These include the description of various discount rates, the ability to use immediate gain methods other than the unit credit method, and the general expansion to encompass similar disclosures that some actuaries have already been using.

The following additional comments are organized by section of the Second Exposure Draft.

Section 3.2.q.: This portion of the General Procedures requires the actuary to "calculate a reasonable actuarially determined contribution, if applicable (Sections 3.20 and 3.21)." The reference to Section 3.21 ("Reasonable Actuarially Determined Contribution") seems to fit, but it is not clear whether the reference to Section 3.20 ("Contribution Lag") is intended.

Section 3.11 – Practical Experience with LDROM: North Carolina's recent experience with LDROM disclosure may be informative. In 2016, the North Carolina General Assembly enacted a session law requiring that the LDROM be included in certain of the consulting actuary's annual funding valuation reports. (Although the term "LDROM" did not exist, the required measure meets the definition under the Second Exposure Draft.) The LDROM is now reported for the three largest systems administered by the State.

[1] Specifically, although I agree that the low-default risk obligation measure (LDROM) "does not provide universally useful information," I believe it could be useful in some circumstances, disagree that it is a breach of the ASOP framework, and do not feel strongly that it should be eliminated.

Of course, North Carolina is just one example, and perhaps not an especially indicative one for contemplating a universally required disclosure. Its retirement systems are among the better-funded statewide retirement systems in the United States, with funding policies including 12-year level-dollar closed amortization that have been followed consistently by the General Assembly and Boards of Trustees. The effects of universal LDROM disclosure might depend on factors including funding level, funding policy (and adherence to it), governance structure, the nature of engagement with stakeholders, and others.

In the years since it has been disclosed in North Carolina, to my knowledge the LDROM has not been a central focus of actuarial presentations about retirement system funding. However, it has been used in education about the significance of the investment return assumption. It has also been referenced in formal risk discussions, appearing for example in bond disclosure documents. This points to the potential use of the LDROM by people other than the actuary's principal and for purposes other than plan funding decisions.

There might be additional context that actuaries might need to provide, or other users of the LDROM might be expected to understand, if fixed-income market conditions cause the LDROM to be less than the actuarial accrued liability under the funding policy. A colleague and I elaborated on this in a comment on the First Exposure Draft.[2]

Section 3.11 – Application to All "Funding Valuations": Under Sections 3.11 and 4.1.o, only if the work product is a "funding valuation" must the LDROM be calculated and disclosed. According to Section 2.11, a "funding valuation" is "a measurement of pension obligations or projection of cash flows performed by the actuary intended to be used by the principal to determine plan contributions or to evaluate the adequacy of specified contribution levels to support benefit provisions." (The term "principal" is defined in ASOP No. 1 as "a client or employer of the actuary.")

I would not propose any change to the definition of "funding valuation," but agree with other comments that the LDROM, if preserved, should be tailored to more specific circumstances rather than "funding valuations" in general.

There are certain work products arguably meeting the definition of "funding valuation" where an LDROM requirement would not serve any intended purpose. For example, these could include multiple-year projections of funded status and contribution rates; actuarial

[2] From Comment Letter #9 on First Exposure Draft: "There will be times in the future, just as in the past, when market fluctuations or sustained conditions will cause the Section 3.11 measure to be less than a retirement system's assets or its valuation liability. Such conditions, though far from current reality, should be considered in principles-based guidance. Using North Carolina as an example, for more than 30 consecutive years from the 1960s through the 1990s, the yield on long-term Treasury securities exceeded the long-term investment return assumption. As recently as 2009, long-term, high-quality fixed-income yield indices during certain months exceeded the long-term investment return assumption…. If the [LDROM] is less than current plan assets, stakeholders might conclude wrongly that the actuary is recommending action relative to asset allocation…. If the [LDROM] is less than the valuation liability, stakeholders might conclude wrongly that the valuation liability is overstated. We might see unintended consequences such as entities misusing a temporarily low [LDROM] to advocate for higher rate-of-return assumptions, contribution holidays, or benefit increases without commensurate funding."

notes prepared for a governing board (where law, ordinance, or regulation outlines the required content); demonstrations of projected fund balances over time; or analysis of proposed benefit changes where the report might typically provide incremental impacts rather than plan-level measures of actuarial accrued liabilities. In these situations and others, it seems reasonable for the LDROM requirement, if preserved, to be satisfied by simple reference to an annual valuation report prepared for funding purposes rather than a new calculation or disclosure untethered to anything else in the report.

Section 3.14 – Amortization Method: I agree with the factors to consider (a. through g.). I also recommend that this list include "the degree to which the anticipated pattern of amortization relies on assumed payroll growth for the plan population."

Section 3.19 – Clarification: I agree with other comments suggesting edits to clarify this section. At minimum, it should be clarified that the last sentence of the first paragraph ("The actuary should assess whether…") does not depend on the same condition as the previous sentence ("If contributions are set by law or by a contract…").

Sections 3.19 and 4.1.y. – Application of Surplus: These sections require an estimate (Section 3.19) and disclosure (Section 4.1.y.) to be performed when "the contribution allocation procedure results in an actuarially determined contribution that is less than the normal cost plus interest on the unfunded actuarial accrued liability." It would be helpful to clarify that the normal cost may be reduced by the excess, if any, of the actuarial value of assets compared to the actuarial accrued liability. For example, suppose the actuarial value of assets is $150, the actuarial accrued liability is $100, and the normal cost is $10. The "normal cost plus interest on the unfunded actuarial accrued liability" may be greater than $0, but the standard should allow for an actuarially determined contribution of $0 without requiring the estimate or disclosure described in Sections 3.19 and 4.1.y.

Thank you for consideration of these comments. You are welcome to contact me with questions.

Sincerely,

Patrick Kinlaw