CCA CONFERENCE OF CONSULTING ACTUARIES
Public Plans Community

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July 22, 2020

ASB Comments
American Academy of Actuaries
1850 M Street NW, Suite 300
Washington, DC 20036

Re: Comments on ASOP 4

Members of the Actuarial Standards Board:

The attached comments were developed through the coordinated efforts of members of the Conference of Consulting Actuaries' (CCA) Public Plans Community and are being submitted to the ASB by the Steering Committee of the CCA Public Plans Community. However, these comments do not necessarily reflect the views of the CCA, the CCA's members, or any employers of CCA members, and should not be construed in any way as being endorsed by any of the aforementioned parties.

The members of the CCA Public Plans Community represent a broad cross section of public-sector actuaries whose extensive experience with public plans provides the framework for our response. The membership includes over 50 leading actuaries whose firms are responsible for cost and liability measurements for the majority of public sector retirement systems. We believe the overall response reflects a substantial consensus among the actuaries who provide valuation and consulting services to public pension plans.

Paul Angelo, FSA, FCA, MAAA, EA (By Direction)

Chair of the Public Plans Community on behalf of the Public Plans Community Steering Committee

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

Dear Board Members:

We, the Steering Committee of the Public Plans Community of the Conference of Consulting Actuaries[1] (CCA PPC), have reviewed the recently released second exposure draft of a proposed revision to Actuarial Standard of Practice (ASOP) No. 4, *Measuring Pension Obligations and Determining Pension Plan Costs or Contributions*. We note that we agree with many of the changes between the first and second exposure draft and appreciate the ASB's consideration of prior comments and efforts to develop the second exposure draft. Nevertheless, there remain a number of items on which we continue to offer comment.

Note: Throughout this document, where we suggest specific edits within the ASOP text, we have struck through text that we ~~recommend removing~~, and have underlined text we <u>recommend adding</u>.

1. Section 2 – We recommend the addition of a definition of "funding policy" and a modification of the definition of contribution allocation procedure.

   By our count, the term "funding policy" appears eight times within the exposure draft, often stated as the "plan sponsor's funding policy." Instead of assuming that actuaries know what the ASB means by a "funding policy," it would improve the clarity of the standard to define it. We also note that the funding policy for a public pension plan is often not set by the plan sponsor(s), so the standard should define and refer to the "funding policy" and not the "plan sponsor's funding policy."

   In our view, a "funding policy" defines the anticipated contributions to the plan. It may be based on an actuarially determined contribution, a statutory contribution rate, or some other method. It can be a single value or a range of values. It can be expressed as a percent of payroll or a dollar amount. It can be determined in a variety of ways, including by the plan sponsor, through collective bargaining, or by the trustees of the pension plan. Actual contributions may differ from those anticipated by the funding policy due to unanticipated changes in payroll or legislative appropriations, or in some cases at the discretion of the plan sponsor. However, in general we agree with the intent expressed in last paragraph of Section 3.19 that the guidance of the standard should apply presuming that the plan sponsor will make the contributions anticipated by the funding policy.

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In contrast, a contribution allocation procedure is a process used to develop a single actuarially determined contribution. The "funding policy" may refer to more than one actuarially determined contribution developed using different contribution allocation procedures. For example, the ERISA minimum required contribution and the maximum tax deductible amount are calculated using two different contribution allocation procedures resulting in two different actuarially determined contributions, and a plan sponsor's funding policy could incorporate both those amounts.

To clarify the usage of these terms throughout the standard, we recommend adding a definition of "Funding Policy" and amending the definition of Contribution Allocation Procedure to reflect the understanding of the terms as described above.

a. We recommend the following definition of **Funding Policy** within Section 2:

   "A guiding policy that employs one or more contribution setting procedures in order to generate one or a range of potential contribution values. These contribution setting procedures may be **contribution allocation procedures**, producing **actuarially determined contributions**, or other contribution setting procedures (e.g., procedures defined in statute or by a contract, such as a collective bargaining agreement), producing contributions that may not be actuarially determined."

b. When a funding policy generates multiple actuarially determined contributions (for example, because the funding policy intends to establish a range of contribution amounts), then that funding policy employs multiple contribution allocation procedures, each of which produce a single value. Accordingly, we recommend the definition of contribution allocation procedure in Section 2.8 be clarified to read:

   "A procedure that uses an **actuarial cost method**, and that may include an asset valuation method, an **amortization method**, and an **output smoothing method**, to determine ~~the~~ an **actuarially determined contribution** for a plan. ~~The~~ Each procedure ~~may~~ produces a single value, but multiple procedures may be used as part of a **funding policy**. ~~such as **normal cost** plus an amortization payment of the unfunded **actuarial accrued liability**, or a range of values, such as the range from the ERISA minimum required contribution to the maximum tax-deductible amount~~."

2. Section 3.2 – We submit the following comments to the recommended general procedures:

   a. The general procedures technically only apply "when measuring pension obligations and determining periodic costs or actuarially determined contributions." For some public pension plans, however, the valuation does not determine periodic costs or actuarially determined contributions, but is used to assess the adequacy of a contribution defined in statute or appropriated by the legislature. It should be clear that these valuations are also subject to the general procedures. Consequently, we recommend that the introductory sentence be amended to read as follows:

      "When measuring pension obligations and determining or assessing periodic costs or ~~actuarially determined~~ anticipated contributions, the actuary should perform the following general procedures:"

   b. 3.2(f) – In cases where an actuary does not select some or all assumptions, the actuary should still identify the assumptions being used to measure obligations, contributions, or costs. Since there are always assumptions used in these measurements, we submit this section is always

applicable. We recommend the following changes:

"select or identify the applicable actuarial assumptions, ~~if applicable~~ (section 3.8);"

c. 3.2 (k), (l), (m), (n), (o) – Similarly in cases where an actuary does not select any of the following, they should still identify what is being used, if applicable. We recommend the following changes:

   3.2(k) "select or identify an **actuarial cost method**, if applicable (section 3.13);"
   3.2(l) "select or identify an **amortization method**, if applicable (section 3.14);"
   3.2(m) "select or identify an asset valuation method, if applicable (section 3.15);"
   3.2(n) "select or identify an **output smoothing method**, if applicable (section 3.16);"
   3.2(o) "select or identify a **cost allocation procedure** or **contribution allocation procedure**, if applicable (sections 3.17 and 3.18);"

d. 3.2(p) – As discussed above regarding the definitions of funding policy and contribution allocation procedure, a funding policy may or may not be set by the plan sponsor and may or may not be based on a contribution allocation procedure. The critical assessment is of the implications of the anticipated contributions as defined by the funding policy. We recommend the following changes:

   "assess the implications of the plan's **funding policy** ~~contribution allocation procedure or plan sponsor's funding policy~~, whether it is based on one or more **contribution allocation procedures** or other contribution setting procedures, if applicable (section 3.19);"

3. Section 3.11 and 4.1(o) – We appreciate the changes made to section 3.11, especially the clarification that the actuary may use any immediate gain actuarial cost method for the purpose of this measurement. However, we still have concerns and submit the following comments:

   a. Our general comment is that the Low-Default-Risk Obligation Measure does not provide universally useful information for the intended user regarding the funded status of the pension plan or the security of member benefits as asserted by the ASB. We recommend removing this section (along with 3.2(i) and 4.1(o)) for the following specific reasons:

      i. To be a universally required calculation, a measure should be generally useful. The Low-Default-Risk Obligation Measure serves a very limited purpose, and is not generally useful for the decisions made by pension plan trustees. There is no evidence that public or multiemployer plans that have disclosed similar information ever used it to make any decision.

      The Low-Default-Risk Obligation Measure is supposed to provide "a more complete assessment of a plan's funded status." While every measure using a different discount rate meets this objective, measures at multiple discount rates are already required to be disclosed in various contexts, and the addition of another measure using another discount rate does not add materially to the information already provided.

      It is also supposed to provide "additional information regarding the security of benefits." However, for plans that cannot or are not likely to be invested in cash flow matching low default risk fixed income portfolios, this disclosure does not provide useful information regarding benefit security. A detailed risk assessment is needed to provide meaningful information on the security of benefits.

ii. The proposed measure may be used as an estimate of the amount of savings the plan anticipates from taking investment risk or the additional cost to the plan sponsors if the plan chose not to take investment risk, potentially as part of a justification of the amount of investment risk taken. However such an analysis is more properly a part of an assessment of investment risk and so should be included solely as a possible risk assessment under ASOP 51. Even the title implies that it belongs in ASOP 51, and the measure itself is used as an example in Section 3.4 of that ASOP.

iii. Many pension plans now include risk-sharing features whereby benefit amounts depend on actual investment returns or changes in a market index compared to some benchmark. The benchmark can be the plan's expected return or a fixed amount. Benefit adjustments may be limited by minimums or maximums, and any increases may be contingent on a plan's funded status.

For these variable benefit features, the Low-Default-Risk Obligation Measure as prescribed provides no useful information regarding funded status or benefit security. It does not represent a theoretical or actual market price for these obligations, and no insurance company or financial economist would use such a measure as the basis for investments backing an obligation for such a plan design. Furthermore, including such a measure in a valuation of variable benefit features is likely to be misleading, and the actuary may be forced to either consider a deviation from the standard or provide an explanation that the measure is meaningless due to the variable benefit features.

The reason a reference portfolio of low-default-risk fixed income securities is used by financial economists is that the pension benefits are assumed to be fixed and payable with near certainty. For variable benefit designs, the pension benefits are not fixed. They are defined to vary with actual investment returns or the movements of a market index. Consequently, the reference portfolio for such an obligation would consist of securities that approximated the changes in the benefit amounts as market conditions change, and the appropriate discount rate for such a portfolio may differ significantly from that prescribed for the Low-Default-Risk Obligation Measure.

iv. Prescribing this measure is a breach in the ASOP framework established in ASOP 1, which calls for guidelines that allow for the actuary's professional judgement and should not be narrowly prescriptive. It would also restrict reflecting "the purpose of the measurement" when measuring obligations and determining costs or contributions, especially in cases when this measurement would have no meaning.

v. For all the reasons discussed, if guidance incorporating this disclosure requirement is retained it should be subject to the professional judgement of the actuary. To do that the guidance should be changed from "should calculate and disclose…" to "should consider calculating and disclosing…"

b. If 3.11 is retained (either as a "should" or "should consider" requirement), the following sections provide recommended changes to the proposed guidance.

i. The phrase "measure of the benefits earned" in the first sentence seems to prescribe a liability measure where current active member liability is the present value of accrued benefits. This is inconsistent with the now permitted use of other immediate gain actuarial cost methods such as entry age normal, where current active member liability is not simply

the present value of accrued benefits earned but rather the portion of the present value of future benefits that is allocated to past years (i.e. the accumulation of past normal costs).

ii. Consistent with the previous comment, we also recommend changing the name to "Low-Default-Risk ~~Obligation~~ Measure." We note when a specific measure is described by the term "obligation," it often implies a measure of the present value of accrued benefits, which is not consistent with some common immediate gain actuarial cost methods. We believe removing "obligation" from the title reduces that potential confusion.

In summary, consistent with the previous section and allowing the use of any immediate gain actuarial cost method, we recommend the following changes to the first sentence of Section 3.11:

"If the actuary is performing a **funding valuation**, the actuary should consider ~~calculate and disclose~~ calculating and disclosing a low-default-risk ~~obligation~~ measure of the benefits earned or costs accrued as of the **measurement date**."

iii. We also recommend moving the reference of an immediate gain actuarial cost method to the start of the second paragraph for clarity. The second paragraph of Section 3.11 would then start:

"When calculating this measure, the actuary should use an immediate gain actuarial cost method. Additionally, the actuary should select a discount rate derived from…"

iv. The paragraph added to accommodate variable benefits is inadequate. First, most variable benefits vary based on actual investment returns or changes in a specified market index not based on the assumed discount rate or expected investment returns. It isn't clear whether the intent is to assume the plan is actually invested in low-default-risk fixed income securities or to value the expected benefits based on the plan's current investments at the lower discount rate. Furthermore, it isn't clear if any contingencies (e.g., 100% funded) should be applied based on the normal valuation measure or the Low-Default-Risk Obligation Measure. And, it isn't clear what the resulting measure is intended to represent for these plan designs. We strongly suggest that plans with variable features be permitted to use the actuary's professional judgment in selecting assumptions to meet the objective of the measure. At a minimum, we suggest the paragraph on variable benefits be amended to read as follows:

"When benefits are affected by ~~the assumed discount rate or expected~~ actual investment returns or changes in a market index, the actuary may reflect the impact of variations in benefits earned as of the **measurement date** assuming the plan's assets are invested in a portfolio of low-default-risk fixed income securities."

c. Section 4.1(o)(5) requires commentary explaining the significance of the low-default-risk obligation measure with respect to the plan's funded status, plan contributions, and benefit security. More clarity is needed on this requirement. We suspect the intent is really to explain the significance of the measure when assessing funded status, plan contributions, or benefit security.

Funded status, for example, is defined as a measure of assets divided by a measure of plan liabilities. The significance of the measure on funded status is just that using a larger denominator in this ratio results in a lower measure of funded status. The significance as to the

meaning of the different funded status measures is more nuanced, and while the required disclosure does not have any impact on plan contributions or benefit security, it might affect assessments of the adequacy of plan contributions or the likelihood that promised benefits will be paid.

i. We recommend the following changes to Section 4.1(o)(5):

"related commentary to help the intended user understand the significance of the low-default-risk obligation measure with respect to assessments of the funded status of the plan, the adequacy of plan contributions, and the security of participant benefits."

4. Section 3.16 and 4.1(t) – Since the intent is to assess and disclose the output smoothing method in relation to the actuarially determined contribution without output smoothing, it is important to consistently specify the "corresponding" actuarially determined contribution in relation to the output smoothing method.

   a. We recommend the following changes to the first sentence of Section 3.16:

   "If the actuary selects an **output smoothing method**, the actuary should select an **output smoothing method** that results in a reasonable relationship between the smoothed contribution and the corresponding **actuarially determined contribution** without output smoothing."

   b. We recommend the following changes to Section 3.16(b):

   "any shortfalls of the smoothed contribution to the corresponding **actuarially determined contribution** without output smoothing are recognized within a reasonable period of time."

   c. We also recommend similar consistent changes to 4.1(t), along with noting that a description of any output smoothing method used is not applicable when none is used. Specifically:

   "a description of any **output smoothing method** used, if applicable. ~~Additionally~~ In that case, the actuary should also disclose ~~an~~ the corresponding **actuarially determined contribution** without output smoothing~~, if calculated~~;"

5. Section 3.17 and 4.1(v) – We appreciate the intent of Section 3.17, but believe it is too prescriptive and does not allow for appropriate actuarial professional judgement as written. The four required considerations are not universally applicable, and other considerations may be of greater importance in a given situation. Consequently, the list in Section 3.17 should be examples of what an actuary should consider instead of a specifically required list.

   Additionally, the guidance in 4.1(v) has the potential to be overly long and complicated, and burdensome to explain in a useful manner. It calls for a description of how each of potentially four contribution allocation procedure methods takes into account each of approximately eight particular considerations in 3.17, creating potentially 32 specific descriptions for every relevant actuarial report. However, we note that Section 3.17 requires its considerations for the allocation procedure as a whole, but not necessarily for each component of the allocation procedure. Some considerations are more relevant for specific components of the allocation procedure, while others are better applied to the allocation procedure as a whole. Furthermore, these considerations are most pertinent when making a change to any method of the contribution allocation procedure.

a. We recommend the following changes to the first sentence of Section 3.17:

"When selecting a **cost allocation procedure** or **contribution allocation procedure**, the actuary should consider ~~the following~~ factors such as:"

b. We recommend the following changes to the first sentence of Section 4.1(v):

"a description of how ~~the~~ considerations within section 3.17 have been taken into account ~~in selecting~~ whenever ~~each method of~~ the **contribution allocation procedure** used to determine the reasonable **actuarially determined contribution** satisfying the requirements of section 3.21 is changed."

6. Sections 3.19, 4.1(x), 4.1(y), 4.1(z), and 4.1(aa) – We appreciate and support the intent of this section, but believe that the text as written is confusing, particularly as the three assessments described are required, respectively, for contribution procedures, for other contribution setting procedures and for both. The three assessments described in 3.19 are universally relevant and important disclosures regardless of how contributions are determined. They should be applied consistently across all funding policies to assess their implications. There are some plans for which the actual funding policy would fail these assessments even though the actuarially determined contribution calculated by the actuary would pass. In that situation, it is important that the assessment is applied to the anticipated contributions of the actual funding policy and not just to the contribution allocation procedure used by the actuary that is not the basis for the anticipated contribution. We recommended a definition for funding policy above and use it extensively here, so as to focus the assessments on the anticipated contribution, however determined. We also note that the tests may require quantitative estimates and are not simply qualitative assessments.

a. We recommend the following changes to Section 3.19:

"Implications of ~~Contribution Allocation Procedure or~~ Funding Policy – If the actuary is performing a **funding valuation**, the actuary should ~~qualitatively~~ assess the implications of the plan's **funding policy**, whether based on a **contribution allocation procedure** or ~~plan sponsor's funding policy~~ another contribution setting procedure, on the plan's expected future contributions and **funded status**. ~~For purposes of this section, contributions set by law or by a contract, such as a collective bargaining agreement, constitute a funding policy.~~ If the ~~contribution allocation procedure~~ **funding policy** results in an anticipated contribution ~~actuarially determined contribution~~ that is less than the **normal cost** plus interest on the unfunded **actuarial accrued liability**, the actuary should estimate how long before the anticipated contribution ~~actuarially determined contribution~~ is expected to exceed that amount. ~~If contributions are set by law or by a contract (such as a collective bargaining agreement),~~ The actuary should also estimate the period over which the unfunded **actuarial accrued liability** is expected to be fully amortized under the **funding policy**. Finally, the actuary should assess whether the ~~contribution allocation procedure or~~ **funding policy** is significantly inconsistent with the plan accumulating assets adequate to make benefit payments when due, and if so, estimate the approximate time until assets are depleted.

For purposes of this section, the actuary may presume that all actuarial assumptions will be realized and the plan sponsor (or other contributing entity) will make contributions anticipated by the ~~contribution allocation procedure or~~ **funding policy**."

b. We recommend the following changes to Section 4.1(x) for consistency and clarity:

"a qualitative description of the implications of the ~~contribution allocation procedure or plan sponsor's~~ **funding policy** on future expected plan contributions and **funded status** in accordance with section 3.19, if applicable. The actuary should disclose the significant characteristics of the applicable ~~contribution allocation procedure or plan sponsor's~~ **funding policy**, and the significant assumptions used in the assessment;"

c. We recommend the following changes to Section 4.1(y) for consistency and clarity:

"if applicable, that the ~~contribution allocation procedure~~ **funding policy** results in an ~~actuarially determined~~ anticipated contribution that is less than the **normal cost** plus interest on the unfunded **actuarial accrued liability**, and, in that case, how long before the ~~actuarially determined~~ anticipated contribution is expected to exceed that amount, in accordance with section 3.19;"

d. We recommend the following changes to Section 4.1(z) for consistency and clarity:

"~~if contributions are set by law or by a contract (such as a collective bargaining agreement),~~ if the plan has unfunded actuarial accrued liability, an estimate of the period over which the unfunded **actuarial accrued liability** is expected to be fully amortized, in accordance with section 3.19;"

e. We recommend the following changes to Section 4.1(aa) for consistency and clarity:

"if applicable, a statement indicating that the ~~contribution allocation procedure~~ **funding policy** is significantly inconsistent with the plan accumulating adequate assets to make benefit payments when due, and if so, ~~as well as~~ an estimate of the approximate time until assets are depleted, in accordance with section 3.19;"

7. Sections 3.21 and 4.1(bb) – We appreciate and support the intent of sections 3.21 and 4.1(bb), but believe they can be made more consistent and more broadly applicable with some minor edits.

a. There are public pension valuations in which no actuarially determined contribution is calculated. Fixed rate plans, for example, may simply assess the funding period implied by the fixed rate. As proposed it is not clear whether or not Section 3.21 requires such a plan to calculate a reasonable actuarially determined contribution. Similarly, the existence of one or more prescribed assumptions should not permit the actuary to avoid calculating a reasonable actuarially determined contribution. To clarify the intent (and to align Section 3.21 with 4.1(bb) by using "reasonable" in more than just the title), we recommend the first sentence of 3.21 be amended to read as follows:

"Except where the **actuarially determined contribution** is based on a **prescribed method set by law**, ~~I~~if the actuary is performing a **funding valuation** ~~where the **actuarially determined contribution** is not based on a **prescribed assumption or method set by law**~~, the actuary should calculate and disclose a~~n~~ reasonable **actuarially determined contribution** using a **contribution allocation procedure** that satisfies the following conditions:"

b. Section 4.1(bb) should also require the actuary to disclose if the actuarially determined contribution is not reasonable, and why:

> "if applicable, a reasonable **actuarially determined contribution**, in accordance with section 3.21, the corresponding **funded status**, and any material assumptions or methods that were used in the calculation that are not otherwise disclosed. If the **actuarially determined contribution** is not reasonable in accordance with section 3.21, the deviation should be identified and explained;"

We appreciate the opportunity to provide feedback on the proposed revisions to ASOP No. 4 and would be happy to discuss our comments in greater detail.

Sincerely,

Members of the Conference of Consulting Actuaries Public Plans Community Steering Committee

Paul Angelo, Chair
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