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July 20, 2020

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

**Re: ASB Comments—Comments on Second 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] are pleased to present the following comments to the Actuarial Standards Board (ASB) regarding the second 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. Nevertheless, we have some comments on the current exposure draft. Note that recommended new text is shown with an underline.

Following are our specific comments on various sections of the proposed ASOP:

- Section 1.2—Since the drafting of the current version of ASOP No. 4, the ASB issued a new ASOP No. 56, *Modeling* (ASOP No. 56). The sixth paragraph of section 1.2 of ASOP No. 56 states, "If the actuary determines that the guidance from another ASOP conflicts with the guidance of this ASOP, the guidance of the other ASOP will govern." However, in the proposed ASOP No. 4, the third paragraph of section 1.2 only references what to do about conflicts with provisions of ASOP Nos. 27, 35, and 44. We recommend adding the sentence, "<u>ASOP No. 56, *Modeling*, provides guidance with respect to designing, developing, selecting, modifying, using, reviewing, or evaluating models</u>" as the second-to-last sentence of the paragraph so that all potential conflicts are consolidated in one place for pension actuaries.

[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.

- Section 3.11—We appreciate many of the changes made to this section since the prior exposure draft, including the expansion to allow any immediate gain actuarial cost method to be used for the calculation. However, we believe a few additional changes are necessary to make this section meaningful for all pension plans. To assist the ASB, following our specific comments we have provided suggested language incorporating all of the comments.

    a. The use of the phrase "measure of the benefits earned" in the first sentence continues to imply the required use of a method (such as the unit credit method) where for active members the actuarial accrued liability is the simple present value of the benefit earned or accrued as of the measurement date. We recommend changing the phrase to "measure of the benefits earned <u>or costs accrued</u>." This allows for the inclusion of immediate gain methods (such as entry age normal) where the actuarial accrued liability for active members is the accumulated value as of the measurement date of the normal costs sufficient to fund the portion of the present value of projected benefits that is allocated or accrued during the years prior to the measurement date.

    b. We recommend that the name of the measure be changed to "Low-Default-Risk Measure," i.e., deleting the word "Obligation." In many contexts (including financial reporting under Financial Accounting Standards Board (FASB) standards), "obligation" measures are present values of accrued benefits using either the unit credit or the projected unit credit cost method. However, under the entry age normal cost method, the resulting measure is generally called an accrued liability rather than an obligation. Removing the word "obligation" will more clearly make the name applicable to both accrued benefit measures and other accrued liability measures. If the ASB believes there should be a word in this name to indicate that it is a liability measure, then we suggest the name "Low-Default-Risk <u>Liability</u> Measure" would be more inclusive and less confusing.

    c. We recommend that the last sentence be changed to clarify what is meant by reasonable, and also that the assumptions selected should be consistent with the discount rate, as follows:

       "Alternatively, the actuary may select other ~~reasonable~~ assumptions <u>that are consistent with the discount rate and reasonable for the purpose of the measurement,</u> in accordance with ASOP Nos. 27 and 35."

    d. With the changes described above, we believe the measure would be meaningful for traditional defined benefit plan designs in which benefit amounts are independent of investment returns or other external factors. However, to the extent benefit amounts vary based on actual investment returns, movements in a market index, or other similar factors, it is unrealistic to expect that cash flows from low-default-risk fixed income securities will be reasonably consistent with the pattern of benefits expected to be paid in the future.

       The current exposure draft attempts to address this issue by allowing the actuary to reflect variations in benefits while still requiring the use of a discount rate based on low-default-risk fixed income securities. However, such measures are still likely to be meaningless for some plan designs. For example, a simple variable design with a fixed hurdle rate and a floor benefit would likely calculate this measure by assuming benefits decline at the rate equal to the difference between the hurdle rate and the discount rate until benefits reach the floor. The resulting measurement does not provide information regarding the plan's funded status, plan contributions, or the security of participant benefits, as appears to be the intent of requiring disclosure of the Low-Default-Risk Measure.

We recommend that the requirements as currently described only apply when benefits are independent of investment returns or other factors that have a similar effect. When benefits are affected by actual investment returns, movements in a market index, or other similar factors, instead of just allowing the actuary to vary the benefit amounts, the standard should allow the actuary to use professional judgment to select appropriate valuation procedures and assumptions to produce a comparable low-default-risk measure. In the example above, the result would likely be to value the benefits using the hurdle rate as the discount rate and adding a value for the benefit floor using alternative valuation measures as described in section 3.5.3. The use of professional judgment will allow the actuary to calculate meaningful measures for the wide variety of variable annuity, gain sharing, market return-based cash balance, and other risk-sharing designs in use today and that may be developed in the future.

e. The consolidated revised section 3.11 reflecting all of our recommended changes and some repositioning of text to improve clarity is as follows:

"3.11 Low-Default-Risk ~~Obligation~~ Measure—If the actuary is performing a **funding valuation**, the actuary should calculate and disclose a low-default-risk ~~obligation~~ measure of the benefits earned or costs accrued as of the **measurement date**.

When calculating this measure, the actuary should use an **immediate gain actuarial cost method**. [Moved from below]

When ~~calculating this measure~~ benefits are independent of actual investment returns, movements in a market index or other similar factors, the actuary should select a discount rate for this measure derived from low-default-risk fixed income securities whose cash flows are reasonably consistent with the pattern of benefits expected to be paid in the future. Examples of discount rates that may meet these requirements include, but are not limited to, the following:

a. US Treasury yields;
b. rates implicit in settlement of plan obligations including payment of lump sums and purchases of annuities from insurance companies;
c. yields on corporate or tax-exempt general obligation municipal bonds that receive one of the two highest ratings given by a recognized ratings agency;

d. non-stabilized ERISA funding rates for single employer plans; and
e. multiemployer current liability rates.

~~When calculating this measure, the actuary should use an **immediate gain actuarial cost method**.~~ [Moved above]

~~When benefits are affected by the assumed discount rate or expected investment return, the actuary may reflect the impact of variations in benefits earned as of the **measurement date**.~~ [Moved below and updated]

Other than the discount rate, the actuary may use the same assumptions used in the **funding valuation** for this measure. Alternatively, the actuary may select other ~~reasonable~~ assumptions that are consistent with the discount rate and reasonable for the purpose of the measurement, in accordance with ASOP Nos. 27 and 35.

When benefits are affected by ~~the assumed discount rate or expected~~ actual investment returns, movements in a market index or other similar factors, the actuary ~~may reflect the impact of variations in~~ should use professional judgment to select appropriate valuation procedures and assumptions under section 3.5.3 to produce a comparable low-default-risk measure of the benefits earned or costs accrued as of the **measurement date**.[Moved from above]"

- Section 3.14

  a. We appreciate and support the application of the guidance on amortization methods to "each amortization base" (in the first paragraph), as well as to the total amortization payments (in the third paragraph).

  b. Both the first and third paragraphs of this section discuss how amortization methods need to reflect a "reasonable time period" or a "reasonable amount," with the first paragraph applying to each amortization base and the third to the total amortization payments. Then the second paragraph discusses what to consider in determining a reasonable time period or a reasonable amount. To make this section easier to follow, we recommend moving the third paragraph to follow the first paragraph so both requirements regarding time periods and amounts are presented together, followed by the considerations that are to be used in both contexts.

- Sections 3.16 (b) and 4.1(t)—To be consistent with section 3.16(a), we recommend that the shortfalls referenced in section 3.16(b) should be with respect to the "corresponding **actuarially determined contribution** without output smoothing."

  Similarly, section 4.1(t) should be updated to reflect this change and to remove the phrase "if calculated," because it is no longer applicable. Therefore, we recommend changing the last sentence of section 4.1(t) to read:

  "Additionally, the actuary should disclose the corresponding **actuarially determined contribution** without output smoothing;"

- Sections 2.8, 3.2(p), 3.19, 4.1(x), 4.1(y), and 4.1(z) —While we generally support their intent, we found the expanded analysis and disclosures required in section 3.19 and related sections confusing as drafted, especially as they apply to the different areas of pension practice. The recommendations below are an attempt to make these requirements clearer to practitioners and more consistent across all areas of pension practice. To assist the ASB, following our specific comments, we have provided suggested language incorporating all of the comments.

   a. We recommend that “contribution allocation procedure” should be defined as producing a single value that is “an” (not “the”) actuarially determined contribution, because this is most consistent with current practice. For example, the calculation of the minimum required contribution under the Employee Retirement Income Security Act of 1974 (ERISA) is a contribution allocation procedure, and the calculation of the maximum tax-deductible contribution under ERISA is a different contribution allocation procedure, but each of those procedures will produce a single distinct actuarially determined contribution once the components of the method are set. Therefore, we recommend changing section 2.8 to:

      “2.8 <u>Contribution Allocation Procedure</u>—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 <u>an</u> **actuarially determined contribution** for a plan. The procedure <u>will</u> produce a single value, such as **normal cost** plus an amortization payment of the unfunded **actuarial accrued liability**.” [remainder of sentence is deleted]

      To coordinate with this change, we recommend that “funding policy” should be a defined term under section 2 (instead of only implying its meaning and specifying an example in section 3.19) to help actuaries understand what is meant by that term and how it may differ from a contribution allocation procedure. That definition should reflect that the funding policy could be a contribution allocation procedure, a range produced by more than one contribution allocation procedure, or some other value not determined by a contribution allocation procedure. The following is proposed language for that definition:

      “<u>Funding Policy—The formal or informal policy under which the contribution anticipated to be made to the plan is determined. The policy may produce a single value determined by a **contribution allocation procedure**, or some other value such as a contribution set by law or by a contract (e.g., a collective bargaining agreement). Alternatively, the funding policy may produce a range of values, such as the range between the values determined by the two contribution allocation procedures for the ERISA minimum required contribution and the maximum tax-deductible contribution.</u>”

      Because the term “funding policy” would be defined in section 2, the second sentence of section 3.19 should be removed.

b. We recommend that any references to "**contribution allocation procedure** or funding policy" be changed to "**contribution allocation procedure** or <u>other</u> **funding policy**" (a more complete reference would be "a funding policy based on a contribution allocation procedure or some other basis"; however, we are suggesting this simpler change in order to be more consistent with the current language in the standard). This occurs in the title of section 3.19, in the first sentence of section 3.19, as well as in section 3.2(p) and 4.1(x) (where "<u>other</u>" would replace "plan sponsor's"), and elsewhere throughout section 3.19. We make this recommendation because, as noted above, we believe that a contribution allocation procedure is a type of funding policy. Furthermore, not all funding policies are set by plan sponsors.

c. We believe some of the assessments in section 3.19 are quantitative and some are qualitative. Therefore, we recommend removing the word "qualitatively" from the first sentence.

d. We believe the three assessments in section 3.19 should be applied to the contribution allocation procedure or other funding policy that is used to determine the anticipated contribution. Specifically:

    i. The requirement to estimate how long before the actuarially determined contribution is expected to exceed normal cost plus interest (when it is currently less than that amount) should be applied to *both* contribution allocation procedures and other funding policies. In either case this assessment will be applied to the anticipated contribution, which may be actuarially determined (i.e., determined using a contribution allocation procedure) or not (i.e., determined using some other funding policy).

    For example, we believe this assessment should be applied to a contribution that is not actuarially determined but is used to make the anticipated contribution to the plan, such as a fixed rate contribution to a public sector plan, but not an actuarially determined contribution that may be calculated for some purpose other than determining the anticipated contribution for that plan. As another example, we do not believe this should apply to a maximum tax-deductible contribution for a corporate plan that is not anticipated to be contributed to the plan.

    Therefore, in the third sentence, we recommend (a) changing "**contribution allocation procedure**" to "**contribution allocation procedure** <u>or other</u> <u>**funding policy**</u>"; and (b) changing both occurrences of "**actuarially determined contribution**" to simply "<u>anticipated contribution</u>" (a concept that is already used in the last paragraph of section 3.19). To be consistent, we also recommend section 4.1(y) be changed to:

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

ii. The requirement to estimate the period over which the unfunded actuarial accrued liability is expected to be amortized should be required for all plans and not just when "contributions are set by law or contract." Therefore, we recommend deleting "If contributions are set by law or by a contract (such as a collective bargaining agreement)," from the beginning of the fourth sentence, and adding "under the **contribution allocation procedure** or other **funding policy**" to the end of that sentence. To be consistent, we also recommend section 4.1(z) be changed to:

"an estimate of the period over which the unfunded **actuarial accrued liability** is expected to be fully amortized, in accordance with section 3.19;" [words removed at the beginning]

e. We recommend changing the final clause of the last sentence of the first paragraph to read "and, in that case, estimate the approximate time until assets are depleted," to clarify that estimating the asset depletion date is only required in the event the "**contribution allocation procedure** or other **funding policy** is significantly inconsistent with the plan accumulating assets adequate to make benefit payments when due." Otherwise, significant work would be required of the actuary without providing meaningful information to the intended user. This is consistent with the wording already found in section 4.1(y).

f. The consolidated revised section 3.19 reflecting all of our recommended changes is as follows:

"3.19 Implications of Contribution Allocation Procedure or Other Funding Policy - If the actuary is performing a **funding valuation**, the actuary should ~~qualitatively~~ assess the implications of the **contribution allocation procedure** or other ~~plan sponsor's~~ **funding policy** 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** or other **funding policy** results in an ~~**actuarially determined**~~ anticipated contribution that is less than the **normal cost** plus interest on the unfunded **actuarial accrued liability**, the actuary should estimate how long before the ~~**actuarially determined**~~ anticipated contribution is expected to exceed that amount. ~~If contributions are set by law or by a contract (such as a collective bargaining agreement), the~~ The actuary should estimate the period over which the unfunded **actuarial accrued liability** is expected to be fully amortized under the **contribution allocation procedure** or other **funding policy**. The actuary should assess whether the **contribution allocation procedure** or other **funding policy** is significantly inconsistent with the plan accumulating assets adequate to make benefit payments when due, and, in that case, 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 other **funding policy**."

g. If a definition of funding policy is not added as recommended above, then, as we have discussed, the second sentence of section 3.19 should be changed to the following:

"For purposes of this section, a funding policy may produce a single or multiple value(s) determined by a single or multiple **contribution allocation procedure(s)**, respectively, or some other value such as a contribution set by law or by a contract (e.g., a collective bargaining agreement)."

In that case, the consolidated revised section 3.19 reflecting that embedded definition as well as all of our other recommended changes is as follows:

"3.19 Implications of Contribution Allocation Procedure or Other Funding Policy - If the actuary is performing a **funding valuation**, the actuary should ~~qualitatively~~ assess the implications of the **contribution allocation procedure** or other ~~plan sponsor's~~ funding policy on the plan's expected future contributions and **funded status**. For purposes of this section, a funding policy may produce a single or multiple values determined by a single or multiple **contribution allocation procedure(s)**, respectively, or some other value such as a contribution set by law or by a contract (e.g. a collective bargaining agreement). ~~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** or other funding policy results in an ~~**actuarially determined**~~ anticipated contribution that is less than the **normal cost** plus interest on the unfunded **actuarial accrued liability**, the actuary should estimate how long before the ~~**actuarially determined**~~ anticipated contribution is expected to exceed that amount. ~~If contributions are set by law or by a contract (such as a collective bargaining agreement), the~~ The actuary should estimate the period over which the unfunded **actuarial accrued liability** is expected to be fully amortized under the **contribution allocation procedure** or other funding policy. The actuary should assess whether the **contribution allocation procedure** or other funding policy is significantly inconsistent with the plan accumulating assets adequate to make benefit payments when due, and, in that case, 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 other funding policy."

- Section 3.21—Under the current wording, we believe it would be possible to satisfy the conditions outlined in section 3.21 in any single year, while not using a consistent methodology to calculate the actuarially determined contribution from one year to the next. While occasional changes to the methodology are to be expected and should be allowed based on actuarial judgment, we believe frequent (such as annual) changes in methodology may not result in a "reasonable **actuarially determined contribution.**" This is a particular concern when the changes are made to allow contributions that are actually "set by law or by a contract (such as a collective bargaining agreement)" to be characterized as a "reasonable **actuarially determined contribution**." For example, we do not believe that a method that varies the amortization period each year so as to have the actuarially determined contribution remain equal to a fixed rate contribution should be considered a "reasonable **actuarially determined contribution.**" We also note that the word "reasonable" is found only in the title to this section. We recommend the following clarifying language for the first paragraph:

> "…the actuary should calculate and disclose <u>a reasonable</u> **actuarially determined contribution**. <u>A reasonable **actuarially determined contribution** is one that uses</u> a **contribution allocation procedure** that <u>is expected to be applied consistently in the future and</u> satisfies the following conditions:"

- Section 3.21(a)—Thank you for reflecting our comment on the prior exposure draft with respect to sections 3.8 and 4.1(l) relating to expectations of significant bias. However, we recommend a similar change be made to the new wording added to the last sentence of section 3.21(a) so that it reads "…and the combined effect of these assumptions is <u>expected to have</u> no significant bias (i.e., it is not significantly optimistic or pessimistic)…" As we noted in our prior comment letter, the actuary cannot know whether an assumption will turn out to be significantly biased without seeing how experience plays out and looking back at that experience versus the assumption. Therefore, we believe the ASOPs should clearly state that the actuary is only held to this standard with respect to what is expected when selecting the assumption.

- Section 3.25 and Section 4.2(b)—It is unclear what is meant by "unable to assess for reasonableness." We believe it is important to clarify that this criterion includes the situation where the actuary would need to perform a substantial amount of additional work beyond the scope of the assignment to do that assessment, which was found in the prior version of the standard. Often actuaries rely on assumptions prepared by other experts that the client has engaged to perform a service. For example, with global companies, there may be a global consolidating actuary who sets discount rate rates in accordance with a global policy and process for all of a company's plans around the world, and the local U.S. actuary must use that discount rate in their valuation. Another example could be when an actuary takes over actuarial valuation services for a plan that used actuarial assumptions that were the result of a detailed experience study recently completed by the prior actuary. The actuary who is using these assumptions may not have all of the information to assess these assumptions for reasonableness, and their client may not want to engage them to duplicate the work done by the expert selected to do the work.

- Section 3.26—Similar to the comment we made in our September 15, 2019, comment letter on the exposure drafts for ASOP Nos. 27 and 35, the second sentence of this section provides that an actuary should prepare documentation in such a form that another actuary could "assume the assignment if necessary." Because internal documentation about the selection of assumptions can contain proprietary work product that is not required to be provided to another actuary who assumes the assignment (in accordance with Precept 10 of the Code of Professional Conduct), we believe the portion of this sentence that refers to assuming the assignment should be removed, or at least clarified to address items of a proprietary nature.

In addition, because this guidance is provided in section 3 and not section 4 of the proposed ASOPs, we read it to mean that it pertains to recommended practices and not to communications and disclosures. Therefore, we recommend that the reference to section 4 be removed from the first sentence.

- Section 4.1— Similar to the comment we made in our September 15, 2019, comment letter on the exposure drafts for ASOP Nos. 27 and 35, we recommend the first sentence be changed to add "<u>with respect to required disclosures</u>" at the end to specify what the actuary should consider in the listed ASOPs when issuing an actuarial report.

- Section 4.1(v)—We believe this section requires a lengthy disclosure that will put undue burden on the actuary preparing it and may be difficult for the intended audience to follow or use. It requires the actuary to discuss how the numerous items in section 3.17 have been taken into account for each "method of a **contribution allocation procedure,**" potentially every year. As defined, each contribution allocation procedure typically has three or four methods, including an actuarial cost method, an asset valuation method, an amortization method, and possibly an output smoothing method. So even if each item description is brief, the combination of each consideration in 3.17 with each method of the contribution allocation procedure described in 3.21 would lead to a long and complicated disclosure. Altogether, we do not believe this disclosure can be brief as currently drafted. For this reason, we recommend that the disclosure in section 4.1(v) be required in total for the contribution allocation procedure and not for each method of a contribution allocation procedure. Accordingly, we recommend the start of the first sentence be changed to remove "each method of" as follows:

  "a description of how the considerations in section 3.17 have been taken into account in selecting the **contribution allocation procedure**"

  We understand that the ASB may be concerned that the disclosure produced by this recommended change would not be comprehensive enough, which might be of most concern in the year when a method of a contribution allocation procedure is changed. Although we do not think it is needed, the ASB could consider adding the following sentence prior to the last sentence in of section 4.1(v):

  "<u>In addition, at the time a method of the **contribution allocation procedure** is changed, the actuary should disclose a description of how the considerations in section 3.17 have been taken into account in selecting the new method of the **contribution allocation procedure**.</u>"

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We appreciate the ASB giving consideration to these comments. Please contact Philip Maguire, policy analyst, pension (maguire@actuary.org, 202-223-8196), if you have any questions or would like to arrange a convenient time to discuss this matter further.

Respectfully submitted,

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