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

RE: Proposed Revisions to ASOP 4

To the Members of the Actuarial Standards Board:

Cavanaugh Macdonald Consulting, LLC thanks the Actuarial Standards Board for this opportunity to comment on the proposed revisions to ASOP 4. We are especially appreciative of the significant effort that was made in this draft to make the standard less prescriptive. As pointed out in the transmittal of this draft, the changes being proposed are at least partially driven by "activity related to public pension plans." As a national leader in providing actuarial consulting services to state and local government pension plans, we have expended tremendous effort over the years working toward educating boards, staff, sponsors, and other stakeholders about appropriately funding these retirement plans. From this experience we have some observations that we believe may be of value in helping to shape ASOP 4 so it that can best advance professional practice and provide useful information to interested stakeholders.

As we will discuss in more detail in our comments, we believe that the requirements of the new section 3.11 will not serve to advance the profession in that the proposed changes provide no particularly new information for the majority of pension plans and are likely to be misunderstood and misused for the plans where this additional information is new. We also include comments relating to some of the other changes.

Limited Application

Before dealing with some specific items in the proposed revisions, we believe there is a broad issue that should be addressed: Much of the new material in the proposed ASOP 4 revision will not apply to the majority of pension plans. Section 3.21 does not apply when there is a prescribed assumption or method set by law, thereby excluding ERISA plans. Likewise, sections 3.13, 3.14, 3.16, 3.17, 3.18, 3.19 will not be applicable for most ERISA plans because these methods are selected via federal laws and regulations. Section 3.11 is crafted so that ERISA plans do not need to calculate any additional items. Another category of plans to which many of these new provisions would not apply are unfunded plans - there is no intent to fund them formally, so no funding valuation is applicable. Thus, many of these new sections really only apply to funded church and public plans. We see no reason to make substantial revisions to a key pension ASOP and then exclude the majority of pension work from those revisions.

Section 3.11

We next wish to address some specific issues where we believe the proposed revisions should be modified. First, we note that Section 3.11 requires that an actuary calculate and disclose a low-default-risk measure of benefits earned when performing a funding valuation. We appreciate the effort in this draft to make this provision less prescriptive than in the prior draft. Those of us in the public sector (as the targets of this section) prepare our work knowing that it will be public record – in the newspapers, on the internet, and frequently discussed by the general public. With two different liability numbers presented, there will be an extreme challenge to explain to the general public how these values have different meanings for different purposes. This is much different than explaining the results of a corporate pension plan to a CFO who has had exposure to the concepts involved. Despite the assertion of the ASB to the contrary, we anticipate that this new, larger number will be treated by the media as the "true" value. Further, this will almost encourage the general public to conclude that if there are two numbers for the same item, then clearly actuaries are trying to hide the truth, are making all of the numbers up, or have no idea what they are doing. This does not seem like a helpful approach in advancing the profession, and in fact, the public may decide to discredit all actuaries, not just public pension plan actuaries.

Section 3.11 is stated to be applicable to funding valuations. As a practical matter for public plans, any study of proposed changes to benefits or funding policies may require an analysis be performed on this basis as well as the funding basis, so that decision makers will know the ramifications of disclosure items connected with their decision. We believe it should be emphasized that this measure may be guiding decisions and will be higher profile than just a simple disclosure in a report.

While the low-default-risk obligation measure may be of interest to some parties, we anticipate that it will not be a useful measure for many public retirement systems. After all, it reflects an investment strategy that would be inappropriate (if not impossible) for most plans. These plans are investing in diverse portfolios designed to take an appropriate level of risk so as to provide benefits at a lower cost than could be managed in the absence of risk. In fact, the trustees of the plan are required by law to be prudent, and it is doubtful that an investment portfolio that only contained these low-default-risk securities would be deemed prudent. To disclose this measure solely to say that a balanced portfolio is providing the benefits at a much lower cost adds little value. We realize that some other disclosures required by the ASOPs may not be useful or appreciated by the clients we serve, but such information tends to either be needed for other actuaries to opine on the reasonableness of the work, or to alert the plan sponsors of some potential problem of which they need to be aware. This disclosure, however, does not assist other actuaries in reviewing the work (and, in fact, adds another item to review) and will not likely give the sponsor any useful information since few sponsors would seriously consider such an investment portfolio. On the contrary, our clients will have to pay to have this work performed, adding to the administrative expense and possibly reducing the funded status of the plan. We question how such a requirement benefits anyone beyond answering some academic and theoretical curiosities.

ASOP 51 suggests that such a measure as this is an option to assess and quantify risk. We actually believe 3.11 could be eliminated altogether, much as all issues related to asset valuation are delegated to ASOP 44. Splitting risk disclosure items between ASOP 4 and ASOP 51 (as this proposed draft would do) appears to indicate the coordination between the ASOPs was not well thought out – a stark contrast with the otherwise careful coordination employed by the ASB. In any case, we strongly believe that this measure should include an "actuary shall consider" clause to provide for discretion when the issuance of additional disclosures will create confusion, especially since these disclosures are for an action that is neither possible, nor desirable for public retirement systems.

As a technical note, we would point out that the first sentence of this section mentions benefits earned as of the measurement date, but then later in the section the use of any immediate gain cost method is affirmed. We suggest the first sentence be changed to allow for cost methods other than Unit Credit to be used.

Section 3.21

This section applies for funding valuations when there is not a prescribed method or assumption set by law. In the real world, this will essentially be applicable to funded church and public plans. Many, if not most, public plans have some additional legislative requirements for setting a method or assumption, but these requirements do not meet the definition of "prescribed assumption or method set by law" as defined in ASOP 4. Frequently, the legislatively-required methods will nonetheless meet the requirements of this section, so that the actuary need only show one set of contribution numbers. In other cases, however, the actuary may be compelled to calculate an alternate contribution rate that may not be materially different from the legislated rate in order to satisfy the requirements of this section. There will be cases where the current method used does not technically meet the requirements of the proposed ASOP language, but our reasonable and compliant alternative would be identical. We can't help but wonder if our work to provide a distinct "compliant" actuarial rate that is nearly or completely identical to the "non-compliant" rate may, in fact, serve to call into question the credibility of the actuarial profession as being concerned with form over substance.

For example, we know of a state sponsoring several retirement plans that by state law are required to amortize gains and losses from a year over 30 years (closed, layered bases). Some of these plans are very well funded and contribute well above the actuarial rate that is calculated using the state-mandated requirements. In fact, because of the benefit provisions that have been adopted for future employees, the projections for one of these plans indicate that it will be 120% to 150% funded over the next 20 years. However, because 30-year base may be too long to be considered reasonable, we will need to calculate a "reasonable" ADC that may be higher or lower (based on recent gain/loss bases) than the state-mandated ADC. Is the actuarial profession well-served by our disclosing a "reasonable" ADC that is few basis points different from the "unreasonable" ADC (because readers in the general public will know the alternative to "reasonable" is "unreasonable") and then comparing it to the statutory rate that is higher? We are already trying to figure out how to tell the Board and its auditors their "unreasonable" rate is higher than the "reasonable" one. Alternatively, there may be some thought of uncomfortably compromising professional integrity and deciding that 30-year amortization is reasonable after all.

We note that section 3.19 requires the actuary to disclose if a funding policy will not accumulate sufficient assets to pay the benefits of the plan. Ultimately, this is the central issue at stake (and, in fact, this is actually a relevant issue for unfunded plans, too). If there is a policy in place that will accumulate sufficient assets, there is little apparent value in providing an alternate measurement of a contribution rate. We believe that the requirements of 3.21 should be applicable only if the actuary has reason to believe that the current funding policy is inconsistent with accumulating sufficient assets. In that situation, the additional information serves to illustrate the needed change in contributions to fund the promised benefits, information which would be needed by the plan sponsor.

Section 4.1.o.5

As we've noted earlier, actuarial work in the public sector is usually a matter of public record, and so the work really must be prepared for all users, not just intended users. We believe it would be helpful to the actuary to have this paragraph include the following statement: *In commenting on these issues, the actuary* *is not required to speculate as to whether or not benefits would be eliminated if such a funding method were used, but should indicate that such issues are relevant.* We believe it is important to understand that the **existence** as well as the **security** of benefits is dependent upon the ability to invest in securities other than low-default-risk fixed income obligations.

Section 4.1.v

The proposed standard calls for describing how the items in 3.17 (which has four items, the first of which lists three items, resulting in a total of six items overall) are taken into account for the requirements of 3.21 (of which there are six items listed). Thus, there are 36 overall items to comment on, although the disclosure "may be brief." First, it will be quite a challenge to address 36 items briefly. Second, we daresay most pension actuaries have not considered intergenerational equity explicitly in developing the asset valuation method – but we also cannot think of a situation in which we would now want to modify our asset valuation method to better address intergenerational equity versus predictability of periodic costs. We would suggest that this disclosure be required only when a method is changed. Further, the fact that this only applies to funded church and public plans seems inappropriate. If this information is indeed important, corporate plan reports should comment on how well each of these 36 items is addressed by the ERISA requirement.

Concluding Thoughts

The Background section of the exposure draft indicates that these proposed changes were made in response to the Pension Task Force, which in turn was formed in response to concerns about public sector pension plans. The implication seems to be that the additional requirements of this ASOP will somehow provide actuaries with the guidance that is needed to help them act in a way that leads to changes in how public pension systems are valued, funded, designed, or disclosed. As we reflect over the past decade or so, there have been major shifts that have occurred with public retirement plans:

- the distribution of investment return assumption has shifted significantly lower
- the mortality assumptions of many systems has moved to a generational mortality basis, including some systems that adopted these changes more than 15 years ago
- contribution rates for employers have increased in most systems, and members have increased contributions in many cases, as well
- benefit provisions for new hires (and for future accruals where legal) have been reduced or adjusted to share risk through variable benefits and hybrid plan designs
- funding policies have been developed to help move toward fully funding on-going plans, with some systems targeting funded ratios in excess of 100% as a risk management tool
- the practice of an open 30-year level percentage of payroll amortization method has all but disappeared
- the level of detail provided to board members and the general public has increased significantly

Through all of this, actuaries have had a significant role in helping public policy-makers analyze options and ultimately make these changes. This does not suggest that actuaries are unsure of what to do and need additional guidance, but rather that actuaries are able to work from the existing principles of the ASOPs to help advance the practice and aid clients in solving their problems.

Yes, there are situations, some very well known nationally, where the sponsors have been ignoring the funding of a retirement system. It is extremely doubtful that any of these proposed ASOP changes will cause law-makers to suddenly realize that they must make changes to public policy and choose pension funding over road improvements or school funding. They may believe that their role as elected officials is to serve the citizens who elected them by guiding public policy and making the challenging choices about how limited resources are to be allocated to best serve the public over time. If we think as a profession that we know better about what society should do, we are incredibly arrogant. All of us would like retirement plans to be fully funded with all risks eliminated. But all of us also realize the importance of schools, roads, fire and police protection, and other government services. To balance all of this requires tough choices, preferably informed choices, and those choices can be best informed with actuaries providing our expertise. Based on the changes observed in the public plan environment over the past 10-15 years, there is a strong indication that our expertise has been offered and well-received. Cavanaugh Macdonald Consulting would strongly encourage that these proposed ASOP changes be included as considerations rather than mandatory disclosures applicable to the limited number of funded church and public plans that exist.

Sincerely,

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