

Working With the ABCD

Part I

IN THIS ISSUE, BOTH WORKSHOP AND TRADECRAFT work together to trace the inner workings of the Actuarial Board for Counseling and Discipline—from our initial letter of inquiry, to the ABCD's response, to an analysis of the findings.

We began with a letter to Frank Irish, chairman of the ABCD, requesting guidance on the selection of a discount rate for a pension plan.

Dear Mr. Irish,

We are a group of actuaries who consult with clients regarding the selection of the discount rate under Statement of Financial Accounting Standards (SFAS) 87 and 106. Some of us also work with auditors to review the work of other actuaries who have assisted clients in selecting the discount rate.

We have summarized on the attached two hypothetical scenarios (with variations) what may occur as an actuary works with a client in the selection process. It is not clear to us whether the actions of the actuary in these scenarios may constitute a material breach of the Code of Professional Conduct.

Accordingly, we ask the ABCD to provide guidance regarding the factors that would be considered to determine if a material breach has occurred.

Thank you for your attention to this request. Please feel free to contact us if you have any questions or would like any clarification of the scenarios.

Sincerely,

Robert J. Rietz, Vincent Amoroso, Barbara Bald,
Mark G. Beilke, Arthur L. Conat, Dennis M. Polisner,
Kenneth A. Steiner, John T. Stokesbury

Discount Rate Scenarios

An actuary has a client that maintains a defined benefit pension plan and a retiree medical plan. The client discloses the expense and liabilities for those plans in accordance with SFAS No. 87 and SFAS No. 106. Each year, the actuary advises the client concerning the appropriate assumptions to use in computing expense and liabilities under these standards, including the discount rate. The client selects the assumptions for the actuary to use in the calculations. When necessary, the client asks the actuary to help convince the client's auditor of the appropriateness

of the discount rate selected.

As part of the process of providing advice regarding the discount rate assumption, the actuary constructs several portfolios

of high-quality bonds whose maturities approximately match projected benefit payments, using bonds as described in the Emerging Issues Task Force's (EITF) Topic D-36 (below). The results are favorably peer reviewed by another actuary. None of these portfolios includes callable bonds or bonds whose yield is uncharacteristically high compared with other high-quality bonds. The highest yield of any of these portfolios is X percent.

Following the creation of these hypothetical bond portfolios, one of two basic scenarios is followed in the selection of the discount rate assumptions and subsequent discussions with the auditor.

Scenario 1

The actuary informs the client that the highest yield on a matched bond portfolio satisfying the criteria in EITF Topic D-36 is X percent.

The client subsequently selects a discount rate of X percent plus 50 basis points (bp) and asks the actuary to provide the disclosure information based on that discount rate. The actuary issues a report containing the required results, stating that (a) the client prescribed the assumptions and (b) the calculations were performed in accordance with SFAS No. 87 and SFAS No. 106.

The client's auditor has questioned the appropriateness of a discount rate of X percent plus 50bp. The client has asked the actuary to provide the auditor with whatever is needed to convince the auditor that the discount rate is acceptable.

The actuary meets with the auditor to discuss the selection of the discount rate. The actuary uses one or more of the following arguments to support the appropriateness of the client's chosen discount rate. (Note that this is not an exhaustive list of arguments that might be used.)

► **ARGUMENT A** The actuary provides the auditor with the individual bonds in the hypothetical portfolio that yields X percent, and attempts to persuade the auditor that X percent plus 50bp is a reasonable discount rate and complies with the accounting standards.

► **ARGUMENT B** The client directs the actuary to construct a different portfolio to support a discount rate of X percent plus 50 bp. The actuary states that such a portfolio

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lio can be constructed only by including bonds rated below the top two categories of a recognized rating agency. The client considers the third-highest rating as also being “high quality” and directs the actuary to include bonds in the third-highest category. The client explains that when EITF Topic D-36 was published in 1993, there were many bonds in the top two rating categories. There are relatively few bonds in the top two categories today, so that the top three quality categories today are equivalent to the top two categories in 1993. The actuary notes that the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC) staffs have each stated that the guidance of EITF Topic D-36 with regard to the criteria for “high quality” is unchanged. The client selects a discount rate of X percent plus 50 bp.

The auditor questions the appropriateness of the selected discount rate, and the client asks the actuary to persuade the auditor of its acceptability. The actuary uses the client’s argument regarding what constitutes “high-quality” bonds in an attempt to convince the auditor that X percent plus 50 bp is a reasonable discount rate and complies with the accounting standards, despite the FASB and SEC staff statements.

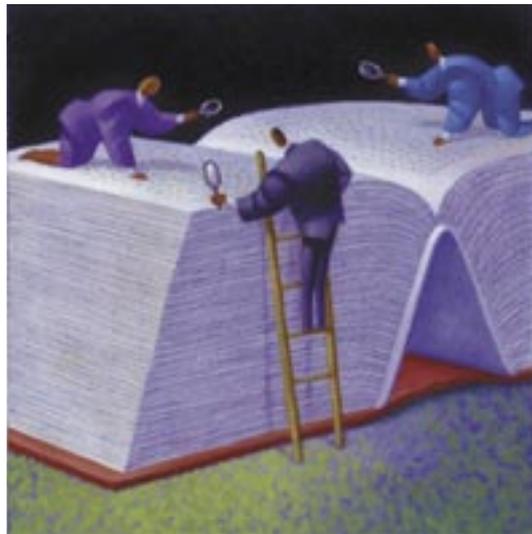
Scenario 2

The actuary advises the client that the highest yield on a matched bond portfolio constructed using bonds that satisfy EITF Topic D-36 is X percent. However, the actuary suggests that the client use a discount rate of X percent plus 50 bp based on one or more of the following arguments. (Note that this is not an exhaustive list of possible arguments.)

► **ARGUMENT A** The actuary constructs another hypothetical portfolio in a manner that generates significantly more cash than is necessary to pay projected benefits in the early years. The actuary assumes this excess cash will be reinvested at higher, long-term rates and used to pay benefits in the later years. (This portfolio

essentially ignores the shape of the yield curve because it substitutes long-term rates for short-term rates.) The yield of this portfolio is X percent plus 50 bp because of the method used to construct it.

► **ARGUMENT B** The actuary counsels his client to use X percent plus 50 bp because several of the client’s competitors



are using that discount rate.

► **ARGUMENT C** The actuary counsels his client to use X percent plus 50 bp because that is the published yield of a particular fixed-income index. This advice is given relying on statements from the FASB and the SEC staff that no index is an appropriate basis for selecting a discount rate but that plan sponsors may use computational “shortcuts” if the shortcuts are expected to produce similar results to constructing a portfolio of high-quality bonds whose maturities match projected benefit payments. The actuary considers relying on a published index with an average duration similar to that of the plans’ benefits to be a reasonable shortcut.

► **ARGUMENT D** The actuary, who is not an expert in analyzing non-standard bonds, constructs another bond portfolio that relies heavily on collateralized bonds that are rated as high quality. The yield on these publicly traded bonds reflects not only the credit of the issuer, whose non-collateralized bonds are not rated as high quality, but also the collateral backing the particular issues. If the issuer defaults, the

bondholders will receive a principal repayment that will need to be reinvested, similar to a high-quality bond with a call feature. Also, the collateral is not liquid, so bondholders may realize a significant delay in the timing of receipt of payments if the issuer defaults.

Thus, the coupons and maturities of the collateralized bonds have higher likelihood of not matching the projected benefit payments as the other high-quality, non-collateralized bonds in the hypothetical portfolio. Because the collateralized bonds have higher yield than non-collateralized, high-quality bonds, the alternate bond portfolio yields X percent plus 50 bp.

► **ARGUMENT E** The firm for which the actuary works has a policy that any valuation using a discount rate above a given percentage (Y percent) must have an additional level of review. The actuary constructs the hypothetical bond portfolio with yield X percent but advises the client

to use a discount rate of Y percent (which equals X percent plus 50 bp.)

The client selects X percent plus 50 bp as the discount rate. The actuary issues a report containing the required results and stating that (a) the client prescribed the assumptions and (b) the calculations were performed in accordance with SFAS No. 87 and SFAS No. 106.

The client’s auditor challenges the assumption, and the client asks the actuary to discuss the assumption with the auditor. The actuary provides the auditor with the same arguments used to justify the higher discount rate in discussions with the employer.

Questions:

1. Did either actuary materially violate the code in the advice given to the client regarding the selection of the discount rate?
2. Did either actuary materially violate the code in using the client’s selected discount rate and describing it as a prescribed assumption?
3. Did either actuary materially breach the code in attempting to convince the

auditor of the appropriateness of a discount rate that was higher than the highest rate developed using methodology that was appropriate under actuarial and accounting standards?

**Emerging Issues Task Force,
Topic No. D-36**

TOPIC: Selection of Discount Rates Used for Measuring Defined Benefit Pension Obligations and Obligations of Postretirement Benefit Plans Other Than Pensions
DATE DISCUSSED: Sept. 23, 1993

The SEC observer made the following announcement of the SEC staff's position on the selection of discount rates used for purposes of measuring defined benefit pension obligations under SFAS No. 87, *Employers' Accounting for Pensions*, and obligations of postretirement benefit plans other than pensions under SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*.

The SEC staff recently questioned a registrant about that registrant's selection of discount rates for purposes of measuring its defined benefit pension obligation under Statement 87. The staff believes that the guidance provided in paragraph 186 of Statement 106 for selecting discount rates to measure the postretirement

benefit obligation also is appropriate guidance for measuring the pension benefit obligation. That paragraph states:

The objective of selecting assumed discount rates is to measure the single amount that, if invested at the measurement date in a portfolio of high-quality debt instruments, would provide the necessary future cash flows to pay the accumulated benefits when due. Notionally, that single amount, the accumulated postretirement benefit obligation, would equal the current market value of a portfolio of high-quality zero-coupon bonds whose maturity dates and amounts would be the same as the timing and amount of the expected future benefit payments. Because cash inflows would equal cash outflows in timing and amount, there would be no reinvestment risk in the yields to maturity of the portfolio. However, in other than a zero-coupon portfolio, such as a portfolio of long-term debt instruments that pay semiannual interest payments or whose maturities do not extend far enough into the future to meet expected benefit payments, the assumed discount rates (the yield to maturity) need to incorpo-

rate expected reinvestment rates available in the future. Those rates should be extrapolated from the existing yield curve at the measurement date. Assumed discount rates should be re-evaluated at each measurement date. If the general level of interest rates rises or declines, the assumed discount rates should change in a similar manner.

Interest rates have been declining and are at their lowest levels in more than a decade. At each measurement date, the SEC staff expects registrants to use discount rates to measure obligations for pension benefits and postretirement benefits other than pensions that reflect the then current level of interest rates. **The staff suggests that fixed-income debt securities that receive one of the two highest ratings given by a recognized ratings agency be considered high quality (for example, a fixed-income security that receives a rating of Aa or higher from Moody's Investors Service, Inc.).** [Emphasis added.]

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For the ABCD's response and an analysis of its findings, see Tradecraft at right.

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