Comments on the Second Draft of the Proposed Revisions to Actuarial Standard of Practice Number 27 Selection of Economic Assumptions for Measuring Pension Obligations

May 31, 2012

The Actuarial Standards Board

The American Society of Pension Professionals & Actuaries (ASPPA) and the ASPPA College of Pension Actuaries (ACOPA) appreciate this opportunity to comment on the second draft of the proposed changes to Actuarial Standard of Practice (ASOP) Number 27, *Selection of Economic Assumptions for Measuring Pension Obligations.*

ASPPA is a national organization of more than 9,500 retirement plan professionals who provide consulting and administrative services for qualified retirement plans covering millions of American workers. ASPPA members are retirement professionals of all disciplines, including consultants, investment professionals, administrators, actuaries, accountants and attorneys. Our large and broad-based membership gives ASPPA unique insight into current practical applications of ERISA and qualified retirement plans, with a particular focus on the issues faced by small- to medium-sized employers. ASPPA's membership is diverse but united by a common dedication to the employer-sponsored retirement plan system. All credentialed actuarial members of ASPPA are members of ACOPA, which has primary responsibility for the content of comment letters that involve actuarial issues.

We recognize the second draft of the Proposed ASOP 27 is a significant improvement over the first draft, and we thank the members of the Pension Committee for their work.

This response has been prepared by actuaries who work primarily on small to mid-sized plans, including a significant number of plans in which the principal employees are directly benefiting. Our comments are predicated on significant modification of the proposed changes to Introductory Actuarial Standard of Practice, most specifically on the definitions of "must", "should" and "should consider."

Responses to the ASB Pension Committee's Questions

Question 1:
Is the guidance as to a reasonable assumption in section 3.6 clear and appropriate? If not, what changes do you suggest?

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Response:
We believe the guidance should be more specific on the nature and extent of a range of reasonable assumptions. Without that specificity, sections 3.5 and 3.6 are difficult if not impossible to implement. Please see our comments below.

Question 2:
Are the examples in 3.6.1 regarding market observations clear and sufficient? Is the language regarding observations including estimates of future experience as well as other considerations clear and appropriate? If not, what changes do you suggest?

Response:
Please add a comment that the list is not exhaustive.

Question 3:
Is the language in section 3.6.2 regarding a range of reasonable assumptions clear and appropriate? If not, what changes do you suggest?

Response:
As stated above, without a clear definition of a range, actuaries will not be able to determine when an assumption chosen is at one end of a range, beyond the endpoint of a range or, if it is below a range, what disclosures under section 3.5.1, 3.8.3g or 3.8.3h or if below the limit imposed by 3.5.1, disclosures under ASOP 41. We believe the interplay between sections 3.6.2, 3.5.1 and ASOP 41 will create confusion within the actuarial community without more specific guidance.

Question 4:
Do you agree that the guidance on arithmetic and geometric returns in section 3.8.3(j) is appropriate? Is the language about the proper incorporation of forward looking expected geometric returns into a building block exercise clear?

Response:
The guidance clarifies what is meant by arithmetic and geometric returns. However, common usage of the term “arithmetic rate of return” is quite different than what the general public might assume. We suggest the Pension Committee of the ASB use the terms “Forward Looking Arithmetic (or Geometric) Rate of Return” to eliminate any confusion. The choice of the measurement period may greatly influence the results using either the arithmetic or geometric methods. Actuaries should be cautioned not to use a measurement period that distorts the results.

Question 5:
Is the language regarding payroll growth in section 3.11.3 clear and sufficient? If not, what changes do you suggest?

Response:
The standard is clear but we believe the standard should caution actuaries that the payroll growth assumption may not be appropriate for small groups.

Other Comments

ACOPA offers the following additional comments:

- ***Scope:*** The last sentence of the first paragraph should read as follows: "Measurements of pension obligations do not generally include individual benefit calculations, individual benefit statement estimates and nondiscrimination testing."

- ***Section 3.4:*** ACOPA recommends that the section be modified to read as follows: "To evaluate relevant data, the actuary should review appropriate recent and long-term historical economic data. Appendix 4 lists some generally available sources of economic data and analyses."

- **Section 3.5.1:** ACOPA strongly disagrees with the wording of section 3.5.1. Changing the term "Conservative" to "Adverse Deviation" is unacceptable. As indicated in our prior letter, there is a body of legal precedents that use the term "conservative assumptions." Please refer to the Appendix for the court decisions. By re-labeling the same concept, ASB imparts a distinction that is not merited. The Pension Protection Act of 2006 stripped actuaries of the ability to set assumptions and methods for purposes of meeting the minimum funding standards for defined benefit plans because actuaries used assumptions that did not include a measure of conservatism. Congress has spoken, a degree of conservatism is not only acceptable, it is now mandated for these purposes. Also, we believe actuaries as well as the public will assume the term "Adverse Deviation" connotes a problem with the assumptions chosen thereby discouraging actuaries from setting assumptions that will result in well funded retirement plans.

  The standard is not clear what is meant by Adverse Deviation. For example, an actuary determines an assumption will reasonably fall between 6% and 7%, including considerations under sections 3.8.3g and 3.8.3h. If the actuary chooses 6% as the assumption, is that assumption using a margin for Adverse Deviation or is it a reasonable assumption without a margin for Adverse Deviation? If the actuary chooses 5%, is that assumption using a margin for Adverse Deviation that requires disclosure under sections 3.5.1? Or is the degree of conservatism in the selection of 5% required to be disclosed under ASOP 41?

- ***Section 3.8.3a:*** Section 3.8.3a should read as follows: "The actuary **may** consider whether the current investment policy is expected to change during the measurement period."

- ***Section 3.8.3e***: Section 3.8.3e should include a specific definition of "Investment Expenses." The definition should take into account that many investment expenses are difficult, if not impossible to determine. One such example is the internal expenses in a mutual fund. The Committee should not create a burdensome requirement.

- ***Section 3.8.3j:*** The last sentence of the first paragraph should read as follows: "The actuary **may** consider the implications of a forward looking expected arithmetic return and a forward looking expected geometric return when constructing an investment return assumption."

- ***Section 3.10.2c***: Section 3.10.2c should read as follows: "However, it may not be appropriate to assume that future contracts will provide the same level of compensation changes as the current or recent contracts." We believe the example does not improve the standard.

- ***Broader concern*****:** The detail required in a disclosure should be tempered by consideration of what is adequate for the assignment. As noted in our April 30, 2011 response to Question 8 in the first exposure draft, ACOPA recommends the Pension Committee of the ASB revise ASOP 41 to reflect this consideration.

In summary, the second draft is an improvement over the first draft. However, we believe substantive additional changes are necessary, and require a third exposure draft.

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This letter was prepared by the ASOP Task Force of the ACOPA Intersocietal Committee, Richard A. Block, Chair. The primary authors were Richard A. Block, MSPA; Thomas J. Finnegan, MSPA; Robert Mitchell, MSPA; Kurt Piper, MSPA, Karen Smith, MSPA, and Clifford Woodhall, MSPA.

Thank you for your consideration of these comments.

Sincerely,

/s/
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/s/
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Addendum

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The 9th Circuit Court of Appeals wrote:

“The Tax Court rejected the Commissioner's attack and found that the challenged assumptions in each plan were reasonable in the aggregate and represented the actuaries' best estimate of anticipated plan experience in accordance with section 412(c)(3). Citrus Valley Estates, 99 T.C. at 465 (holding that plan contributions were properly deducted). The court recognized that the estimates generally fell on the conservative end of the range of acceptable assumptions, but nonetheless found that the assumptions passed the statutory standard.

The Tax Court premised its findings on the belief that the primary duty of a plan actuary was to calculate a funding pattern that safeguards the ability of the plan to deliver the promised retirement benefit. Given this duty, the Tax Court held that it was appropriate for actuaries to maintain long-term conservative views in selecting actuarial assumptions, because cautious estimates result in higher levels of initial plan funding. Id. at 410 12, 426. The Tax Court noted that an element of actuarial conservatism was especially appropriate for new IDB plans that lack credible experience, as all of the plans in question indisputably did. Id. at 411.

The Commissioner appeals the Tax Court's conclusion. Her challenge is entirely legal. She contends that the Tax Court misconstrued section 412(c)(3) and that as a result the court's findings are "robbed of all vitality." Appellant's Opening Brief in Citrus Valley Estates, Inc. v. Commissioner, 49 F.3d 1410, 1995 U.S. App. LEXIS 4500, *7. She urges the Court to remand the Phoenix Cases for reconsideration in light of what she argues are the correct legal standards. We review de novo the Tax Court's construction of the Code. See Estate of Poletti v. Commissioner, 34 F.3d 742, 745 (9th Cir. 1994).

The essence of the Commissioner's complaint is that by endorsing the use of conservative actuarial assumptions, the Tax Court effectively read the "best estimate" provision out of section 412(c)(3). Although the Tax Court expressly found the "best estimate" provision satisfied in each case, the Commissioner argues that the Tax Court misapprehended the nature of the inquiry. Her position, simply stated, is that an assumption cannot be an actuary's "best estimate" if it reflects a more conservative view of an anticipated plan experience than the actuary believes is likely.

As Commissioner reads section 412(c)(3), not only must assumptions be reasonable in the aggregate, but also they must accurately reflect the actuary's subjective belief about the future. In other words, if a plan actuary selects a set of assumptions that the actuary personally does not believe will come true, the assumptions fail the section 412(c)(3) test, even if they are otherwise reasonable in the aggregate, because they do not reflect the actuary's "best estimate" of anticipated plan experience.

According to the Commissioner, the Tax Court's findings in this case are infirm because the court did not review the challenged assumptions under this substantive "best estimate" standard.

Without a doubt, the language of section 412(c)(3) can be read to support the Commissioner's reading. In addition, given the wide range of reasonable assumptions, requiring actuaries neutrally to pick the most likely result within the range would limit the ability of taxpayers to inflate their contribution deductions. These arguments notwithstanding, we follow the lead of the Second and Fifth Circuits and reject the Commissioner's reading of section 412(c)(3). See Wachtell, Lipton, Rosen & Katz, 26 F.3d at 295-96; Vinson & Elkins, 7 F.3d at 1237-39.

We begin our analysis with the recognition that Congress consciously left the specifics of IDB plan funding in the able hands of professional actuaries. See Vinson & Elkins, 7 F.3d at 1238. Although Congress initially toyed with the idea of legislating mandatory funding assumptions and methods for IDB plans, it quickly rejected the notion as excessively inflexible, even though it understood that giving actuaries room in which to exercise their professional judgment would result in a broad range of funding assumptions. See Vinson & Elkins, 7 F.3d at 1238; see also H.R.
Rep. No. 807, 93d Cong., 2d Sess. 27 (1974), reprinted in 1974 U.S.C.C.A.N. 4670, 4694.

We will not disturb this legislative choice to delegate to actuaries an important role in plan funding decisions. Accord, Wachtell, Lipton, Rosen & Katz, 26 F.3d at 295-96 (citing S. Rep. No. 383, 93d Cong., 2d Sess. (1974), reprinted in 1974 U.S.C.C.A.N 4890, 4908 ("The actuarial assumptions made by actuaries in estimating future pension costs are crucial to the application of minimum funding standards for pension plans.")).

We further note that the section 412(c)(3) limitations on actuarial assumptions serve not only as a limit on maximum deductions, but also as a floor for minimum plan funding. This statutory scheme serves the dual but sometimes conflicting goals of guaranteeing adequate plan funding while preventing taxpayer abuse. "Within the range of reasonableness, Congress assigned the task of balancing these goals to actuaries. We will not narrow the statutory gap between the Scylla of underfunding and the Charybdis of tax penalties." Vinson & Elkins, 7 F.3d at 1238. So long as the actuary's funding decisions fall within the range of reasonableness, the substantive provisions of section 412(c)(3) are satisfied.

This means that the "best estimate" provision of section 412(c)(3), properly construed, is essentially procedural in nature. Accord, Wachtell, Lipton, Rosen &

Katz, 26 F.3d at 296; Vinson & Elkins, 7 F.3d at 1238. The "best estimate" language is "principally designed to insure that the chosen assumptions actually represent the actuary's own judgment rather than the dictates of plan administrators or sponsors." Wachtell, Lipton, Rosen & Katz, 26 F.3d at 296. The Commissioner does not allege, nor does it appear in the record, that anyone in this case improperly influenced the actuaries' funding decisions.

We therefore hold that the best estimate provision of section 412(c)(3) was satisfied in each of the cases before us. The mere fact that the challenged assumptions fell on the conservative end of the acceptable range does not render them invalid as a matter of law. Conservative assumptions result in a higher level of initial plan funding, which helps ensure that IDB plans will be able to deliver the promised retirement benefit when due, clearly one of ERISA's most important goals. See H.R. Rep. No. 807, 93d Cong., 2d Sess. 8 (1974), reprinted in 1974 U.S.C.C.A.N. 4670 (noting that one objective of ERISA was to ensure that participants "do not lose their benefits as a result . . . [of the] failure of the pension plan to accumulate and retain sufficient funds to meet its obligations"). Although another goal was to prevent tax abuse by wealthy individuals, this concern was addressed primarily by the section 415 limits on the size of IDB plan benefits. See Code 415(b); H.R. Rep. No. 807, 93d Cong., 2d Sess. (1974), reprinted in 1974 U.S.C.C.A.N. 4670, 4702 (remarking that section 415 limits were enacted to prevent abuse of ERISA's favorable tax treatment by highly paid individuals).

Despite what the Commissioner asserts, our decision, faithful to the statutory scheme, does not give actuaries "unfettered liberty" to produce desirable tax results rather than prudent plan funding. First and foremost, plan funding decisions and methods must be reasonable in the aggregate. Code 412(c)(3). In addition, they must represent the actuary's professional judgment, not the tax-motivated wishes of plan sponsors or administrators. Wachtell, Lipton, Rosen & Katz, 26 F.3d at 296; Vinson & Elkins, 7 F.3d at 1238. Finally, plan actuaries must live up to national professional, ethical, and technical standards which help to minimize the risk of untoward advice. n3 Vinson & Elkins, 7 F.3d at 1238-39.

We find no legal error in the Tax Court's analysis under section 412(c)(3). The Commissioner does not separately challenge the factual findings of the Tax Court regarding the challenged assumptions. See Commissioner v. Duberstein, 363 U.S. 278, 289-91, 4 L. Ed. 2d 1218, 80 S. Ct. 1190 (1960) (reviewing factual findings of Tax Court for clear error). **The Tax Court's conclusions therefore must stand**."