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Session 82 Seminar

Addressing the Financial Risks of Retirement Systems: Actuary's Role in Managing Risk, and How that Fits in Our Standards of Practice

Track: Pension

Moderator: EDWARD E. BURROWS

Panelists: STEPHEN J. BUTTERFIELD
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DANIEL G. LALINE, JR.

Summary: Before ERISA, SFAS 87, various provincial Canadian legislation and CICA 3461, there was little financial regulation of defined benefit pension plans. An actuary's advice to clients on funding and other aspects of plan financing was based on the costs and risks inherent in the plans themselves. With the passage of these acts, plan funding in most cases became a matter of meeting minimum funding standards without exceeding tax-deductible limits. However, over the last 30 years, the inherent risk plan sponsors face from their pension plans has changed. Once small fringe benefits, retirement plans have grown to become substantial financial commitments with the accompanying risk. This seminar is designed to help actuaries better measure, discuss, manage and mitigate risks that pension plans bring to their sponsoring organizations.

MR. EDWARD E. BURROWS: I'm the moderator of this seminar. The panelists include Steve Butterfield, principal of Towers Perrin, located in Vancouver. He's vice chair of the Canadian Institute of Actuaries Pension Plan Financial Reporting

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NOTE: Charts referred to in the text can be downloaded at: http://handouts.soa.org/conted/cearchive/neworleans-june05/082_bk.pdf.

Committee. Dan Laline is a Fellow of the Society, an attorney and a principal of Towers Perrin. He's a consultant to corporate retirement programs and a member of the Actuarial Standards Board pension committee. Gordon Enderle is a Fellow of the Society and a founding partner of Davis, Conder, Enderle & Sloan, a Chicago-based actuarial consulting firm.

First, Steve has a slide presentation on a statement that the CIA issued last March, a statement of principles on revised actuarial standards of practice for reporting on pension plan funding. Then we will open the floor to questions regarding the statement of principles. Following that, we'll continue with the seminar involving Dan, Gordon and the audience.

MR. STEPHEN J. BUTTERFIELD: I'm going to begin with some background on Canadian funding practices, as most of you might not be aware of what the Canadian practices are. Within Canada, there are nine provincial regulators and one federal regulator. The federal regulator regulates companies that have businesses across borders such as transportation and banking. With respect to funding, all the regulators have their own distinct regulations, although they are fairly similar. There is also the Canada revenue agency under the income tax act, which has maximum funding requirements. So there are actually two different regulators that you have to deal with in determining your funding requirements—one is the minimum and one is the maximum.

The provincial regulations that define the minimum funding requirements require that going concern valuations be done as well as solvency valuations, which are effectively wind-up valuations. You must do a solvency valuation, where any deficit must be funded over five years, and you must do a going concern valuation, where any deficit must be funded over 15 years. About all they say about how you do the valuation is that it must be done in accordance with accepted actuarial practice. It's our actuarial standards that define accepted actuarial practice, so it's really within our actuarial standards that you determine how to set your methods and assumptions. Our standards may have a little more application than they would in the States. For instance, under our standards of practice for a going concern valuation, you must select appropriate methods and assumptions, and the assumptions must contain provisions for adverse deviation. But it's up to the actuaries to determine what the appropriate assumptions are. The regulators don't tell us what they are; the plan sponsor doesn't tell us what they are. They really are our assumptions, although there are certainly bounds within what the regulators would accept and what a plan sponsor might want. When we as actuaries sign a valuation report, we state that the assumptions are appropriate, the methods are appropriate and the valuation has been conducted in accordance with accepted actuarial practice. What we're looking at now is changing our actuarial standards to redefine what is accepted actuarial practice.

We issued the statement of principles on March 9, 2005. I encourage anybody who is interested to go to the CIA Web site, which is actuaries.ca, where you can get a

copy of the statement and see the full background on it. The comment period has ended. We got about 50 submissions from various regulators, practitioners and labor groups, and we're currently going through all of those submissions and looking at where we're going.

Why do our standards need updating? They were originally issued in 1981 merely as recommendations. They didn't even contemplate wind-up for solvency valuations at that time. They underwent Consolidated Standards of Practice (CSOP) "translation" in 2002, when they were written in a more formalized style. That re-write was not intended to change them at all, just define them better. There have been numerous task forces set up by the CIA: the multi-employer pension plans, pension funding and public policy principles on pension plan funding, which we call a P5F report. All of these task forces have come up with various recommendations on how pension plans should be funded. Consequently, we were more or less told at the time that enough had been done, and it was time to get on with it.

In addition, the events of 2001 and 2002 highlighted a lot of the issues with respect to how pension plans are funded. Suddenly a lot of companies and a lot of fund sponsors had trouble funding the plans or their funded ratios decreased substantially, and it obviously has become a lot bigger issue in the press. There are also two current task forces that are looking at things. There's a financial economics task force and one on the role of the actuary. The later one is concerned primarily with conflicts of interest, where the role of the actuary is for the plan sponsor or for the member, and what our responsibilities are as actuaries. They've issued a preliminary report as well.

Bringing all of this into context, finally there's a review of pension plan valuations going on. The federal regulator, Office of Superintendent of Financial Institutions (OSFI), said that he can't trust a lot of the valuation reports and that there was a lot of junk out there. We don't believe it's true, so we as a profession have randomly selected 100 valuation reports. We have a team going through those reports to determine whether they comply with accepted actuarial practice and with all the provincial regulations. I expect that they'll be issuing the results of that finding at the St. John CIA meeting.

The Pension Plan Financial Reporting Committee (PPFRC) is a committee that is responsible for recommending changes to the standards of practice. We're just really at the first step. We've issued a statement of principles and then, provided we get submissions that say we're going in the right direction, we'll follow a process that will end up with a final standard being adopted. The statement of principles starts off with a couple of pages of what the roles and responsibilities are. We want to make it clear up front who is responsible and what the roles of the various stakeholders are. The statement delineates accepted actuarial practice and then defines five principles that we believe are the underlying principles for accepted actuarial practice. It also covers some of the initiatives we'll have going forward.

We looked at the roles and responsibilities as we see them as a committee of the plan sponsors. "Administrators" is the term used in Quebec. Actually, in Canada we have adopted the term "funder" as the person that would be responsible for the funding policy. We realize that for governments or jointly trusteed plans it's a different entity, so whoever that entity is, they're responsible for setting the funding policy. They have to determine how they want to fund their plan. If they want to fund it to 150 percent or if they're happy to see it at 50 percent or whatever margin, they're the ones who have to determine that. It's not for actuaries to tell them how to fund it. They're the ones who have to develop that funding policy. They also set the investment policy. It's fine for us to say it should all be fixed income or it should be 60/40, but ultimately that's the plan sponsor's decision. Within that, the pension regulators have a responsibility to define the minimum funding requirements. If a plan sponsor says they don't want to fund it, but the regulator thinks it has to be funded up to a particular level, then that's the bar the plan sponsor has to attain. They also establish certain investment constraints. They don't want to see it all be 100 percent invested in company stock, for example. The tax authorities are on the other side of it. They want to make sure you don't put aside too much money. They put limits on how much can be put aside and establish certain investment constraints as well.

So what is the actuary's role in this? We see it in terms of the pure actuarial role. It's something that we've had a lot of comments on. An actuary still has a role as a consultant in helping the plan sponsors and the regulators develop all of these policies. But the true role of an actuary is to measure and report the assets and liabilities and costs and then disclose the pertinent risks. We're not the ones that say you should contribute this amount of money. We would say if this is your funding policy, then this is how much you should be contributing and here are the risks associated with that. It's not our role to establish the acceptable levels of risk, and it's not our role to establish how plans should be funded.

One of the things we've talked quite a lot about, and something that I think needs to come to the forefront more, is that risk cannot be eliminated. We can talk about investing 100 percent in fixed income and eliminating the majority of the investment-related risk. But you're still not eliminating all of it, unless you're going to perform cash flow matching. You still have mortality risk. You still have early retirement risk. You have a lot of risks out there. Even if you have a dedicated portfolio, some of the bonds may default. You can't eliminate risk unless you want to go to 150 or 200 percent funding, and public policy has to determine that. So we're really saying it's public policy that has to determine what risk is an acceptable risk for people's pensions.

We believe that there are two key objectives of accepted actuarial practice. One is the obvious security of benefits, which is promoted primarily through a hypothetical wind-up valuation. If the plan wound up today, what would the benefits be, how would you settle the plan and settle all the benefits? In addition, you should have enough assets on hand to settle those benefits. The second objective is the stability of contributions, which is primarily promoted through a going concern valuation.

This is something we've had a lot of comments on and a lot of people do not like where we're going here. I think we're going to redefine this as more of a budgeting exercise. It's not necessarily stability of contributions, but an allocation of costs to periods. It's an exercise for people to understand what the long-term costs of a pension plan are. They don't necessarily have to fund it in that manner, but they should understand what the long-term costs are and should be able to allocate those costs to periods. The going concern valuation does have a part to play in that role particularly with final average pay plans. For flat dollar plans and career average plans, it doesn't have as much of a role to play.

Accepted actuarial practice should require reporting on benefit security, so it should require a wind-up valuation. Instead of contribution stability, it should report on a proper allocation of costs, which is a going concern valuation. It should then also report on the funding policy. If a plan sponsor says that its goal as a funding policy is to be 100 percent funded on a going concern basis with 2 percent margin in the going concern interest rate, then you would report on that funding policy. You still have to report the minimum and the maximum required under law. You're really looking at five different valuations. A lot of those are going to overlap and you'll only have two or three, but really it amounts to reporting in five different scenarios.

The first principle of the statement is that every plan sponsor, whatever the entity is, would have a written funding policy. In Canada, you're already required to have a written statement of investment policies and procedures. I'm not sure if such a document is required in the States. This policy must address the key risks facing the plan, the wind-up scenarios and the going concern scenarios, and discuss how the provisions for adverse deviation would be appropriate for addressing those risks.

In our original statement of principles, we envisioned that the funding policy will deal with all of these specific requirements, what methods and assumptions would be used and so on. There have been a lot of people commenting that a funder can't possibly do this and that this is a role for actuaries. This is particularly what we're getting from the plan sponsors. So we'll probably modify it somewhat to potentially take some of these away from the funder, and they still will be the responsibility of the actuary. But certainly the plan sponsor should be telling us how surplus should be used, how quickly they want to amortize deficits and those sorts of things.

There is general agreement that plan sponsors should have a funding policy. But another thing that there is some debate on is whether we as actuaries can impose that upon plan sponsors. In Canada we probably can, although whether we want to go that far is another question. As I said earlier, the provincial funding regulations say that valuations have to be conducted in accordance with accepted actuarial practice. If accepted actuarial practice states that you must report the financial position of the plan based on the plan sponsor's funding policy, in effect you can't sign a valuation and say it's in accordance with accepted actuarial practice unless there's a funding policy. For a registered pension plan, which is the same as your

qualified plans, you would have to have a funding policy in order to comply with the funding regulations. I think we would rather see that in regulations as opposed to us trying to look like we're being a regulator, but there's certainly some debate in how it would work.

We're getting pushed back on the second principle as well, which is whether a going concern valuation should be a requirement. There are people who believe that there is no use for a going concern valuation, and that as long as there are sufficient assets on hand at any given time to provide for the wind-up benefits, you don't need to fund this mythical going concern valuation. We believe that it is worthwhile information for plan sponsors to have. It provides them with a budgeting exercise. We as actuaries would not be fulfilling our duties to plan sponsors and to members if we did not provide that information to them so that they could see what the long-term costs of the plan may be. However, we also believe that this should be on a best estimate basis. The purpose of the going concern valuation is not security of benefits; it's a budgeting exercise. If it's a budgeting exercise and a cost allocation exercise, then best estimate assumptions are the appropriate starting point. We don't need a margin for adverse deviation with a going concern valuation—that's what the wind-up valuation is for. If the plan sponsor wants to have provisions for adverse deviation, then it could have them, but we would report the best estimate assumption and then report how much margin there is within that.

The third principle deals with wind-up valuation. In Canada, the requirement is really a solvency valuation, which is a bit of a bastardized wind-up valuation. You have to report the pure wind-up valuation and then, to the extent that you're using any smoothing of assets or liabilities, that would be a separate line item. But people could clearly see what the funded status was on a pure wind-up basis, and then they could see what adjustments were being made.

We are proposing the inclusion of an incremental annual cost for wind-up valuations. If you go with the premise that security of benefits depends on a wind-up valuation and that's the purpose of it, then you need to know what the wind-up valuation is expected to be one year, three years or five years from now. If you have a group that's about to hit a threshold where they'll be eligible for early retirement, or if you have a final average pay plan and you would expect to see earnings go up, that number in some situations can be very different than a going concern normal cost. Right now in Canada, most plans are being driven by solvency. They're funding for a wind-up liability over a five-year period and a going concern normal cost. Theoretically it should be a wind-up normal cost that they're funding for. It doesn't exist; we know that. Mathematically we'll provide guidance on how to determine it, but it is basically what you think your solvency liability will be a year from now.

In the fourth principle, the funding requirements are dictated by the funding policy, subject to legislation. That's not going to be within our standards. We've provided information on the assets, the liabilities, although we like to get away from the term

liabilities, and the present value of the future costs discounted at some interest rate. We have all of the numbers and the numbers are reported, such that the contribution requirement comes out of the funding policy and the legislation, but is not part of our standards. We're not recommending contributions per se. We would be reporting the contributions that would be required for them to comply with the funding policy and the regulations, given the other items as the inputs.

Principle five of the statement discusses the disclosures in the valuation reports. It includes all the standard disclosures. There is not a whole lot different here. One offshoot of this is that we envision putting out a lot more guidance. If we're going to say that going concern valuations should be done on best estimate assumptions, we need to put out guidance as to how you would select best estimate assumptions. That will be a challenge for our committee of 12 people to put out assumptions on what we think the best estimate going concern interest rate is.

Another area where we see guidance really is required is smoothing. We believe there is a place for smoothing, but we believe that the place for smoothing is in the contribution requirements. Smoothing of assets, in effect, has a place for smoothing contribution requirements. It does not have a place for the reporting of the financial position of the plan. The assets are the assets if you want to know whether the plan is funded or unfunded or to what extent it is funded. Smoothing can have a role to play if it is unfunded. If you suddenly see an unfunded liability arise, do you have to immediately start funding that or can you smooth the contribution requirements in? That's where we see a role for funding, but not in the reporting of the financial position.

We know we have to have a lot more dialogue with the regulators. What we're proposing is a fairly substantial change, and to do this without having the regulators on our side is going to be difficult. The comments we're receiving from the regulators so far are that they like going concern valuations with provisions for adverse deviation. They like the actuaries choosing those. They trust them more than anybody else and therefore want to see that status quo remain. Actuaries are saying there's litigation here as well. If we decide an appropriate provision for adverse deviation and then it's not right, are you going to sue us? There's a give and take here.

Right now, we're hoping to have a new standard in place by 2006. I personally think that's very, very optimistic. We certainly don't have complete consensus within the profession as to where to go with it. It was given to the CIA. One of the things we wanted to make very clear is that we haven't made up our minds. This is the direction it's heading, but we're certainly open to comments and suggestions, and we're listening to everybody. With that, I'll open up the floor for comments and questions.

FROM THE FLOOR: Obviously this isn't the right place to debate the Institute proposals, and I don't propose to do so. But there are two issues that it might be

profitable to discuss. One is whether the Institute, as opposed to the regulator or the funder, should insist on a going concern valuation. For the most part, we've taken the view that the Institute should not be the source of requirements; it should either be funders deciding what to do or regulators deciding what needs to be done. I think the profession in Canada was a little insecure that maybe the two would decide they didn't need the going concern number, and so the one requirement we did include, whether anybody wants it or not, is that the actuary has to do this going concern valuation.

In the original document, it's described as being about contribution stability. I think we're rightfully beating a hasty retreat from that, since the obvious question is if it's about contribution stability, show us the period where contributions were stable. Since we've been conspicuously unable to deliver contribution stability, we're now repositioning it as allocation of cost. The problem with allocation of cost is that's what the accountants are doing. Our clients already do a going concern valuation for accounting purposes, the purpose of which is to allocate costs in a rational way to periods of time. My guess is that their tolerance will diminish for having a wind-up valuation to drive benefit security and then two going concern valuations, both of which are about allocating costs, one of which will use an interest rate and one of which will have an equity premium. It's just seems to me a little heavy-handed. If the regulators want it, that's fine, but I don't see why the Institute would insist on it.

The second thing, which I think is an interesting idea, is that all of the plans should have a written funding policy. My concern there is if I go to my private sector clients, right now they would all have a written funding policy. It only takes about a sentence or two: They will contribute however much is required to satisfy the requirements of applicable legislation, and they will reserve the right to contribute more if it is advantageous from a business perspective to do so at the time. The question I have is why would anybody want more than that? Why would they want to commit to how they're going to deal with surpluses that they don't now have, how they're going to amortize deficits in the future, and how they're going to react to situations not yet present? Why wouldn't they just say they'll comply with the law and, in regards to doing more than that, they reserve the right to make that decision at the time in the circumstances of the day?

MR. BUTTERFIELD: To start with, I was surprised to know that our current standards require a going concern valuation. I think we, as actuaries, are not complying with our standards in a lot of situations. You look into a valuation for a supplemental pension plan, and you're doing it for a letter of credit for a wind-up scenario, but it's not in accordance with accepted actuarial practice if you don't do a going concern valuation. I was surprised to see it's actually in our standards now. I personally agree with you. I don't think it should be a requirement in our standards. I'm fighting my battle within the committee and losing so far, but we'll see where it goes. I'd like to see the regulators maintain it, but I think it is a regulatory consideration, and I keep throwing out the situation of supplemental pension plans. Are you going to tell me that our standards should require us to do a going concern

valuation every time we value a supplemental plan, even if the purpose of it is to determine the amount of a letter of credit in case of a wind-up or changing control? It has no meaning, so why would our standards require it? For a registered pension plan, it definitely has a place, and I would like to see the regulators keep it, but whether it belongs in our standards is another question.

The same thing goes with the funding policy. Whether it belongs in our standards or belongs in regulation is another question that needs to be addressed. I can certainly hear you on the funding policy. The vast majority of single employer plans will have that policy, although right now they implicitly have the policy of including provisions for adverse deviation. Plan sponsors may have different views on whether they want to have provisions for adverse deviation in their going concern valuations or not. Right now, we are just deciding they need to have them. Is that appropriate or should they be the ones that are telling us whether that exists or not?

FROM THE FLOOR: I'd like to offer a comment on that point also. The type of statement that you describe would be very typical in the United States as well, but I have clients that have looked at what their funding policy should be for internal decision-making purposes, rather than publication to plan participants, for example. They will want to consider accelerated rates over and above the minimum levels. Having thought through what those levels might look like, when the time comes, the decision process is already in place. It makes for a more efficient process for making a determination on a level of contribution.

MR. MARK RULOFF: Steve, I appreciate your discussion of the government and that what's important to them is the solvency wind-up. To the plan sponsor though, what is important is perhaps the contribution policy. We talk about two different types of actuaries—the financial economics actuary and the traditional actuary—when actually they can co-exist in one person. The solvency liability is the liability that should be marked to market and your assets should be marked to market, and what you report on your financial statement should be based on that. When it comes to the company setting a policy, smoothing is fine. Planning to avoid those bumps in the road is a great idea. Including the equity risk premium is fine. Recognizing that you can earn higher returns from stocks is fine. But when it comes to the government saying what the minimum contribution should be, the rule only needs to consider the solvency liability. It only needs to make sure that these plans on wind-up have enough assets. That minimum contribution will be very volatile. It's then entirely up to the corporation and the actuary to make a policy contribution that is nice and smooth above that.

MR. BUTTERFIELD: I'm mildly surprised that the regulator's submissions that we received so far, and we've received four from different regulators, want to see the going concern valuations stay. They do not want to see it go, so their focus is not purely on the wind-up valuation. One of the things that we have also kept in mind is that we may get 8 and 10 and 12 percent interest rate environments again. If you're in a 10 percent interest rate environment and all you're doing is funding for a

wind-up scenario and then interest rates drop again, your contribution requirements can go up in a hurry if you don't have an immunized portfolio of some form. We're trying to develop standards as well that will last through time in terms of any economic scenario. We do believe that the wind-up valuation does satisfy the financial economics viewpoint in that everything's marked to market, and so we are showing exactly what it is when it's marked to market. So then if the going concern is a budgeting exercise, then that's fine; we don't need to listen to financial economists saying that we can't assume an equity risk premium.

MR. BURROWS: Would the wind-up valuation be based on high-grade prime rates?

MR. BUTTERFIELD: In Canada, our committee issues guidance for the assumptions for wind-up valuations. We surveyed insurance companies to find out what interest rates underlie group annuity purchases. For December 31, 2004 valuations, based on the survey data, we recommended that actuaries use long-term government of Canada bond yields (a 30-year bond yield) plus 45 basis points in conjunction with the UP 94 projected to 2015 table. We believe that to be the appropriate proxy. If you went out to purchase an annuity from an insurance company at December 31, 2004, that's the rate they would price it on and that's how you have to do your valuations. As of December 31, 2004, almost every plan is valued at 5.25 percent for any benefits that are expected to be settled by annuities.

MR. BURROWS: Is there any specific consideration for duration of liability?

MR. BUTTERFIELD: We do not provide guidance on that. Our view is if you're going to shorten the duration, maybe you would have a lower interest rate, but you also wouldn't need as much projection in your mortality table. It's questionable if there would be much difference. We don't think the insurance companies take that into play too much.

MR. BURROWS: The insurance companies in this country claim that they do.

MR. BUTTERFIELD: There's a difference between whether it's a 5- or 10-year duration, or 15 or 20, that's true. But when you're talking about a pension plan, you're talking about the duration of your retiree liabilities. That would include all of your actives that are eligible to retire as well, so it might be everybody 55 and over. There's not a big range of durations out there in terms of those groups. It's not like we're just going to go out and purchase an annuity for 80-year-olds; it's for the whole group.

MR. BURROWS: I have a couple of questions on this wind-up liability. When you have to project incremental costs for next year, do you take demographics into consideration?

MR. BUTTERFIELD: You should. We are in the process of putting out a paper that will describe how we envision actuaries should calculate it. We want you to use

what will be the wind-up liability one year from the valuation date, assuming that there's no change in the discount rate, theoretically an open group projection and then you wind it up. However, there are issues. Solvency valuation assumes everybody left, so how do you project the membership? Presumably your going concern valuation assumptions are appropriate assumptions for projecting your membership, and then you assume it winds up at the end of the year. Mathematically it might not work perfectly, but a number can come out of it that has some meaning.

MR. BURROWS: As a required calculation, will this be a new concept?

MR. BUTTERFIELD: Yes.

MR. BURROWS: Is the wind-up valuation supposed to reflect shut-down benefits?

MR. BUTTERFIELD: In Ontario, yes. We would say that the wind-up valuation should include plan shut-down benefits. Ontario is an example of a jurisdiction that does not require you to fund those benefits, though they should still be reported on. If a jurisdiction doesn't require you to fund them, that's fine, but they should still be reported on.

MR. BURROWS: What is a consent benefit?

MR. BUTTERFIELD: A consent benefit is when you can retire at 55 unreduced with the consent of the company. For example, if you get 80 percent of your benefit at 55, with the consent of the company you can get 100 percent. That is a consent benefit. Various jurisdictions treat them differently within Canada. In Ontario, the law says if you have a consent benefit, consent is deemed. In other jurisdictions, that's not the case.

MR. BURROWS: If there are no further questions, now Dan is going to lead our discussion.

MR. DANIEL G. LALINE, JR.: The next part of our discussion will focus on the U.S. standards of practice and the implications of risk management in our current U.S. standards of practice. Gordon and I will be sharing the discussion in a very interactive format, so when something piques your interest, please comment and ask questions.

Our standards of practice have a purpose statement. It's important for us to recognize that though we are primarily pension practitioners, in the United States the standards of practice are under an umbrella that covers all actuarial work. There are basically four general purposes of the standards. First is to provide actuaries with a framework for performing professional services. Second is to offer guidance on the relevant issues in accordance with the performance of those services and to give direction on appropriate documentation and disclosure rendered when the

services are performed. The third purpose is very important for us to understand in the current structure of the standards, and it is to reflect generally accepted practice and to confirm the range of that practice. The fourth is, on occasion, to change the standards or elevate current practice to incorporate new recent advances in actuarial methodology and actuarial science.

Having sat on the pension standards committee for about a year and a half now, it's interesting to observe the comment letters as they come in, particularly as it reflects to that third purpose. There are many commentators out there, and it's probably true throughout the profession, who believe the standards perhaps should reflect what best practice should be. As you look at these purpose statements, that's not the current objective of the standards. At least for purposes of beginning this discussion, it's important to understand that the standards are out there to put the bounds around currently accepted practice. It's also important for us to understand, at least in the pension arena, that we have a pretty broad range of practice because of the nature of our clients. We have clients that range from small, single employer pension plans all the way up to large corporate plans and on into the public and the union sectors. These standards are currently designed to operate across all of those environments, which is an important dynamic in the way the standards are currently structured.

Having said that, let's take a brief moment to look at the standards that apply, particularly in the pension arena. I can classify these standards into two general categories. The first applies to special situations. I would put Actuarial Standard of Practice (ASOP) 2 as well as ASOP 34 in this category. ASOP 2 was published to give guidance when Financial Accounting Standard (FAS) 87 and FAS 88 were promulgated. It effectively hasn't been touched in many, many years. One may question whether or not we currently need this as a separate standard of practice. ASOP 34 is the standard that applies to provide guidance in actuarial services in connection with domestic relations orders, whether they be qualified or not.
The other standards are much more general in their application. I'd like to contrast these with the Canadian situation a little bit. The way the standards development has operated in the United States, we have tended to write standards for areas of actuarial practice, and then those standards are revisited periodically over time. From a standard setting viewpoint, we have a timing issue in that we do not re-issue the entire body of standards for pension work simultaneously. It is more of a timely periodic revisit of the various aspects. Having standards on specific areas issued periodically provides us with a bit of a challenge in the United States, which I don't have the sense is true in Canada.

ASOP 4 is generally viewed as the umbrella standard. It sits effectively over the selection of assumptions that are done through ASOPs 27 and 35 and the new standard for the selection of asset valuation methods, which is in the process of being promulgated. ASOP 4 was issued in October of 1993. It's currently in the process of being reviewed. An exposure draft has been issued, and we're in the process of taking the comments in and digesting the comments. In all likelihood,

we'll probably be re-issuing a second exposure draft on that statement.

ASOP 27, the selection of economic assumptions is probably the standard that causes the most discussion within actuarial circles. It was issued in 1996 and contains the concept of best estimate. After about eight years, the profession is now rightly questioning whether or not that's the appropriate structure for the selection of the economic assumptions. I think we need to talk about whether or not that's also the correct structure for the demographic assumptions.

The subject of ASOP 35 is the demographic assumptions. It was issued in 1999. In addition, the proposed ASOP on asset valuation methods had been issued for comments. We received quite a number of comments. We have just finished the process of going through the comments and modifying the standard. It will be re-issued for a second exposure draft, probably within the next couple of months.

I'd like to focus on the role of the standards and try to encourage some debate and commentary around whether this role should change. Currently, the role of the standards is essentially to describe minimum acceptable practice and eliminate bad practice; it currently is not to set best practice. In terms of the structure of the standards and other guidance available to actuaries, the Pension Practice Council, which also sits under the umbrella of the Actuarial Standards Board, periodically issues guidance on how to apply actuarial standards, as well as how to do certain aspects of the calculation. So there are essentially two bodies of guidance out there—the standards themselves and the practice notes, which are perhaps a bit more formulaic and descriptive of how an actuary might undertake a particular assignment. The question is whether that structure is serving the profession well. Should we consider standards that perhaps move more toward a best practice and offer more of a leading edge statement of how an actuary should perform a given assignment?

What our standards do now is describe a broad range of practice within the profession. As we begin to grapple with some of the risk issues and some of the under-funding issues that the public perceives in the pension plan funding environment, it's appropriate to rethink the structure of the standards and whether or not we've got it right, whether or not we need something that's a bit more formal in terms of guidance than what we currently have. Are there any thoughts or comments?

MR. THOMAS NAFFE RICE: In Louisiana, we generally allow the actuary to be a prominent part of selecting the interest and other actuarial assumptions that go into the valuation. As long as you feel comfortable with the actuary and his oversight, whether it is peer review or something else, you're almost better off simply knowing that the plan will be funded. When you start revealing the unfunded liability ratios, the funding ratios, the accounting requirements and the like, you give people perceptions that if it's over-funded, there are surpluses, or if it's under-funded, we're going down the tubes. They think there will be benefit increases when there

are surpluses and more regulations when it's going the other way. Interest rates go up, they go down. The actuary knows that things have certain tandem moves. He or she has a good overall perspective of it. I think the standards we have are reasonable. I hope that in establishing standards they don't confine the actuary too much and allow the fact that the actuary does have a good, overall view of how the funding is going and what the employer wants and what the employees need. Actuaries generally have good hearts. When I was listening to the Canadian speaker, it sounds like they're going to go into a whole new set of regulations. Sometimes not over-regulating is the best thing.

MR. ELI NICHOLAS DONKAR: I certainly think that as professionals we think that our judgment is valuable in deciding how to approach a variety of problems, but there are situations that may come to bear on us from the outside. For example, using the U.K. Morris review as a model, one might say that it's too flexible and therefore you're not doing enough to assure your various customers that you're really doing for them what they need to have done. This is not an answer to your question, but a suggestion that we might want to think about doing something more than just minimally acceptable practice, largely from the perspective that if we don't do it ourselves, someone else might do it for us. If there is a choice between two sources of this approach, I'd rather have us looking at ourselves rather than other people doing it for us.

MR. LALINE: I'd like to offer a comment or two relative to the two speakers' comments. I'm comfortable that actuaries, left to their own devices, can exercise judgment reasonably and professionally. Part of the challenge we have, at least with respect to funding rules right now in the United States, is that we have a structure that permits plans to get to a poorly funded status, such as when valued on a market basis. Those plans, should they go under, pass off liabilities to the Pension Benefit Guaranty Corporation (PBGC). Public perception of that is not favorable. I think if actuaries could exercise their judgment, through professional standards we could begin to address that type of phenomenon. That would probably call for the actuarial profession to have more of a role like it has in Canada than it does in the United States. Part of our challenge in the United States is that we have to deal with our regulatory and legal environment as well as the professional standards themselves.

MR. BUTTERFIELD: From my perspective, it would be better for you to define best practice, if you could find any agreement within the profession as to what constitutes best practice. That's always been the stumbling block in Canada. We try to identify what good and best practice is, then we find out that the views in the profession are all over the map. Even when they think they all share a common view, about the only view they share is each should be able to do it his or her own way. So we end up instead with an ill defined and very wide range of accepted practice, because anything narrower seems to be cutting out some politically influential group. The acid test in all of these is going to be something that's pretty simple.

In Canada, we tend to build off what the actuary's expected return on the pension fund is in the long term. While the standards constantly refer to this, there is no agreement about how long the long term is and when it starts. One group of actuaries says if you look at the valuation and the liabilities, the returns in the next 20 years are the relevant returns, and those are going to be heavily influenced by current interest rates, so current interest rates have an important role to play in deciding what that long-term return is. Another constituency is of the view that long term covers millennia and starts centuries from now and is trying to identify what the normal stake is in a world that's never normal, and so they have absolutely no hesitation about building their expected returns off 7 percent interest rates when interest rates are 12 percent and no hesitation building them off 7 percent interest rates when interest rates are 4 percent. Until the profession is prepared to address that issue head-on, we're not going to get standards that have any meaning.

MR. THOMAS S. TERRY: It's a great question you're asking about whether the standards are hitting the mark. It strikes me that our standards that we have right now are inherently defensive in nature. We have been talking a lot about risk and litigation risk and the exposure of actuaries today, at least in the United States. Everything I can glean is that the actuarial standards of practice are designed to protect us from nasty outside forces that might come in and attack us.

MR. LALINE: That's absolutely true.

MR. TERRY: The question is: How do we use actuarial standards of practice on a day-to-day basis? As I talk to prospective clients about my company's services, I'll boast about how we do this and that, but I have never boasted that our actuaries adhere to the actuarial standards of practice. It's just not a high bar. I would bet most of us seek to excel in a lot of areas in which we work; we seek to break into new frontiers and try new things. But I don't think the actuarial standards of practice serve us in that regard. Should there be another foundation upon which the standards of practice are built? I don't know the answer to that. I will say that in my mind they sit off in the corner and they don't necessarily drive a lot of what we do day to day unless I'm in an extraordinarily defensive mode.

MR. LALINE: Let me offer one commentary on that. Would one be comfortable with a structure of standards that's different from what we have today? Today, if you are in a defensive position where you've done some work, but it's challenged perhaps through a lawsuit, you can point to the current standards of practice and show that your work has fallen within those standards of practice. If we were to move to a best practice codification, and for whatever good reason, you opted not to do 100 percent of best practice because it wasn't called for in the circumstances, if your work gets called into question and you're brought into court, are you more comfortable defending it in that type of standards environment or are you more comfortable defending it in our existing standards environment? That's one issue of the debate around how these standards are structured.

FROM THE FLOOR: I think the acceptable level of practice protects the individual actuary, but in order to help the profession, a best practice would be better. As an alternative to what we do now, think of the FASB. Individual accountants can go out to their clients and try to help the clients with their particular situation, but the FASB comes in and constrains them and says here's what you should do. It sets a higher bar. In that way, they kind of prevent the SEC and others from coming in and forcing things on them. Because we have not done a good job as a profession on this, others are coming in and telling us how to do things.

MR. BUTTERFIELD: In developing our standards in Canada, we've had discussions on what is best practice and we take away what you don't really have to do to get to the minimum, because it is a minimum standard. But we started from best practice and then took away things.

FROM THE FLOOR: As a former member of the committee that worked on ASOP 27 and some of the other standards, I am aware of some of the intricacies and details behind the scenes. One of the controversial issues that Dan brought up was the best estimate range that some people wonder about. There really is not a universal agreement among actuaries as to the absolutely correct return on assets or equity risk premium. There's a wide range of opinions on that, many of which are defensible and strongly argued and hard to counterargue. The committee felt that it was very important to have flexibility, otherwise there was some thought that actuaries might have to turn their fellow actuaries in to the actuarial standards board for not agreeing with their own judgment. We obviously didn't want to have that type of situation. There's been some criticism recently and there were some articles in the pension forum about the efficacy of ASOP 27. I think it's looking at the wrong issue. The issue is not necessarily about the detailed requirements of ASOP 27; what's more important is how actuaries are implementing the principles of ASOP 27. Are there any abuses that people can point to in actuaries choosing discount rates or other factors? I would submit that they're very rare at this point. Even if somebody might criticize the exact language and details of ASOP 27, I think they would be hard-pressed to say that actuaries have not adopted the spirit and the thoughts of ASOP 27 in their work.

MS. KELLEY McKEATING: If you have actuarial standards that are intended to identify a minimum standard of practice, it's relatively easy for the profession to come to a consensus, move forward and actually establish that standard. If you're trying to define best practice, it's enormously challenging to achieve consensus. Your timelines get stretched out and it takes forever to actually come up with a standard. The majority of people would probably say that best practice is the bar you want to reach. But if you rephrase the question and ask if people want the cycle from proposal to finalizing a standard to be one year or 10 years, then they might feel differently. I think that is a pragmatic, practical thing that has to be considered. This isn't just a theoretical question; this is a real thing. If you ever want to have any standards, then sometimes defining best practice just can't work.

MR. BURROWS: Let me suggest that there is a third option that we haven't talked about, which is to define minimum acceptable standards, but to be somewhat more explicit than we have been. I was on the board when we adopted ASOP 27. I made the comment at the time that we had just adopted a standard that you could drive a truck through, and I still think there's a certain amount of truth in that. We've been criticized for not being sufficiently explicit. It would be less of a reach to have standards that are not best practice, but that are more explicit than our current standards.

MR. GORDON C. ENDERLE: We're seeing that, coming up, the standards have a lot of challenging issues for us. We need to remember that we are part of a profession. In an article I was reading, one commentator differentiated between a profession and an occupation, saying that a profession has earned the right to regulate itself. One of the challenges I see facing actuaries is we're just too darn smart, we're just too darn capable. In trying to find a best practice and trying to say is this acceptable, is this good, is this best, we're never going to reach a conclusion when you put 100 really smart people in a room if all of them want to be able to say, "I'm smart and I know this works." It's important for us to have some responsibility to the profession. Sometimes it's best to be on a team, but it's hard when you have really smart people who are capable by themselves to get them to buy into a team.

One of the challenges we have beyond the lead, follow or get out of the way question is that these standards apply to plan sponsors independent of their situation, but we know all plan sponsors are not created equally. Slide 2 on page 1 is from the January 2004 SOA Webcast. It shows the relationship between the pension assets and the market cap for Fortune 1,000 companies. Along the y-axis, you can see the relationship between assets over market cap, and the x-axis shows how many different companies there are at each point. The median is 14 percent, but some companies are well over 100 percent of market cap, or pension assets compared to market cap, and some are way below. There is a wide divergence in plan sponsors. Some plan sponsors use defined benefit plans for capital accumulation, some for tax strategies; there are small employers, and other organizations have 20,000, 30,000, 40,000 people in their plan. Consequently, it's difficult to come up with one set of standards that can cover and make sense to all different types of practitioners.

There are a lot of different ways to illustrate that. Pension plans vary in importance to a plan sponsor. I considered comparing the cash flow required to fully fund the plan to the cash flow that the company generates. Just being under-funded doesn't give me sufficient knowledge about how risky things are. If a company can cover the termination deficit with less than one year's worth of cash flow, I'm not too concerned, whereas if it's going to take 10 years of cash flow, I'm really concerned.

The Bush proposal differentiates between financially weak and financially strong

plan sponsors. There are differences that the standards of practice probably need to keep in mind with respect to different plan sponsors. One challenge for the actuarial profession in general is that we are very comfortable with formulaic answers. We like equations. But in order to be really effective as a standard of practice, I don't think we can come down to an equation. I don't think we can write down on a sheet of paper how you'd find out what the appropriate interest rate is. That's going to be a standard that's really difficult for us to achieve, but the lack of formula also creates some discomfort for many people in our profession.

As actuaries, to whom are we responsible? I was surprised when I reviewed the code of professional conduct how often our responsibility to the public at large is mentioned. ERISA makes it very clear that we are employed on behalf of the plan participants. Federal regulators rely on our capabilities as well. The financial markets rely on us to put together solid measurements of liabilities that go into financial statements that they use. Of course, most of us are working for consulting firms, so the people who pay our bills certainly warrant some responsibility on our part. The challenge here again is the risk, whatever that means. It can mean different things to each different constituency. The hardest question is: What do you do when the interests of these constituencies diverge? How does the actuary respond? One of the central purposes of our standards of practice is to help us as a profession navigate this difficult intersection. It's easy to be a great actuary when everybody likes you. When the plan's well funded and the benefits are great and your investments are going well and the CFO likes your presentation, that's the easy time to be an actuary. It's more difficult to be an actuary when the plan sponsor all of a sudden finds itself in a difficult business climate and the morale of the company's going down, you have union problems, there are all kinds of bad press and then the markets fall out of bed.

I'd like to open up the floor and find out what people think about the professionalism of actuaries with regard to the cases that have shown up in the news lately, especially the cases that have been taken over by the PBGC. When I tell people I'm an actuary, if they can figure out what I do, they'll often ask me how all those people lost their pension money. I'll say maybe they didn't lose it because of PBGC, then they say if you tell them how much money to put in the plan, why didn't they put it in, how come it wasn't enough, did you tell them the right amount? Let's come back to our precept, our code of professional conduct and our obligation to the public. When the public looks at a situation like United Airlines or US Air or Bethlehem Steel and sees that people are losing money, have we as a profession upheld our responsibility and have our standards helped us?

FROM THE FLOOR: It's a fine line we have to walk these days. Everybody's very focused on deficits, because the perception correctly is that there are a lot of poorly funded plans out there exposing members to risk, and this is a bad thing. I have no fault with that. The problem is it was only five or six years ago that we could have been exposed to exactly the opposite criticism. We had a bunch of over-funded pension plans where shareholders had been asked to put in too much money, and it

had ballooned up to create large surpluses that were now in some sense at risk. They leak out as better benefits. I think you have excise taxes in the States. In Canada, we have decisions that say if you shut a store and your plant has surplus in it, you have to cut the members in for a share. The problem is, as the plans get mature, the leverage gets large relative to the business. If the plan sponsor is insisting, as they usually do for reasons I don't fully understand, on being 50, 60 or 70 percent in the stock market, you just can't win. You're going to tip over one side or the other. You're going to have, at normal times, either big unfunded liabilities or surpluses. Someone's always going to be mad at you. We have to somehow find a way to make this work, and it's not just actuarial practice. If you as an actuary are told by a sponsor that we can't have big surpluses because we'll forfeit them in part, we can't have big deficits because members will be exposed to large losses, we want 70 percent of the fund in the stock market and it's a mature plan, bring us a funding policy, you can't do it. Something has to give. There needs to be a dialogue that goes outside the actuarial profession and involves sponsors and involves regulators to try to configure this in some way.

MR. ENDERLE: We're aware that you can't eliminate risk. Somebody told me once the goal was just 110 percent funding on wind-up, which still doesn't eliminate risk, but it helps a little bit. That would take $300 billion out of the Canadian economy, and assuming the U.S. economy is at least 10 times the size, that would take $3 trillion out of your economy just to up the bar from 100 percent to 110 percent. It's not actuaries who can do that, that's public policy, that they're willing to make those changes to the economy in order to secure benefits just a little bit more.

FROM THE FLOOR: The director of the Congressional Budget Office recently testified before a congressional committee, and his testimony was published on the Internet. He made a lot of comments about the case you just referenced, and as he went through the examples, he used a lot of phrases like "loopholes" and "taking advantage of the law," implying that there was some manipulation of the results or some underhanded deviance of actuaries or plan sponsors. I read that with astonishment, because my recollection of the whole process is that actuaries have diligently tried to learn what the rules and regulations are. They are extremely complicated, very detailed and spell out almost precisely what plan sponsors can do and not do. So to say in a congressional testimony that plan sponsors are taking advantage of loopholes, I think one person's loophole is another person's detailed regulation. I blame the situation more on the congressional legislation and regulations and the whole regulatory structure, rather than on how actuaries and plan sponsors are trying to respond. I would go back to pre-ERISA when the actuaries did tell the plan sponsor what to pay. There was no minimum requirement per se; there were some maximum requirements, but not as stringent as they are today. Plan sponsors did pay above the minimum and tried to have contribution policies that were sensible rather than just doing the minimum required, so I think you're pointing the finger in the wrong direction with some of your comments.

MR. ENDERLE: I'm not trying to point fingers; I'm just trying to raise points for

consideration. Certainly in mentioning cases that went to the PBGC, I'm not at all trying to demean any of the firms that were working with it or any of the actuaries that worked on those cases. If it were me personally, they'd probably be in the same boat as the PBGC. But one of our goals here is to try to engender comments, so thanks for your comments.

MR. TERRY: I wonder what our practice would look like if we didn't have all those complex rules. I think you're right, that we raised among ourselves a generation of actuaries that are good puzzle solvers. We're good at figuring out tough, tricky rules. But maybe we've lost sight of principles and the ideals by which a properly funded plan should be managed. We point to the rules and we say we just follow the rules, so I can understand why a cynic might point to the rules and use the word "loopholes." Right or wrong, they are the rules, so we can defend ourselves in that regard, but quite frankly, I think we tend to be more rules-oriented than principles-oriented in a lot of the consulting work we do. At least I do; I realize that that's true for myself.

MR. RULOFF: I think one of the best ways to manage risk is through the contribution policy. If we got away from everybody focusing on the minimum and just telling our clients to put in the minimum, that would help in regard to managing risk. I also want to counter something Steve said about contributions and taking that out of the economy. That's a huge number to be taken out of the economy, but it doesn't get taken out of the economy. They take the money and put it in stocks and bonds. It goes into the economy. Just because it's not with that particular plan's sponsor doesn't mean it disappears from the economy.

FROM THE FLOOR: Sometimes I wonder if Microsoft decided to put in a defined benefit plan and give credit for five years of service, but took the chance that the public would perceive them as being totally unfunded and in trouble, have we failed in communicating to the public exactly what it means to be unfunded? I'm curious how that fits in with all this. Take a strong company with good cash flow but no funding, and compare that to the types of plans we hear that go to the PBGC. Microsoft and Intel aren't too far away from the kind of employers that really could benefit from a defined benefit plan. They have both longer service employees and young employees. If they put in a defined benefit plan, their cost for the young employees would be very low, very reasonable. If those people cashed out under $10,000, they would be happy just taking what they got. Meanwhile, they can provide pensions for their longer term employees. But when they put in that plan, they're going to be unfunded.

MR. ENDERLE: That's a good point. One of the questions we're trying to struggle with here is how do our standards of practice help us manage risk. If you take a look at what's happening in government in the regulations right now, a lot of the discretion is being taken away from the actuary. Is that because regulators are getting greedy and they're just going to make good value judgments or are they feeling that we as a profession aren't being sufficiently proactive? I don't know the

answer, but it begs the question. When we talk about managing risk and we talk about our standards of practice, the choices of course are lead, follow or get out of the way. I'm not sure as a profession we know what we're going to do, but I think that's the central question.

FROM THE FLOOR: I agree with Mark, which you might find surprising. When we talk about pulling money out and assessing it and benchmarking it on a more appropriate market value of liability, the money's still there. It's still in the economy, but we're assigning it to the appropriate generation versus deferring it to a future generation that may never have an opportunity to earn those benefits.

In terms of our work, the fact that neither the public nor the lawmakers understand the intricacies of our work creates enormous risk for the profession to eventually take a hit for some of the failures as pointed out in defined benefit plans. We are regularly looking to duck the bullet, and we've been fortunate enough so far. Part of it may be because of the position that we take as a profession, which is to be the providers of information, not necessarily the makers of law. As long as we have standards that allow us to at least identify the range within which we can work, we can demonstrate that we are applying those laws with rational judgment to meet our clients' needs to conform to the laws. Or do we step out and attempt to find a single position or approach and say this is the way it should be?

I think that's part of the challenge of the profession. When we talk about financial economics, we all nod our heads at certain different components of it. We're divided as to whether to send a letter off to FASB right now and tell them to break up the balance sheet into these two components and just get it right and we'll stop fighting. I don't know if that's even relevant, because it's going to be the pension funding rules that are going to continue to drive employers into or out of defined benefit plans for their employees. Our position is very difficult. If we take a stand, then we have to be willing to get hit by one of those bullets. If we're providers of information as it relates to the laws that are being presented to us, it has met the profession's objectives of having standards and at the same time serving the public. If you want to get out front and say these should be the rules, then you have to be willing to accept full responsibility for the failures of those rules when we're wrong.

FROM THE FLOOR: I would assume that that discussion was held in Canada, because you clearly made a decision that you will take a measurement approach to risk. Was this concept debated in coming to that decision?

MR. BUTTERFIELD: That's where we are. There are a lot of actuaries with a lot of responses that said that we're abdicating our responsibility as actuaries and that it should still be our role to determine what appropriate margins should be. It's going to be a challenge for us. The regulators particularly have said we trust you as a profession to develop those provisions and we want you to still be responsible for it.

MR. ENDERLE: That was right on target. Those were great comments. This is a

very challenging area, and I hope that we as a profession can continue to keep a dialogue going among ourselves and try to find the best way we can to go forward to balance all the competing interest groups.

FROM THE FLOOR: I just wanted to remind us that things have been very different over the lifetime of some of these plans. Circumstances are very different, and this is not the first time the actuarial profession has been criticized about contribution levels. The New York State teachers were contributing about 23 percent back in 1983, and now they're at around 5 percent and people are upset about going up to 8 percent. The profession was very criticized back in that time, because the assumptions we used were too conservative. We should remember things have changed with regard to the demographics, what we thought about long-term thinking versus short-term thinking and the view of the world. We need to be thinking about what we do within the framework of today's context, understanding that the context and the world around us has changed a lot.

MR. BURROWS: Thank you all.