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Comments from DoD Office of the Actuary (OACT)

Requests for Comments

Display and Disclosure

Q1. This statement proposes to display gains and losses from changes in assumptions, including the discount rate assumptions, as a discrete item on the statement of net cost. See paragraphs **Error! Reference source not found.-Error! Reference source not found.** in the standard, paragraphs **Error! Reference source not found.**-A10 in the basis for conclusions, and the illustration in Appendix B, "Pro Forma Statement of Net Cost Displaying Separate Line Item for Gains and Losses Due to Changes in Assumptions," for more information regarding display and disclosure.

1.1 Do you believe that the display will be informative?

OACT: Yes.

1.2 Do you believe the standard provides satisfactory guidance as to what should be displayed as gains or losses from changes in assumptions?

Please provide your rationale in as much detail as possible.

OACT: The 5-year concept appears reasonable, but there is some ambiguity in the wording. It should be noted that an assumption related to something that occurs within 5 years doesn't necessarily have to be *excluded* from what's shown as gains/losses due to assumption changes. For example, there may be a change in an assumption that specifically relates to something that occurs 2 years out in the current valuation (and 3 years out in the prior valuation); however, the effects may last longer—e.g., a COLA increase for a given year will affect pension amounts beyond that year. Even if an assumption about something that occurs within 5 years changes and there are no effects beyond that year, there should not be a prohibition against including it in gains/losses due to changes in assumptions.

While paragraph 21 includes the "but are not limited to" language, it is surprising the drafters of this ED did not include "size relative to the actuarial liability (AL)" as a factor. Language to that effect should be included in paragraph 21. The most important determinant of the significance of any actuarial gain/loss is its size relative to the AL, not the size compared to the same gain/loss the year before or the proportion of the change in net cost. (An exception to this in an unfunded liability valuation is experience gains/losses due to Fund yield assumptions, which should be evaluated relative to Fund size; but that case isn't relevant here.)

A similar lack of understanding is apparent in paragraph A7. Year-to-year volatility doesn't necessarily indicate anything of actuarial significance. For example, an assumption change gain/loss of 0.3% of the AL may represent a

large percentage change from an assumption change gain/loss of 0.1% of the AL the year before, but both are actuarially insignificant.

The ED fails to note the unavoidable grey areas that can result from benefit changes; specifically, how do you determine what is inherently part of the benefit change and what is an assumption change? Paragraph 21's allowance for judgment somewhat covers this; however, it should be noted that this is an example of something requiring judgment.

Related to this, new statutory benefit provisions—creating programs for which no prior experience data exists—obviously lead to the potential for assumption-change gains/losses. The effects can be indirect, e.g., changes to retiree health provisions for over-65 beneficiaries can have impacts on participation by under-65's, which may be a separate assumption. These necessary assumption-change gains/losses are attempts to predict future unknown experience. Assumptions are at best no better than guesses, with varying degrees of experience to consider depending on the available history of credible data. As experience emerges, refining the assumptions may be possible, but in each case assumption-change gains/losses will occur. Note also that there are occasions where historical experience alone is not considered the best predictor of future experience. In a given valuation, assumption change gains/losses are attempts to better model future experience and therefore to reduce future experience gains/losses; experience gains/losses pertain to the effect of the valuation year's experience. Hence the relative sizes of the two different categories of gain/loss in a given valuation does not indicate anything of significance. Paragraph A1 demonstrates a lack of understanding of this fact.

Q2. The statement also proposes that the components of the expense associated with long-term liabilities be disclosed in notes to the financial statements. See paragraphs **Error! Reference source not found.** and **Error! Reference source not found.** in the standard, paragraph **Error! Reference source not found.** in the basis for conclusions, and the illustration in Appendix C, "Pro Forma Note Disclosure of Liabilities and Expense," for more information regarding display and disclosure.

Do you believe that disclosure of the components of expense is informative? Please provide your rationale in as much detail as possible.

OACT: Yes, although we already provide this information. It appears you are eliminating the requirement (paragraph 88 in SFFAS 5) to show the gain/loss due to changes in the medical trend assumptions as a separate line item (it now can be included in the gains/losses due to changes in assumptions). We have no objection to that. If the intent is to eliminate that requirement, paragraph 88 of SFFAS 5 should be amended, but the ED does not show that in the "Effect on Prior Standards" section.

<u>Selecting the Discount Rate Assumption</u>

Q3. This statement proposes that the preparer provide the 10-, 20- and 30-year market rate for Treasury securities in the notes to the financial statements as a benchmark comparison with the discount rate used by the entity. See paragraph **Error! Reference source not found.** for the note disclosure standard and paragraph **Error! Reference source not found.** in the basis for conclusions for the rationale for the disclosure of market rates.

Do you believe that disclosure of market rates as described above is informative? Please provide your rationale in as much detail as possible.

OACT: (You mean paragraph 24.) This would not be informative and in fact would be confusing. If current market rates are not the basis for calculating the AL, there is no reason to disclose them as a "benchmark comparison." The notes should include the basis for selecting the discount rate. In the case of DoD retirement and retiree health, the basis for the discount rate assumption (and other key assumptions) is the relevant statutorily created Board of Actuaries (Chapters 74 and 56, respectively, of Title 10, USC) that oversees the Fund. In other words, stating that the discount rate assumption is 6% because that's what the Board decided is appropriate and sufficient. Using different assumptions in financial statement valuations than those used in valuations to support Board requirements would lead to unnecessary confusion and is not warranted. More on this later in our comments.

Q4. The statement addresses long-term assumptions that have a material effect on the reporting, for example, those used for measuring expense and liabilities associated with pensions, other retirement benefits, and post-employment benefits. The statement excludes short-term assumptions of which it provides specific examples (see paragraph **Error! Reference source not found.**), and defines "long-term assumptions" as those involving projections of 5 years or more (see paragraph **Error! Reference source not found.**) and, accordingly, short-term assumptions as those involving projections of fewer than 5 years.

4.1 Do you believe that the 5-year division between short- and long-term assumptions is appropriate?

OACT: See comments above in response to 1.2.

4.2 Do you believe the exclusion of short-term assumptions in the measurement of expense and liability amounts from the display requirement is appropriate?

OACT: It seems appropriate although again there is some ambiguity. Although not in our purview, it seems that items like accounts receivable and accounts payable should not require a separate line item for gains/losses (or "changes attributable to", as the terms "gain" and "loss" are typically only used for actuarial liabilities) due to assumption changes. An item that is in our purview—Incurred-But-Not-Reported (IBNR) liabilities—definitely should not require a separate line item for changes attributable to assumption changes. It isn't warranted and would be contrary to standard practice. The 5-year concept for the most part seems about right, although it shouldn't be considered a hard-and-fast rule. For example, IBNR might theoretically

involve miniscule cash flows that could extend longer than 5 years, although the amounts are completely immaterial. Paragraph 21 is probably sufficient to cover this.

4.3 Are "short-term assumptions" clearly delineated?

4.4 Should other short-term assumptions be listed as examples?

OACT: Should include assumptions related to IBNR.

Please provide your rationale in as much detail as possible.

Q5. This statement proposes a standard for selecting the discount rates for present value measurements of expense and liability amounts. The standard provides that the discount rate should be the interest rate(s) on marketable Treasury securities of similar maturities to the cash flows of the payments for which the estimate is being made. The discount rate(s) should reflect average historical rates on marketable Treasury securities rather the current market rate(s). See paragraphs **Error! Reference source not found.**-28 in the standard and paragraphs **Error! Reference source not found.-Error! Reference source not found.** and especially A28 in the basis for conclusions.

5.1 Do you believe average historical Treasury rates are appropriate discount rates for measuring long-term liabilities in the federal government, rather than current market rates?

OACT: The ED is correct in noting that the long-term focus of federal programs makes use of current market rates as the basis for the discount rate inappropriate. However, there are several problems with the ED's proposals related to discount rates.

The requirement (paragraphs 27 and A33) to use year-specific discount rates—essentially a select-and-ultimate (s&u) approach—is fundamentally inconsistent with the new-entrant-cohort version of the Aggregate Entry Age Normal (AEAN) cost method, the method required by SFFAS 5. This new-entrant-cohort version is an accepted, appropriate version of AEAN that is described by both Tino and Sypher (Society of Actuaries Study Note 360-28-95) and Daskais (Study Note 360-21-91) . Requiring the s&u approach would result in internally inconsistent standards.

A significant portion of the problem is the fact that under this method, the normal cost percentage (of pay), or the NCP (in the case of pensions), should not change in consecutive valuations if assumptions don't change. However, with s&u discount rates the NCP does change if assumptions don't change. For example, if projection-year-specific discount rate assumptions in one valuation are 10%, 9%, 8%, 7%, 6%, 6%, 6%, etc, then not changing the assumptions for the following valuation would require 9%, 8%, 7%, 6%, 6%, 6%, 6%, etc, which would result in a change in the NCP. The problem is not alleviated by attempting to characterize the varying discount rates on a duration-specific—as opposed to projection-year specific—basis, as the ED does in paragraph 27. While keeping duration specific discount rates constant

may leave the NCP unchanged, it will lead to an overall gain/loss, and further, duration-specific characterizations can be mathematically converted to a projection-year specific basis. Thus unchanged on a duration-specific basis does not equate to unchanged on a projection-year specific basis. This ambiguity creates confusion as to what constitutes a change in assumptions.

The problem is not alleviated by paragraph 27's allowance for a single rate if the "result" is not materially different. This still would require doing the calculation under the flawed s&u approach as a comparison to show the "result" is not materially different. Also, which "result" must not be materially different? Different single rates would be required for the overall liability vs. the various components of expense to not materially differ. The standard should not require s&u, nor a comparison to it, even if the FASAB Board wants to allow it. Again, this would result in an internally inconsistent standard. Note that the ASOPs do not require s&u.

Paragraph A24 is correct in arguing for expected long-term rates; however, the perspective of the government's borrowing cost with the public isn't necessarily relevant from the point of view of the employer entity (e.g., the DoD in the case of the Military Retirement System) in the case of a "funded" plan. From DoD's perspective, the plan is funded. Therefore the investment yield perspective for the discount rate has relevance. From the employers' perspective, the statement in A25 about the equivalence of two plans with the same benefit provisions (one funded and one not) isn't necessarily correct. From the overall federal government perspective, it isn't clear what constitutes the best basis for the discount rate assumption.

From the overall government, or US Treasury perspective, Paragraph A24's statement that the rationale for using marketable Treasury securities for the discount rate is that they reflect the government's borrowing cost with the public is questionable. A private company would not value a given future obligation at its own borrowing cost. However, in the sense that Treasury securities represent risk-free investments, as described in A27, arguments can be made for their use as the discount rate basis. In the case of US Military pensions and retiree health benefits, using Board assumptions for the financial statement valuations makes the most sense. Congress has created "funding" in a trust fund comprised entirely of investments that mirror marketable US Treasury securities, and further has created independent expert Boards for setting the assumptions used in the valuations of these plans. The Board assumption basis is reasonable from the employer perspective (i.e., the investment yield perspective) and is also reasonable in terms of the perspective advocated in A27 because of the nature of the trust funds. The Board's assumption for the discount rate relates to a long-term assumption of yields on risk-free US Treasuries, given the investments to which the trust funds are restricted. Arguments that the discount rate shouldn't be impacted by the particular portfolio of securities in the trust funds (which were purchased at various prior times) at a given time, aren't valid in the context of an alternative involving a vague, undefined "historical" average. Board assumptions as to long-term yield on the trust funds is as good a basis as any to determine the discount rate, and is in fact more credible given the independence and the credentials of the Board members.

Use of Board assumptions also guarantees internal consistency among the assumptions, as the Board's assumptions and methods are required to be "in accordance with generally accepted actuarial principles and practices." Use of Board assumptions is consistent with the concept advocated in A34 that the discount rate shouldn't necessarily change every year.

An important point is that the focus be long-term, not based on current, snapshot market rates. The ED addresses this to some extent in acknowledging the need for consideration of expected re-financing rates.

Paragraph 28's statement about the need for exercising judgment in selecting the discount rate is appropriate. Implications that discount rates—no matter how they're selected—can be known with a high degree of precision, given the time-frame underlying the actuarial liability calculations, are misleading and deceptive.

5.2 How would you interpret the word "historical" in the phrase "average historical Treasury rates," for example, a 1-year average? 5-year average? 20-year average?

OACT: As previously stated, it's unclear. This isn't to suggest a precise definition should be used to determine the discount rate. Rather, the lack of a precise definition is consistent with Paragraph 28's statement about the need for judgment, and therefore also consistent with the idea of using the discount rate assumption set by Congressionally-established expert Boards for trust funds restricted to investing in securities that mirror marketable US Treasury securities.

5.3 The proposed standard incorporates prior FASAB guidance regarding selecting economic assumptions. It invokes Actuarial Standards of Practice and does not affect the explicit SFFAS 5 requirement for consistency among assumptions. See ED paragraphs 33, which contains revisions to relevant SFFAS 5 paragraphs. Some observers advocate expanding the scope of the standard to provide for selecting all economic assumptions because they are concerned about consistency between the discount rate and other economic assumptions employed. Do you believe that the guidance in the revised SFFAS 5 paragraphs (as shown in paragraph 33 of this exposure draft) is sufficiently specific regarding the necessity for the discount rate to be consistent with other economic assumptions?

Please provide your rationale in as much detail as possible.

OACT: The cross-reference to the ASOPs makes it sufficient.

<u>Selecting the Valuation Date</u>

Q6. This statement proposes a standard for selecting the valuation date for present valuations for long-term liabilities. See paragraphs **Error! Reference source not**

found.-Error! Reference source not found. in the standard and paragraphs **Error! Reference source not found.**-A44 in the basis for conclusions.

Do you believe the valuation date approach is appropriate? Please provide your rationale in as much detail as possible.

OACT: The valuation date approach is appropriate. With respect to the measurement, reporting, and valuation dates, the ED is not changing current practice as per Interpretation 3. This approach is already being used.

<u>Reasonable Estimate vs. Best Estimate</u>

Q7. This statement involves estimates that reflect the preparer's judgment about the outcome of events based on past experience and expectations about the future. Estimates are to reflect what is reasonable to assume under the circumstances rather than the preparer's "best estimate" or other phraseology. The preparer may use his or her own assumptions about future cash flows. However, the entity should explain why it is inappropriate to use assumptions generally used in the federal government, as evidenced by independent sources, if the assumption the entity used is different. See paragraph **Error! Reference source not found.** in the standard and paragraphs **Error! Reference source not found.**-A44 in the basis for conclusions.

Do you believe the approach regarding "reasonable estimate" rather than "best estimate" assumptions in paragraph 31 is appropriate? Please provide your rationale in as much detail as possible.

OACT: You mean paragraph 32. The approach regarding "reasonable estimate" rather than "best estimate" is appropriate and consistent with the ASOPs, particularly the section of ASOP 27 referenced in paragraph A44. The FASAB's conclusion articulated in A44 is appropriate and correct.

However, the end of paragraph 32, beginning with, "…the entity should review assumptions used generally in the Federal Government as evidenced by independent sources…" is inappropriate unless the DoD Boards are considered "independent" sources. There is no overarching assumption-setting body for the Federal Government. Which assumptions are supposed to be used as the comparison? Congress made the DoD Boards independent, and the law (Chapters 74 and 56 of Title 10, USC) does not require that the assumptions used for valuing the Military Retirement System or the Retiree Health program conform to any particular federal government assumptions. The only requirement is that the assumptions be approved by the Boards and conform to "generally accepted actuarial principles and practices." Of significance is the statement in section 1053 of the 1983 House Armed Services Committee Report 98-107 (which accompanied the legislation creating the Military Retirement Fund), "Care must be exercised to minimize the ability to manipulate the interest rate. The committee recommends that an independent Board of Actuaries be established and that they, alone, be charged with the responsibility for determining the interest rate and other actuarial assumptions in accordance with generally accepted actuarial principles and practices."

Benefits and Costs

Q8. The Board believes that this proposal would improve Federal financial reporting and contribute to meeting the Federal financial reporting objectives. The Board has considered the perceived costs associated with this proposal.

Please consider the expected benefits and perceived costs and communicate any concerns that you may have in regard to implementing this proposal in whole or in part. Please provide your rationale as much detail as possible.

OACT: As previously stated, the standard as proposed creates an internal inconsistency with the year-specific discount rate proposal (paragraphs 27 and A33). Again, the allowance for use of a single rate if the "result" is not materially different does not alleviate the problem.

We have also explained why it is important that Board assumptions be used for the financial statement valuations. Also, we have concerns about requiring a disclosure of current market rates on US Treasuries and a requirement to justify assumptions not matching some sort of undefined "independent" source for assumptions "used generally in the Federal Government" unless the DoD Boards are clearly considered legitimate "independent sources."

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