AMERICAN ACADEMY of ACTUARIES

September 25, 2013

Ms. Susan M. Cosper
Technical Director
Financial Accounting Standards Board (FASB)
401 Merritt 7, P.O. Box 5116
Norwalk, CT 06856-5116

Re: Possible Pension Project

Dear Ms. Cosper:

The Pension Finance Task Force (PFTF), which is jointly sponsored by the American Academy of Actuaries[1] and the Society of Actuaries, is pleased that FASB may revisit the accounting for single employer pension plans. The PFTF is charged with bringing the insights of financial economics into the mainstream of pension actuarial practice, and FASB's potential pension project relates closely to our mission.[2]

We support accounting treatment for single employer pension plans that immediately reflects economic reality and therefore does not result in the misallocation of resources. Current accounting treatment under FAS 87 and 88, as modified by FAS 132 and 158, could be improved. Particularly noticeable problems include:

- the distortion of reported corporate earnings created by both the anticipation of pension asset earnings not yet achieved and various smoothing and deferral devices; and
- incentives to engage or not engage in financial transactions, created by settlement and curtailment recognitions unrelated to the direct economic impact of those transactions.

We hope to comment more fully as the project develops. Our comments below address problems with current accounting that we consider most pressing.

General principle

We regard the sponsorship of a pension plan as economically equivalent, in most respects, to an employer issuing debt to employees in exchange for foregone current wages. The pension trust fund, if any, serves as collateral for the debt.

Discount rate

[1] The American Academy of Actuaries is a 17,500-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States

[2] The views expressed in this letter do not necessarily represent the views of anyone other than the PFTF.

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The discount rate or rates used to discount the pension obligation should reflect the seniority of the debt, the level of collateral provided, the credit-worthiness of the employer and any extra-contractual obligations created through the operation of law. That is, the pension discount rate should correspond to interest rates observable in the capital markets for debt that is similar in amount, timing and risk of default.

Pension plans subject to ERISA, as modified subsequently through the Pension Protection Act (2006), create debt that is collateralized by segregated plan assets; there is typically very little default risk, and the discount rate should therefore generally be very close to cash-flow matched Treasury or swap rates. When an ERISA plan is poorly funded and the sponsor is at risk of liquidation before it can fully fund the plan, a discount rate closer to the rate it would have to pay on debentures may be warranted. We note that some companies that go through Chapter 11 bankruptcy proceedings emerge with their pension debt intact, which argues for a rate reflecting a lower default risk than might otherwise be suggested by the sponsor's credit-worthiness.

Unfunded plans, typically supplementary executive plans, do not have dedicated collateral and are less likely to survive a bankruptcy reorganization; this implies a discount rate similar to the rate the company would have to pay on debentures with a comparable term structure.

Expected return on assets

Ideally, actual asset returns should be recognized in P&L. Expense volatility, which is often raised as a reason not to report actual return, can be managed through asset-liability management techniques. Not recognizing unmanaged volatility is misleading and potentially harmful to many interested parties. We believe that accounting that appears to manage risk through smoothing and deferral is a poor substitute for real risk management.

Currently, under both U.S. GAAP and International Financial Reporting Standards (IFRS), asset return is divided into two components:

- *The P&L component*. Under U.S. GAAP, the return-on-assets component of pension cost is calculated by applying the "expected rate of return" of a portfolio, which usually includes risky assets, to the current value of that portfolio. Under IFRS, effectively, the discount rate used to value obligations is applied instead of the expected rate of return.
- *The Other Comprehensive Income (OCI) Component*. Under both U.S. GAAP and IFRS, the OCI component of asset return is equal to the difference between the actual return on the investment portfolio and the P&L component described above. Under U.S. GAAP, the OCI component is "recycled" into P&L eventually if it is not first offset by subsequent asset gains or losses. Under IFRS, this component may not be recycled.

We would prefer including the actual asset return in P&L and dropping any OCI component. If that is not possible, then the P&L component should be the return as if the entire portfolio were invested in a cash-flow matching portfolio of default-free assets, such as U.S. Treasuries.

Taking market risk should not be rewarded until risk premiums are actually realized, as there is no immediate value created by shifting assets from default-free assets to riskier assets.
A less preferable alternative, but still superior to current U.S. GAAP treatment, would be to adopt the IAS 19 practice of effectively applying the discount rate to the assets for determining the P&L

component. This treatment has the relative advantage of not reflecting risks taken beyond those reflected in liabilities.

Asset smoothing
To best reflect economic reality, asset smoothing should not be permitted for any purpose.

Gain/loss, prior service cost, settlements, curtailments, and other nonrecurring events
We believe the economic impact of events that trigger these accounting items should be recognized immediately when those events occur.

Classification of net periodic cost
Net periodic cost is the sum of components that might logically appear under separate headings in P&L:

- The service cost component is part of current compensation
- The interest cost component is part of interest on debt
- The asset return component is part of the return on investments held by the company

Measure of balance sheet liability for final-salary related plans
The measure that best reflects the value of the promise depends on the extent to which future pay increases are part of the employer's legal obligation, such as an executive's employment contract or a union contract, each through its respective term. That is, we believe it preferable to report an ABO, rather than a PBO, liability for most salary-related plans. Salary increases are at least partly under the control of the parties to the employment contract and will be negotiated or determined in the future. Further, in no other instance that we know of are anticipated salary increases factored into the financial statements. Information on future projected increases in liabilities may be more appropriate for disclosure as opposed to reporting.

Accounting for cash balance plans[3]
We would prefer that the ABO be reported for all plans. If that is not possible, we note that, in our experience, the current application of the projected unit credit cost allocation method to cash balance plans is not consistent among sponsors. For example, if a cash balance plan includes annual pay (principal) credits that increase with age and/or service, some sponsors will reflect the future higher pay credits (usually prorated over service), while others will merely reflect current account balances as of the measurement date.

The current account balance is the amount that employers and employees assign to the value of the benefit at a point in time, and should thus be the benefit reflected in the financial statements.

Economic assumptions other than discount rates
All economic assumptions, such as cash balance interest credits or lump sum conversion rates should be based on market data observable at the measurement date. For example, if annuities are converted

[3] A "cash balance plan" is a defined benefit pension plan where an employee's claim on trust (or employer) assets is defined as a hypothetical account balance that grows with interest and principal credits, analogous to earnings and contributions in a defined contribution plan. In a traditional defined benefit plan, in contrast, the employee's claim is typically defined as a monthly annuity, generally for the life of the employee after he or she retires.

to lump sums under IRC Section 417(e), then the rates used for the conversion should be consistent with observable corporate yields (the basis for 417(e)) as of the measurement date.

Value of overfunding

For an overfunded plan, any net pension asset recognized should be net of any excise taxes or other anticipated cost that would arise on reversion. For consistency, some of the P&L calculations described above may have to be adjusted where a pension is in a surplus position.

Where the sponsor recognizes surplus value, disclosure of the basis for the claimed value of surplus would be helpful.

Optionality in pension liabilities

Many pension plans have features that resemble options. For example, a cash balance plan may have an annual interest credit defined as the 30-year Treasury rate but not less than 4%. The methods used to value such optionality vary widely. It would be helpful if sponsors disclosed how material option-like features of a pension plan are valued.

Administrative expenses paid out of plan assets

Many sponsors pay plan-related expenses, such as PBGC premiums, out of plan assets. We believe that the actual value of such expenses should be recognized as part of annual expense.

Our comments apply specifically to defined benefit pension plans. Some of our comments may also apply to postretirement benefits other than pensions. We note, however, that there may be significant differences between these two types of plans. In particular, employers often reserve a right to unilaterally terminate or modify non-pension postretirement benefits. Another important difference is that defined pension benefits accrue in proportion to employee service while eligibility for non-pension benefits is often based on the moment when the employee achieves age and service requirements (e.g., the later of age 55 or attainment of 10 years of service), while still reserving a right to make major changes.

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We would be happy to participate in any future discussions or provide additional input as the FASB deems appropriate. Please contact David Goldfarb, the Academy's pension policy analyst (202-785-7868 or goldfarb@actuary.org) if you have any questions or would like to discuss these items further.

Sincerely,

Gordon J. Latter, FSA, MAAA
Chairperson, Pension Finance Task Force

cc: Phil Hood, Project Manager, FASB