AMERICAN ACADEMY of ACTUARIES

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April 27, 2016

Mr. Todd Weiler
Assistant Secretary for Manpower and Reserve Affairs
United States Department of the Army
United States Department of Defense
111 Army Pentagon
Room 2E468
Washington, DC 20310-0111

Re: The Use of Personal Discount Rates in the Calculation of Lump Sum Payments from Military Pensions

Dear Mr. Weiler,

The American Academy of Actuaries[1] Pension Practice Council respectfully asks for your consideration of our comments and concerns regarding the use of personal discount rates to calculate lump sum payments from military pensions as required in the National Defense Authorization Act for Fiscal Year 2016 ("the Act"). In particular, we understand that the personal discount rates on which this legislative provision was based are substantially higher than would be typical for the lump sum settlement of a pension benefit. Such discount rates would result in lower lump sum amounts under the Act than would be paid, for example, by private pension plans. We respectfully urge the Department of Defense to carefully consider how the Act is to be implemented with respect to the use of personal discount rates.

The language from the Act that defines the determination of a single lump sum amount that will be offered to service men and women in exchange for giving up a portion of their military pension payments is as follows:

> ''(b)(2)(B) reducing the aggregate amount estimated pursuant to subparagraph (A) by an appropriate percentage determined by the Secretary—
>
> > (i) using average personal discount rates (as defined and calculated by the Secretary taking into consideration applicable and reputable studies of personal

[1] The American Academy of Actuaries is an 18,500-member professional association whose mission is to serve the public and the U.S. actuarial profession. For more than 50 years, the Academy has assisted 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.

discount rates for military personnel and past actuarial experience in the calculation of personal discount rates under this paragraph); and
(ii) in accordance with generally accepted actuarial principles and practices.

Generally accepted actuarial principles and practices, including Actuarial Standards of Practice, refer to only financial inputs when selecting a discount rate. "Personal discount rates," as we understand the term, also include a non-actuarial element of individual preference or utility. Consequently, personal discount rates are not explicitly condoned by Actuarial Standards of Practice; and there are no generally accepted actuarial principles or practices for selecting or utilizing personal discount rates.

Under Actuarial Standards of Practice, when an actuary selects a discount rate, the purpose of the measurement must be considered as a primary factor. For the purpose of a settlement, which would include offering a lump sum in exchange for a pension benefit, the Standards suggest that the actuary may use a discount rate implicit in annuity prices or other defeasance or settlement options. (ASOP #27, paragraph 3.9.b) For the purpose of valuing a retirement benefit in a domestic relations action, unless another assumption is clearly warranted by the facts and circumstances, the standards require the use of "a low-risk rate of investment return, determined as of the measurement date and based on the cash-flow pattern of benefits being valued (for example, the current or a recent average yield to maturity on US Treasury bonds of comparable duration, or a published index reflecting yield rates for high-quality corporate bonds)." (ASOP #34, paragraph 3.3.4.a)

When lump sum payments are offered in exchange for a promised pension benefit, the Internal Revenue Code requires private pension plans to use discount rates specified through regulation that are based on high-quality corporate bond yields. In financial markets, pension benefit promises and other obligations to make regular future payments to other parties (e.g., bonds and loans) are priced using discount rates based on "risk-free" yields on Treasury securities plus an upward adjustment for any risk that the future payment promise might not be fulfilled (credit risk). The use of a higher personal discount rate produces a smaller lump sum and results in a lump sum amount that is not consistent with the value placed on the original annuity promise by financial markets.

Discount rates typically used for these kinds of settlements (including lump sums from corporate pension plans) might range from 2% to 4% over the period 2010 – 2015. Based on the studies referenced in the Final Report of the Military Compensation and Retirement Modernization Commission, it is our understanding that "personal discount rates" may be 8% or higher for officers and 12% or higher for enlisted personnel. This higher rate would result in settlement amounts under the Act that are, in some cases less than half the amount[2] that the same benefit would be settled for in a corporate pension plan, as part of a domestic relations action, or in the broader financial markets.

Those who accept lump sum amounts determined at higher personal discount rates are likely to either not understand the financial value of their annuity benefits, or have an immediate financial

[2] Assuming 2 percent annual cost-of-living adjustments, the present value of a benefit paid over 20 years discounted at 11.5 percent is about half of the present value of the same benefit discounted at 3.0 percent.

need that cannot be met through the annuity payments. In selecting the appropriate personal discount rate under the Act, we encourage the Department to carefully consider the extent to which the discount rate should reflect a service member's financial sophistication and immediate financial needs or whether the discount rate should be independent of these considerations. Furthermore, we believe consideration should be given to whether all service members should be offered lump sums based on the same discount rate and whether that discount rate should be comparable to the discount rate required for lump sum payments from corporate pension plans.

Regardless of the discount rate used, we strongly encourage the Department to provide a full and thorough disclosure about the discount rates used to calculate the settlement offers. Such a disclosure should include comparisons to settlement amounts that are calculated based on widely used discount rates and/or comparisons to what it would cost to replace the foregone pension benefits in the financial markets.[3] This disclosure will help to ensure that participants are informed of any shortfall that exists between the lump sum amounts they are being offered and the generally accepted financial value of the annuity benefits they would be giving up.

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We appreciate the opportunity to submit comments on this hearing. If you have any questions or need further information, please contact Matthew Mulling, pension policy analyst (mulling@actuary.org; 202-223-8196).

Sincerely,

William R. Hallmark, MAAA, ASA, EA, FCA
Chairperson, Pension Practice Council
American Academy of Actuaries

[3] For example, in November 2015, the ERISA Advisory Council published a model notice illustrating what "full disclosure" might mean for a participant being offered a lump sum in a corporate pension plan.