



AMERICAN ACADEMY *of* ACTUARIES

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May 16, 2003

Mr. David R. Bean  
Director of Research  
Project Nos. 22-2P and 22-2E  
Governmental Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

Dear Mr. Bean:

I am writing on behalf of members of the American Academy of Actuaries'<sup>1</sup> Pension Accounting Committee and welcome the opportunity to provide comments on GASB's proposed statement on accounting and financial reporting by employers for other postemployment benefits (OPEBs).

We appreciate the care with which the proposed standards have been drafted and the efforts made to include actuarial perspectives. The proposed requirement that actuarial valuations be performed for the calculation of the annual required contribution (ARC) and other OPEB information places an important responsibility on our profession. Our expertise in determining appropriate financing for employee benefits such as life insurance, health insurance, and pensions dates back for more than a century. Even for more recently implemented benefits such as OPEBs for retirees, our profession has endeavored for more than 20 years to aid in the understanding of the financial implications, for both the short-term and the long-term.

Our written response here and testimony at the forthcoming public hearings are based on our expertise in analyzing OPEB plans and conveying their significance to plan sponsors. We have established professional standards for measuring financial implications and disclosing actuarial findings to interested parties. It is in the spirit of that expertise in measurement and communication that we commend the Board for presenting the current proposed standards and express concern about certain aspects of the proposal that threaten the credibility of its entirety.

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<sup>1</sup> The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States. In addition to setting qualification standards and standards of actuarial practice, a major purpose of the Academy is to act as the public information organization for the profession. The Academy is nonpartisan and assists the public policy process through the presentation of clear actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal and state elected officials, regulators and congressional staff, comments on proposed federal and state regulations and legislation, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualifications and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

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This letter will provide detailed discussion and commentary on the issues we believe to be most significant. The following is a summary of those issues and our related recommendations.

## **Summary**

### ***Overall Approach***

We agree with the overall approach of moving from pay-as-you-go accounting to accrual accounting. All benefit obligations should be measured and disclosed. We believe, because of the significant impact of the proposed standard on employer expense, that consideration could be given to a phase-in of expensing while requiring full disclosure as of the effective date.

### ***Implicit Rate Subsidy***

The approach of exempting disclosure and recognition of obligations and cost that represent both economic and actuarial realities is flawed. For a subset of plans, it retains the pay-as-you-go approach, which is contrary to the intent of the standard. It damages the integrity of the entire standard and we strongly recommend reconsideration of this issue. The benefits of disclosure and recognition of these significant values far outweigh any relatively small cost.

### ***Alternative Method***

The alternative method proposed will systematically understate plan costs and obligations. It is almost as complicated as a true actuarial valuation, and it will not result in the desired savings. We recommend the development of a simpler method than the one proposed, with appropriate disclosure about the potential inaccuracies involved. If that approach is not taken we recommend the elimination of an alternative method altogether.

### ***Discount Rate***

For plans that are partially funded, the use of a weighted discount rate that reflects both the funded portion and unfunded portion of the plan will create a mathematical dilemma. The blended rate cannot be known until the funded and unfunded percentages are determined. These percentages, however, cannot be determined until the discount rate is known. The Board should re-visit the discount rate selection process and provide for a more manageable procedure for partially funded plans.

### ***Projected Unit Credit Method***

This method is not specifically listed in the standard as an acceptable method, although, GASB Statement 27 does list this method as one of the acceptable methods. We recommend that this section of the standard parallel Statement 27 and include the projected unit credit method as an acceptable method for OPEBs.

## **Discussion**

### ***General Actuarial Considerations Related to Aging and Group Premiums***

The proper reflection of the effect of aging in an OPEB valuation impacts two of the issues addressed in this letter. They are the implicit rate subsidy and the alternative method. This discussion will provide perspective with respect to both issues.

The Board's draft embraces the use of premium as an indicator of long-term cost for the alternative method for small plans and also for many larger plans having an "implicit rate subsidy." This portion of our response letter addresses the importance of age differences in OPEB costs and misconceptions about the use of group premium in OPEB measurement.

An OPEB actuarial valuation is based on a projection of future claim rates for individuals. For that purpose, individual demographics (age, date of hire, etc.) are gathered and become major determinants of future benefit payment. Demographics such as age and years of service are determinants of the probability (for withdrawal, retirement, mortality, etc.) that an individual will receive benefits in any future period. There are, of course, similarities to pension valuations here, but age has even more importance with OPEB valuations. Analyses of the primary OPEB benefits (life insurance and health care benefits) strongly indicate that age is a consistent predictor of relative payment levels. Over the long time span of future benefits, the individual participants get older. A key to accuracy in projecting plan costs is to correctly model per capita payments by age. Group premium is not useful for this.

An actuarial payment projection requires an assumption about the annual benefit level per capita, or rate, from which the projection begins. Given the significant differences by age in utilization for both life insurance benefits and health benefits, almost all OPEB valuation software in use is capable of assuming a different initial claim rate at each benefit age. Clearly, actuarial projections of any sophistication are not using group premium as input.

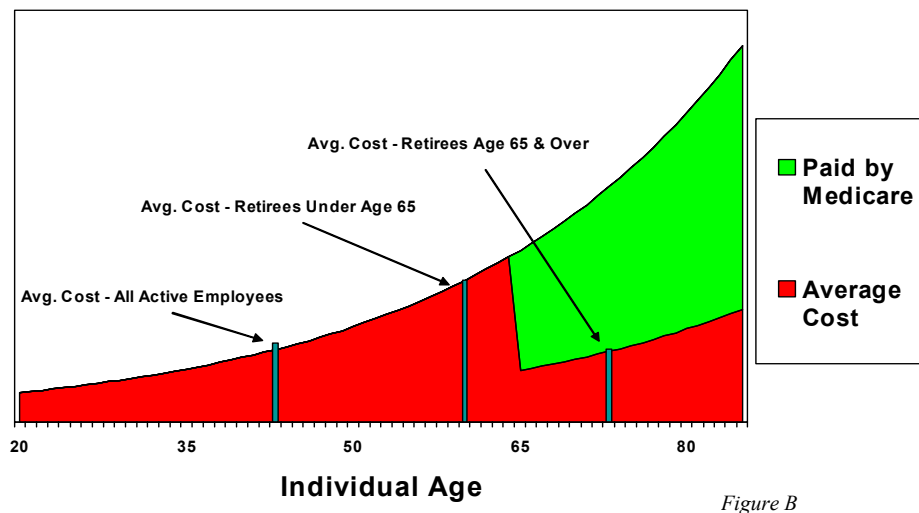
Figure A shows the general relation between average health care cost and age, with the portion paid by Medicare indicated beyond age 65. (Life insurance costs have a similar relation with age, although without Medicare as an offset.) Health and life rates increase with age. Because of Medicare's role as primary payer, those age 65 and over are usually grouped separately from those under age 65.

## Average Cost of Health Care



A premium rate common to a large age range (which we called “common premium” in our December 13, 2002 letter) is not necessarily appropriate to any one age. The common premium will overstate or understate the average cost at most ages. Figure B shows how premium based on an average over all ages might relate to the likely cost at each age of the group covered. The average cost for active employees is not adequate to pay for the likely costs of retirees under age 65. The retirees obviously receive a current subsidy.

## Average Cost of Health Care



How large is the subsidy? In 2003 amounts, the implicit subsidy will often be as much as \$3,000 annually for each participant retiring before Medicare eligibility.

A forward projection of costs that ignores the age differences will not be accurate as the group changes. The group will change, by gaining and losing participants and by the participants aging. Over the long periods associated with OPEB eligibility, the inaccuracies caused by ignoring aging are likely to be substantial. Actuarial OPEB models easily incorporate these aging differences, however.

Thus, the Academy responds to the Board's proposal for an alternative method and an exemption for implicit rate subsidy situations in the following context: Aging considerations beyond those inherent in group premium are necessary for accurate OPEB valuations, and these considerations are now included in actuarial valuations with relative ease and low expense.

### ***The Alternative Method***

The proposed statement puts forth an alternative measurement method for small plans. The Academy understands that the motivation for this alternative to an actuarial valuation was to avoid the cost of an actuarial valuation. The Board recognized that requiring an actuarial valuation might be financially burdensome to smaller entities. The Board proposes an alternative that would be simpler but would not meet actuarial standards. We do not necessarily oppose an alternative measurement method for small public entities, if it is truly at a significantly lower cost and is not misleading.

In the summer of 2001, an Academy representative engaged in a dialogue with the Board about possibilities of simplified methods. The actuary pointed out that the simpler the model, the less refined would be the accuracy of the results. In August of 2001, the Board formally requested the assistance of the Academy in determining the feasibility of an alternative estimation method of calculating the obligations associated with small OPEB plans. Subsequently, in December of 2001 the Academy provided the staff with an illustration of the complexities involved in developing an acceptably accurate model. The staff then decided to develop its own alternative.

Our review of the proposed alternative method suggests that it is still likely to be considered too complex to be handled by small entities internally. Specialists may arise to do this measurement, but we are concerned about the corners that will be cut to keep costs low. Plan sponsors need to understand the long-term implications of a retiree health plan. We doubt that the new "specialists" will be able to furnish that understanding in the near future. We see no evidence now that such specialists exist, and if they do not emerge, the alternative method could face serious challenges. The emergence of such specialists is predicated on a "field of dreams" faith that, having built a model playing field, players will show up and be ready to play. Given that the only requirement to play is that fees not be high, we are skeptical that the alternative method will attract the quality of work that will make compliance meaningful.

Whether the alternative method ends up in the hands of specialist advisors or internal staff, we are also concerned that an entity's auditor will require more extensive work since it cannot rely on the work of another professional. Additional audit fees will offset some (possibly all) reductions in measurement fees.

The Board should not base its support of this alternative method on a belief that plans start simple and gain complexity only with more participants. Often the opposite happens; size brings simplifying conformity. Many small employers have fairly complex benefit and contribution structures. It may be unworkable and inappropriate for them to use the alternative measurement in the exposure draft.

All of this makes us doubt that the alternative method will result in an inexpensive but accurate method. In addition, we have learned in the last few months that some actuarial firms believe they can furnish small entities with actuarial valuations at relatively low cost.

If the Board still feels the necessity of sanctioning a non-actuarial measurement alternative, we suggest developing a simpler method that would alert small public entities to the likely magnitude of their obligation and encourage them to seek the help of an actuary if that magnitude is of concern. This should be accompanied by an appropriate disclosure about the potential lack of accuracy of the results. We are persuaded a simpler method can be found and urge the Board to seek experienced practitioners to develop a safe harbor method. Such a method could be considerably cheaper than the proposed alternative but also less likely to mislead people as to the nature of the obligations. With a satisfactory alternative method, we are also not opposed to a size limit that is larger than the one currently proposed, i.e., 100 members. However, if a more simplified alternative with appropriate disclosures is not pursued and adopted, we believe the entire concept of an alternative approach should be eliminated.

#### ***Exemption When Implicit Rate Subsidies Apply***

Despite all the evidence noted above in the 'General Considerations' section, the public perception continues that if a single rate is mentioned for a group, that rate must be the "fair cost" for any individual in that group. This one-size-fits-all solution to the question of cost is not sustained by analysis, however, and is not sustained by economic markets. It is not allowed under most circumstance by actuarial standards.

The proposed GASB standard falls back on this perception to allow an exemption of liabilities stemming from "implicit rate subsidies." Such subsidies are defined in the proposal in a way that is unclear to members of our committee and is likely to leave many questions for those trying to determine the applicability of the exemption to their situation. **We strongly recommend it not remain in the final standard.** Accounting standards that aim to measure today what will be paid 10, 20 and 30 years from the present, should reject the easy but incorrect answer.

The Board's alternative is contrary not only to actuarial standards, but also contradicts all the financial reporting standards by the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA) and other accounting rules pertaining to long-term liabilities for life insurance or health benefits, some of which have been in effect for 10 years. While those accounting standards may be perceived as flawed, those who complained about the bias against premium as a proxy for costs have largely accepted its validity. Premium may be an easily attainable number, suitable for pay-as-you-go accounting on a short-term basis, but when examining costs associated with long-term accruals or funding, a surer basis is needed. For plans affected by the implicit rate subsidy, the Board has contradicted itself with respect to a move to accrual accounting. It has retained pay-as-you-go accounting for plans with the subsidy.

The only reason mentioned in the exposure draft (Paragraph 52) for this exemption is that "for cost-benefit reasons...the employer should not be required to incur the cost of measuring and reporting the implicit rate subsidy." This reasoning implies the subsidy is immaterial. If the subsidy were immaterial, we would agree. Occasionally, the subsidies are relatively insignificant and, in those cases, the actuary will usually suggest to the auditor that a valuation will not be needed.

Far more often, however, the implicit rate subsidy is very significant. The amount of the subsidy for a handful of retirees for one year may be more than the cost of an associated actuarial valuation, let alone the cost of subsidies for hundreds or thousands of participants for decades in the future. The Board is serving taxpayers and users of financial reports poorly if the exemption is solely considered "for cost-benefit reasons."

In December, the Academy took the unusual step of having three of its vice presidents co-sign a letter to the Board urging reconsideration of the implicit rate subsidy approach. We appreciate that the Board has chosen to highlight this approach as one of the key issues in the employer draft. We further appreciate that one Board member has presented an alternative view on the issue, and that it refers to the concern expressed by some of our members. Let me add that the concern is not isolated among a few actuaries. Almost all actuaries who work with OPEBs on a regular basis and who have expressed their view of the GASB draft are concerned that, with this matter, the Board is turning its back on actuarial and accounting precedents.

That concern on the part of practicing actuaries has generated many examples of the likely problems inherent in the Board's approach. Just a few of the problems were put in the appendix of the December letter. We would strongly encourage each board member to understand the implications of the exemption approach as reflected in those examples. We will not include further examples in this letter but simply restate our concerns about including the exemption in the final standard, note the one subsidy we would exempt, and conclude with some practical ramifications for the standard as a whole if the exemption is interpreted.

The American Academy of Actuaries strongly recommends that the exemption be deleted from the final standard, because:

- The exemption sanctions pay-as-you-go accounting;
- The exemption will in many cases hide major liabilities;
- The exemption saves no meaningful money in terms of the larger goal of useful information;
- The exemption destroys comparability across plans;
- The exemption destroys comparability with financial reporting in the private sector;
- The exemption indiscriminately classifies employers having no true subsidy with those subsidizing retirees;
- The exemption will be confusing to users;
- The exemption will place new burdens on auditors;
- The exemption is confusing in its current language; and
- The exemption destroys the credibility of a GASB standard that has been carefully and judiciously crafted in so many other ways.

There are two instances in which we agree that an implicit rate subsidy does not result in an employer obligation for retirees. The first is where each willing participant pays the same rate, whether active or retired, and the employer's only role is one of administration and occasional banker. In such a case, the subsidy of the older retirees is by the active participants and not the employer. We agree that there is no significant liability to an employer that remains simply in the role of pass-through administrator for actives as well as retirees. The second is in the case of a community rated HMO where there is truly no reflection of the employer's age structure in the rates paid to the HMO.

If the GASB standard language on exemptions for implicit rate subsidies were narrowed to these two instances, we would support the exemption.

We understand the intention of the exemption to be beyond this definition, however, and to encompass situations where an employer pays to support the benefit structure. A situation where the amount required of early retirees is the "common premium" for both actives and retirees usually indicates 1) a long-term commitment by the employer and 2) a subsidy that will continue and grow in the years ahead. We feel the accounting rule should encourage the employer and financial report users to become aware of the employer commitment to a subsidy at an early opportunity. In some cases the subsidy may be considered significant and in others it may not, but the proposed requirement that the subsidy be disclosed but not measured is unlikely to make anyone comfortable. It remains pay-as-you-go accounting.

### ***Discount Rate***

The Academy agrees that the actuarial assumptions used to develop the actuarial values to be reported under these statements should reflect the long-term nature of the obligations under OPEB plans.

One of the assumptions having substantial impact on such values is the investment return assumption (discount rate). Paragraph 31.c. of the statement on the plan, appropriately

specifies, that for funded plans the investment return assumption should be based on the long-term expected return of the asset mix of the fund. However, that paragraph is vague relative to the nature of this assumption for unfunded plans.

Paragraphs 117 – 119 provide a look at the Board’s thinking in this area.

- Clearly, there are several options set out in Paragraph 117 that are not acceptable to the Board.
- Paragraph 118 indicates, “...the statement requires the use of the long-term expected yield on the investments that are expected to be used to pay benefits...” It goes on to prescribe the use of “the employer’s investments” in the case of an unfunded plan. While public entities often invest cash flows for short periods as part of a cash management process, such employers generally have no long-term investments.

For funded plans, we believe that actuarial judgment will be required to set the assumption based on expected long-term returns on plan assets. For unfunded plans, there will also be actuarial judgment required to set an assumption, which reflects the long-term expectations for the returns on assets held by the employer. This will include expectations for inflation and expected real returns on the employer’s assets.

The principal concern we have with the discount rate approach is for those plans that are partially funded. The exposure draft indicates that the discount rate should represent a blended rate that reflects the weighted average of funded and unfunded portions of the plan. This approach, however, presents a mathematical dilemma. The actuary must know what the blended rate is before he or she can determine the funded and unfunded portions of the plan, but the blended rate cannot be determined until those portions are known. We recommend that the Board provide more specific guidance on the selection of a blended discount rate when a plan is partially funded.

### ***Projected Unit Credit***

We are concerned that the absence of the projected unit credit method from the list of acceptable actuarial cost methods (and its inclusion in only a footnote reference) may lead to some confusion over the appropriateness of its usage. The projected unit credit method is widely used in the valuation of postretirement benefits, largely due to the requirements of FAS 106. We believe the standard should be modified to clarify that this method is acceptable in the computation of the annual required contribution for medical and life insurance benefits.

Perhaps the confusion can be cleared up by simply expressing the list of acceptable actuarial cost methods in the same manner as in GASB Statement 27, i.e., including projected unit credit in the list of acceptable methods and having the related footnote describe circumstances when the unprojected unit credit method might be appropriate.

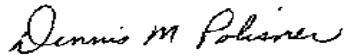
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### **Conclusion**

We appreciate this opportunity to comment on the Board's exposure draft and would welcome the opportunity to work with the Board and staff to address the issues contained in this response. Please contact Heather Jerbi, the Academy's pension policy analyst ([Jerbi@actuary.org](mailto:Jerbi@actuary.org); 202-223-8196) if you have any questions.

Very truly yours,

A handwritten signature in cursive script that reads "Dennis M. Polisner".

Dennis M. Polisner, FSA, MAAA  
Chair, Pension Accounting Committee  
American Academy of Actuaries