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RE: Marriage of M

Dear :

Thank you for your letter of October 14 requesting clarification of the reasons I selected certain assumptions in the valuation of Mr. M's pension benefits. Specifically, you request clarification of the use of an age 55 assumption and the use of a 5.0% investment return.

I will explain each of those issues below, but first let me give the principles, which I try to implement in my own practice.

First of all, I am mindful of who uses my reports and for what purposes, my "constituencies," if you will. These include all of the following:

- the participant spouse (generally referred to in the masculine gender in what follows),
- the non-participant spouse (generally referred to in the feminine gender),
- the attorneys on both sides,
- the judge,
- possibly a QDRO drafting attorney, and
- another actuary retained to give a second opinion.

In addressing these constituencies, I strive for clarity, and a straightforward presentation which sets out all the issues considered, states the position I adopt or recommend, and explains the consequences of this position. I stand ready to revise my reports, upon instruction (and hopefully agreement) from the parties, and subject to appropriate disclaimers.

Second, I have adopted a policy of consistency. In my reports, it makes no difference whether I am retained by the participant or non-participant spouse. I use the same methods and factors. In cases where one side or other wants to adopt a more aggressive posture, I fully disclose the source of the request and the effect of the requested change. Quite frequently, I don't even know which spouse has retained me, and I greatly prefer to be a joint and neutral expert.

Third, I strive for stability. It is not uncommon to update pension reports two or three times over a year or longer. The assumptions that I use are selected so that I do not have to change them often. The interest assumption is generally reviewed each calendar quarter, and the mortality tables every couple of years. Therefore it is easy for me to point out (and for my readers to understand) how the pension values change solely as a result of the passage of time, and to tease out the effects of fluctuations in the economic environment.

Fourth, I strive to comply with all published statements of actuarial opinion, and fully to disclose and discuss any significant departure, which may be required by the peculiarities of a particular case.

Having set out the principal considerations let me explain how this plays out in practice.

Selection of a Retirement Age

One of the decisions needed to calculate a lump sum present value is the assumed retirement age. I always determine my values at the retirement age which gives the largest value to the community.

I do this for several reasons. First of all, I believe, and my experience confirms, that most people will maximize their benefit values. Even without an actuarial valuation, most people know intuitively when their benefit values peak, and choose to retire at that time. If the participant has my report to confirm that intuitive sense, then it is even more likely that retirement will occur when the benefit value is highest.

Note that the highest benefit does not necessarily correspond to the highest monthly benefit. In many plans, the early retirement benefit is more valuable simply because it is payable sooner and for a longer period. For instance, many plans impose a 50% reduction at age 55 when the normal retirement age under the plan is 65. In order to reflect true "actuarial equivalence," the reduction should be closer to 60%. Therefore, the age 55 benefit is more valuable than the age 65 benefit. The term "subsidized early retirement" is also used to describe this circumstance.

Second, failure to value the benefit at its highest would be doing a disservice to the participants. My job is to be neutral and objective, as fair as possible to both parties. It is always possible for one spouse to accept a lower value for an asset as a result of negotiations between the spouses, but I would be seriously derelict in my responsibilities if I concealed the possibility of additional value by adopting an arbitrary rule, even if the rule gives a reasonable result in most cases. One of the services you are paying me for is my actuarial training, which enables me to test alternatives and determine where the maximum benefit occurs. In the previously described case, the maximum occurs at age 55.

Third, if the participant spouse decides to retire at a time when the retirement benefit is not at its maximum, that is his decision to make, but the non-participant spouse should not have to pay for it. There is a series of articles in the literature which allege that failure by the participant spouse to optimize retirement benefits may in fact be a conversion of community property to separate property.

In summary then, I see the choice of retirement age as a risk transfer issue. There are many contingencies associated with the valuation of a benefit, such as: whether the participant dies prematurely, changes jobs before vesting or becoming eligible to retire, receives substantial compensation increases, gets laid off, suffers declining health, and so on. As long as there has been no final division of the property, both spouses are sharing this risk. Both are entitled to reap the benefits of good experience and both will suffer the losses of bad experience. Once the division has occurred, the non-participant spouse no longer has to bear these risks. Her risk then becomes one of investment management – making sure that her investment strategy will provide her with the anticipated retirement benefit – or even deciding that current needs are more pressing than retirement needs thus using her share of the benefit immediately and not investing it at all. My job, as I see it, is to steer a middle ground through all the alternative events that might happen in the future, and to use those decisions to get a value that is reasonable and fair to both parties.

Selection of an Interest Rate

The choice of an interest rate is circumscribed by published standards of practice.

Among my other credentials, I am a Fellow of the Society of Actuaries, and a member of the American Academy of Actuaries. One of the obligations of those memberships is to abide by the published Standards of Actuarial Practice. These Standards cover such issues as when an actuary is qualified to perform an engagement, how he should behave as an expert witness, the principles which must be considered and included in the fulfillment of an engagement, full disclosures of all assumptions and methods, the content of the actuarial report, and when and how the actuary can make public statements of opinion. Working from that base, over the last twenty years I have attempted to develop a set of procedures and practices that implement the Standards in an effective and efficient way for dissolution calculations.

The disadvantage of adhering to a published standard of practice is that the actuary is constrained in the choices he can make, especially in an advocacy situation. However, the advantage is that I know what I do is defensible in court and representative of mainstream actuarial opinion and practices. The Standards of Practice are published on the Academy website at www.actuary.org, or I can send you copies of any in which you are interested.

Actuarial Standard of Practice #34, Actuarial Practice Concerning Retirement Plan Benefits in Domestic Relations Actions, specifies standards for the selection of the investment return assumption.

Section 3.3.3 Actuarial Assumptions specifies the following:

> "Discount Rate – Unless another assumption is clearly warranted by the facts and circumstances, the discount rate selected for valuing retirement plan benefits in domestic relations actions should be 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 U.S. Treasury bonds of comparable duration, or a published index reflecting yield rates for high-quality corporate bonds)."

Within the parameters of this standard, I believe my selection of a 5.0% investment return is reasonable and produces a fair result.

Whether or not the employer can actually obtain an 8% return on their investments (and I believe that even CalPERS is having trouble meeting that goal) it is inappropriate to use the valuation interest rate for dissolution calculations, as you have suggested.

Valuation rates are used to set an employer's contribution levels and financial reporting. It is generally in the employer's interest to set the rate as high as reasonably possible to minimize the charge against earnings and an unfavorable reaction in the stock market. Furthermore, since pension plans are valued each year for contribution purposes, companies can "correct" a prior year underfunding in a later year. So if there is an understatement due to an interest assumption that is not attainable, the damage is temporary because higher contributions can be made in later years to cover the shortfall.

I have no such luxury in calculating the benefits for a domestic relations action. I get one opportunity to select the assumptions which I think can reasonably be attained by a prudent investor. Actually, 5.0% may be a little low in today's market, but I think the need to be absolutely up to date every minute is countered by the need for stability and consistency as explained above. If interest rates rise and appear to be stable at a higher level, I will probably raise my assumption in January.

I hope this explains my reasoning in making the assumptions that I have made. Please let me know if something is not clear.

Sincerely,

Patricia P. Watt
Fellow of the Society of Actuaries
Enrolled Actuary