Comment #14 - April 29, 2011 - 6:43 p.m.

ASOP No. 27 Revision
Actuarial Standards Board
1850 M Street, NW, Suite 300
Washington, DC 20036

Re: ASOP No. 27 – Comments on Exposure Draft

Dear Sirs:

This letter responds in the following six sections to your request for comments on the Exposure Draft issued for Actuarial Standard of Practice ("ASOP") No. 27 ("ASOP No. 27") on the Selection of Economic Assumptions for Measuring Pension Obligations.

The letter is structured as follows:

- Introduction
- Prior Observations and Comments
- Specific Comments on Questions Asked
- Other Comments on Exposure Draft
- Best Practices
- Summary

Introduction

Thank you for the opportunity to comment on the ASOP No. 27 Exposure Draft.

Please note that these comments are mine alone and do not represent those of the New York City Retirement Systems or the City of New York.

Prior Observations and Comments

I have previously given thought to the issues of ASOP No. 27 and refer you to my Discussion of the paper entitled "A Reevaluation of ASOP 27, Post-Enron: Is It an Adequate Standard of Professionalism?" by Mr. Frank Todisco that was published in the January 2005 edition of the Society of Actuaries' Pension Forum. The January 2005 Pension Forum can be found at http://www.soa.org/library/newsletters/the-pension-forum/2005/january/pfn0501.pdf.

In that Discussion I recommended that ASOP No. 27 be revised to clearly allow for the use of the principles of financial economics in setting economic assumptions. I also suggested that there be a tightening of the best-estimate range and expanded requirements for disclosure.

Thereafter, in a letter dated August 1, 2008, I responded to the ASOP No. 27 Request for Comments with some of the following observations:

- Since the publication of the January 2005 Pension Forum, my thinking on the development and presentation of actuarial information had further evolved.

- In particular, I had come to believe that the actuarial profession needs to revise its core terminology and the foundational concepts on which it develops and selects economic assumptions for measuring pension obligations. For example:

  - In the context of valuing cash flows, the concepts of financial economics should be observed and the word "liability" should used only when its measurement is determined using assumptions consistent with the marketplace.
  - Consistent with this idea, actuaries who prepare pension "liabilities" should do so using only the "observed" market-place discount rates. Such discount rates should reflect the market environment and the risks inherent in the cash flows being discounted.
  - Actuaries should be required to reference any calculation made on other than a market-consistent basis as an "actuarial present value" (or some other term) that does not conflict with market-consistent terminology.

- Note: That being said, I do believe that there are still situations for which actuaries could use actuarial assumptions that are based on "expected rates of return on investments". However, if used, I believe that such assumptions should clearly be noted as such, that such assumptions are inconsistent with economic realities and fail to address economic risks and that their use should not be considered as producing a "liability".

  Along these lines, I also believe that it would be acceptable to allow actuaries to continue utilizing economic assumptions developed consistent with current ASOP No. 27 provisions in conjunction with other Traditional Actuarial Practices ("TAP"). However, if so used, I believe actuaries should be required to disclose the economic risk implications that such analyses do not currently reflect.

<u>Specific Comments on Questions Asked</u>

Following are specific observations on the questions set forth in the ASOP No. 27 Exposure Draft:

1. Is the language in section 3.1 of ASOP No. 27, indicating that assumptions can be based either on the actuary's estimate of future experience or on the actuary's observation of the estimates inherent in financial market data, clear? *Yes.*

Do you agree that either approach produces a reasonable assumption? *Given the guidance that assumptions can be made for different purposes, and if the approach is consistent with the purpose, then either approach could produce a reasonable assumption. As noted earlier in the letter, however, I am uncomfortable with the use of estimates of future experience (i.e. expected rates of return) unless accompanied by adequate discussion of the risks around the expected returns. Note: Discussion of risks should accompany any economic assumption choice.*

If not, what change do you suggest? *NA*

2. Section 3 clarifies that there is no explicit link between an investment return assumption and discount rate. Does this create challenges for any existing actuarial processes? *No.*

If so, please provide a description of the actuarial practice and how the new standard creates a problem. *NA*

Is the removal of the material in section 3.6.2 of the current standard, which addresses the building-block method and the cash flow matching method, appropriate? *If the ASB wishes to provide illustrations of practice within an ASOP, then it should not be removed. If the philosophy of the ASB is to set forth the ASOP and leave training elsewhere, then removal makes sense. I am indifferent but would encourage the ASB to be consistent across all ASOPs.*

Are the examples in section 3.7 of ASOP No. 27 sufficient to communicate the various purposes for which actuaries may need to choose a discount rate? *The examples are excellent, especially the apparent recognition in Section 3.7.d that pricing (as opposed to employer contribution determination and budgeting) may be better done using market-related discount rates.*

3. Do you agree that a reasonability standard is an appropriate way to set economic assumptions? *Yes.*

If not, why not? *NA*

4. Do you agree that the guidance on arithmetic and geometric returns is appropriate? *I believe the understanding of the differences should be a prerequisite for anyone claiming to practice actuarial science. That said, I believe having the guidance in the ASOP is useful, especially when non-actuaries choose to read an ASOP.*

Should the consequences of the use of geometric or arithmetic returns be disclosed? *Only at the discretion of the actuary, as he believes appropriate to the communication and in accordance with his professional judgment.*

5. Do you agree the guidance in section 3.6.3(d) regarding active investment management is appropriate? *Yes.*

6. Is the guidance in section 3.15.6 on the use of expert advice clear and sufficient? *As I read the words technically, they look fine. However, when I read the entire Section 3.15.6, I come away with a discomfort that "selection or advise must reflect the actuary's professional judgment" may look like the selection or advise is not the actuary's but the other experts, and is only being endorsed by the actuary. I would like it to be clearer that actuaries are really doing the selecting and advising, not just endorsing others.*

7. Do you agree that it may be appropriate for the actuary to include conservatism in his or her assumptions? *Yes, but this may be something that calls for a much wider-ranging discussion of risks, the primary reason for conservatism.*

Are the disclosure requirements for a conservative assumption sufficient? *I think so, but am still concerned about overall risk disclosure, where and how much.*

8. Do you agree it is appropriate to require the actuary to provide rationale for assumptions or changes in assumptions? *Yes, but not to the extent of excess or precision.*

If so, do you agree that the proposed changes represent the appropriate approach? *Yes.*

<u>Other Comments on Exposure Draft</u>

In addition to responses to the questions posed in the Exposure Draft, I would like to make the following, additional, technical comments:

- Section 1.2 references that ASOP No. 27 defers to ASOP No. 4. This may be part of a greater review and organization of the ASOPs but I would generally like to believe that ASOP No. 27 would be considered primary on any issues related to the selection of economic assumptions and keep ASOP No. 4 as a coordinating ASOP.

- Section 3.6.3.e seems to suggest that Investment Expenses must (the actual wording is "may" but no alternatives are suggested) be taken as a reduction in the investment return assumption. I currently use explicit recognition of expenses (i.e. repay Investment Expenses in the second year following incurrence, with interest) and would like to believe this practice would be permitted.

- Section 3.8.3 might benefit from adding a Subsection d. referencing consideration of issues such as extra salary increases during the final years of employment (a.k.a. "spiking") and any other issues that could impact the proper evaluation of pension obligations.

In addition, although I understand the reasoning behind the Pension Committee of the ASB choosing to issue ASOP No. 27 before completing its review of ASOP No. 4, ASOP No. 35 a potential new ASOP on risk, I believe the interrelationships to be so great that they should be addressed in a fully comprehensive way and released concurrently. In particular, I would contend that there would be benefit to delaying the issuance of each of these ASOPs dealing with pension financing until the Pension Committee and the ASB have more fully reviewed, debated and determined the implications on all pension ASOPs of the real world of financial economics, market pricing and transparent reporting.

Best Practices

I have always believed that actuaries should seek to use the best science and the best practices they can bring to bear on financial risk management problems.

This objective is supported by the goal set forth in the motto of the Society of Actuaries (i.e., "The work of science is to substitute facts for appearances and demonstrations for impressions").

Important questions have been raised about what is meant by actuarial science and the appropriateness of ASOP No. 27.

With respect to ASOP No. 27 specifically, I said in my August 1, 2008 comments that I believed the actuarial profession should seek to:

- Revise its terminology to be consistent with the financial community at large.
- Embrace the principles of financial economics and allow for the development and selection of assumptions for measuring pension obligations based on market-related language and theories.
- Require greater disclosure of risks when providing financial information.

I believe the Pension Committee has taken a significant first step towards the latter two comments and, I hope, will be able to move further over time and in conjunction with update of ASOP No. 4, ASOP No. 35 and the proposed ASOP on risk.

I also believe that the actuarial profession should revisit the Introduction to Actuarial Standards of Practice (a.k.a. ASOP No. 0). In particular, the actuarial profession and the ASB should further consider where they wish to balance the ASOPs between "generally accepted actuarial practice" and "best actuarial practice".

In general, I believe the actuarial profession should seek to move its ASOPs closer to "best practice".

Summary

Thank you again for the opportunity to comment on the ASOP No. 27 Exposure Draft on the Selection of Economic Assumptions for Measuring Pension Obligations.

Although my comments may not seem to show it, I believe the Pension Committee has made an excellent start to addressing the complex issues raised by the concepts of financial economics and its acceptance and benefit to the pension actuarial community. I hope this good work will be followed by more until ASOP No. 27 becomes fully modern and then is tailored to fit well with the other pension ASOPs.

I encourage the ASB to continue pushing the actuarial profession on the discussion of what constitutes best practice and to move as expeditiously as possible to make further revisions to ASOP No. 27 and all current actuarial practices in order to adequately incorporate the theories of financial economics into the ASOPs and the ongoing measurement of pension obligations.

To the extent traditional actuarial science cannot be defended in a real world of market values, hedging, and swaps and, likely in the future, transparent reporting, then the actuarial profession may become extinct or, possibly worse, just having its duties dictated and being limited to following the leadership of others.

I believe the Pension Committee may have postponed the arrival of the actuarial asteroid and hope it will continue its leadership to avoid that asteroid ever hitting.

Thank you.

Yours truly,

Robert C. North, Jr.
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