COMMENT 13: JULY 31, 2008

ASOP No. 27 Request for Comments
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August 1, 2008

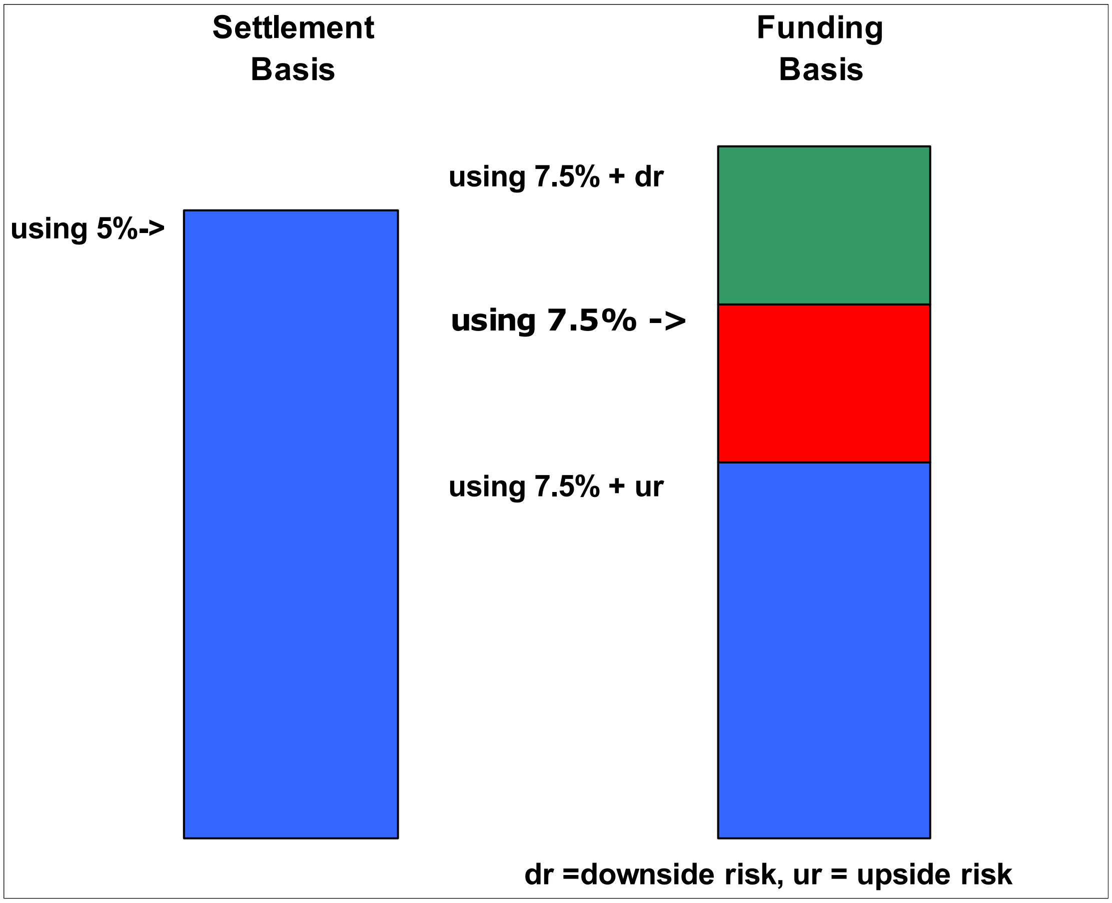
The Actuarial Standards Board has asked for comments from practicing pension actuaries concerning ASOP No. 27, *Selection of Economic Assumptions for Measuring Pension Obligations*. The underlying reason for this request, according to the Q&As accompanying this request, appears to be the question of how financial economics theory might affect current disclosure and funding practices.

1. Economic assumptions, in particular the discount rate assumption, are used for a variety of purposes; calculating actuarially equivalent benefit forms, performing relative value determinations, disclosing liabilities for accounting purposes, funding pension benefits, performing projections of pension plan solvency, etc. There are still a number of areas where a single long-term interest rate is required and this Standard provides a logical method for calculating such a long-term rate.

2. Where financial economics requires the use of a “market” interest rate, the practitioner can rely on Section 3.11 which allows for the use of prescribed assumptions when the actuary is obligated to use something other than his or her best judgment.

3. With the passage of PPA 06 prescribing the rates to use for private sector single employer plans, ASOP No. 27 will primarily be used to develop assumptions for public sector pension plans and Taft-Hartley multi-employer plans. In my opinion, the primary arguments used to apply market rates to value private sector plans do not apply in the public sector.

If the Board proceeds with its review of this or other standards to include elements of modern theory, I would encourage the focus be more on including an element of risk measurement in disclosures rather than moving 100% to a risk free disclosure rate. This can be illustrated as follows.



The bars represent measurements of a pension plan liability using different interest rate assumptions. The bar titled "Settlement Basis" represents a measure of pension plan liability using a risk-free rate of 5%. The stacked bars titled "Funding Basis" show an array of liability results for the same pension plan, measured at various interest rates. The liability measured to the top of the red bar is valued at a typical valuation assumption of 7.5%.

However, the fact that most plans choose to invest in a well diversified portfolio of assets, and in this case those assets are anticipated to return 7.5% over a long time horizon, the expected value of liabilities at 7.5% is the correct value to disclose. However there is a risk that they could return <u>more or less</u> given market sensitivities. In order to demonstrate that risk, the liability measurement can be shown with its likely distribution of values, as shown in the array of bars in the Funding Basis graph. While the measurement to the top of the red bar is the most likely measure of liability, it could fall between the two measures of risk demonstrated by the bottom of the red bar or the top of the green bar.

My understanding is that financial economists would like to mandate that plans measure and disclose liabilities in accordance with the Settlement Basis, shown above, using the risk free rate of return. I believe that since the plan is not invested at the risk free rate of return it is not logical to measure the liabilities entirely on that basis. A better disclosure of the risk in liability measurement would be to provide a range of results, similar to the Funding Basis chart, which demonstrates the amount of risk in the investments and the probable outcomes of taking that risk. Moving entirely to a risk-free rate does not adequately communicate the variability in the possible future valuation results but instead simply moves 100% to a worst-case scenario.

Another reason for maintaining the measurement of liabilities at the fixed long-term best estimate interest rate, is that it provides a means of measuring funding progress towards a plan sponsor's goals. It would be very difficult to know if the plan's funded status is improving or deteriorating if the size of the measuring stick is adjusted annually.

Another argument that I have heard financial economists make is that plan improvements have been liberally granted because the associated costs were based on an "artificially high" discount rate. Marking liabilities to a market rate of return could result in an even greater bias. For example, if pension plans had been required to disclose their liabilities at market rates during the early 1980's we would have seen "enormously overfunded" pension plans, which I am certain would have resulted in even greater benefit enhancements than those that actually occurred.

On a more global scale, I am concerned that the use of financial economics in pension plan disclosure may push more plan sponsors into investing in risk free instruments. This could have a destabilizing impact on an economy which is already showing increased volatility. As more money chases a limited number of liquid fixed income investments, their prices will be artificially bid upwards. Similarly, as pension plans divest their equity holdings it could lead to a depression of stock values. Such destabilization would cause problems during a period of transition but eventually the markets would create new methods of finance which will make stocks look more like bonds and vice versa, leaving investors very much in the same position they are now.

The July 31, 2008 Financial Times published a letter to the editor from Avinash Persuad, a professor emeritus who has had some experience with the mark-to-market movement in the U.K. While his letter is primarily concerned with the movement as it pertains to banking disclosures, many of his points are extremely relevant to the pension funding/accounting discussion. He states: "The right solution is to be found by grappling with the fundamental issue: what is the price telling us and when is that an appropriate measure of value? Current market prices tell us what an asset would be worth today. This is highly relevant to anyone who has short-term funding like overnight deposits……Where mark-to-market needlessly compounds a crisis is when we require institutions with long-term funding to apply current market prices to valuation and risk decisions….Those with long-run funding are the appropriate risk absorbers of the system. They should be able to buy assets when prices have plummeted, not because of an artificial accounting construct, but because their funding allows them to diversify appropriately and naturally across crisis and good times."

For all of the reasons cited in this piece, I would urge the Board not to revamping ASOP No. 27, in any way which mandates the use of mark-to-market liability measurements. I do however understand the need for improved disclosure of risk and I hope the ASB considers maintaining a single long term rate of return for pension liability disclosure but perhaps with the impact of investment risk included as a part of the liability disclosure.

As you deliberate on this topic I would recommend you keep these words of Oscar Wilde in mind – 'The cynic knows the price of everything and the value of nothing."

Please note that the opinions expressed herein are my own and may not reflect the opinions of others with whom I am professionally involved.