COMMENT 18: AUGUST 1, 2008

August 1, 2008

ASOP 27 Request for Comments
Actuarial Standards Board
1100 Seventeenth Street, NW, 7th Floor
Washington, DC 20036-4601

Dear ASB Members:

Attached are my comments in re ASOP 27.

As indicated in the text, I incorporate by reference the paper: *What's Wrong with ASOP 27? Bad Measures, Bad Decisions* which Larry Bader and I authored. It appears in the SOA's Pension Forum for January 2005.

The ASB Procedures Manual (page 13, item E) indicates that the Chairperson of the ASB may authorize public hearings. Factors that may lead to public hearings include (E1b) the anticipated level of controversy; and (E1c) the significance to the profession of the guidance contained in the proposed standard. I believe that these factors are present in this instance and thus urge the ASB Chair to hold such hearings. I hope that I will be offered the opportunity to testify.

Very truly yours,

Jeremy Gold

Comments on ASOP 27

Jeremy Gold

I find it difficult to comment constructively on ASOP 27 because it is both so central to pension actuarial practice and so flawed. The task is also made difficult because ASOP 27 stands in conjunction with other pension ASOPs which are not open for review at this time.

The actuarial profession has been reluctant to write ASOPs with the rigor and detail of statements promulgated by the Financial Accounting Standards Board. Although I understand that I will have an opportunity to comment on this shortcoming in conjunction with the Introduction to ASOPs, my comments on ASOP 27 are presented as if the Introduction called for more robust standards.

Over a period of at least 30 years, pension actuaries have seen their opportunities to self-govern progressively reduced as others (notably Congress, FASB and GASB) have written rules for us. Although Congress and the accounting standards writers all began by adopting traditional actuarial approaches, Congress and FASB have seen the need to step in to fix problems which we have shown little inclination to address on our own. GASB has recently begun a review of GASB 25 and GASB 27, which may also address perceived weaknesses in these standards based on traditional actuarial practice.

The best of modern pension actuarial science would fix virtually all of the problems that have, over the years, caused Congress to amend ERISA in ways that complicate actuarial practice and have discouraged sponsors of defined benefit pension plans. Congress has iteratively imposed a patchwork of fixes that Manning and Segal (2002, presentation at EA meeting) have called the "Insanity." Even though PPA was intended to be a basic and comprehensive reworking of pension funding rules, it became so responsive to political demands that it added to the Insanity. As actuaries, we could have done far better than Congress did. But we have not earned the opportunity to write our own rules and, I fear, even if we now begin to write robust modern standards, we are unlikely to recoup our long lost powers to self-govern. Perhaps quixotically, however, I think we should aspire to self-rule and should begin immediately to write the rules that might eventually persuade others to cede power to us.

How might we begin? I suggest that the core of each ASOP should prescribe (yes, I used that dirty word) what actuaries should do in the absence of rules imposed by others. In the pension arena, we might prescribe solvency standards that would apply broadly. We might define pension costs as the value of benefits currently earned rather than as a mish-mash of benefit costs, financing strategies, and amortizations of past events. I use the word "might" in each of the last two sentences because any such rules could only become standards after appropriately rigorous study and due process.

Once an ASOP has described the rules we would impose absent other impositions, the ASOP could discuss how the practice must be modified to accommodate the rules of others. As is already done, ASOPs would then deal with deviations attributable to defensible positions taken in exception to the standard. Actuaries might also be called on to comment when the impositions of others are not deemed reasonable by the practicing actuary. The deviations and comment requirements might appear in each ASOP or be generalized in one or more broadly applicable ASOPs.

I reference and thereby incorporate the paper *What's Wrong with ASOP 27? Bad Measures, Bad Decisions* (Bader-Gold, 2005) which was also referenced in the call for comments. What follows may be deemed an extension of that paper.

The most glaring failing of ASOP 27 is its equating of the "discount rate" and the "expected return on assets" (Section 3.6). This approach has been dismissed by FASB, by Congress, and by actuaries and others (economists, accountants, governments) world wide. I do not believe that it is necessary for me here to offer a precise critique. It is simply wrong to use the expected return on assets to discount liability cash flows.

ASOP 27 identifies four primary (and some ancillary) assumptions deemed to be economic: discount rate, expected return on assets, inflation, and salary scales. I would relegate the return on assets and salary scales to the ASOP section which is made necessary by the rules of others because I do not think these items are necessary components of pension cost methods. Naturally, I do not expect my view to prevail at this time. I also realize that there are some applications (e.g., budgets and managerial projections) where these elements might have a place.

I would no longer use the word "assumptions" to characterize discount and inflation rates. Rather, I would call them "observations" since they can be observed in the prices of traded instruments in the capital markets. Discount rates have a term structure and the use of that structure should be required when nominal liabilities are being discounted. When liabilities are inflation indexed, the term structure of real discount rates should be used. Liabilities that are only partly indexed (e.g., automatic cost-of-living to a maximum of 3% annually) may require actuaries to use option pricing methodologies.

For some purposes (e.g., solvency) default-free discount rates are necessary. For financial value, when the obligation may be subject to default, term structure rates should reflect the market price for comparable default risk.

Actuaries should neither be "assuming" nor "predicting" when observing and measuring are possible. The observed term structure (of, e.g., risk-free rates) is not a predictor of future rates of return. It is better understood as the price today for future cash flows expressed as an annual return -- expressed as such for historical reasons. Similarly, the difference between the yield curves for nominal and real Treasury securities is not a prediction about inflation; rather it is the market price for the exchange of a nominal promise for a real one; it is a function of the supply and demand for inflation protection.

Some of today's non-economic "assumptions" (ASOP 35) may, in coming years, become economic observations. The capital markets have begun to trade mortality securities much as they began trading inflation securities decades ago. When this market becomes more robust, it will be appropriate for the actuarial profession to recognize this event. As with the inflation example, mortality securities should not be understood as predictors of the term structure of future mortality, but rather as the price today for transferring mortality risk in market transactions; as before, supply and demand for mortality protection will drive the price.