COMMENT 21: AUGUST 1, 2008

August 1, 2008

ASOP No. 27 Request for Comments
Actuarial Standards Board
1100 Seventeenth Street, NW, 7th Floor
Washington, DC 20036-4601

Re: ASOP No. 27 Request for Comments

Dear Sirs:

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

- Introduction
- Prior Observations and Comments
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Introduction

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

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 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. As mentioned in your Request for Comments, 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 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.

General Comments

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

In particular, I have 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 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 27 Request for Comments:

1. Under ASOP No. 27, an actuary selects an economic assumption by developing a "best-estimate range" and selecting a specific point within the best-estimate range. How do actuaries comply with the ASOP? *I believe most actuaries create a best-estimate range using the building-block method as described in the Pension Practice Council Practice Note entitled Selecting and Documenting Investment Return Assumptions dated May 2001.*

What methodologies do they use to select a specific point within a "best-estimate range"? *I believe most actuaries choose the center of the range, although there may often be pressure to choose an assumption from the less-conservative end of the range.*

Is the "best-estimate range" approach the appropriate standard of practice? *Overall, no, if the actuarial profession is to take a market-oriented approach to establishing economic assumptions. In such case, there is generally one "observed" economic scenario for determining a discount rate, for example. To the extent that expected rates of return are used to develop "Budgeting Targets" to be used with Actuarial Cost Methods for creating funding patterns, and additional information on the economic risks are disclosed, the best-estimate range may be as reasonable as any.*

Does the ASOP inhibit the use of a more appropriate approach to selecting assumptions? *ASOP 27 does not make clear the acceptability of approaches other than those that develop discount rates using expected rates of return on investments.*

Are there any specific changes that should be made to the ASOP to describe appropriate practice more accurately? *I believe that my suggestions herein would require a significant rewriting of ASOP 27. That rewrite is beyond the scope of my comments at this time.*

2. Under ASOP No. 35, an actuary selects a non-economic assumption by considering the relevant "assumption universe" and selecting a specific assumption from the appropriate assumption universe. Should ASOP No. 27 incorporate the concept of an "assumption universe" with respect to economic assumptions? *No. ASOP 27 should move to separating "observed" economic information from "actuarial assumptions". In my understanding, the actuarial universe concept described in ASOP No. 35 that is generally applied to demographic assumptions that tend to be less varied, but are derived from the observed, would not work as well with economic assumptions.*

3. Currently, the selection of an economic assumption that is not within the "best-estimate range" is considered a deviation from the guidance in ASOP No. 27.
Should the ASOP permit an actuary to select an economic assumption that lies outside the best-estimate range (for example, to include a margin for conservatism, or to calculate a range of values instead of a single measurement of plan obligations)? *I believe the current Deviation Standard is adequate.*

If so, what specific guidance should ASOP No. 27 provide with respect to the selection of such economic assumptions? *NA.*

4. Currently, the guidance in ASOP No. 27 does not include the asset valuation method or the difference between the market value and actuarial value of a plan's assets among the considerations in selecting an investment return assumption. Is it appropriate for an actuary to consider either of those factors when selecting an investment return assumption? *If an "actuarial assumption" is being established without directly "observing" market information, yes. If the Actuarial Asset Value deviates significantly from the Market Value, then this should be considered when establishing the "actuarial assumption" since the rate of return expected depends upon the future value and the starting value.*

Should the ASOP advise actuaries to consider those factors? *It should not be necessary, but yes.*

5. Have there been any specific changes in actuarial science or practice since the original adoption of ASOP No. 27 that conflict with the guidance in the ASOP? *The principles of financial economics are generally at odds with the primary concept of ASOP 27 that the discount rate should be based on the expected rate of return on investments.*

Should the ASOP accommodate any such practices? *Yes, ASOP 27 should accommodate the principles of financial economics.*

If so, what specific guidance should ASOP No. 27 provide with respect to such practices? *See General Comments section.*

6. Comments received by the ASB in response to an exposure draft of ASOP No. 4 supported the idea that pension standards should accommodate actuarial practice that incorporates the concepts of financial economics as well as traditional actuarial practice. Does the application of financial economics to the selection of economic assumptions conflict with the guidance in ASOP No. 27, and if so, in what specific ways does it conflict? *With respect to the overall thrust of ASOP 27 as currently written, yes, ASOP 27 appears to conflict. ASOP 27 builds discount rates from expected rates of return on investments. Financial economics uses observed interest rates to determine the value of cash flows.*

Should ASOP No. 27 provide specific guidance with respect to financial economics and, if so, what should that guidance be? *Yes, ASOP 27 should permit and even prefer the concepts of financial economics. ASOP 27 should also require the recognition of risk, particularly when non-financial economics assumptions are used.*

7. Is there a need for guidance concerning the selection of economic assumptions for purposes other than measuring pension obligations (for example, for measuring pension risk)? *Yes.*

If so, in which specific areas is guidance needed? *Expected rates of return on investments should not be permitted to be used as discount rates without full disclosure of the measurement issues and risks involved.*

Should any such guidance be provided in ASOP No. 27 or in a separate ASOP? *Preferably, such guidance should be in ASOP 27. If not, ASOP 27 should be retained but limited in its application to just "budgeting issues" and require discussion and disclosure of risks. The requirements of a new ASOP, embracing the principles of financial economics, should then be given preference.*

What specific guidance, if any, should ASOP No. 27 provide with respect to such practices? *ASOP 27, as noted in the General Comments, should be revised with respect to terminology, preference for economics-based concepts and requirements for risk identification and disclosure.*

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 the actuarial science and appropriateness of ASOP 27.

I believe that the actuarial profession would do well to place a hold on the issuance of additional ASOPs dealing with pension financing until it has reviewed, debated and determined the implications on all pension ASOPs of the real world of financial economics, market pricing and transparent reporting.

I also believe that the actuarial profession should spend some additional time on its upcoming discussion on the Introduction to Actuarial Standards of Practice (a.k.a. ASOP 0). In particular, to actuarial profession and the ASB should decide where it wishes to balance the ASOPs between "generally accepted actuarial practice" and "best actuarial practice".

Summary Comments

Thank you again for the opportunity to comment on ASOP 27 on the Selection of Economic Assumptions for Measuring Pension Obligations.

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

With respect to ASOP 27 specifically, I believe the actuarial profession should:

- 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 encourage the ASB to push the actuarial profession to have a serious, soul-searching, zero-based, no-sacred-cows-protected discussion of whether revisions should be made to ASOP 27 and all current actuarial practices and ASOPs with respect to the measurement of pension obligations.

If the existing 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.

Thank you.

Yours truly,

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