AMERICAN ACADEMY of ACTUARIES

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

Dear ASB Members:

The American Academy of Actuaries[1] Pension Committee appreciates the opportunity to comment on ASOP 27. There are several areas we feel need to be refined since ASOP 27 was initially issued. While we understand that revising an ASOP is a long process, we hope that the four areas listed below receive strong consideration when the ASB discusses ASOP 27 revisions.

Best Estimate Range – Potential Improvements to the Standard

By discussing a range, the current ASOP acknowledges that reasonable people will have differing opinions on future inflation, investment returns, salary growth, etc. Room for disagreement among professionals should be retained.

A range also communicates that the future is unknown. For example, one actuary may believe future inflation will be 2.5 percent per annum while another believes 3.0 percent per annum is a better assumption. Neither actuary knows future inflation with certainty, but both could be shown to be reasonable long-term assumptions.

The definition of the "best-estimate range" in ASOP 27 seems to communicate something beyond the prior two points. The standard states that an actuary's best-estimate assumption is generally represented by a *range* rather than one specific assumption. This statement does not integrate well with actual practice. When an actuary is called upon to make an economic assumption, the actuary generally needs to produce a specific number and not a range. By stating that the best-estimate range includes all points in which the actual results are more likely to fall than not, the standard legitimizes any point in the range. The standard seems to be telling the actuary who needs to make a specific assumption that any rate in the range is equally appropriate.

We believe that the standard should focus the actuary's attention toward developing an assumption based on fundamental analysis and away from defining a range from which any point is defensible. If the ASB did not intend the best-estimate range to be thus interpreted, the standard should re-communicate the concept. Alternatively, the standard could drop the best-estimate range entirely, or reword it as the range in which an actuary

[1] The American Academy of Actuaries is a 16,000-member professional association whose mission is to assist public policymakers by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

doesn't have to caveat his or her report as misleading if a principal chooses a value in that range.

With regard to estimating future investment returns, it is appropriate to focus the actuary's attention on the current economic environment more than historical results. While Sec. 3.13 of ASOP 27 does point out that some historical data may not be applicable due to changes in the economic environment, this message could be better developed and more highly emphasized.

Applying the reasonableness standard in Sec. 3.3.5 of ASOP 35 to the setting of economic assumptions could be helpful. It would be preferable for actuaries to support their assumptions with arguments as to whether they are achievable and sustainable over time given the underlying economics related to equity returns, rather than simply pointing to the distribution of historic equity returns and choosing returns at certain intervals.

The committee's sense is that most actuaries do not believe it is reasonable to simply take historical statistics and apply them as a basis for future estimates without a fundamental analysis that results in either an adjustment to these results or assurance of their continued appropriateness. Economic assumptions must incorporate reasonable estimates for economic growth and other critical economic factors that align with current economic conditions and a viable future outlook. Differences in current economic conditions versus those which existed at the start of historical periods must be considered and taken into account. In other words, the future is not certain to reproduce the past.

Investment Return and Discount Rate

Sec. 3.6 of ASOP 27 states:

> *The investment return assumption reflects anticipated returns on the plan's current and future assets. The discount rate is used to determine the present value of expected future plan payments.* ***Generally, the appropriate discount rate is the same as the investment return assumption.*** [emphasis added]. *But for some purposes, such as SFAS No. 87 or unfunded plan valuations, the discount rate may be selected independently of the plan's investment return assumption, if any. In such cases, the discount rate reflects anticipated returns on a hypothetical asset portfolio, rather than on the plan's expected investments.*

Since ASOP 27 was first published in 1996, there have been considerable developments in actuarial practice around the determination of pension liabilities and the determination of a discount rate. For example, current IRS funding rules for qualified, single-employer pension plans have divorced the discount rate from the expected asset return. Also, financial economic theory argues that the discount rate for certain liability measurements should be separate from the expected return on any assets that collateralize the liability.

Discount rates behind common calculations of pension obligations for corporate plan funding and accounting are primarily interest rates observable in the financial markets today. The nature of an interest rate that is observable in the financial markets is fundamentally different from an actuarial assumption about an unknown future contingency. The ASB may want to provide separate guidance on choosing an investment return assumption and a discount rate. Such a requirement would not preclude the two values being the same, but would presumably require the actuary to take into account the purpose of the measurement; to state that the discount rate was chosen to reflect a long-term investment assumption; and to provide appropriate documentation supporting the choice.

<u>Disclosure</u>

Asset-liability modeling studies typically examine actuarial results based on a wide range of assumed investment performance, not just those within a "best-estimate range." The standard should permit actuaries to provide the results of those projections, with appropriate disclosure of the purpose of the study, as well as underlying mean returns and standard deviations by asset class, without being subject to a deviation disclosure.

As stated earlier, financial economic theory suggests that fixed income rates are appropriate discount rates for determining pension liabilities, regardless of any assets held in trust to collateralize those liabilities. These rates can range from “risk-free” rates to rates on debt with significant credit risk. The standard should permit actuaries to use discount rates defined by financial economic theory if that approach is appropriately disclosed by the actuary, without being subject to a deviation disclosure because they fall outside a best-estimate range.

Finally, ASB should consider expanding the disclosure requirements in ASOP 27 to include a rationale for the chosen economic assumption. FASB pension disclosures currently require commentary that supports the pension asset-return assumption. Something similar in ASOP 27 would promote transparency with regard to the economic assumptions, and perhaps act as a spur to further development of the thought processes used in determining them.

We thank you for this opportunity to share our thoughts on needed revisions to ASOP 27. Should you have any specific questions or would like more information, please contact the American Academy of Actuaries’ pension policy analyst, at 202-223-8196. Thank you for your consideration of this matter.

Sincerely,

James F. Verlautz, FSA, EA, MAAA, FCA
Chair, Pension Committee
American Academy of Actuaries