COMMENT #4 – July 25, 2008

From: Tom Cavanaugh [mailto:TomC@cavmacconsulting.com] **Sent:** Friday, July 25, 2008 2:08 PM **To:** ASB Comments **Subject:** ASOP 27 Review

I am writing on behalf of my organization in response to the ASB's request for comments regarding Actuarial Standards of Practice No. 27.

Before addressing specific questions raised in the March 27th request for comments, we would like to note that our collective 100+ years of pension work have been almost exclusively with state and local government pension plans, and therefore our specific comments cannot help but be informed by that experience. We recognize there is considerable discussion and debate in the actuarial community today regarding the economic assumptions to use for public pension plans, and, as we are sure the ASB is aware, there is a current project being undertaken by the AAA's Public Interest Committee to address whether or not the AAA should take a stance on the applicability of financial economic techniques to public pension plans. Therefore we would simply offer that a review of ASOP 27, which must include and is probably driven by financial economics issues, may be a bit premature. It certainly would be confusing to the users of our services (and not a few actuaries as well) if the ASB and the AAA were to come to different conclusions on this very important topic.

That said, we offer the following responses to the specific questions raised in the 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? What*

methodologies do they use to select a specific point within a "best-estimate range"? Is the "best-estimate range" approach the appropriate standard of practice? Does the ASOP inhibit the use of a more appropriate approach to selecting assumptions? Are there any specific changes that should be made to the ASOP to describe appropriate practice more accurately?

We have utilized the building block approach in developing the best-estimate range and selecting the interest rate assumption to use in actuarial valuations. We believe the best estimate range is the appropriate standard of practice, but would welcome guidance on additional disclosure that enhances a client's understanding of what the single point within the best estimate range represents, and demonstrates the variability of results based on other points within the range.

2. *Under ASOP No. 35, an actuary selects a noneconomic 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?*

Unlike non-economic assumptions which tend more to be reflective of prior plan experience, economic assumptions should be based on future long-term expectations rather than past results. In addition, the interest rate assumption is dependent on the investment policy of the plan sponsor, particularly the plan's asset allocation, which does change as the plan's risk tolerance changes. Non-economic assumptions have no parallel.

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

Selections outside the best estimate range should be permitted as long as they are accompanied by a detailed explanation of the actuary's reasoning for the selection (or range of values selected).

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? Should the ASOP advise actuaries to consider those factors?*

No. Current smoothing techniques are meant to recognize market returns over reasonably long periods of time so as to capture the underlying growth in the value of investments held while avoiding the disruptions caused by very short term market fluctuations. The assumed investment return should reflect expected market returns of the plan's assets.

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? Should the ASOP accommodate any such practices? If so, what specific guidance should ASOP No. 27 provide with respect to such practices?*

To us, this question is aimed at financial economics. We do not believe the ASOP should accommodate a branch of economics which many public sector practitioners believe is not applicable to public sector pension plans.

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? Should ASOP No. 27 provide specific guidance with respect to financial economics and, if so, what should that guidance be?*

See response to #5.

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)? If so, in which specific areas is guidance needed? Should any such guidance be provided in ASOP No. 27 or in a separate ASOP? What specific guidance, if any, should ASOP No. 27 provide with respect to such practices?*

The measurement of pension obligations inherently reflects a certain level of risk. Guidance on the appropriate manner to communicate this risk to plan sponsors could be helpful by encouraging calculations of reasonable ranges of results for contribution levels and funding ratios.

8. *Are the disclosure requirements of ASOP No. 27 appropriate? Are there any specific disclosures that*

should be added to or removed from the ASOP? Is there additional information concerning economic assumptions that would be useful to another actuary who takes over or reviews a plan or to other users of an actuarial report?

The current disclosure requirements do not need to be amended.

9. Are there any other areas of concern with respect to ASOP No. 27?

No.

10. How might any of your comments apply to ASOP No. 35? Are there similar issues that apply to both ASOPs? Should the ASB review ASOP No. 35 at the same time it reviews ASOP No. 27?

In a similar vein to the answer to question #2, we think the approach to setting economic assumptions should be different than that used for non-economic assumptions. As a result we believe they should be tackled separately.

Tom

Tom Cavanaugh
Chief Executive Officer
Cavanaugh Macdonald Consulting, LLC
3550 Busbee Parkway, Suite 250
Kennesaw, GA 30144
direct 678 388-1708
cell 516 220-9896
fax 678 388-1730
TomC@CavMacConsulting.com
www.CavMacConsulting.com

CONFIDENTIALITY NOTICE

This e-mail, including attachments, is intended only for the use of the individual or entity to which it is addressed and may contain confidential information that is legally privileged and exempt from disclosure under applicable law. If the reader of this message is not the intended recipient, you are notified that any review, use, disclosure, distribution or copying of this communication is strictly prohibited. If you have received this communication in error, please contact the sender by reply e-mail and destroy all copies of the original message.