COMMENT 20: AUGUST 1, 2008

Memo to ASOP No. 27 Request for Comments

Actuarial Standards Board
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Sent via email on August 1, 2008 to comments@actuary.org

Introduction:

Public and multi-employer plans may be the only pension DB plans remaining that are still able to use the actuary's recommendations in assisting a pension plan sponsor with budgeting and funding issues. Corporate finance issues and federal regulations have effectively eliminated the use of any independent actuarial determinations with respect to the investment return / discount assumption for those plans.

While the changes in the corporate pension plans may require modifying the existing ASOP 27 regarding the discount rate, such need or necessity does not exist for these other plans. The debate regarding the application or appropriateness of the recent financial economics approach for at least the public plans is ongoing and has not been resolved. Bill Bluhm, President of the American Academy of Actuaries was recently quoted in a July 21, 2008 *Pension and Investments* article saying that "the discussion has been both internal and external to the Academy, and is still under way." In fact, the Academy just last week issued notice that it will hold a public forum on the disclosure of the market value of assets and liabilities in public pension plans on September 4, 2008. While this is an ongoing and unresolved issue within the profession, we do not think it appropriate for the ASB to make a determination regarding the use or application of financial economic issues to public plans.

The point of these comments is to express some opinions and also include comments on some of the differences between public and private pension plans to the ASB as they consider any changes to the existing standards.

Question 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?*

- In the early 1990's, many actuaries used the building block approach and may have reduced the result for "risk premium" from the pure mathematical additive measures based on the plan's current asset allocation. However, the same building block approach can lead to incorrect expected long-term annualized returns. Using arithmetic averages rather than geometric averages is one problem. Another is not recognizing the impact that re-balancing a portfolio will have on the expected returns.
- Recently, there has been movement to a more stochastic approach such as that based on the paper from *The Long-Term Expected Rate of Return: Setting It Right* by Olivier de La Grandville, *Financial Analysts Journal,* Nov/Dec 1998. Some consulting firms use this methodology as the firm's basis for setting the investment return assumption under the

current ASOP 27 provisions for “best estimate”. This then determines the 25-75 percentiles range since the results are expected to be inside the range at least as often as outside of it.

- We agree that the full 50% range is rather broad and that an appropriate point within the range should generally be closer to the median based on the risk parameters accepted by the sponsor.
- How to narrow the range may be difficult to set as a standard, but disclosing the range at least educates the clients and plans of the volatile nature of picking a single discount rate assumption.
- Rather than describe how to pick a single rate within the range, the ASB may better serve the profession and the public by looking into how to better disclose the nature of the volatility of the assumption.

▪ Public plans usually go through very extensive investigation of experience analysis every 3-5 years. This process focuses a lot of attention and study on the process of setting both economic and demographic assumptions for these plans. Thus, the actuary and the client allocate a fairly reasonable amount of time and effort on evaluating the assumptions which may not always occur with other types of plans. This makes the use of a stochastic approach not only more common but practical and acceptable for larger public plans.

▪ The question posed above: “Does the ASOP inhibit the use of a more appropriate approach?” implies that the current approach may be inappropriate. It goes on to ask if there are specific changes that should be made to describe appropriate practice more accurately. This is a leading question – financial economics assumes there is only one valid approach and it should apply to all pension plans. As stated above this issue is still being debated. Thus, the Standards should not attempt to mandate what is appropriate or not appropriate until the purpose of the measurement is understood.

- When considering funding future pension benefits, the economic assumptions need to include not only the expected benefit payments in the future – including both additional service credits and salary increases for salary based plans – but also the expected investment income to be received. Thus the actuary’s role is to assist in this forecasting effort. The forecast should best reflect the nature of the items being projected. For almost all public plans, their asset allocations for current assets include a balanced portfolio of assets including those that are not risk free assets. The higher returns associated with the higher risk assets make up an important part of the expected income or assumed earnings to be used to fund future benefit payments.
- Within the public sector the benefit obligations are generally protected by statute and other legal requirements such that the reduction in any past or **future** benefit accruals cannot occur. Thus, the real benefit obligation cannot be truly represented by a benefit based only on current salary and service.
- Also very common within the public sector, is the expectation of future cost-of-living adjustments on benefit payments. To attempt to evaluate these future benefit increases on only a portion of the ultimate benefit would again be misleading as to the true nature of the benefit obligation.

Question 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?*

- This question raises the issue of the "assumption universe", as in ASOP 35. ASOP 35 is usually based on the plan's own experience. Thus, the assumption universe for setting an economic assumption should reflect the expected long-term plan experience given its past investment practices or expected changes in the investment practices. If a plan has achieved or expects to achieve investment returns in excess of a risk free rate of return due to its asset allocation in the future, then that higher rate most appropriately should be included in the assumption universe for purposes of measuring the benefit obligations as currently required under ASOP 27.
- If the purpose of the measurement is something that does not fit the current ASOP 27 requirement, then Section 3.6.3(a) permits a different investment return assumption if it is to measure the obligations on something other than an ongoing basis. The reference to an ongoing basis for a pension plan should reflect the expected portfolio of the assets invested to pay for the benefits and reflect both a longer time horizon and a diversified investment portfolio. If the purpose is other than for an ongoing basis of a pension plan, then the current ASOP permits alternative measurements.

Question 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?*

Again, this points to the purpose of the calculation. Additional calculations used to disclose the volatility or risk associated with the single selected point within the best estimate range, or even outside of it, should be permitted for educational and informational purposes. However, since the funding and disclosure purposes require a single assumption, that assumption should remain within the best estimate range and represent a reasonable point as determined by the actuary to be appropriate to the purpose of the calculation.

Question 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?*

We do not believe that the asset valuation method has a direct impact on the appropriate investment return assumption. Nor would the magnitude of any difference between the market value and the actuarial value have an impact on the expected investment returns. The current purpose of selecting the investment return assumption is to forecast the expected revenue stream to assist in making the benefit payments. The market value of the assets can be volatile. The actual difference between market value and actuarial value, at any point in time or over a period of time, should not be a factor in the selection of the investment return assumption. However, it could be a factor in selecting the asset valuation method.

Question 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?*

- The current ASOP provides that the purpose of the ASOP is to select economic assumptions for measuring the obligations of defined benefit pension plans. One key general consideration is the purpose and nature of the measurement.
  - New financial economic theories provide measurements which are being promulgated, at least initially, for purposes other than for funding and budgeting. They are capital market measurements which have a great deal of application for the corporate finance model but do not fit the funding models for public plans.
  - In the January 2005 *Pension Forum* article by Bader and Gold, referred to in the ASB request for comments, they discuss several issues that go beyond just the investment discount rate to support their premise that financial economic values are relevant to public pension plans. However, they would have us ignore future benefit accruals and future salary increases for benefits that cannot be terminated, sold or otherwise transferred to another entity. In addition, they make the statement that "employer budgeting is an all-but-forgotten piece of pension actuarial science." However, within the public pension plan universe the budget of costs over different generations of taxpayers is the primary reason for performing an actuarial valuation. It is also one of the key financial values that goes into setting a municipal bond rating when evaluating a public entity. There are many issues related to the financial economic theories that go beyond setting an investment rate of return or a discount rate. The discussion continues as mentioned above and the ASB should allow such discussion to continue before revising a standard that already permits different measurements to be evaluated.
  - It is this divergence of the purpose of the measurement of the obligations that needs to be addressed by the ASB.
  - It is not within the ASB's position to mandate how a plan is funded or its financial status disclosed. Those responsibilities lay with the plan sponsor and the accounting profession.
  - Thus, what is needed is a way for different calculations to be accepted under the ASOP if there are indeed different purposes and goals to be accomplished.
- We believe this question is directed at the recent emergence of the financial economic discussions. This may be a change in actuarial science but practice has not changed for those plans that are not under proscribed regulations to do otherwise. There should be room within the standards to accept changes in theories. However, changes in practice do not necessarily follow changes in theories, unless they have either been mandated outside of the profession or have become generally accepted as a reasonable measure within the profession. Also, there could be acceptable differences within the profession as to what is reasonable based on different purposes. The purposes of the measurements should be clearly communicated in the actuarial statements.

Question 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?*

Comments above reflect some issues surrounding the financial economics issues. We believe the current standards would allow for the financial economics practice as long as its purpose is communicated. It is a capital market measurement based on the theory of financial economics and assumes a risk free investment return rate not necessarily related to the plan's current asset portfolio. This risk free rate may be considered by some to be in conflict with the current standard to reflect the expected investment returns based on the pension plan's current portfolio for an ongoing plan. An ongoing plan uses a longer time horizon (and projects the service and salary components of the benefit obligations) and usually a diversified investment portfolio. Even corporate plans may not change their portfolios to risk free assets even with the new proscribed standards for termination or settlement-type liability disclosures.

The current standard may need to allow for the new financial economics theories more explicitly rather than implicitly or by using Section 3.6.3 (a) where the purpose of a termination or settlement liability calculation is clearly permitted.

While we do not object if the ASOP permitted the disclosure the financial economic value of benefit obligations, we do not believe it is the position of the ASB to require or recommend such disclosure. If the ASB were to <u>require</u> all actuaries to disclose a financial economic approach to all measurements of pension obligations, the result would be a dramatic change for the public and multi-employer plans.

We respectfully ask the ASB to allow the discussion to continue with its current debate and to avoid taking on the responsibility of making a decision that could lead to inappropriate disclosures for public plans and a negative backlash to the profession. It is one thing to permit different approaches but it is another to require a new approach before it is generally accepted as appropriate for all situations.

Question 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?*

We believe any standards regarding the disclosures of risk are best suited in a separate ASOP to be developed by the ASB in the future. Note that there is risk in all kinds of actuarial assumptions. It may be easier to measure risk in the investment return assumption and it may be more volatile than other economic or demographic assumptions but any discussion of risk should consider all assumptions not just one isolated assumption.

Question 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?*

As discussed above, a new ASOP regarding measurement of risk may be needed in a separate ASOP. The current ASOP provides guidance on selecting economic assumptions for ongoing pension plans and still permits additional assumptions for purposes other than for funding or budgeting. A financial economic disclosure should be optional until otherwise mandated by an outside entity.

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

None that are not already discussed.

Question10: *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?*

It would appear that the questions are being driven by the new financial economic theory and all questions posed imply this is the underlying concern. Since that issue only focuses on the investment return/discount assumption, none of the assumptions covered by ASOP 35 are impacted. However, as noted above, risk is associated with demographic assumptions and if the ASB wishes to create an ASOP on disclosing risk, then both economic and demographic assumptions should be covered.

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