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Via Email

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

Subject: Request for Comments – Actuarial Standard of Practice (ASOP) No. 27

Mercer is pleased to provide our response to the ASOP 27 request for comments. These comments were prepared by Mercer's Actuarial Resource Network, a group of senior actuaries in the Retirement Practice area representing all of the U.S. geographic areas in which Mercer operates.

We would like to thank the Actuarial Standards Board (ASB) for their efforts in this important area. We have the following comments in response to your questions:

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?

Response: In practice, the principal may have as much expertise in selecting certain economic assumptions as the actuary and may also have ultimate responsibility for selection of assumptions (e.g., FAS calculations). In those situations, the actuary will often develop a best-estimate range, and agree that any assumption within that range is not unreasonable. The principal then selects the assumptions. The ASOP needs to explicitly recognize this process by describing the difference between the actuary advising on the assumption as described above (the actuary would still retain responsibility for making sure any results were not misleading) and the actuary selecting the assumption.

However, the term “best-estimate range” may be misleading. Not all assumptions within the “best-estimate range” would necessarily be considered equally likely by the actuary. Better



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nomenclature might be “reasonable range”, with “best estimate” being reserved for the single assumption within that range that the actuary would select. We believe the public would better understand that terminology, and it would also better lend itself to distinguishing between an actuary’s description of a client’s assumption as “not unreasonable” versus the actuary’s certification that a given assumption is the actuary’s best estimate.

The ASOP should also clarify that an economic assumption could still be considered “best estimate” even if it does not incorporate small changes in the results of formulaic or mathematical processes from year to year. For example, if a given process produces a 7.25% discount rate in one year, and the same process produces a 7.21% discount rate in the next year, changing the discount rate assumption may imply that the results of the calculation are more precise than the approximate nature of the calculation would allow.

Along similar lines, the ASOP should also clarify that the use of rounding conventions is within acceptable actuarial practice, as long as that rounding does not distort the final results.

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?

Response: We believe that the assumption universe concept could cause confusion when applied to economic assumptions.. Economic assumptions are values that tend to be part of a continuous function, while demographic assumptions choices tend to be discrete (e.g., a given table). One could consider an economic assumption universe to be a bounded range, but we are not sure how that would differ from the best-estimate or reasonable range.

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?

Response: Yes, the ASOP should permit the use of assumptions that are outside the reasonable range, as long as the actuary discloses the numerical effect of doing so and the rationale for doing so.



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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?

Response: Yes, the ASOP should advise actuaries to consider those factors. However, more specific guidance as to how those factors are to be considered is probably too complicated and therefore inappropriate for the ASOP, at least at this time.

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?

Response: As noted in the following question, the model informally known as financial economics has received widespread publicity. We believe that financial economics and the "traditional" model are both tools, and thus both have appropriate uses. We also believe that ASOP 27 must make it clear that either model may be appropriate, depending on the situation. On a different note, we believe the ASOP must emphasize the use of reasoned judgment, rather than mechanical processes, and discourage the over-reliance on past experience. Also, as noted below, we believe that the ASOP should suggest that actuaries using either model include in their results a description, either qualitative or quantitative, of the risk inherent in the calculation results.

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?

Response: Certain aspects of ASOP No. 27 are consistent with financial economics and other aspects conflict. ASOP No. 27 should be clarified to address this, making sure to incorporate the concepts of financial economics as well as traditional actuarial practice.

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Section 3.3 is generally consistent with financial economics as it says:

“The actuary should consider the following factors when identifying which types of economic assumptions to use for a specific measurement and when selecting those assumptions that will be used:... the characteristics of the obligation to be measured (measurement period, pattern of plan payments over time, open/closed group, materiality, volatility, etc.)...”

Financial economists could interpret this statement as saying that since the characteristics of pension obligations are typically bond-like, the discount rate should usually be based on yields on bonds with similar features to the pension obligation (pattern of payments over time, likelihood of pension payments being made and credit quality of the debt, etc.). This viewpoint is articulated explicitly in the *Pension Actuary's Guide to Financial Economics* in the following quote:

“Thus, pension finance suggests the market liability of a pension plan should be determined by looking at how the financial markets price similar cash flows. Cash flows from bonds may be closely matched to pension payments, and thus, financial economics looks to the discount rates inherent in the debt markets to determine pension liability market values. It is important to note that, from this perspective, the determination of a market liability is not based upon the expected investment return of assets held in trust.”

Although the material noted above could be viewed as supporting the notion that ASOP No. 27 is not in conflict with financial economics, a different conclusion could be reached by reading Section 3.6 of ASOP No. 27. It says that “Generally, the appropriate discount rate is the same as the investment return assumption.” ASOP No. 27 further goes on to provide significantly more discussion of selection of the investment return assumption than the discount rate, which could be considered further evidence of the implied relative importance of these assumptions. This appears to conflict with financial economics, which argues that the appropriate discount rate for the liabilities is based on the characteristics of the obligation to be measured rather than the on the investment return of the assets supporting the obligation.

ASOP No. 27 should be revised to minimize direct conflict with financial economics. Although there is not universal support within the actuarial profession for the application of many principles of financial economics to actuarial practice, there is enough support so that ASOP No. 27 should be clarified to avoid the perception that using financial economic principles is a deviation from the standard.



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The discount rate is one of the most significant economic assumptions for measuring pension obligations. ASOP No. 27 should be revised to focus emphasis on the general concepts discussed in Section 3.3, and include more neutral guidance regarding the purpose and context of the pension measurement and whether the appropriate discount rate should be the same as the investment return assumption or based on the financial economic principle of focusing primarily on the characteristics of the obligation.

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?

Response: The entire concept of measuring and understanding risk needs much more exposure within the pension actuarial profession. Practice has not yet sufficiently evolved, nor have principals' needs been sufficiently defined, to be able to produce meaningful standards on this topic. Rather, providing education to actuaries should be the focus at this time. The question of whether there should be one standard or two will depend on the guidance. Ideally, actuaries should be discouraged from emphasizing single-point estimates in favor of the use of ranges that will help identify and quantify risk. We recognize that the needs of the principals may force a continued use of point estimates, but that should not preclude also providing ranges. Indeed, encouraging the use of ranges may help disabuse users of actuaries' work of the notion that actuaries are responsible for predicting the future.

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?

Response: Disclosures should include both the assumption itself and the supporting rationale for choosing that assumption. This is consistent with the focus on judgment rather than mechanical processes for selecting assumptions, and follows the expectations of at least some of our intended audience (auditors). It is also consistent with the ASOP 41 requirements to provide "sufficient information ... so that another actuary could form an objective opinion as to the reasonableness of the assumption". Providing supporting

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rationales gives the report credibility and integrity and enhances the professionalism of the product.

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

Response: No comment.

Question 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?

Response: In general, we view ASOP No. 35 as a better model stylistically for a standard than ASOP No. 27 as it focuses on the process and factors by which an assumption is derived. Thus, we agree that ASOP No. 27 is more urgently in need of improvement and that it should receive the lion's share of the focus and emphasis. However, changes in practice with regard to demographic standards are evolving, and some of the expansion of ASOP No. 27 to acknowledge various models may be eventually be appropriate for ASOP No. 35 as well. (The major improvement we would make to ASOP No. 35 would be to increase the clarity around the importance of reflecting potential mortality improvement as an important consideration in assumption selection.)

We appreciate your consideration of these comments.

Sincerely,

A handwritten signature in black ink that reads 'Ethan E. Kra'.

Ethan E. Kra, FSA, EA
Worldwide Partner

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