

May 12, 2011

ASOP No. 27 Revision
Actuarial Standards Board (ASB)
1850 M Street, Suite 300
Washington, DC 20036-4601
comments@actuary.org

RE: Proposed Revision of Actuarial Standard of Practice (ASOP) No. 27

To Whom It May Concern:

Thank you for offering us this opportunity to respond to the Exposure Draft (ED) of ASOP No. 27 on selecting economic assumptions for measuring pension obligations. The Pension Finance Task Force (PFTF), a joint initiative of the Society of Actuaries and the American Academy of Actuaries, is charged with bringing the lessons of the financial economics field into common use by actuaries. The subject matter of the Exposure Draft is of great interest to us.

We were particularly pleased to read the following on page vii:

“Discount Rate and Investment Return Link Broken... In some situations, the actuary might use an investment return assumption as a discount rate, but in other situations the actuary might use other estimates or observations, such as a particular quality bond yield curve as a discount rate....different end-users may have different measurement purposes.... An actuary may need to measure a pension obligation on more than one basis.”

This is a decided improvement over the current version of ASOP 27 which appears to prohibit the use of market-consistent economic assumptions unless required by law or regulation. Our task force believes, to the contrary, that market-consistent assumptions are often the only valid approach for pricing¹ liabilities. Our comments reflect that point of view.

Our comments address the following: (1) the need to separate the selection of market-consistent assumptions² from other types of assumptions; and (2) a need for further guidance on (a) when different types of assumptions are appropriate and how market-consistent assumptions might be constructed, and (b) additional disclosures that may be appropriate when non-market-consistent assumptions are used. We hope to address some of these matters in greater detail in our comments on the proposed revision to ASOP 4.

1) Market-consistent assumptions, or observations, should be discussed separately from the discussion of budgetable assumptions

- a) The overall thrust of the ED remains what it is in the current ASOP 27, the setting of assumptions for a traditional actuarial valuation where stability of contributions or costs is a major determinant. These latter assumptions we refer to as *budgetable* assumptions. Setting market-consistent assumptions and setting budgetable assumptions are two entirely different processes, addressing

¹ Economics draws a clear distinction between “value” and “price.” Market participants may value assets and liabilities differently, a difference of opinion that facilitates trades among market participants. In deep and liquid markets, trades are made at “equilibrium” prices that are driven by supply and demand for the asset or liability.

² Market consistency extends to assumptions not usually thought of as economic assumptions. For example, there may soon be an active market in longevity bonds thereby providing market prices for the mortality assumption.

different parties for different purposes.

- i) *Market-consistent* assumptions are assumptions that reflect the price of market instruments (e.g., bonds) that are tradable in deep and liquid markets, and whose risk profiles are comparable to the risk profile of the liability, or some aspect of the liability, being measured (e.g., the cash flows of the pension obligation). Market-consistent assumptions are most often used to estimate the market price of a pension commitment, to assess compensation cost and to measure funding progress. Less frequently, they are used to determine contributions.

Budgetable assumptions is our term for what the ED refers to as “reasonable” assumptions, or assumptions that are not anticipated to produce significant cumulative gains or losses over the measurement period (Paragraph 3.1). We interpret that definition to mean that budgetable assumptions represent the actuary’s best estimate of future experience. Budgetable assumptions are typically used to derive a contribution stream that reflects asset growth expectations, but they are sometimes used for purposes of financial reporting and for other purposes. These are the assumptions actuaries often incorporate into their funding strategies.

- b) An actuary who wishes to set market-consistent assumptions must address a number of issues not mentioned in the ED. For example, merely to set a market-consistent discount rate, the actuary might need to address:

- How to set discount rates when there is no deep and liquid market in securities whose cash flows match the cash flows of the liabilities;
- Whether perceived anomalies in the markets justify a departure from using the discount rates implicit in marketable securities;
- How to extend a yield curve to time periods where no securities are being traded;
- Whether swaps, Treasury bonds or some other securities are most appropriate for setting a yield curve; and
- How to value embedded options.

It should be noted that, despite these and other considerations, the range of market-consistent assumptions chosen by actuaries has been narrow relative to the ranges we have seen for budgetable assumptions.

- c) Section 3, Analysis of Issues and Recommended Practices, is the heart of the ED. Section 3.1 echoes the earlier quotation from page vii when it states “An assumption based on market observations is reasonable if it fairly reflects current financial market data.” An actuary selecting market-consistent assumptions will indeed wish to see consistency among the chosen assumptions, but consistency will be in terms of market prices at the date of valuation. The remainder of Section 3, by conflating the selection of budgetable and market-consistent assumptions, confuses the issue. Section 3.7, in particular, conflates the selection of a budgeting assumption (expected return on assets) with a market-consistent discount rate.

We therefore suggest that the ED state that, “unless specifically mentioned otherwise, the discussions herein relate to the selection of assumptions for purposes other than determining a market-consistent financial value.”

2) Further Guidance Needed

- a) The PFTF urges the ASB to consider when market-consistent assumptions are appropriate, and how they might be constructed. We believe it would be of great help to actuaries, in dealing with regulatory bodies, to point to a robust actuarial standard in this area.

We are aware of the profound difficulties facing the ASB if it should venture into this area. For one, the actuarial profession is divided on when market-consistent assumptions are appropriate. Second, there is disagreement on how market-consistent assumptions should be constructed. (It should be noted that the range of disagreement is not as great as it is with setting budgetable assumptions). Nonetheless, it is a vital issue to the profession, and the ASB might wish to think through how it would address the matter in the future.

- b) The PFTF believes that a market-consistent valuation provides the best estimate of the price of pension obligations. A valuation based on budgetable assumptions provides different information. Multiple valuations of a plan using different actuarial assumptions, and possibly using different asset values, can cause confusion, which will inevitably need to be reconciled by the actuary. It is therefore a matter of some urgency for the profession, possibly the ASB, to consider how valuations on a budgetable basis and on a market-consistent basis should be reconciled and communicated. We expect to comment on this point in more detail in our response to the proposed revision of ASOP 4.

The PFTF remain devoted to the task of improving pension actuarial practice and enhancing the professional reputation of actuaries. Thank you for your attention to our comments. Please contact Jessica M. Thomas, the Academy’s senior pension policy analyst (202-785-7868; thomas@actuary.org), if you have any questions or would like to discuss these items further.

Sincerely,



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