

## Memorandum

**To:** Actuarial Standards Board  
**From:** Norman L. Jones, FSA  
Gabriel, Roeder, Smith & Company  
**Date:** July 31, 2008  
**Subject:** Response to Request for Comments Concerning ASOP No. 27  
Selection of Economic Assumptions for Measuring Pension Obligations

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- 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:** For public sector plans (our primary practice area) investing mostly in traditional types of securities (common stock, bonds, etc.) we generally employ the building block method as provided in section 3.6.2, taking into account measurement specific factors as provided in section 3.6.3 and advice of experts as provided in section 3.14.4. The best estimate range is based on statistical analysis of historical information adjusted for future expectations based on generally accepted economic principles. The specific point selected within the best-estimate range is typically at or near the midpoint.

For larger plans investing more in non-traditional securities, we employ stochastic modeling based on the plan's asset advisor's capital market assumptions to arrive at the long term expected nominal rate of return at or near the 50<sup>th</sup> percentile at a specified horizon, again taking into account measurement specific factors and considering advice of other experts.

The "best estimate range" is appropriate and we strongly encourage its continued use. However, more guidance regarding the appropriate width of the range would be helpful.

- 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:** It would be reasonable to add a corresponding provision, although it would be somewhat redundant since ASOP No. 27 already provides for the equivalent of an “assumption universe” by addressing Sources of Economic Data in section 3.13, Knowledge Base in section 3.14.3 and Advice of Experts in section 3.14.4.

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:** Actuaries are free to calculate a wide range of values, but those based on economic assumptions that lie outside the “best estimate range” should always be identified in a manner that will be useful to those who will or may make decisions based on the result.

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:** Asset valuation methods are adequately addressed in ASOP No. 44. Generally, selection of an asset valuation method and the selection of economic assumptions are independent. However, if the actuarial value of assets is significantly higher or lower than the market value of assets, it would be reasonable to require the actuary to disclose the extent to which economic gains or losses would be required to offset losses or gains that would otherwise flow through to actuarial valuation results over the asset smoothing period.

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:** Certainly modeling and forecasting tools have become much more sophisticated since ASOP No. 27 was adopted in 1996. However, in our practice, we see no conflict with the guidance in the ASOP.

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:** With regard to the first question, one specific conflict is the last paragraph of Section 3.3 which states: “As stated above, the actuary should consider recent economic data. However, the actuary should not give undue weight to recent experience.” The term “undue weight” may be problematic to the application of financial economics in cases such as determining market yields at the valuation date which may rely entirely on recent experience. We recommend changing that last sentence to, “However, the actuary need not give undue weight to recent experience.” In general, we feel that ASOP No. 27 does not conflict with the application of financial economics. For example, if the actuary chooses to discount each cash flow at a risk-free (or market) yield of the same maturity, the current standards may be met under an interpretation of the cash-flow matching method in Section 3.6.b. and using select and ultimate rates as in Section 3.6.4.a.

With regard to the second question, our understanding of the intent of actuarial standards of practice is to provide a universal framework for all practicing actuaries to follow consistent with the Code of Conduct. ASOPs do not dictate practices nor do they recommend best practices. We feel that it is imperative that if the standards are revised to reflect the application of financial economics that the revisions include financial economics as an alternative and that all current practices be retained in the standard.

The need for current standards to be retained is of utmost importance for public sector retirement systems, the vast majority of which budget contributions based on the long-term expected return on assets. The use of the long-term expected return is consistent with the measurement of budgeted contributions designed to meet obligations in the long run.

We understand that the issue of applying financial economics to the public sector is currently a hot topic. Incorporating financial economics into ASOP No. 27 while at the same time retaining current practices could provide valuable additional information to this debate. On the other hand, if amending ASOP No. 27 to allow financial economics curtails any current practices, it would have immediate negative consequences to the public sector, to public sector actuaries, and to the public image of actuaries as a whole. The debate on this question must not be settled by one side rewriting the actuarial standards.

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:** Actuaries should be pro-active with clients in assessing pension risk, but they should have wide latitude in their approaches. Other than general encouragement, no specific guidance is needed. To do so, would risk limiting their ability to exercise professional judgment.

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:** Generally, present disclosure requirements are appropriate. With respect to additional disclosures, see response to item # 4.

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

**Response:** Generally no. ASOP No. 27 has served the profession well. While any standard can be improved by fine tuning from time to time to accommodate evolving actuarial practices, it is our view that revolutionary changes to ASOP No. 27 would be a mistake.

One good addition may be to add guidance on selecting economic assumptions in a closed plan in which asset allocation decisions will need to gradually recognize persistent changes in liquidity needs.

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:** Certainly, ASOP No. 35 should be checked for consistency before any ASOP No. 27 change is implemented and determine whether similar changes to ASOP No. 35 are needed concurrently.