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Introduction

In their paper entitled "Reinventing Pension Actuarial Science" and in other writings, Mr. Lawrence N. Bader and Mr. Jeremy Gold have done a great service to the actuarial profession by introducing some of the principles of financial economics to the pension arena.

They have challenged actuaries to debate whether our actuarial science should be classified as "flat world," "round world" or "star trek" science.

In doing so, they suggest rethinking and revising Actuarial Standard of Practice Number 27 ("ASOP27") which establishes a Standard of Practice requiring the recognition of expected rates of return before the related, additional risk has been endured.

Where this writer believes Bader and Gold are strong is their suggested approach to the measurement of assets and liabilities. They suggest that the best practice for the measurement of assets is market value. They suggest that the best measurement of liabilities uses expected rates of return on assets whose probabilities of repayment are comparable to the probabilities of making the desired benefit payments.

Where Bader and Gold might do more, however, is to address the IMPLICATIONS of a financial economics approach to the measurement of pension finances on:

- ***Funding Policy*** – How much to contribute and when? Failing to recognize the additional expected earnings consistent with additional expected risk would result in expected decreases over time in the employer contribution rates for pension funds whose portfolios accept such risk. The authors deem this approach to be better than giving the benefit of the potential mismatch between the assets and liabilities to the generation that creates it. How do the authors address the goal of intergenerational equity so common in Public Pension Plans?
- ***Investment Policy*** – How much risk is appropriate? If a plan sponsor can handle the risk of equities in its pension fund, why not? For Public Pension Plans where risk can be spread over multiple generations of taxpayers, why shouldn't the risk be taken? Note: In spite of their presumed value, tax-efficient, augmented corporate balance sheets, such as those proposed by Irwin Tepper and Fischer Black, have generally not been put into practice.
- ***Benefit Policy*** – What level and type of benefits should be provided? Do the parties involved in negotiating benefit improvements really want to value benefit changes without getting the benefit of advance recognition for risk?
- ***Accounting/Expense Policy*** – At what rate should pension liabilities be recognized? As the world demands greater transparency in the reporting of assets and liabilities, it is unlikely that anything other than a market value/fair value model will prevail. In such a world, how or should one separate and recognize the reasonably uniform rates of benefit accrual inherent in most pension plans? How should one recognize in the values of accrued benefits the usually volatile rates of discount inherent in the markets? How should one deal with the almost always volatile rates of return on the assets supporting the pension liabilities? Even more than today, will accounting rules drive behavior rather than measure it?

This writer personally believes that the financial economics approach espoused by Bader and Gold is a proper methodology for the measurement of actuarial liabilities.

However, it is not clear that such proper measurement should automatically result in changes in more traditional approaches to funding policy, investment policy and/or benefit policy.

Proper measurement may logically produce better information for disclosure purposes and it is likely to be necessary in a world that

implements transparent, market value/fair value accounting rules. However, for accounting/expense policies, it is not clear how more proper measurement can effectively assist policy makers in their goal-setting for pension plans. In fact, could such proper measurement, if demanded by accounting rules, result in those rules becoming drivers, rather than measurers, of pension funding, investment and/or benefit policies?

A more extensive addressing of these issues would be helpful to this writer.