

BAS 2007 CONSULTATION PAPER – INVITATION TO COMMENT

Introduction

Section 9 of the consultation paper “Towards a Conceptual Framework” issued by the Board for Actuarial Standards (BAS) invites the views of stakeholders and interested parties.

I am a Fellow of the Faculty of Actuaries in Scotland, and after reading the consultation paper I would like to make some brief comments on the contents of the document. I also attended the BAS consultation meeting held in The Merchant’s Hall in Edinburgh on 18 January 2008. I am a Scheme Actuary, and therefore my response is based on my background in final salary occupational pension schemes.

In my response I have limited my comments to the contents of Section 8 – “Applying the Concepts to Standards” which appears to contain detailed proposals rather than simply concepts.

General Principles

I agree with the general principles set out in paragraph 8.2, and in particular the need to advise the user of the potential risks and uncertainty.

Concepts and Principles Relating to Actuarial Quantification

Again, I broadly agree with some of the quantification principles set out in paragraphs 8.3 to 8.30 but comment further below.

Typically, actuaries disclose a discounted (or present) value of liabilities under some assumed rate of discount. I agree that the cash-flows of, for example the Technical Provisions of a pension scheme, could easily and usefully be disclosed to the user. This would enable the user to clearly observe the expected, but not certain, pattern of future benefit-outgo and plan their investment strategy accordingly.

However, care would have to be taken to explain the cash-flows to the user, i.e. whether the figures are in real or nominal form, i.e. whether or not the values have been deflated to allow for the effects of future inflation.

From a pensions background, the cash-flow analysis will be significant different if the members are assumed to take a Pension Commencement Lump Sum or if the Trustees decide to insure the annuitant rather than pay the pension from the assets of the Scheme.

I am surprised that BAS feels the need, as stated in paragraph 8.24, to limit the range of assumptions to be used in particular classes of calculations – although no examples of these classes of calculations is given. Is there any rational to justify this imposition on the Actuarial Profession?

I am also unsure how and why BAS feels the need to specify how Actuaries are to achieve prudence in a given context, as stated in paragraph 8.29. Actuaries use their professional judgement to prepare a best estimate or prudent actuarial basis for a particular purpose.

Paragraph 8.29 gives the example of the Technical Provisions of a pension scheme – which must be calculated on prudent assumptions. However, it is my understanding that it is now the Trustees who are responsible for setting the assumptions on a prudent basis, upon seeking actuarial advice.

Actuarial Reports Within Scope of the Conceptual Framework

Again, I broadly agree with some of the quantification principles set out in paragraphs 8.31 to 8.55 but comment further below.

Many of the ideas here are already contained in legislation and Guidance Notes, for example GN9 requires Actuarial Valuations to disclose the objective of the calculations, comments on the quality of data, disclose all significant assumptions, sensitivity analysis, analysis/reconciliation from the previous Actuarial Valuation results etc.

I agree that the significant assumptions should be justified, and the separation of fact and actuarial judgement (objective and subjective).

I am concerned that the cash-flow comments made in paragraph 8.37 will not provide the user with information that would be of any benefit. Paragraph 8.16 suggested that cash-flows should be disclosed (see my earlier comments) however BAS say here that the “total undiscounted amount of the projected cash-flows” should be disclosed. I read these to be two different things.

As discussed above, providing the cash-flows is a useful piece of information to the user – subject to disclosing suitable assumptions, caveats and explanation. On the other hand, I can see no benefit to the user in stating that “the liabilities of the scheme are estimated to be £100m payable over a period of 80 years”. This fact can be true of two pension schemes – one where £99m is due tomorrow and another scheme were £99m in due in 79 years time. Unlike the suggestion in paragraph 8.16 to disclose the individual cash-flows, I consider that providing a single undiscounted figure does not provide the user with any additional useful information.

Paragraph 8.48 c) refers to a range of percentiles, i.e. a confidence interval. Performing such calculations would require the specification of the correct distribution as well as the parameterisation of the first two moments.

Paragraph 8.48 c) also refers to stress testing. I wonder how much value would be added by looking at such extreme events at the tails of a distribution. For example, it may be accepted that at some point in the future the Stock Market will experience another crash – but it is not possible to determine neither the severity nor the frequency of such an event.

Paragraph 8.48 d) requires a probability to be assigned to the chances that the assets held will meet the value of the liabilities. I would have thought that a more relevant probability would be to determine whether or not the existing assets held together with future contributions (including any contributions payable under a Recovery Plan for a pension scheme) will meet the emerging liabilities over some given time horizon.

For example, if a pension scheme, has a deficit of assets to meet the value placed on its liabilities or Technical Provisions (measured on a prudent basis) then for a scheme holding “matching” assets the probability of those assets meeting the liabilities is zero (including any contributions payable under a Recovery Plan for a pension scheme).

Given a central or best estimate of the liabilities, actuaries would need to fully determine a statistical distribution in order to assign a probability to whether or not the assets held could meet those liabilities. Given the interaction of the actuarial assumptions and also the interaction of the assets and liabilities through inflation, this would appear to be a complex and spurious calculation.

Sensitivity analysis can be used to show the financial magnitude of changing one or some of the assumptions but it would be difficult to quantify the likelihood of that alternative scenario occurring in reality, for example the probability that inflation averages 0.5% per annum over the best estimate.

The use of probabilities has always been problematic to communicate to users. Whilst users could easily understand the 50:50 nature of the toss of a coin, I am not convinced they would understand very small probabilities.

Actuaries need to provide users with useful information concerning the variability of future experience and the inherent risks involved but they should not be overwhelmed with meaningless statistics and infinitesimal probabilities based on an assumed normalised distribution.

It is my opinion that the establishment of the Board for Actuarial Standards will help to raise the profile of the Actuarial Profession and improve the public’s perception of the profession. In this regard, I am happy to submit this contribution of my own personal views with the wider aim of making sure that the profession deliver the information that users can rely on and use to make informed decisions.

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