

The Ambachtsheer Letter

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FINANCIAL ECONOMICS AND ACTUARIAL PRACTICES:

WHY THEY MUST CONVERGE

“While actuaries do not need to accept the conclusions that many people reach when they apply financial economic theory to pension plan management, it is imperative for actuaries to understand the arguments and perspective behind those conclusions...”.

Quoted from the “Pension Actuary’s Guide to Financial Economics” published by American Academy of Actuaries and the Society of Actuaries, 2006.

Revolutionary Actuaries

It turns out we were not alone writing a ‘pension revolution’ book last year. A small band of revolutionary actuaries brought a copy of their own new book to the New York launch of our “*PENSION REVOLUTION: A Solution to the Pensions Crisis*” book last week. Of course as an official joint publication of the AAA/SOA, their book couldn’t have ‘revolution’ in its title, or anywhere else in its 50 pages for that matter. Indeed, page 1 of the “*Pension Actuary’s Guide to Financial Economics*” proclaims emphatically that “this guide is not a statement about how actuaries should practice nor how pension plans should be operated”.

Why should the rest of us care about the uneasy relationship between the principles of financial economics and traditional actuarial practices? Why is it worth writing a *Letter* about an effort by a small (but growing) band of actuaries to bridge the chasm between the two? It matters because traditional actuarial practices continue to govern how financial information about pension arrangements around the world involving trillions of dollars is calculated and disseminated, and how determinations are made about the contribution levels required to keep these arrangements sustainable over the long run.

If current actuarial practices are at odds with the principles of modern financial economics, then questions naturally arise about how actuarial information should be interpreted, and whether the funding and investment recommendations that flow from that information should also be questioned. As the *Letter* title suggests, it is our view that the current financial economics principles-actuarial practices gap does indeed result in serious informational uncertainties and questions about funding and investment recommendations. This view is informed by recent personal contact with a number of pension plan situations that have ‘issues’ perceived to require attention. Informational uncertainties resulting from current actuarial practices are an important ‘issues’ contributor in each of these cases.

So in our view, the time has come for the principles of modern financial economics and actuarial practices to converge. While the authors of the *Guide* undoubtedly agree with this view, they were not in a position to directly say so in their publication. Instead, they said it indirectly by clearly explaining the powerful insights that financial economics brings to the principles and practices of pension finance and investments. It is important that these insights not be lost in how pension plans are costed and financed in practice.