What the Low-Default-Risk Obligation Measure (LDROM) Is… And What It Is Not

The Actuarial Standards Board (ASB)[1] requires public pension plans (for plan years after February 15, 2023) to begin disclosing a new liability measure that assumes the pension plan is invested solely in high quality bonds. Public pension plans typically invest in a diversified portfolio including stocks, bonds, real estate and private equity, and funding calculations are based on the expected return of that portfolio. The new disclosure requirement does not change this approach for funding the plan but provides additional information on what the liability measurement would be if the plan were to adopt an all-bond investment strategy.

It is highly unlikely that a public pension plan would adopt an all-bond investment strategy, and there is no indication that any plans intend to do so. For that reason, the new disclosure has limited practical application for public sector plans. However, understanding this new measure – what it is and what it is not – is critically important to ensure the new disclosure is not used to mischaracterize the financial health of a pension plan.

Bottom line: LDROM shows the high cost of an all-bond portfolio and the value of a well-diversified investment strategy.

WHAT LDROM IS:

- **Low-Default Risk Obligation Measure (LDROM) is a new required disclosure of a number typically larger than a plan's funding liability.**
  - The LDROM is calculated using a discount rate based entirely on high quality bond yields instead of the expected return on the plan's diversified investment portfolio.
- **LDROM is an illustration of expected taxpayer savings.**
  - The difference between the pension liability used for funding a plan and the LDROM represents the expected savings to be achieved by investing in asset classes with higher expected returns than bonds.

WHAT LDROM IS NOT:

- **LDROM is not a measure of public pension plan funding.**
  - A public pension plan's funding target is calculated based on the board's funding policy, typically using a discount rate equal to the expected investment return on the plan's actual assets as currently invested, not on a theoretical portfolio of low-default-risk bonds.
- **LDROM is not a measure of pension plan health.**
  - This disclosure may be used to mislead stakeholders about a plan's financial health. The financial health of a pension plan depends on many factors including the size of any funding shortfall compared to the resources of the plan sponsor(s) and the strategy in place to attain 100% funding.
  - In particular, having plan assets less than the LDROM does not provide information on whether the plan will be able to make future benefit payments.

[1] The Actuarial Standards Board (ASB) sets standards for appropriate actuarial practice in the United States through the development and promulgation of Actuarial Standards of Practice (ASOPs). These ASOPs describe the procedures an actuary should follow when performing actuarial services and identify what the actuary should disclose when communicating the results of those services.

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WHAT LDROM IS NOT:

- **LDROM is not the "true measure" of public pension liabilities.**
  - For many years some financial economists have claimed public pension plans are understating the value of the pension promise by not using discount rates similar to those required for the LDROM. This new disclosure requirement will likely lead to a resurgence of such claims.
  - To counter this risk of misrepresentation, the ASB specifically states that "[t]he calculation and disclosure of this additional measure [the LDROM] is not intended to suggest that this is the "right" liability measure for a pension plan."

WHAT YOU NEED TO KNOW:

- **The LDROM may be used to mislead stakeholders, including workers, policymakers, and taxpayers about the financial health of a pension plan.**
  - The additional calculation is simply one point of additional information. In particular, it is not the one true measure of pension liability, as some may claim.
  - Assessments of the financial health of a pension plan rely on multiple measures, particularly the size of any unfunded liability compared to the resources of the sponsor and the contribution strategy to pay off any unfunded liability.
- **Funding versus LDROM**
  - Consistent with established ASB guidance, discount rates for funding public pension plans continue to reflect the expected investment return of the pension portfolio.
  - Under that approach, the LDROM would only be appropriate for funding if the plan was actually invested entirely in high quality bonds.
  - There are no indications that public plans intend to shift to investing entirely in bonds, so the LDROM should not be viewed as an appropriate funding target or a reasonable basis for developing adequate contributions for ongoing public pension plans.
- **The difference between LDROM and a plan's funding liability can be used to illustrate the advantage of investing in the plan's diversified portfolio.**
  - The difference between the funding liability and the LDROM represents the expected savings for plan sponsors, employers, taxpayers, and participants from investing in the plan's diversified portfolio instead of an all-bond portfolio.
  - The difference also represents the approximate cost to plan sponsors, employers, taxpayers, and participants of lowering investment risk by investing entirely in an all-bond portfolio.
- **Using a discount rate based on current bond yields makes LDROM a volatile liability measurement.**
  - Long-term bond yields, on which the LDROM discount rate is based, can vary significantly from year to year. In contrast, the expected return on assets, on which the discount rate is based for funding, is relatively stable from year to year. As a result of its more volatile discount rate, the LDROM will also be volatile, especially when compared to the funding liability.
- **The LDROM is not based on a realistic bond portfolio.**
  - The cash flows from the LDROM portfolio must reasonably approximate the future benefit payments from the pension plan. In practice, this means that the LDROM portfolio will be a much longer duration bond portfolio than is typically used as a part of the plan's diversified portfolio.
  - The LDROM portfolio is restricted to high quality bonds – typically US Treasuries or high-quality corporate bonds.

Frequently Asked Questions

WHY DO PENSION FUNDS INVEST IN A DIVERSIFIED PORTFOLIO?

Public pension funds generally have long investment horizons, and thus can invest for the long term. Because investment returns on a diversified portfolio are expected to be higher than fixed income returns over longer periods, investing in a diversified portfolio of return-seeking assets, including equities, is appropriate. In essence, these investments are held through up and down cycles, which offset each other.

This is the same dynamic in personal investing, as younger people generally are encouraged to invest their retirement dollars more aggressively in stocks than older retirees. For example, lifetime funds are designed to invest more conservatively as a plan participant approaches retirement and has a shorter investment horizon. The difference is that an ongoing public pension plan always has a long investment horizon.

CAN A PLAN SIMPLY BE SETTLED IF ITS ASSETS EQUAL THE LDROM?

The LDROM really presents more of a theoretical value of settling a plan's liabilities than is practical. This is true for a few reasons.

First, plan benefit payments can stretch out for seventy years. There are few, if any, bonds that you can purchase that match benefit payments past 30 years. This means that a plan would have to reinvest at some point in the future and the cost of bonds at that future date is uncertain. However, the LDROM inherently assumes reinvestment at the same rates.

Secondly, the LDROM essentially assumes that all dollars are invested at today's bond yields, though plans already hold bonds. Next year, when the LDROM is calculated again, it will again assume all investments are liquidated and used to buy new bonds again with pricing based upon more recent prices.

Third, if many large plans were to do this, it would add significant buy-side pressure on the bond market and could impact bond yields, given the trillions of dollars in pension plan assets.

In the public sector, where plans remain open to new hires, it is rare that plans choose to give up the additional investment returns of a diversified portfolio in favor of an all-bond strategy.

WHAT SPECIAL ISSUES DOES THE LDROM PRESENT TO RISK-SHARING PLANS?

Risk-sharing plans face additional considerations when calculating the LDROM, as many have adopted cost-sharing and automatic benefit adjustments that are triggered by the plan's fiscal condition. Ultimately, plans need to project future benefit payments and discount them in order to calculate the liabilities under any scenario.

This presents a decision point: Does the LDROM return assumption trigger these plan changes?

If the LDROM is viewed as an attempt at mapping out a scenario where future returns are set equal to a portfolio that only achieves returns equal to today's bond yields, a plan may choose to assume that these risk-sharing provisions are triggered repeatedly in the future due to the inferior returns of the all-bond portfolio (lowering benefits or shifting more costs to workers).

In contrast, a plan may choose to assume the funding status in the future is based on their actual assumptions, which would result in less, or no, risk-sharing in the future.

WHAT DOES THE DIFFERENCE BETWEEN A PLAN'S FUNDING LIABILITY AND THE LDROM TELL US?

Stocks and bonds have different expected returns over time, with stocks expected to provide higher returns. Over short-to-medium timeframes, stock market volatility is the tradeoff.

As such, funding a stream of benefit payments that stretch out over many decades is more efficient when investing in a diversified portfolio, as opposed to an all-bond portfolio.

In practice, if a plan reports a funding liability of $1 billion and an LDROM of $1.5 billion, that means that investment professionals expect it would cost an additional $500 million to liquidate the plan's investments and buy bonds (at recent prices) in order to meet the plan's benefit obligations.

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Sample Language for Valuation Reports

(Assumes language appears in risk assessment section of valuation report and that LDROM methods and assumptions are disclosed in the methods and assumptions section of the report.)

The pension plan invests in a diversified portfolio of stocks, bonds, real estate, and private equity with the objective of maximizing investment returns at a reasonable level of risk. The potential for investment returns to be different than expected is a key risk for the plan. Reducing the plan's investment risk by investing solely in bonds, however, would also likely reduce the plan's investment returns thereby increasing the amount of contributions needed over the long term.

The Low-Default-Risk Obligation Measure (LDROM) represents what the funding liability would be if the plan invested its assets solely in a portfolio of high-quality bonds whose cash flows approximately match future benefit payments. Consequently, the difference between the plan's Actuarial Accrued Liability and the LDROM can be thought of as representing the expected taxpayer savings from investing in the plan's diversified portfolio compared to investing only in high quality bonds.

ASOP 4 also requires commentary to help the intended user understand the significance of the low-default-risk obligation measure with respect to the funded status of the plan, plan contributions, and the security of participant benefits.

COMMENTARY ON SIGNIFICANCE -- OPTION 1

The LDROM helps understand the cost of investing in an all-bond portfolio and significantly lowering expected long-term investment returns. The funded status and Actuarially Determined Contributions are determined using the expected return on assets which reflects the actual investment portfolio. Benefit security for members of the plan relies on a combination of the assets in the plan, the investment returns generated on those assets, and the promise of future contributions from the plan sponsors.

Since the assets are not invested in an all-bond portfolio, the LDROM does not indicate the funding status or progress, nor provide information on necessary plan contributions or the security of participant benefits. The difference between the plan's Actuarial Accrued Liability and the LDROM can be thought of as representing the expected taxpayer savings from investing in the plan's diversified portfolio compared to investing only in high quality bonds.

COMMENTARY ON SIGNIFICANCE -- OPTION 2

The actuarial valuation reports the funded status and develops contributions based on the expected return of the plan's investment portfolio. If instead, the plan switched to investing exclusively in high quality bonds, the LDROM illustrates that reported funded status would be lower (which also implies that the Actuarially Determined Contributions would be higher), perhaps significantly. Unnecessarily high contribution requirements in the near term may not be affordable and could imperil plan sustainability and benefit security.