

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.

¹The 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.



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This toolkit has been endorsed by GFOA.