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S&P Pension Brief: A Closer Look At A New Actuarial Liability Measure And What It Means For U.S. Public Finance Issuers

What Is The New Actuarial Liability Measure?

The Actuarial Standards Board (ASB), which sets and monitors actuarial practices in the U.S., is mandating that effective Feb. 15, 2023, actuarial funding reports include a new liability measure called the low-default-risk obligation measure (LDROM). This new liability measure supplements the actuarial funding recommendations in the report.

There are multiple definitions of pension liability that might be useful for analyzing an issuer's finances. Here are a few such definitions:

- Total pension liability (TPL): Reported in financial audits, this accounting liability is based on a discount rate typically equal to the assumed asset return, although it could be lower if funding discipline is poor.
- Actuarial accrued liability (AAL): Included in the actuarial funding valuation, the actuary uses this to guide their contribution recommendations. This funding liability is typically based on a discount rate equal to the assumed asset return.
- Low-default-risk obligation measure (LDROM): To be included in the actuarial funding valuation and based on a very low discount rate derived from low-default-risk fixed income securities. The impact of a lower discount rate is a higher liability calculation.

LDROM: What It Is And What It Isn't

The LDROM could provide additional information regarding the security of benefits that members have earned as of the measurement date. Plan sponsors have flexibility to define LDROM in multiple ways, as long as the discount rate is very low. For example, it could be defined such that neither benefit accruals nor assets are projected to grow for the employee population, similar to how corporate liability is calculated, which would provide a point-in-time measure of liability. However, S&P Global Ratings expects that LDROM will generally be calculated with projected benefit accruals, but without expected asset growth–essentially the funding calculation (AAL) but with the lower discount rate. This could be used to hypothetically indicate what future costs might be if the plan were to practically eliminate market risk from its asset profile.

We foresee that the inclusion of LDROM could result in some confusion and potential misunderstanding, as it will have the lowest funded ratio, which is likely to generate discussion and could be misconstrued as a true measure of funded status. Although LDROM could be a valuable tool in risk and benefit security discussions, it does not represent a real-word expectation of future funding needs, so a ratio of assets to LDROM may be less of a "funded ratio" than a tool for risk analysis. For S&P Global Ratings to view a low discount rate as a conservative assumption, it would expect to see less volatile investments, and that is not necessarily the case with LDROM. Given the ongoing nature of governmental entities, the inherent revenue and expenditure flexibility to absorb

minor variations in benefit costs, and the long time frame over which benefits are accrued and paid, S&P Global Ratings does not expect U.S. public finance issuers to adopt nearly risk-free pension funding practices.

How Will S&P Global Ratings Use This Information In Determining Ratings?

When assessing benefit obligations and their associated funded status, we analyze the TPL as reported in a plan or issuer's audit. Under guidelines set by the Governmental Accounting Standards Board that are applicable for all public sector plans, the TPL best suits the purpose of measuring expected future obligations while being comparable across the public sector. We have detailed our views on differing approaches to the discount rate in our article, "Looking Forward: The Application Of The Discount Rate In Funding U.S. Government Pensions," published Sept. 13, 2018, on RatingsDirect.

Our focus on the actuarial funding valuation, within ratings, is primarily toward the expected contributions, and associated assumptions and methods in the calculation, that might help us assess funding discipline and future budgetary stress for an issuer.

We incorporate additional information, including the LDROM and any other useful information that is provided outside of the audit, on a credit-specific basis. Conceptually, a plan's assets are invested to provide the long-term assumed return, typically near 7% for public plans in the U.S., and the LDROM might be a useful way to measure market risk in the pension trust by comparing it to the AAL, assuming it's defined according to our expectations noted above. This could then be used as an illustration of market-driven contribution volatility risk for a specific issuer, which could aid in credit risk analysis because a plan's funded level, if based on risky investments, could quickly turn in down markets.

Additional Complications With The LDROM As A Risk Metric

As a risk metric, there could be complications with the LDROM calculation for variable or risk-sharing benefits that the plan actuary is expected to discuss in detail. Examples of state pension plans with variable benefits include:

- South Dakota Retirement System: If the funded ratio were to fall below 100%, the cost-of-living adjustment (COLA) would be lowered to reach 100% funding.
- Tennessee Consolidated Retirement System: COLAs, as well as active and employer contributions, may be adjusted to maintain full funding.
- Wisconsin Retirement System: Benefit levels, as well as active and employer contributions, may be adjusted to maintain full funding.

The LDROM for the above plans might not reflect these variable risk-sharing attributes if the only change is the discount rate, and so would require further discussion from the actuary to fully understand market risk to an issuer sponsoring such a plan. For more detail on risk-sharing plans, see "Pension Spotlight: Risk Sharing Dilutes Pension Burden For Five States," published April 21, 2021.

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