the voice

Florida Public Pension Trustees Association **Annual Edition 2023**

SHIFTING LANDSCAPES:

SHAPING TRUSTEE EDUCATION FOR THE FUTURE

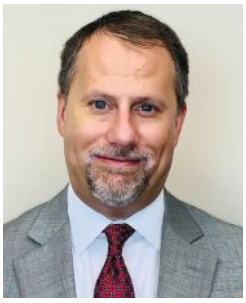
FPPTA®

FLORIDA PUBLIC PENSION TRUSTEES ASSOCIATION

SINCE 1984

ASOP No. 4 Revisions – Navigating Actuarial Regulations

By Piotr Krekora, ASA, EA, MAAA, Senior Consultant, Gabriel, Roeder, Smith & Company



By Pete Strong, FSA, EA, MAAA Senior Consultant, Gabriel, Roeder, Smith & Company

Introduction

In December 2021, the Actuarial Standards Board (ASB) adopted revisions to the Actuarial Standard of Practice (ASOP) No. 4 entitled, *Measuring Pension Obligations and Determining Pension Plan Costs or Contributions*. The revised standard is effective for actuarial reports issued on or after February 15, 2023 with a measurement (valuation) date that is on or after February 15, 2023.

Some of the recent ASOP No. 4 changes can be characterized as technical and may go unnoticed by casual users of actuarial reports. These include, but are not limited to:

1) Calculation and disclosure of a reasonable actuarially determined contribution;
2) Revised guidance pertaining to amortization methods;
3) Additional assessments of the plan's contribution allocation procedure or funding policy; and
4) Performance of an experience gain/(loss) analysis.

The majority of reports issued for Florida pension plans already comply with most of the key changes to ASOP No. 4 (other than the new LDROM disclosure discussed below) by virtue of complying with Chapters 112, 175 and 185 of the Florida Statutes and the administrative rules codified in Chapter 60 of the Florida Administrative Code. As such, most trustees can expect to see relatively minor additions to valuation reports that will not affect the operation of their plans.

The key revision to ASOP No. 4 getting the most attention is the new requirements to disclose a "Low-Default-Risk Obligation Measure" (LDROM). This new requirement is likely to generate some discussion.

Low-Default-Risk Obligation Measure (LDROM)

The LDROM has received considerable attention both within and outside the pension actuarial community. In short, the LDROM is the value of the pension plan's liabilities measured using an interest rate, or rates, derived from the yield(s) on low-default-risk (highly rated) fixed income securities. This liability measure should be included in all funding actuarial valuation reports (with valuation dates on or after February 15, 2023) and be accompanied by commentary to help intended users understand it.

The ASB's rationale for this new requirement, as outlined in their transmittal memorandum of ASOP No. 4, is as follows:

"The ASB believes that the calculation and disclosure of this measure provides appropriate, useful information for the intended user regarding the funded status of a pension plan. The calculation and disclosure of this additional measure is not intended to suggest that this is the "right" liability measure for a pension plan. However, the ASB does believe that this additional disclosure provides a more complete assessment of a plan's funded status and provides additional information regarding the security of benefits that members have earned as of the measurement date."

The actuary's commentary should aim at helping the intended users (the Board of Trustees for a plan and the plan sponsor) understand the significance of the LDROM with respect to the following:

a. The funded status of the plan;
b. Plan contributions; and
c. The security of participant benefits.

One could think of the LDROM as the liability for a pension plan that invests all of its assets in low-default-risk fixed income securities (highly rated bonds). Absent real efforts by pension boards to move all of the trust's investments into such investments, the LDROM by itself has no effect on a plan's operations. However, disclosure of the LDROM and its supporting commentary may provide insight (e.g., showing trustees the "What if?" impact of transitioning investments from a diversified portfolio to a LDROM portfolio).

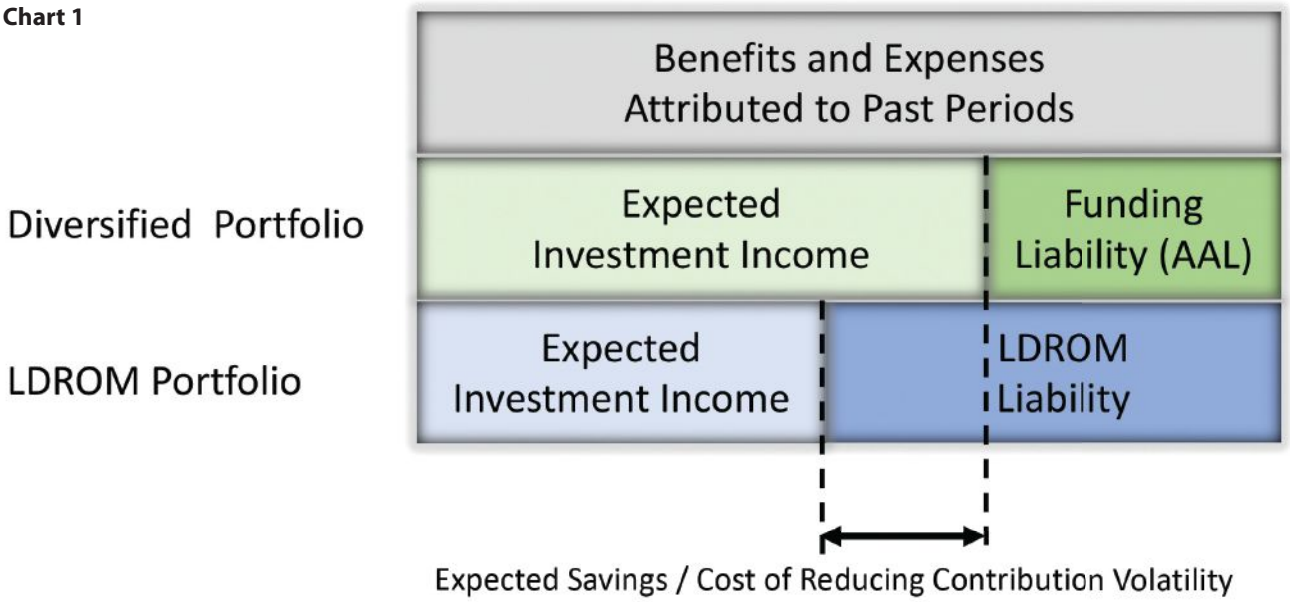
With some exceptions, moving investments to a LDROM portfolio would not affect the total amount of benefits expected to be paid from the trust or the current market value of assets held in the trust. However, future expected investment earnings would change. The following chart shows how expected investment income would decrease if assets are moved to a LDROM

continues on page 54 ▶

Navigating Actuarial Regulations...

CONTINUED FROM PAGE 53

Chart 1



portfolio (this chart is intended to illustrate the concept, not actual amounts). Lower expected investment income would need to be offset by higher contributions from the plan sponsor, and the plan's liability would increase from the current "AAL" to the "LDROM Liability".

Put another way, diversified portfolios are ***expected*** to save taxpayers on future pension contributions compared to LDROM portfolios. The current value of the expected savings is represented by the difference between the LDROM Liability and the Funding Liability (AAL). The key word in this comparison is ***"expected"*** – diversified portfolios are expected to earn more investment income over time but are often considered to be riskier than LDROM portfolios and usually have higher volatility in year-to-year returns. As such, while expected contributions for a plan with a diversified portfolio are lower than for a plan with a LDROM portfolio, contributions for the latter will tend to be more stable and predictable. This observation allows for a different interpretation of the difference between the LDROM Liability and the AAL: the cost of having more predictable, steady contributions.

Chart 1 above helps illustrate the effect of moving all plan assets into low-default-risk fixed income investments on (1) the plan's funded status (the funded ratio would decrease), and (2) plan contributions (Expected contributions would increase due to lower expected investment income).

Volatility of the LDROM

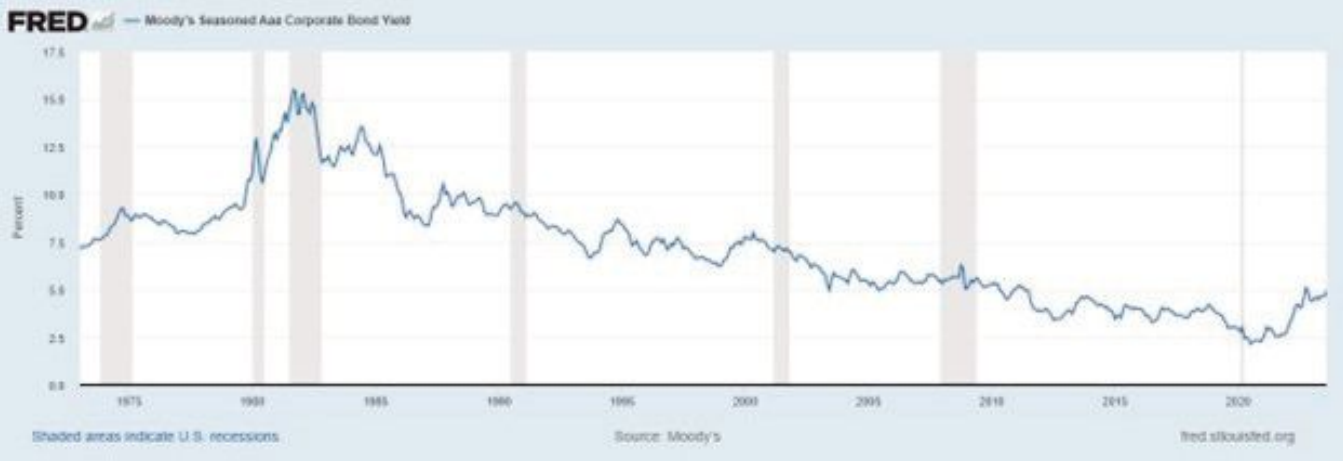
In a diversified portfolio, year-to-year investment earnings are volatile, but long-term expected returns change rather slowly. This results in fairly stable liability measurements. The LDROM, on the other hand, is dependent on the current market yields of high-quality fixed income securities. These rates can vary significantly from year to year, which can consequently result in significant changes in the LDROM from year to year. Even though rates have risen over the last two years, market LDROM interest rates are currently still somewhat low compared to historical rates over the last few decades. Chart 2 illustrates historical changes in the Moody's Seasoned Aaa Corporate Bond Yields, as compiled by the Federal Reserve Bank of St. Louis:

Chart 2: Moody's, Moody's Seasoned Aaa Corporate Bond Yield [AAA], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/AAA, September 26, 2023.

The next chart shows the Actuarial Accrued Liability (AAL) and the LDROM as of October 1, 2022 for a sample pension plan, as well as the LDROM values developed using Aaa Corporate Bond Yields as of 1990, 2000, 2010 and 2020.

In this example, the valuation interest rate was 6.75%, and the LDROM interest rate was 4.59% (as of October 1, 2022). The actuarial cost method is Entry Age Normal. All calculations use the same population as of October 1, 2022 and the interest rates indicated on the graph. The LDROM liabilities based on historical

Chart 2



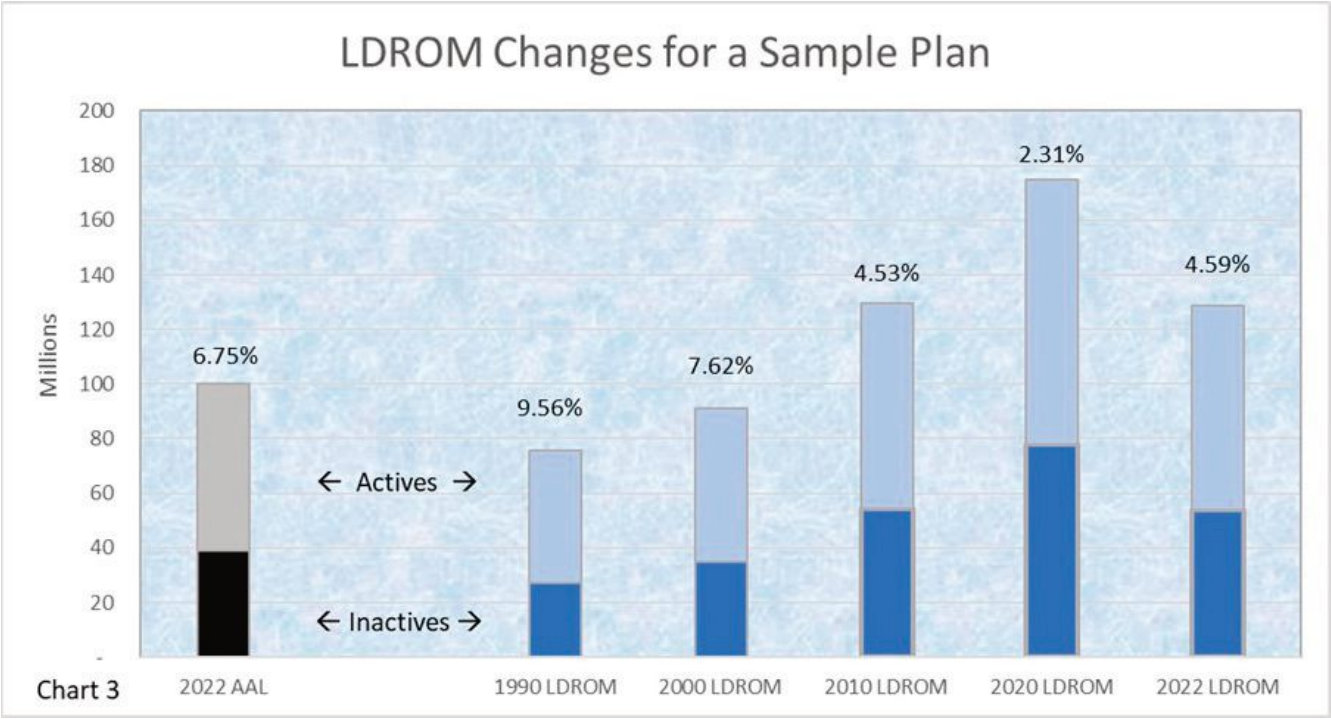


Chart 3

rates are shown for illustrative purposes, to show the sensitivity of the LDROM to various interest rates. The main takeaways from this graph are (1) the LDROM values are more volatile over time than the AAL, and (2) while the LDROM liability values have exceeded the AAL in the recent past, this hasn't always been the case historically.

continues on page 56 ▶

Summary

Effective for actuarial valuation reports with valuation dates after February 15, 2023, there is a new requirement to calculate and disclose a LDROM and provide supportive commentary. As explained in the ASB's transmittal memorandum, this disclosure *"is not intended to suggest that this is the "right" liability measure for a pension plan, or that plan assets should be invested accordingly."* The main purpose is to show

Navigating Actuarial Regulations...

CONTINUED FROM PAGE 55

what a plan's liability would be if the plan's assets were invested exclusively in low-default-risk (highly rated) fixed income securities.

About the Authors:

Piotr Krekora, ASA, EA, FCA, MAAA, PhD, is a Senior Consultant in GRS' Fort Lauderdale, Florida office. Piotr is a member of the GRS Office of the Chief Actuary. In this capacity, he provides strategic thought leadership to public sector clients as well as ensuring that service is being provided at the highest level by all GRS employees. He can be reached at Piotr.Krekora@grsconsulting.com, or (954) 527-1616.

Pete Strong is a Senior Consultant in the Fort Lauderdale office of Gabriel, Roeder, Smith & Company. His actuarial work covers valuations, GASB/FASB accounting disclosure, plan design studies, experience studies, and cash flow projections. He can be reached at Pete.Strong@grsconsulting.com, or (954) 527-1616.

Note: The views expressed in this article are those of the authors. ■