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Second Exposure Draft of Actuarial Standard of Practice No. 4 Released

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On Monday Jan. 27, 2020, the Actuarial Standards Board released their long awaited second exposure draft of Actuarial Standard of Practice No. 4 pertaining to measuring pension liabilities and costs. This has been extremely controversial in the public pension community, as the first draft would have required—for the first time—the calculation and disclosure of a low-risk liability calculation. This value has been known by various names, including "Market Value of Liability (MVL)," "Solvency Value," and "Investment Risk Disclosure Measure."

MVL is widely rejected by the public pension community as a meaningful measure. But MVL is widely embraced by certain academics and financial professionals as the "true" or "correct" liability. While MVL has some relevance for private plans covered under ERISA that can terminate and settle their liabilities, it is inapplicable for public pensions that have not and often cannot. This has been a significant dispute for nearly 20 years. Sixty-seven comments letters were received on the first exposure draft, including Pension Trustee Advisors, formal and informal groups of public pension actuaries, several public retirement systems, and jointly from NASRA, NCPERS and NCTR. These generally refuted the appropriateness of the proposed MVL measure. But there were many supporters of the measure as well.

Public pensions measure their costs and liabilities on a going-concern basis based on the expected return on plan assets. This is analogous to how individuals save for retirement—based on what they anticipate needing and the investment returns they anticipate earning. MVL is based only on plan benefits earned as of the measurement date and a low-risk rate of return. Because of the lower discount rates, MVL is generally a significantly higher number than the actuarial liability reported by the pension systems. This has led to misleading statements that the systems are understating their "true" liabilities.

If the Actuarial Standard of Practice had embraced MVL, misleading conclusions would likely result. In their comment letter to the Actuarial Standards Board, NASRA, NCTR and NCPERS wrote: "… we believe that such a measure will be used to mislead stakeholders—policymakers, the media, pension plan participants, and the general public—about the condition of the pension plan."

While the ASB did not reject an MVL-type measure, they did make some helpful and logical changes to the required disclosure requirements of the ASOP.

If this exposure draft is adopted, which is likely, pension actuaries (including public pension actuaries) will be required to calculate

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and disclose a "Low-Default-Risk Obligation Measure." There is more flexibility in this "LDROM" vis-à-vis the MVL, including:

- MVL is calculated based only on accrued benefits, LDROM may be calculated on any "immediate gain" actuarial method, which typically could include either the same method as used in the standard actuarial valuation or the MVL.
- If benefits are affected by the assumed discount rate or investment return, the actuary may reflect this impact. This may be significant for plans with variable benefits dependent upon the funded status of the plan.
- The discount rate selected is not prescribed but may include any one of a number of low-default-risk fixed income rates.
- The disclosure asks for "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." This allows extensive clarification, including citing the ASOP explicit statement that, "The calculation and disclosure of this additional measure is not intended to suggest that this is the 'right' liability measure for a pension plan."

This flexibility raises the significant question when complying with the LDROM measure—**whether to report an MVL or the funding liability at a low-risk discount rate.** Table 1 shows a plan's liabilities under different measures:

Table 1
Public Pension Plan's Liabilities Under Different Measures

Actuarial Basis	Accrued Benefits Only	Standard Actuarial Valuation
Low-Risk discount rate	$12 billion	$15 billion
Expected Return on Plan Assets	$8 billion	$10 billion

In Table 1, the plan is reporting liabilities of $10 billion under the funding valuation basis. The MVL is $12 billion. If MVL were disclosed, there could be a misleading interpretation that this is the "true" liability, and that $10 billion is an understatement. But if the system instead disclosed $15 billion, the system could explain that this is simply the plan liability if invested 100 percent in low-risk investments, rather than the balanced portfolio of higher returning investments. The system could further comment that the expected value of their investment strategy is the $5 billion difference. Although the number $15 billion is larger than the number $12 billion, this approach could result in more clarity and a better understanding of the reasons for the difference.

This is an important strategic disclosure and communication decision for systems and their advisors.

The ASOP exposure draft also includes specifications of a Reasonable Actuarial Determined Contribution, clarifies certain disclosures, and expands on acceptable amortization methods. The full exposure draft can be found at https://tinyurl.com/ASOP4ED2020

Comments are due by April 30, 2020 (expected to be extended), and we therefore anticipate that this new ASOP would be effective in 2021. We encourage retirement systems to work with their actuaries and advisors to address key issues with this new ASOP, including:

- When disclosing an LDROM, should this be the MVL, with risk of misinterpretation, or the larger liability calculated on the same method as the funding liability?
- How should this calculation be made considering adjustable benefits and inflation assumptions?
- Does our actuarially determined contribution comply with the new ASOP?
- Do we want to issue a comment on this exposure draft? ■

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