Rate of Return Assumptions for Minnesota’s Public Pension Plans

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To the Minnesota Legislative Commission on Pensions and Retirement
St. Paul, MN
August 29, 2013
Expected Rate of Return
Assumptions for Public Pensions

Expected rate of return assumptions are used to compare the current value of pension assets with future pension liability.

Two common purposes:

1. Project the future returns on pension fund assets.
2. Adjust future pension liabilities to present-day value.
   - Obtaining present-day value requires discounting future pension benefit payments by an interest rate.
   - Provides consistent value comparisons of benefit payments that don’t necessarily occur at the same time.
Future Economic Performance Affects the Expected Rate of Return

• New Normal:
  – Population is aging
  – Labor force growth is slowing
  – Ongoing federal fiscal risks

• Probably Means:
  – Slower economic growth
  – More uncertainty about the future

• In other words, past performance does not guarantee future results.
U.S. Real GDP growth is expected to average just 2.5% per year over the next 30 years, well below the 3.1% 20yr average prior to the Recession.

Source: U.S. Bureau of Economic Analysis (BEA); Global Insight (GII)
CPI inflation is expected to average 2.0% annual increases over the next 30 years, somewhat less than the 3.0% avg between 1982-2012.

Source: U.S. Bureau of Labor Statistics (BLS); Global Insight (GII)
In the long run, baby boomer retirements are expected to cause federal budget deficits to grow.

Source: U.S. Bureau of Economic Analysis; Global Insight (GII)
Two Leading Approaches for Valuing Future Pension Liabilities

1. GASB Guidelines:
   - Discount future benefit payments based on the expected rate of return on plans’ assets.
   - Implicitly assumes future investment returns are just as certain as benefit payments.

2. “Fair-Value” method:
   - Discount by a market rate that reflects the risk characteristics of the obligations.
   - Accounts for the different risks associated with investment returns and benefit payments.

Source: Congressional Budget Office (CBO)
Select Discount Rates for Measuring Pension Plans’ Liabilities

- **Minnesota’s Investment Return Assumption**
- Yield on Aaa Municipal Bonds (adjusted to obtain taxable yields)
- Yield on Aaa Corporate Bonds
- Yield on 10-yr Treasury Bonds

* Under guidelines recommended by the Government Accounting Standards Board (GASB), S&L governments typically discount future pension obligations based on the expected rate of return on the plans’ assets. Or “GASB Guidelines”.


** Concept similar to what the Congressional Budget Office (CBO) describes as appropriate for discounting pension liabilities. Or “CBO Fair-Value” approach.


*** Concept similar to Moody’s new methodology for analyzing and comparing state and local government pension liabilities as well as to standards set by the Financial Accounting Standards Board (FASB) for private sector DB plans. Or “Moody’s & FASB Guidelines”.


**** Concept recommended by some experts as the “Riskless Rate” approach.


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Long-Term Trend Forecast

- IHS Global Insight
- 8.0% or 8.5%
- 6.7%
- 6.0%
- 4.3%

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Percent
Impact of Discount Rate Assumption

• Each measure indicates the difference in risk to receiving future benefit payments.
  – Pension payments guaranteed ➔ low-risk rate
  – Pension payments not guaranteed ➔ higher-risk rate

• Getting the discount rate wrong has consequences.
  – Too low ➔ overstate liabilities ➔ unnecessary costs today
  – Too high ➔ understate liabilities ➔ pushes costs to future
Summary

• Uncertainty about near-term economic performance suggests caution about raising assumed investment rate of return.

• Common view in economics and finance recommends a “Fair Value” approach to calculating the present value of lower risk pension obligations.