MANAGEMENT AND BUDGET

Rating Agency Perspectives on Pension Discount Rates

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Overview

- Credit rating framework
- Perspectives on discount rates
- Statements about Minnesota’s credit profile

Bond Ratings

- Bonds may be rated by one or more of the three major credit rating agencies

	G.O. Rating	Outlook
Fitch Ratings	AAA	Stable
Moody’s Investors Service, Inc.	Aa1	Positive
S&P Global Ratings	AAA	Stable

- A bond rating is a measure of credit risk to investors
- “AAA” is the highest rating; “D” bonds are in default
- The higher the credit rating
  - The lower the risk, and
  - The lower the interest rate

Credit Rating Framework

Credit ratings are a comprehensive evaluation of an issuer's:

- Governance
- Economy
- Budget and Finances
- Long-Term Obligations

Similarly, evaluations of an issuer's pension liability look at many aspects, including: actuarial funding levels, amortization methods, discount rates, and longevity projections.

Standard & Poor's Pension Methodology

S&P analyzes the state's actuarial contribution levels and whether the state is maintaining minimum funding progress on the plans' funded ratios.

"We expect the discount rate to not only align with expected realistic performance of the target asset portfolio, but also reflect prudent and informed decision-making on how much market volatility and liquidity risk, or budgetary stress, an issuer can absorb.

In our view, based on current market conditions, a sustainable discount rate guideline for the typical plan is 6.00%."

S&P Credit Opinion for Minnesota

February 18, 2021 Credit Opinion:

Historically, we have viewed the state's pension fund discipline to be weaker than average; however, its unfunded pension liabilities relative to both population and personal income are extremely low, and we do not view them as a potential budgetary pressure.

However, there is some risk that plan funded ratios could begin to decline if the plans' long-term rate of return does not meet the 7.5% assumption. We view 7.5% as an optimistic rate of return given current market conditions.

Fitch's Pension Methodology

Fitch analyzes whether there has been stabilization or progress in the plans' funded ratios over time and a commitment to contributing at actuarially calculated levels.

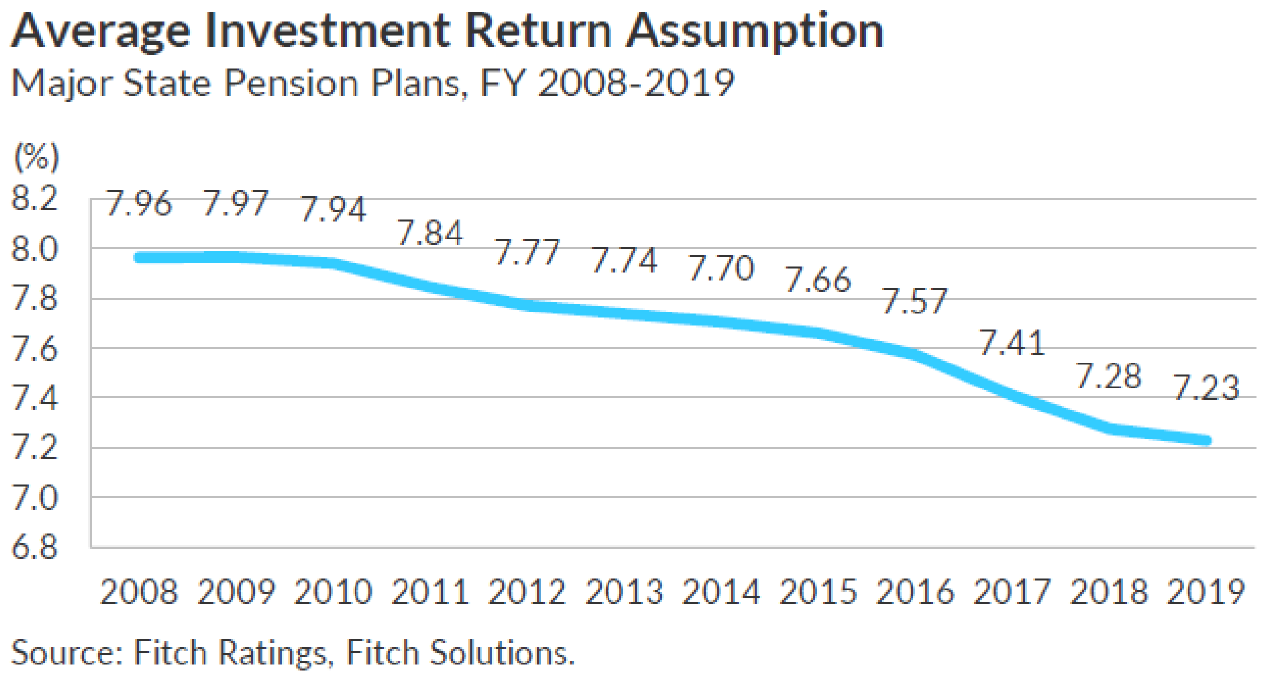
Fitch also recalculates total pension liabilities to a standard 6% investment return assumption.

"Fitch views the high investment return assumptions used by most defined benefit pension plans as a significant source of long-term risk, resulting in valuations that understate both retirement obligations and the contributions necessary to reduce liabilities over time."

Fitch on Declining Investment Return Assumptions

Fitch has reported that since the Great Recession, state pension managers have gradually adopted more conservative targets for investment return assumptions.

"Defined benefit pension investment return assumptions had averaged 8% a decade ago, but more recently have moved closer to 7% as plans continue to gradually shift expectations downward."



Fitch Credit Opinion for Minnesota

September 9, 2021 Credit Opinion:

Pension investment return assumptions and annual pension contributions in Minnesota are determined by state statute rather than by actuarial valuation. Contributions were consistently below actuarial levels. This comparative credit weakness has been offset to date by the relatively small size of the overall obligations relative to the state's ability to support them.

. . . although investment return assumptions, at 7.5%, remain well above Fitch's standard 6% assumption.

Moody’s Pension Methodology

Moody’s approach values accrued pension liabilities independently from pension plan asset amount, composition and return expectation. They calculate a “tread water” indicator as well as an asset shock indicator.

Moody’s uses the FTSE Pension Liability Index, composed of high-quality taxable bonds, as a discount rate in their adjustments. The annually adjusted FTSE Pension Liability Index was 2.84% as of June 30, 2021.

“Issuers may have incentives to use overly optimistic assumed rates of return or to take on greater pension investment risks, or both, which have the effect of understating the unfunded pension liability.”

Moody’s Credit Opinion for Minnesota

September 2, 2021 Credit Opinion:

The state’s adjusted net pension liability (ANPL) is below the 50-state median and expected to remain below average in light of recent reforms. As of our most recent pension medians report, Minnesota ranks the 10th lowest for ANPL compared to revenue and the 17th lowest for ANPL compared to GDP.

For fiscal 2019 and 2020, the state exceeded our tread water contribution necessary to prevent growth in unfunded liabilities, with actual contributions equal to roughly 110% of the tread water in each year.

Continued strong pension contributions is a factor that could lead to a rating upgrade.

Thank you

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