State Pension Plans: Great Returns Don't Assure Peace in the Valley

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A 30.3% investment return in FY 2021 by the State Board of Investment should pave the way for a rather quiet year for Legislative Committee on Pensions and Retirement. But nothing is ever quite that easy in pension land.

Much has been made of the bifurcated nature of the post-TCJA/Covid era economy. But if a comprehensive list of the era's "winners" was being assembled, we could now confidently include Minnesota state and local government employers and employees on that list.

The 2021 state pension plan valuation reports are in, and the results are no less stunning than the size of the state's budget surplus. Thanks to the Minnesota State Board of Investment's (SBI) 30.3% fiscal year return – continuing a multi-year trend that places the SBI in the first percentile of performance for public plans bigger than $20 billion -- most of the state's plans have flipped from deficit to surplus on a current market value basis with current contribution levels often well in excess of what is needed to pay for new benefits earned each year. On an actuarial basis in which investment gains and losses are smoothed over 5 years to accommodate and manage inherent risks from market volatility, most plans remain slightly to moderately underfunded (with the exception of a couple of chronic laggards). Yet the $19 billion in investment returns the SBI performance represents makes state and local plans look the best they have in twenty years, regardless of the perspective taken.

It's interesting to consider how much of this improvement in public employees' economic interest and welfare stems from the actions taken by Minnesota's biggest rhetorical and political villains. During tax and government finance committee hearings in the 2021 session, public union and employee testimony along with several legislators highlighted and excoriated the findings of a Washington Post analysis that examined the financial results and actions taken by 50 of the biggest U.S. corporations during the Covid economy. That examination found nine out of ten turned a profit, collectively distributing more than $240 billion to shareholders through dividends and stock buybacks while cutting 100,000 employees. What did not get any recognition was the fact that according to its domestic public markets asset listing, the State Board of Investment had a $15.2 billion equity position in these 50 corporations at the end of 2020 representing over 50% of the value of the state's entire domestic equity portfolio.[1] Such is the mental compartmentalization demanded in debating the modern political economy.

Be that as it may, this is also excellent news for current and future taxpayers whose checkbooks and public services are exposed to the demands of retirement obligations. With respect to pension policy, the focus can shift a bit away from "what do we do to fix things," toward "how do we make the most of

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[1] According to SBI Comprehensive Performance Report for the quarter ending December 31, 2020, the total market value for the domestic equity portfolio was $28 billion.

this opportunity." With unfunded obligations at a twenty-year low, now would be a highly opportune time to explore the wide variety of structural reform options available in defined benefit, defined contribution, and hybrid plans. However, with plans currently looking as good as they have in a very long time, the motivation for such exploration is almost certainly non-existent.

A "Plan B" option to make the most of this opportunity would be to at least make further fixes to the flawed funding policies and reporting practices that make fiscally responsible and financially sustainable defined benefit plans more difficult. At the very top of that list is the discount rate employed to value pension plan liabilities in today's dollars. Minnesota plans (and for that matter all public defined benefit plans) use their assumed investment return as their discount rate which is a problem in its own right.[2] Using a more aggressive return assumption compounds the problem. Minnesota's assumed return of 7.5% is 50 basis points above the national median.

Battle Lines are Forming

The Panel believes it is prudent to lower the rates immediately. The Panel also supports future study to refine these assumptions, ***as well as to examine the investment return versus discount rate assumptions independently of each other. This is a first step, as additional reductions to the rate will likely be needed in the future.*** (emphasis ours)

> Recommendations to Governor Dayton from the Blue Ribbon Panel on Pension Reform, December, 2016

On the basis of this recommendation five years ago, Minnesota's public pension plans (eventually) lowered their discount rates to the current 7.5%. In the latest valuation reports the actuary for both the state employees (MSRS) and local employees plans (PERA) reports this 7.5% rate "deviates materially from the guidance set forth in the Actual Standards of Practice" and recommends a discount rate in the range of 5.71% - 7.00%. At recent pension plan board meetings, PERA (on a 7-4 split vote) voted to recommend legislation to go down to 6.5%. The MSRS board is proposing legislation to go down to 7.0%. The actuary for the teachers' plan (TRA) – which we note remains the weakest of the three major plans – remains comfortable with a 7.5% rate and as a result TRA is proposing no change at this time.

Meanwhile, the entire universe of pension beneficiaries -- 22 different state public sector union and retiree advocacy organizations – have submitted a letter to legislative leaders, agency management, and pension plan boards opposing "any proposals which lower the assumed rate of return for our pension

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[2] Basic principles of economics dictate the correct way to convert future cash flows to current dollars is with discount rates that reflect the riskiness of those cash flows. Cash flows to pay pension benefits are low risk – they have to be paid. This is why the federal government requires defined benefit plans in the private sector to use very conservative, high-quality corporate bond rates to value their future pension liabilities. Discounting pension liabilities using expected returns heavily based on risk equities of all types is often argued as the responsible way to avoid "over-contributing" for pension promises when in reality it's just the opposite. There is no better way to threaten the long-term viability of defined benefit plans than by making them appear cheaper than they really are and undercut necessary and fiscally responsible contribution policies in the process. Or as defined benefit pension expert Barton Waring, author of *Pension Finance: Putting the Risks and Costs of Defined Benefit Plans Back Under Your Control*, has said: "The use of an inaccurate discount rate creates real and consequential differences in the health of the pension plan as the use of the expected return assumption as the discount rate virtually guarantees the eventual failure of any plan using it"

funds without first doing a comprehensive analysis and having up to date experience studies," adding that the focus instead "should be on the most pressing concern, additional state funding to address the lost purchasing power of retirees' pension benefits."

It's important to understand what does not and does happen with a discount rate (a.k.a investment return assumption) change. It doesn't change what the SBI invests in nor their future actual returns. It doesn't change existing statutorily determined benefit levels.[3] It doesn't change statutorily determined member and employer contribution rates. It would, however, significantly affect the all-important perception game. More accurate reflection of the present value of existing pension liabilities help keep benefit increases or contribution cuts at bay while preventing some ongoing state contribution supports from terminating due to "premature" full funding reporting.

We applaud PERA and MSRS for their leadership on this issue which is likely to frustrate if not upset a significant subset of their respective memberships. We expect to have much more to say on this issue and the arguments raised in the months ahead.

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[3] Actuarially determined benefits like early retirement benefits and service purchases can be affected by the change.