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Public DB plans follow corporate lead in using “select and ultimate” rates

By Hazel Bradford

Officials in Vermont and Minnesota are responding to the pressure to lower their pension plans' assumed rates of return by doing so temporarily, without changing the long-term assumptions.

Instead of having a single rate of return, state officials are taking a page from their corporate counterparts and using a combination of rates that changes over time, known in actuary parlance as “select and ultimate” rates.

“One rate is not going to fit every scenario. This gives you the ability to look at things in a more comprehensive way,” said Vermont State Treasurer Beth Pearce, whose office in Montpelier administers the $3.3 billion Vermont State Retirement Systems. Under the select and ultimate method, the rate declined to 6.25% for fiscal 2012 ended June 30, from 8.25% for state employees and teachers, and 8% for municipal employees. It will rise slowly in a predetermined manner over 17 years to an ultimate rate of 9%.

In Minnesota, a legislative session dominated by the rate-of-return issue ended with the decision to try out a new approach for a five-year “select” period. After that, the new 8% return assumption will revert to the 8.5% rate in effect since 1989 for the $21.8 billion Minnesota Public Employees Retirement Association, the $11.3 billion Minnesota State Retirement Association, and the $17.3 billion Teachers Retirement Association of Minnesota, all based in St. Paul.

“We came to that decision through a lot of legislative compromises,” said Edward Burek, deputy director of Minnesota's Legislative Commission on Pensions and Retirement, St. Paul.
Even though some legislators wanted to push the rate of return to 4% or 5%, the increased contributions needed to protect the funding ratio if liabilities went up chilled that idea. “When they saw the impact on liabilities, they just couldn't take the hit,” Mr. Burek said in an interview.

Officials plan to monitor the effect of the lower rate over the next five years, but “I think everybody is hoping that (the market) improves and the problem just goes away,” he said.

Until it does, the select and ultimate approach means that plans using it “are going to have less investment loss to absorb,” said David Driscoll, a principal with Buck Consultants, Boston, who along with officials at investment consultant NEPC helped develop the actuarial and investment models that convinced Vermont officials to make the switch.

“We're very pleased with that,” said Ms. Pearce, Vermont's treasurer. “We didn't want the need for a certain return to drive our investment decision. We're very comfortable with our asset allocation.”

“Particularly with systems that want returns with riskier assets, select and ultimate makes a lot of sense,” said Mr. Driscoll.

He and other actuaries point out that since passage of the Pension Protection Act of 2006, corporate defined benefit plan sponsors have had to shorten the time frames for calculating their return assumptions, with the option of using segment rates to set discount rates for three periods.

Chris Lavelle, a former actuary who now serves as Vermont's investment consultant with NEPC's Boston office, said public plans already use ultimate and select assumptions to determine salary scales and other projections. “This is just using the same principle in responding to this (market) environment. This is more reflective of the economic reality. I think it works pretty nicely.”

Making the switch would undoubtedly require more analysis and calculations for public plans, but “I think a bit more upfront work is worth it,” said Kai Petersen, a principal with Buck in Los Angeles. “There is also more analytical rigor with this approach.”

“To the extent that it better reflects the expected investment return, then this method would be an improvement,” agreed Jean-Pierre Aubry, assistant director of state and local research for the Center for Retirement Research at Boston College. Still, he stresses that plans should base interest-rate assumptions on the “intimate knowledge” of asset allocations and markets.

The new approach can be politically more palatable as well, if contribution increases can be muted and a plan's funded status doesn't get thrown out of whack.

“It was the best decision that gave us a more conservative approach to ensure the financial stability of the system,” said Kevin Gaffney, who represents Vermont's state employees' association and chairs the $1.39 billion Vermont State Employees Retirement System, which along with the $1.52 billion teachers system and $410 million municipal system, make up the Vermont system.

Other public pension executives are starting to ask questions, said Mr. Driscoll of Buck Consultants. “We advocate consideration of it, and we offer it as an alternative. It might take some time to catch on, but I think it's worth the effort.”