Selecting Your OPEB Expected Long-Term Rate Of Return Assumption

Actuarial Consulting Group

Markets have changed and investment advisors are lowering their expectations of future returns. In this article we discuss the considerations in managing your selection of the Expected Long-Term Rate of Return (ERR) assumption when prefunding or considering prefunding retirement plans under these adverse market conditions.

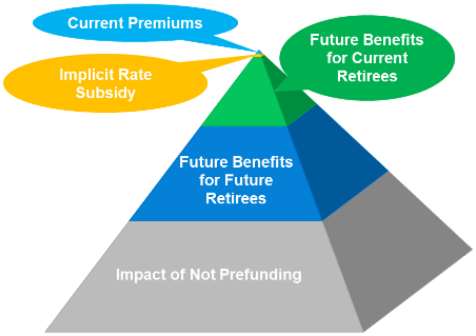
Background

The ERR is used by pension and other post-employment benefit (OPEB) plan sponsors in their actuarial valuations to calculate the Actuarially Determined Contribution (ADC) and the balance sheet liabilities, including the Total Pension Liability (TPL) and Total OPEB Liability (TOL). As the outlook for future returns decreases, plan sponsors are faced with questions about whether they should be lowering *their* expectations, too. Lowering the ERR increases the ADC, TPL, and TOL. While the outlook is less than optimistic, there are options to smooth the impact as we'll discuss later.

Why is the ERR assumption decision so important?

The ERR is critical because:

- Investment returns can pay from 50% to 70% of the cost of the plan, depending on the return achieved
- GASB 68 and 75 mandate liabilities be discounted using the plan sponsor's ERR; a 1% change in the discount rate could mean a 10%-25% change in liability



- Government bond rating agencies review the plan sponsor's choice of ERR (and other assumptions and methods) when assessing the soundness of management policies
- Contribution risk is directly correlated to the plan sponsor's ERR assumption

Retirement Plan Management

There are four policies used to manage pension and OPEB plans: the Benefits Policy, Funding Policy, Investment Policy and Accounting Policy. Each of these policies affect the other, thus changes to one of them means the impact on the others should be assessed.

Governmental employers should be familiar with the recent changes in Accounting Policy required by GASB for retirement plans. With GASB 68, 73, and 75 the full accrued liability has been brought onto the balance sheet, dramatically increasing the unfunded liabilities of many plans, which at one time were required to be reported on a cash accounting basis. These changes brought transparency to plan costs spurring some to revisit the Benefit Policy by changing design and some to revisit their Funding Policy and Investment Policy by prefunding.

While what we are considering (lower investment advisor ERRs) are less impactful than the recent accounting policy changes, it still warrants a review on how changes in this assumption impact policies for funding, accounting and possibly even benefits.

Recent Changes in Investment Advisor ERR

There are three main OPEB trust service providers in California, the California Employers Retiree Benefit Trust (CERBT), CSU Auxiliary Multiple Employer VEBA Trust (administered by Keenan Financial Services), and Public Agency Retirement Services (PARS).

Service Provider	Investment Advisor[1]	ERR Horizon
CERBT	CalPERS	20-to-60 years
Keenan	Morgan Stanley	20 years
PARS	Highmark Capital Management	30 years

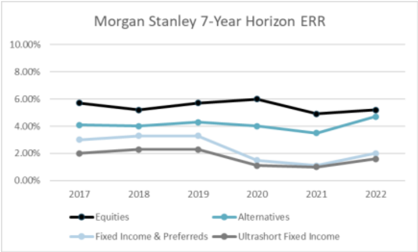
Asset allocation plays a big role in determining an ERR. The trusts managed by PARS and the CERBT have several off-the-shelf investment strategies with fixed asset allocations. These two organizations have recently announced updates to their ERRs for each one of these strategies:

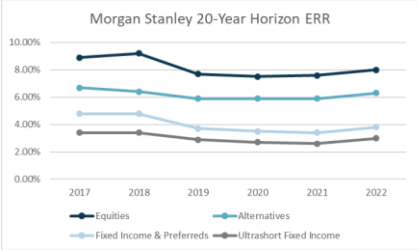
CERBT and PARS Expected Rates of Return (since last update)

CERBT	**Strategy 3**	**Strategy 2**	**Strategy 1**
Equity/Fixed	***35/65***	***52/48***	***70/30***
2018	6.22%	7.01%	7.59%
2022	5.00%	5.50%	6.00%

PARS	**Conservative**	**Moderately Conservative**	**Moderate**	**Balanced**	**Capital Appreciation**
Equity/Fixed	***15/85***	***30/70***	***50/50***	***60/40***	***75/25***
2015	4.95%	5.68%	6.48%	6.85%	7.39%
2022	4.66%	5.30%	5.95%	6.24%	6.60%

Morgan Stanley Expected Rates of Return





The CSU Auxiliary Multiple Employer VEBA Trust has an investment policy that targets a fixed level of return, and to achieve that target return Morgan Stanley has more latitude in changing the asset allocation. As a result, we do not have similar ERRs, but we do have Morgan Stanley's Global Investment Committee (GIC) 2022 Update of GIC Capital Market Assumptions[2], which shows a similar reduction occurring in the 20-year ERR in 2019, while the 7-year forecast was mixed.

Key Observation: CalPERS and Highmark do not publish their ERRs annually, but Morgan Stanley does. This is due to the differences in the purpose of the publications. CalPERS and Highmark are publishing ERRs to retirement plan sponsors

[1] CalPERS and Highmark base their ERRs in part on ERRs published by Wilshire Associates

[2] Morgan Stanley 2022 Annual Update of GIC Capital Market Assumptions

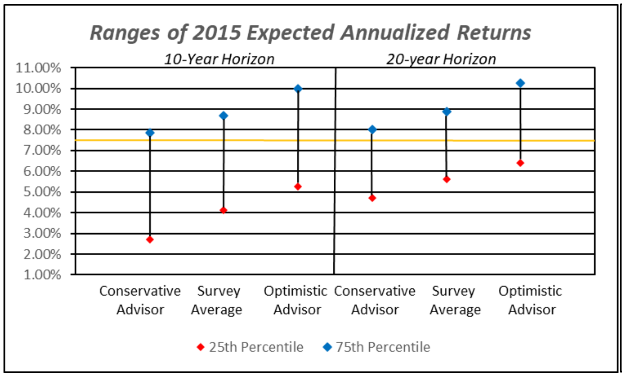
specifically for use as their ERRs for funding. Morgan Stanley's report is published to a broader audience and is not specifically for retirement plan funding. In particular, retirement plan sponsors have a ***longer-term*** time horizon for investing and they are not expected to change their ERRs as frequently as others.

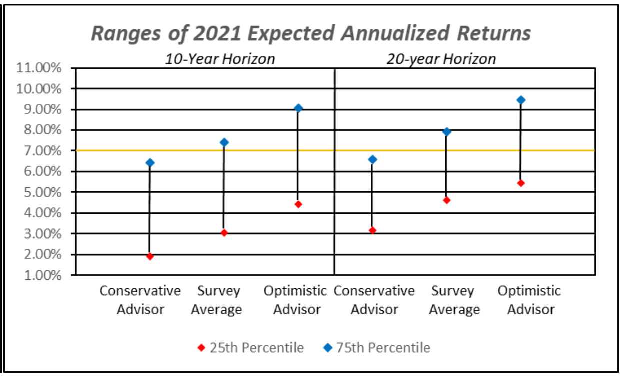
Why do Investment Advisors Have Different ERRs?

Generally, investment advisor ERRs tend to be similar in traditional investments, such as US equity and US fixed income. The differences in assumptions are more pronounced for alternative investments such as real estate, hedge funds, and private equity. Different strategies between advisors using these alternative investments in an effort to boost ERR is a likely reason for the disparity. A certain level of optimism about the future can also play a role.

In an effort to assess investment advisor optimism, one firm performs a survey of investment advisor ERRs and produces a report showing their comparison. The 2021 Horizon Survey of Capital Market Assumptions[3] included 39 investment advisory firm respondents, up from 29 in 2015. The firms responding include Morgan Stanley and Wilshire Associates (a source of ERRs by asset class used to develop ERRs published by Highmark and CalPERS). All firms reported ERRs with 10-yr horizons and some also reported separate ERRs with 20-yr horizons.

Based on the survey they found certain investment advisors tend to be the more conservative and others more optimistic. They differentiate these two groups in their analysis comparing them to the overall survey average. Below we show tables summarizing the 2015 and 2021 results:





Each range represents ERRs between the 25th percentile and the 75th percentile. The gold line represents a hypothetical plan (i.e., set of cash flows) they used to match with the 10-yr and 20-yr average ERRS from the study to come up with a specific ERR for that plan. This hypothetical plan would have lowered their ERR from 7.5% in 2015 to 7.0% in 2022 and the ranges meant:

- In 2015, the plan had a 7.50% ERR and the Survey Average group would say they have a 42% chance of achieving it over the next 20 years and
- In 2021, the Plan's ERR is 7.00% and the Survey Average group would say they have a 27% chance of achieving it over the next 20 years.

[3] 2022 Horizon Survey of Capital Market Assumptions

What the Regulators Say about the ERR

Most agencies fall under GASB accounting regulations, but some (e.g., charter schools and some auxiliaries) are governed by FASB. GASB and FASB rules for using the ERR in calculating balance sheet liabilities and annual expense differ. Both allow a credit in annual expense for expected investment earnings during the year, but GASB also allows liabilities to be discounted using the ERR while FASB requires the use of a risk-free rate of return based on bonds.

GASB and FASB refer the reader to the Actuarial Standards of Practice (ASOPs)[4] for methodologies in setting the ERR. The ASOPs require the actuary to use a building block approach that combines inflation, real rates of return by asset class, asset allocation, and projected cash flows[5], with the first three items required to be documented in your footnote disclosure. Actuaries are required to determine their best estimate of the ERR for purposes of funding and accounting valuations. However, when the ERR is set by another party, the actuary's role becomes one of assessment to determine if the ERR used is reasonable.

The rating agencies (Moody's, S&P and Fitch) also weigh in on the ERR. When assessing the health of the plan sponsor, they'll review assumptions and methods used by the plan sponsor to manage the plan and compare them to best practices. When it comes to the ERR, they will actually adjust the liabilities using their own ERR, which in 2022 is **6.00%** (S&P and Fitch) or **4.21%** (Moody's). This promotes consistency and comparability between entities they assess.

The Plan Sponsor ERR

Ultimately, the plan sponsor (or more precisely the financial manager) owns the ERR assumption because they are the one held accountable when it is wrong. But, when it comes to ERR, there really isn't any right answer. There are just answers that have more risk than others.

Contribution risk is defined as the potential of actual future contributions deviating from expected future contributions.[6]

Sample Plan Cost Breakdown Between Contributions and Investment Earnings				
Discount Rate / ERR	4.00%	5.00%	6.00%	7.00%
Expected Earnings	50%	59%	65%	70%
Expected Contribution	50%	41%	35%	30%

As the ERR increases, the more significant the reduction in expected contributions. This makes funding targets appear significantly more achievable, but also riskier. For strategic long-term planning purposes, it is easier to deal with having windfall returns than it is dealing with

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[4] For example, paragraph 42 of Statement 74 states "Unless otherwise specified by this Statement, the selection of all assumptions used in determining the total OPEB liability should be made in conformity with Actuarial Standards of Practice issued by the Actuarial Standards Board."

[5] ASOP 27 Selection of Economic Assumptions for Measuring Pension Obligations

[6] ASOP 51 "Risk Assessment in Practice"

perennially missing the investment return objective. This in an incentive for the financial manager/plan sponsor to be more conservative than the investment advisor when selecting their ERR for their funding policy.

GASB 75 and ASC 715 require disclose of the impact on the pension or OPEB liability due to a +/-1% change in the discount rate. The impact on the ADC/Expense is usually higher, but isn't required to be disclosed. Both of these items should be reviewed when making a change.

Options for Change

Making changes to your current ERR depends on several factors and you should consult with your actuary and investment advisor before making a change. When changing the ERR assumption, phasing it in can smooth out the impact the change has in your ADC, expense, and unfunded liability on your balance sheet.

For example, the State of California participates in CERBT Strategy 1 and has been phasing in a change in their OPEB plan ERR as follows: FY18 7.28%, FY19 7.00%, FY20 6.75%.

CalPERS took a similar approach with lowering the ERR for the *pension plan* from 7.50% to 7.00%. And they stated in their latest ACFR that in light of the new investment advisor ERR, they may be *lowering it again* in the near future!

ACG uses a building-block model based on ERRs by asset class published by JP Morgan[7], who is considered conservative and is one of the respondents in the Horizon Survey. Our consultants used this model for a pension plan sponsor that has a stand-alone trust. They were using a 7.50% ERR five years ago, which was supported by their investment advisor. At the time, our model was arriving at an ERR below 7.00%. We worked with the plan sponsor and their asset advisor to divorce the "employer's expectations of ERR to be achieved by the investment advisor" from the "employer's ERR to be used in calculating plan costs" to reduce contribution risk. The reduction in the employer's ERR occurred over the five-year period in 25-50 bps increments to a final rate of 6.00%, just in time for their upcoming bond issuance.

Conclusion

The funding policy ERR is an important assumption decision since it has a big impact on the long-term contribution strategy. Strategies for managing contribution risk suggest a conservative ERR outlook in your funding policy, even when the investment policy ERR is designed to be aggressive. Recent reductions in ERR published by CalPERS and PARS may not be a big deal if you have already been reflecting conservatism to account for news like this. Nevertheless, you don't have to change your ERR in your funding policy as a result of this news, but should be aware of increased contribution risk and formally assess whether the funding policy ERR should be changed.

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May 17, 2022

[7] 2022 JP Morgan Long-Term Capital Market Assumptions