In our last article we discussed the long-term downward trend in interest rates and how it has dramatically increased the cost of funding pensions. In 1985 you could have funded a $1,000 lump sum benefit payable in 30 years for only $38. At today's interest rates (30-year Treasuries are around 3%), it costs more than 10 times as much --$422 -- to fund that benefit. But, as we noted, many plan professionals will argue that current interest rates only reflect short term conditions. Because pension benefits are long-term liabilities they should be valued using interest rates reflecting long run trends. Taking this approach, multiemployer plans can use a "reasonable rate" based on what the plan's portfolio is expected to earn, in the long run. Indeed, most multiemployer plans use a 7.5% rate. Problem solved. Or is it? Use of a relatively high (relative to current rates, that is) interest rate to value plan liabilities and determine funding and investment policy is based in part on the assumption that current interest rates are "abnormally low" and that "long term yields" must go higher. Of course, it is a very safe assumption that interest rates will rise … "sometime." And it's true that, over the last 30 years, the average long-term rate (e.g., 30-year Treasuries) has been around 6.4%. Add another 100 basis points for the (historical) high-quality spread over Treasuries and you achieve this 7.5% assumption.

But just looking back 30 years and taking an average ignores what has really happened with interest rates over the last 30 years. The trend -- over the last 30 years, over the last 10 years and over the last 12 months -- has been for interest rates to go down. The following chart shows long-term interest rates over the last three decades.

**Ryan Labs 30 Year Treasury Composite Rate**

End of year 1983-2012
The point of actuarial "smoothing" (or any approach that uses average rates) is to smooth out periodic ups and downs, to get at the "real" long run interest rate. But when the trend is all in one direction -- in the case of long term interest rates, down -- then all that averaging does is allow you to ignore the trend and pretend that rates are higher than they actually are.

When you think about it -- and consider the direction of interest rates over the last 30 years -- you have to conclude that using a 7.5% valuation interest rate must be based on a belief that interest rates are going to go up. Is that belief realistic? Consider: the population in the developed world is rapidly aging, creating demand for safe returns and driving down rates; the dollar's status as the world's reserve currency makes it the natural "safe haven" in uncertain times, driving down rates; and developing countries are pursuing aggressive "export driven" monetary policies, undervaluing their own currencies and buying dollars, and driving down rates. Yes, it's reasonable to argue that the Fed has its finger on the scale and is holding rates down. But, long term, it's very unlikely that interest rates will go up dramatically -- say to 7.5%.

So -- at some point, the impact of lower rates on multiemployer plan valuations will have to be recognized. That's the first problem with using such a high (and, we believe, unrealistic) rate for plan design, benefit enhancements, contribution policy and investment policy.

The second problem is, as we said in our first article, low rates are a signal: in the "new normal," returns are going to be lower, not just for fixed income securities, but for equities too. When market interest rates are, for instance, around 8.0%, achieving a 7.5% return is relatively straightforward. When the Fed Funds rate is 0.25%, chasing a 7.5% bogey gets significantly more difficult. Plans are forced to take on more and more risk and leverage, increasing the possibility not just that they will come up short but that they will lose big.

The final problem: when it becomes clear that there's not a 7.5% "magic bullet" that will solve the problem of funding retirement benefits in the new environment, and as the risks taken on by plans trying to pull that off mount, there will be changes in regulations.

We're not saying plans should drastically reduce their valuation discount rate all at once. But key decisions that will have real world consequences -- decisions about investment strategy and design -- must reflect real world conditions, not some unrealistic rate you are "allowed to use" because regulatory convention has not caught up.