STATE TREASURER OF NORTH CAROLINA
DALE R. FOLWELL, CPA

TO: Teachers' and State Employees' Retirement System (TSERS) Board of Trustees

FROM: Patrick Kinlaw, Director of Policy, Planning and Compliance

DATE: April 25, 2024

RE: Sample Format of Regular Report Regarding Investment Performance

Purpose

This document provides the Boards of Trustees (Boards) of TSERS and the Local Governmental Employees' Retirement System (LGERS) with a draft format of a report that RSD staff expects to use in future years' January meetings, to satisfy a request made by motion of the LGERS Board on January 25, 2024. The motion was to direct RSD staff to prepare a **"regular written report on investment performance since it is integral to the discussions of the Board related to the ECRSP [Employer Contribution Rate Stabilization Policy] and COLAs [Cost-of-Living Adjustments]."** Following the LGERS Board's approval of this motion, the Chair of the TSERS and LGERS Boards directed staff to prepare the same type of report for TSERS in future years.

This document provides background on the topic, and then provides draft hypothetical formats of the reports for both TSERS and LGERS as if such a report had been required in advance of the January 2024 meeting of the Boards. The first annual report in accordance with the recently adopted motion will be presented to the Boards in January 2025.

Background

The Boards typically make recommendations to the legislature each year regarding contribution rates (or amounts) and benefit improvements in relation to the fiscal year that will begin in July. In the case of TSERS, the General Assembly makes decisions and appropriations regarding benefit adjustments. In the case of LGERS, the Board is authorized to make certain decisions under limited conditions without legislative actions.

The Boards' recommendations and decisions typically occur at their meetings in January, to allow for communication to the legislature and other interested or affected entities. The recommendations and decisions are informed by the reports that the consulting actuary published in the previous October, as well as preliminary (not final) estimates of the investment performance during the recently concluded calendar year. Estimates of the most recent calendar year investment performance are provided by the Investment Management Division (IMD) of the Department of State Treasurer to the Retirement Systems Division (RSD) around the middle of January – in other words, in the days leading up to the Boards' January meeting.

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In preparation for the Boards' meeting each January, RSD staff has provided the Boards with various reports to inform the Boards' decisions and recommendations. These reports have been in both detailed and "executive summary" formats, and in both written and verbal formats. As RSD staff understands the LGERS Board's January motion, it does not necessarily require an elimination of the reports and information below, which still may be provided on a discretionary basis.

- The materials for the January meetings have included overviews of the available information regarding actuarial investment gains and benefit improvements. These overviews quote the relevant information from the consulting actuaries' reports. If the actuaries have found that there are actuarial investment gains potentially available for benefit improvements, the overviews have provided further information about the most recent year's estimated investment return for the Boards' consideration. See for example the information provided in the "Cost of Living Adjustment" sections of the documents presented in January 2023 (page 3 for State Board and pages 2-4 for Local Board) and January 2024 (page 3 for State Board and pages 2-3 for Local Board).
- Page 1 of each of the above-linked documents provides an "Executive Summary" of the staff's perspective on decisions and recommendations available to the Boards.
- To ensure the Boards have an opportunity to discuss and ask questions about this important topic, RSD staff has also provided a verbal summary near the beginning of each January meeting agenda, as well as additional summaries for each Board relative to that Board's own decisions. The Department of State Treasurer publishes recordings of the meetings on the Boards' website. For example, see the briefings from the recording of the January 2023 meeting, at 1:30:00-1:40:50 (general), 2:12:05-2:16:00 (TSERS), and 4:06:40-4:11:10 (LGERS).
- RSD staff has, in recent years, repeatedly invited Board members to attend quarterly meetings of the Investment Advisory Committee (IAC), or to monitor the investment performance and other public documents posted each quarter on the IAC's website.
- Staff has informed Board members of other investment summaries prepared regularly and published on IMD's website.
- At each meeting, the Boards have received a report from a Board member who also serves on the IAC, providing information about the most recent IAC meeting that may be of interest to the Boards.

Hypothetical Draft Reports for TSERS and LGERS

The following pages contain hypothetical reports in accordance with the January 2024 motion adopted by the LGERS Board, as if the reports had been required in advance of the January 2024 meeting. This is to prepare the Boards for the likely formatting of the reports.

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Hypothetical Draft Report for TSERS

The following is a draft report prepared as if the January 2024 LGERS Board motion had been adopted prior to the January 2024 meeting of the TSERS Board. The first "regular report" prepared in accordance with the LGERS Board motion will be presented to the TSERS Board in January 2025.

Executive Summary of Information Regarding Investment Returns and Benefit Improvement Decisions for Teachers' and State Employees' Retirement System (TSERS) as of January 2024

I. Key Statutory Provisions and Board Policy Provisions

a. G.S. 135-5(o) provides that TSERS retirees and beneficiaries "shall be entitled to" inflation-based (limited to 4%) adjustments to retirement allowances "provided that any such increase in allowances shall become effective only if the additional liabilities on account of such increase do not require an increase in the total employer rate of contributions."

b. G.S. 135-5(o) further provides that TSERS retirees and beneficiaries "may receive cost-of-living increases in retirement allowances if active members of the system receive across-the-board cost-of-living salary increases. Such increases in post-retirement allowances shall be comparable to cost-of-living salary increases for active members in light of the differences between the statutory payroll deductions for State retirement contributions, Social Security taxes, State income withholding taxes, and federal income withholding taxes required of each group. The increases for retired members shall include the cost-of-living increases provided in this section [i.e., in I.a. above]. The cost-of-living increases allowed retired and active members of the system shall be comparable when each group receives an increase that has the same relative impact upon the net disposable income of each group."

c. The Board's Employer Contribution Rate Stabilization Policy (ECRSP) requires that the Board's recommended contribution rate for FY ending 2025 be at least equal to the recommended contribution rate for FY ending 2024 increased by 0.35% of compensation. For this purpose, the recommended contribution rate for FY ending 2024 "should be adjusted for the effect of any benefit change enacted by the General Assembly, taking effect during [FY ending 2025], including COLA supplements, that was not incorporated in the Board's recommendation for [FY ending 2024]."

II. Statements by Consulting Actuary (Buck) in Most Recent Actuarial Valuation Report

a. "The December 31, 2022, valuation indicates an actuarial investment loss was incurred during 2022, and there are no investment gains available to support a recommendation of either of the following by the TSERS Board of Trustees: [1] a cost-of-living adjustment (COLA) that would take effect on July 1, 2024; or [2] a one-time supplement to participants in receipt of benefits on September 1, 2024, payable October 2024." (p. 13)

b. "Based on the methods and assumptions used for projections discussed later in the presentation, the standard conditions for the Board to consider proposing a potential COLA effective July 1, 2025, following the December 31, 2023, valuation would include the following minimal levels of investment return on market values of assets during 2023…. If calendar year 2023 market value returns exceed 14.91% (or about $11.4 billion for TSERS), [TSERS] is estimated to have an actuarial investment gain (rather than a loss) for 2023 and a COLA effective July 1, 2025 could be considered." (p. 14)

c. "Buck cannot provide legal advice. Neither this slide, nor any other slide, should be interpreted as legal advice as to the Board's ability to provide a COLA to retirees or recommend a COLA to the legislature." (p. 13)

III. Preliminary Calendar Year 2023 Investment Returns

a. In January 2024, staff of the Department of State Treasurer's Investment Management Division (IMD) informed RSD that the preliminary calendar year 2023 rate of investment return for the North Carolina Retirement Systems was +10.2%. This estimate is subject to change.

IV. Staff Observations

a. Based on p. 13 of the consulting actuary's most recent valuation report, there were no actuarial investment gains as of December 31, 2022 available to support a benefit improvement during FY ending 2025.

b. Based on p. 14 of the consulting actuary's most recent valuation report, the preliminary investment return of +10.2% during calendar year 2023 is less than the rate of +14.91% that would have been necessary to establish an actuarial investment gain to support a potential benefit improvement during FY ending 2026.

c. Benefit promises must be funded either by future contributions (and investment returns thereon), or by past contributions (and investment returns thereon), or some combination. An unfunded actuarial accrued liability (UAAL) means that the past contributions and investment returns thereon have not been fully sufficient to support already-promised benefits.

V. Additional Resources

a. TSERS actuarial valuation report published October 2023, describing the funded status of TSERS as of December 2022, relative to benefits already promised.

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   i. UAAL as of 12/31/2022: $11.3 billion (p. 8)
   ii. Actuarial Value of Assets as of 12/31/2022: $85.4 billion (p. 46)
   iii. Actuarial Accrued Liability as of 12/31/2022: $96.7 billion (p. 46)
   iv. Additional cost of 1% permanent increase in retirement allowances: $560.8 million, or an increase of 0.41% in the employer contribution rate for a 12-year period (p. 13)
   v. Additional cost of one-time 1% supplemental payment to retirees and beneficiaries: $56.6 million, or an increase of 0.31% in the employer contribution rate for a single year (p. 13)

b. TSERS funding projections from Buck in these meeting materials, taking into account only benefits already promised.
   i. Preliminary Estimated UAAL as of 12/31/2023: $10.5 billion (p. 8)
   ii. Projected Employer Contribution Toward Retirement in FY ending 2025: 16.79% of compensation (p. 3); equates to $2.0 billion General Fund, $3.2 billion all funding sources; does not include member contributions (6% of compensation) or contributions toward retiree medical, death, or disability
   iii. Projected Employer Contribution Toward Retirement in FY ending 2026: 17.14% of compensation (p. 3); equates to $2.0 billion General Fund, $3.3 billion all funding sources; does not include member contributions (6% of compensation) or contributions toward retiree medical, death, or disability

c. Recommendation alternatives from RSD staff in these meeting materials.

d. Consumer Price Index history through June 2023 from the U.S. Bureau of Labor Statistics.

e. Board of Trustees website with past meeting materials, including minutes describing quarterly updates on Investment Advisory Committee (IAC) meetings.

f. IAC website with meeting materials, including link to archived years' materials, containing quarterly reports on investment performance and other information about investment policies and recommendations.

g. Investment performance and fee reports published by IMD; some reports are quarterly and some annual.

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Hypothetical Draft Report for LGERS

The following is a draft report prepared as if the January 2024 LGERS Board motion had been adopted prior to the January 2024 meeting of the Board. The first "regular report" prepared in accordance with the motion will be presented to the Board in January 2025.

Executive Summary of Information Regarding Investment Returns and Benefit Improvement Decisions for Local Governmental Employees' Retirement System (LGERS) as of January 2024

I. Key Statutory Provisions and Board Policy Provisions

a. G.S. 128-27(k) provides that LGERS retirees and beneficiaries "shall be entitled to" inflation-based (limited to 4%) adjustments to retirement allowances "provided that any such increase in allowances shall be contingent upon the total fund providing sufficient investment gains to cover the additional actuarial liabilities on account of such increase. The determination of whether there are sufficient investment gains to cover the possible postretirement increase in allowance shall reside exclusively within the discretion of the Board of Trustees and shall be informed by the findings within the annual actuarial valuation reports. In considering whether to grant a postretirement increase, the Board of Trustees shall take into account both the rate of inflation as determined by the Consumer Price Index and the record of investment gains or losses during the preceding three-year period."

b. G.S. 128-27(k) further provides that "[n]otwithstanding the foregoing linkage between increases in the Consumer Price Index and correlative contingent increases in retirement benefits determined by the availability of sufficient investment gains to cover the additional actuarial liabilities arising from those increased benefits, the Board of Trustees, may in any year, considering an increase, if any, in the Consumer Price Index, fund a cost-of-living increase in a percentage amount, measured in tenths of one percent (1/10 of 1%), of up to four percent (4%), provided that the Board may use only investment gains to fund such an increase."

c. G.S. 128-27(k1) provides that LGERS retirees and beneficiaries "shall be entitled to" inflation-based (limited to 4%) one-time pension supplement payments, "provided that any such one-time pension supplement shall be contingent upon a determination by the Board of Trustees under subsection (k) of this section that a permanent increase in benefits will not be paid during the same fiscal year as the one-time pension supplement, but the total fund is providing sufficient investment gains to cover the additional actuarial liabilities on account of such one-time pension supplement. The determination of whether there are sufficient investment gains to cover the one-time pension supplement shall reside exclusively within the discretion of the Board of Trustees and shall be informed by the findings within the annual actuarial valuation reports. In considering

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whether to grant a one-time pension supplement, the Board of Trustees shall take into account both the rate of inflation as determined by the Consumer Price Index and the record of investment gains or losses during the preceding three-year period."

a. The Board's Employer Contribution Rate Stabilization Policy (ECRSP) requires that the Board's recommended contribution rate for FY ending 2025 be adjusted "for the effect of any enacted benefit change taking effect before or during [FY ending 2025] that was not incorporated in the Policy Contribution [for FY ending 2024]."

II. Statements by Consulting Actuary (Buck) in Most Recent Actuarial Valuation Report

a. "The December 31, 2022, valuation indicates an actuarial investment loss was incurred during 2022, and there are no investment gains available to support authorization by the LGERS Board of Trustees of either of the following: [1] a cost-of-living adjustment (COLA) that would take effect on July 1, 2024; or [2] a one-time supplement to participants in receipt of benefits on September 1, 2024, payable October 2024." (p. 12)

b. "Based on the methods and assumptions used for projections discussed later in the presentation, the conditions for the Board to consider granting a COLA effective July 1, 2025, following the December 31, 2023, valuation would include the following minimal levels of investment return on market values of assets during 2023…. If calendar year 2023 market value return is at least 15.09% (or about $4.45 billion for LGERS), [LGERS] is estimated to have an actuarial investment gain (rather than a loss) for 2023 and such gain may be enough to provide some level of COLA effective July 1, 2025." (p. 13)

c. "Based on the methods and assumptions used for projections discussed later in the presentation, the conditions for the Board to consider granting a one-time supplement to all in-receipt participants as of September 1, 2025 (payable in October 2025), following the December 31, 2023, valuation would include the following minimal levels of investment return on market values of assets during 2023…. If calendar year 2023 market value return is at least 15.09% (or about $4.45 billion for LGERS), [LGERS] is estimated to have an actuarial investment gain (rather than a loss) for 2023 and such gain may be enough to provide a one-time supplement payable in October 2025." (p. 14)

d. "Buck cannot provide legal advice. Neither this slide, nor any other slide, should be interpreted as legal advice as to the Board's ability to provide a COLA to retirees or recommend a COLA to the legislature." (p. 14)

III. Preliminary Calendar Year 2023 Investment Returns

a. In January 2024, staff of the Department of State Treasurer's Investment Management Division (IMD) informed RSD that the preliminary calendar year 2023 rate of investment return for the North Carolina Retirement Systems was +10.2%. This estimate is subject to change.

IV. Staff Observations

a. Based on p. 12 of the consulting actuary's most recent valuation report, there were no actuarial investment gains as of December 31, 2022 available to support a benefit improvement during FY ending 2025.

b. Based on pp. 13-14 of the consulting actuary's most recent valuation report, the preliminary investment return of +10.2% during calendar year 2023 is less than the rate of +15.09% that would have been necessary to establish an actuarial investment gain to support a potential benefit improvement during FY ending 2026.

h. Benefit promises must be funded either by future contributions (and investment returns thereon), or by past contributions (and investment returns thereon), or some combination. An unfunded actuarial accrued liability (UAAL) means that the past contributions and investment returns thereon have not been fully sufficient to support already-promised benefits.

V. Additional Resources

a. LGERS actuarial valuation report published October 2023, describing the funded status of LGERS as of December 2022, relative to benefits already promised.
    i. UAAL as of 12/31/2022: $4.4 billion (p. 8)
    ii. Actuarial Value of Assets as of 12/31/2022: $32.7 billion (p. 47)
    iii. Actuarial Accrued Liability as of 12/31/2022: $37.1 billion (p. 47)
    iv. Additional cost of 1% permanent increase in retirement allowances: $201.3 million, or an increase of 0.31% in the employer contribution rate for a 12-year period (p. 12)
    v. Additional cost of one-time 1% supplemental payment to retirees and beneficiaries: $19.0 million, or an increase of 0.22% in the employer contribution rate for a single year (p. 12)
    vi. Rates of return for calendar years 2020-2022: +11.14% (2020); +9.66% (2021); -10.35% (2022) (p. 34); three-year geometric return +3.0%

b. LGERS funding projections from Buck in these meeting materials, taking into account only benefits already promised.
    i. Preliminary Estimated UAAL as of 12/31/2023: $4.4 billion (p. 10)
    ii. Projected Employer Contribution in FY ending 2025: 13.60% of compensation for non-LEOs and 15.10% for LEOs (pp. 4-5); equates to

$1.2 billion ($1,168 million); does not include member contributions (6% of compensation)

iii. Projected Employer Contribution in FY ending 2026: 14.35% of compensation for non-LEOs and 16.10% for LEOs (pp. 4-5); equates to $1.2 billion ($1,235 million); does not include member contributions (6% of compensation)

c. Decision and recommendation alternatives from RSD staff in these meeting materials.

d. Consumer Price Index history through June 2023 from the U.S. Bureau of Labor Statistics.

e. Board of Trustees website with past meeting materials, including minutes describing quarterly updates on Investment Advisory Committee (IAC) meetings.

f. IAC website with meeting materials, including link to archived years' materials, containing quarterly reports on investment performance and other information about investment policies and recommendations.

g. Investment performance and fee reports published by IMD; some reports are quarterly and some annual.