January 26, 2023

Summary of Funding/Benefits Alternatives for Recommendations and Decisions for Fiscal Year Ending in 2024

Local Governmental Employees' Retirement System (LGERS) Board of Trustees

Executive Summary

This document summarizes alternatives for the Board's funding and benefits recommendations and decisions for the fiscal year ending in 2024.

For LGERS itself, the Board sets employer contribution rates and has limited authority to provide increases to ongoing retirement benefits (COLAs) or one-time payments to beneficiaries (supplements). For the other benefit programs described in this memo, the Board does not establish funding or benefit requirements itself. For those programs, the Board may make recommendations to the legislature informed by the most recent annual valuation reports from the consulting actuaries, published in October 2022.

Staff believes the following are substantive issues for the Board to consider:

(1) Establishment of employer contribution rates for LGERS, along with consideration of COLAs or supplements. A decision about COLAs or supplements, if any, is connected to the decision about the employer contribution rate for the upcoming fiscal year. The two are connected by actuarial assumptions and methods adopted by the Board, including the Employer Contribution Rate Stabilization Policy (ECRSP).

(2) Whether to recommend a benefit improvement under the Firefighters' and Rescue Squad Workers' Pension Fund (FRWSPF). Under the Board's policy, such a recommendation would require a simultaneous recommendation to increase the monthly member contribution rate from $10 to $15. It also requires that the Board request any additional appropriation necessary to support the increase. The assessment of how much funding is required to support a benefit increase is challenging in the current market environment (funding surplus measured at December 31, 2021, followed by a significant 2022 market downturn that is known but not yet precisely measured). The Board's policy provides guidance for a minimum funding amount, and staff provides additional considerations in this memorandum.

(3) Possible recommended program design changes to address the projected actuarial shortfall in the Retirees' Contributory Death Benefit Plan. This is addressed in a separate agenda item of today's meeting.

The remainder of this memo provides details regarding each Retirement System.

LGERS

Issue. G.S. 128-30(d)(5) requires that employer contributions to LGERS in each year "shall not be less than the sum of the rate per centum known as the actuarially determined employer contribution [ADEC] rate… as adjusted under a contribution rate policy adopted by the Board of Trustees and known as the 'required employer contribution' rate." G.S. 128-30(d)(2a) requires that the ADEC rate "shall be calculated annually by the actuary using assumptions and a cost method approved by the Actuarial Standards Board of the American Academy of Actuaries and selected by the Board of Trustees."

1. <u>ADEC Prior to Contribution Rate Policy</u>

The most recent LGERS actuarial valuation report documents the ADEC rates for the fiscal year ending in 2024. The "ADEC Prior to Contribution Policy" is the mathematical contribution rate that would fund the system using the Board's assumptions and methods adopted on January 28, 2021, and plan population and asset information as of December 31, 2021. For employees other than law enforcement officers (non-LEOs), the "ADEC Prior to Contribution Policy" is 10.43% of pay. For law enforcement officers (LEOs), it is 12.39% of pay.

2. <u>Adjustment for Employer Contribution Rate Stabilization Policy (ECRSP)</u>

The Board adopted the current ECRSP on April 29, 2021. This policy serves to provide predictable incremental increases in the employer contribution rate to protect against potential adverse experience for the five fiscal years ending 2023 through 2027. **The ECRSP would result in recommended contribution rates for the fiscal year ending in 2024 equal to 12.85% of covered pay for non-LEOs and 14.10% of covered pay for LEOs.**

For non-LEOs, the rate is determined as the prior year's policy contribution (12.10%) plus 0.75%.[1] For LEOs, the rate is determined as the non-LEO rate (12.85%) plus 1.25%.[2] These ECRSP rates have the effect of increasing the ADEC from the rates in part (1), by a total of $174 million for the second year of the five-year ECRSP.[3] They represent an increase of $60.3 million from the amounts employers are expected to pay for the fiscal year ending 2023.

Cost of Living Adjustment (COLA). Under G.S. 128-27(k) and (k1), the Board may authorize a COLA no greater than 4%, or a supplement that is no greater than 4% of the annual retirement allowance.[4] If the Board authorizes a supplement, the Board must also determine that it will not provide a COLA taking effect in the same year as the supplement.

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[1] Additional adjustments would have been required if there had been any enacted change in benefits, assumptions, or methods, not yet incorporated in the policy contribution, with an effect measured by the consulting actuary. However, there have been no such changes. Another adjustment would have been required if the non-LEO rate described in part (1) above (10.43%) exceeded the policy rate of 12.85% by at least 1.00% of compensation, but it does not.

[2] Additional adjustments would have been required if there were enacted LEO-specific changes in benefits not yet incorporated in the policy contribution, with an effect measured by the consulting actuary, but there have been none.

[3] As illustrated in the footnotes to the "Summary" page of this document, the approximate dollar amounts for appropriations effective July 1, 2023, are estimated using the "Estimated State Payrolls for Retirement Appropriations Purposes for the 2022 Session of the North Carolina General Assembly," set forth in a letter from the Director of the Retirement Systems to the State Budget Director and the Director of the Fiscal Research Division of the General Assembly, dated June 3, 2022. For example, the approximate increase in ADEC ($174 million) is estimated as $1,334,524,000 (the LGERS LEO payroll from the aforementioned memo) multiplied by 1.71% (the difference between 14.10% in part 2 and 12.39% in part 1), plus $6,261,738,000 (the LGERS non-LEO payroll) multiplied by 2.42% (the difference between 12.85% in part 2 and 10.43% in part 1). Once a similar payroll letter is finalized for the 2023 Session of the General Assembly, the dollar amounts would change in accordance with the new estimated payroll amounts.

[4] The COLA or supplement must also be no greater than inflation during the calendar year. Since inflation during calendar year 2021 exceeded 4%, the relevant limit is 4%.

The cost of a COLA or supplement authorized by the Board is limited to the actuarial investment gains. Notwithstanding the amount of investment gains experienced in a year, the ECRSP provides that the employer contribution for any year through fiscal year ending in 2027 will be adjusted for the effect of any benefit change taking effect during the year. This would include the cost of COLAs or supplements.

The consulting actuaries' report from October 2022 shows that during calendar year 2021, the investment gains recognized on an actuarial basis were $770 million, more than commensurate with the cost of a 4.00% permanent COLA. The report cautioned that in making any decision, the Board should consider the question, "Is the investment gain permanent?" The report also observed that despite the actuarial investment gains recognized in 2021, "the unfunded liability of LGERS remains significant at $3.2 billion," and that "[year-to-date] 2022 investment returns have been far below the assumed return."

The report summarized the costs of permanent COLAs and one-time supplements as follows. (Italicized numbers are filled in by RSD staff actuary based on consulting actuary's report.)

<u>Permanent COLA Costs</u>

Percent COLA	None	1.00%	2.00%	*3.00%*	4.00%
Increase in Unfunded Liab. ($M)	$0	$189	$379	*$568*	$757
Increase in Employer Contribution as Percent of Pay for 12 Years	0.00%	0.32%	0.64%	*0.96%*	1.28%
Increase in Annual Employer Cost for 12 Years ($M)	*$0.0*	*$24.3*	*$48.6*	*$72.9*	*$97.2*

<u>One-Time Supplement Costs</u>

Percent of One-Time Supplement	None	1.00%	2.00%	*3.00%*	4.00%
Increase in Unfunded Liab. ($M)	$0	$18	$36	*$54*	$72
Increase in Employer Contribution as Percent of Pay for 1 Year	0.00%	0.23%	0.46%	*0.69%*	0.92%
Increase in Employer Cost for 1 Year ($M)	*$0.0*	*$17.5*	*$34.9*	*$52.4*	*$69.9*

In evaluating whether the investment gains of $770 million recognized during 2021 are "permanent," the Board may consider that the estimated investment experience during calendar year 2022, on a market value basis, was a <u>loss of $5.6 billion</u>. This is the staff actuary's estimate based on an estimated percentage return of <u>negative</u> 10.4%, as compared to the assumed return of <u>positive</u> 6.5%. These losses will be recognized into actuarial figures over the coming years. In projections presented today, the consulting actuary estimates that the 2022 investment losses will require continued increases in employer contribution rates through the fiscal year ending 2029 (beyond the current ECRSP period) to fund already-promised benefits, even if the assumed return of positive 6.5% is achieved in each year 2023 and later. The cost of any COLA or one-time supplement, as determined by the above tables, would be added onto these anticipated contribution rate increases.

Under its current policy, the Board could:

A. **Implement a COLA** effective July 1, 2023. The maximum COLA eligible for Board enactment would be 4.00%. That amount of COLA would call for increasing the employer contribution rate by 1.28% of pay for 12 years under the ECRSP. At current payroll levels, this would equate to approximately $97 million per year for 12 years to be paid by local government employers, for a total 12-year expenditure of approximately $1.2 billion.

B. **Implement a one-time supplement** to be paid during October 2023. The maximum supplement eligible for Board enactment would be 4.00%, and a supplement at that level would call for increasing the employer contribution rate by 0.92% for a single year, or approximately $70 million.
C. **Implement no COLA or one-time supplement**.

The Board could implement either (A) or (B), but could not implement both.

The increase in employer contribution rates described for (A) or (B) is not a direct requirement of statute, but is part of the Board's ECRSP. In the view of staff, it is prudent to require corresponding increases to the employer contribution if a COLA or supplement is authorized. Unlike the State System's ECRSP, the Local System's ECRSP does not guarantee employer contributions at least equal to the actuarially determined requirements (ADECs) over its five-year term. There is a risk that contributions will not keep pace with ADECs, putting the plan at a long-term funding disadvantage and requiring steep increases in employer contributions at the end of the five years. This risk is closely correlated to the risk of capital market downturns beyond the Board's control, which in fact have been observed during calendar year 2022. In view of this very significant risk to the stability of LGERS, the ECRSP is designed to ensure funding exceeding actuarially determined amounts in its early years (for example, the $174 million planned for the fiscal year ending 2024), to build protection against this risk for the remainder of the five years. COLAs or supplements not paid for by an adjustment to employer contributions reduce the extent to which the ECRSP protects against this risk.

Policy Options for Consideration by the Board of Trustees.

- The Board could set an employer contribution rate for the fiscal year ending in 2024, equal to 14.10% for LEOs and 12.85% for all other employees, with no COLA or one-time supplement authorized. This would require an increase of approximately $60 million in employer contributions as compared to the fiscal year ending in 2023.
- The Board may follow any of the options in (A) through (C) above. Under the Board's policy, options (A) or (B) would require an adjustment to the employer contribution rate as described in the tables under the "COLA" section above. Furthermore, if the Board were to elect option (B), the Board would be required by statute to determine that it will not authorize a COLA under option (A) taking effect in the same year.

Firefighters' and Rescue Squad Workers' Pension Fund (FRSWPF)

Issue. The Board adopted the State Contribution Rate Stabilization Policy (SCRSP) on April 29, 2021. Under Section IV of the SCRSP, the recommended State contribution for the fiscal year ending in 2024, prior to any adjustment for benefit changes, is the greater of (1) the appropriation for the fiscal year ending in 2023, plus $350,000; or (2) the underlying actuarially determined contribution (ADEC) determined by the consulting actuary for the fiscal year ending in 2024. The ADEC for the fiscal year ending 2024 is the mathematical contribution amount that would fund the system using the Board's assumptions adopted on January 28, 2021, and plan population and asset information as of December 31, 2021.

Item (1) is equal to the recommended and actual appropriation for the fiscal year ending 2022 ($19,702,208) plus $350,000, or $20,052,208. Item (2), the underlying ADEC, is $3,253,378 according to the most recent FRSWPF actuarial valuation report. Therefore, the SCRSP results in a recommended State contribution of $20,052,208 for the fiscal year ending in 2024, which is the greater of item (1) or item (2). This is $350,000 greater than the appropriated amount for the fiscal year ending in 2023. The SCRSP provides that this recommendation should be adjusted if there is a recommendation for a benefit increase as described below.

Benefit Increase. Under Section V of the SCRSP, the Board could recommend that the General Assembly increase the pension amount of $170 per month by up to $15, subject to the two conditions below.[5]

Member Contribution (First Condition): Along with any recommended benefit increase, the Board would recommend that the member contribution rate be increased from $10 to $15 per month. This would increase the members' share of the cost of ongoing benefit accruals from about 32% (the current figure) to about 45%-48% (depending on the amount of the recommended benefit increase).

Additional Funding (Second Condition): Along with any increase in the benefit, the Board would recommend an additional appropriation at least equal to the "benefit improvement funding requirement" (BIFR). The second column of the table below, labeled "$28.8m Available," provides the total funding recommendation for each scenario, equal to $20,052,208 (the funding recommendation if there were no benefit increase) added to the BIFR, if any. The BIFR is based on the presumption that the fund has $28.8 million in "surplus funding" to support benefit increases. This comes from two sources:

- $12.0 million portion: The FRSWPF was measured to be 102.4% funded on an actuarial basis as of December 31, 2021, with $508.5 million in actuarial value of assets, as compared to $496.5 million in actuarial accrued liability. This created a $12.0 million actuarial surplus measured as of December 31, 2021. This part of the surplus funding existed as of December 31, 2021, but has likely been reversed with market experience during 2022. RSD's staff actuary estimates that the 2022 investment experience at

[5] The SCRSP provides that the Board may recommend a benefit increase if all of four conditions are met. The first condition is that the benefit increase is not greater than the most recent June-over-June increase in the Consumer Price Index. That increase was 9.06%, which would equate to an increase in the pension from $170 to $185 (i.e., $186 would exceed this limit). The second condition is that the Board recommends an additional appropriation if required, as outlined in these materials. The third condition is that the Board recommends an adjustment to the member contribution rate as outlined in these materials. The fourth condition is that the Board consider any change that has been made to the tax on gross premiums on property insurance. This tax, as provided under G.S. 105-228.5, was amended by S.L. 2021-180, effective January 1, 2022, to clarify the definition of "gross premiums" as it pertains to surety bonds. In the judgment of Retirement Systems staff, this amendment is not material to the Board's analysis.

market value was a loss of $90 million, based on an estimated percentage return of <u>negative</u> 10.4%. These losses will be recognized into actuarial figures in coming years.

- $16.8 million portion: The funding recommendation under the SCRSP, outlined above, would call for contributions exceeding the underlying ADEC by $16.8 million during the fiscal year ending 2024 (equal to $20.1 million minus $3.3 million). <u>This part of the surplus funding does not yet exist, is dependent on funding by the General Assembly, and by the time it is funded, may not represent a "surplus" because of the intervening 2022 investment experience.</u>

Because there may be various views on whether each component of the $28.8 million amount is available to support a benefit recommendation increase, the table below further provides funding amounts if the Board chose to disregard either the $12.0 million or the $16.8 million pieces, or both, as available. (Italicized numbers are filled in by RSD staff actuary based on consulting actuary's report.)

Monthly Pension	$28.8m Available (Min. Req. / BIFR)	$16.8m Available (Disregard $12.0m)	$12.0m Available (Disregard $16.8m)	$0 Available
$170 (current)	$20,052,208	*$20,052,208*	*$20,052,208*	*$20,052,208*
$171 - $174 rows not shown				
$175	$20,052,208	*$20,052,208*	*$22,651,842*	$34,678,971
$176	*$20,052,208*	*$20,805,494*	*$25,577,195*	*$37,604,324*
$177	*$20,052,208*	*$23,730,846*	*$28,502,547*	*$40,529,676*
$178	*$20,052,208*	*$26,656,199*	*$31,427,900*	*$43,455,029*
$179	$20,052,208	*$29,581,551*	*$34,353,252*	$46,380,381
$180	$20,479,775	*$32,506,904*	*$37,278,605*	$49,305,734
$181	*$23,405,127*	*$35,432,256*	*$40,203,957*	*$52,231,086*
$182	*$26,330,480*	*$38,357,609*	*$43,129,310*	*$55,156,439*
$183	*$29,255,833*	*$41,282,962*	*$46,054,663*	*$58,081,792*
$184	*$32,181,185*	*$44,208,314*	*$48,980,015*	*$61,007,144*
$185	$35,106,537	*$47,133,667*	*$51,905,368*	$63,932,496

Policy Options for Consideration by the Board of Trustees.

- The Board could recommend a State appropriation for the fiscal year ending in 2024, equal to $20,052,208, with no benefit improvement recommended. This would require an increase of $350,000 in the appropriation as compared to the fiscal year ending in 2023.
- The Board may recommend a benefit improvement based on the table above, while making the associated recommendations for member contribution increases and funding increases. To assist decision-making, staff recommends that the Boards ascertain which portions of the "surplus funding" should support any benefit improvement recommendation ($12.0 million, $16.8 million, both, or neither), and work accordingly from the appropriate column of the table above.
- The Board may base a decision on what it is recommending for LGERS, while remaining consistent with the provisions of the SCRSP.

Registers of Deeds' Supplemental Pension Fund (RODSPF)

Issue. The most recent valuation report shows the recommended Actuarially Determined Employer Contribution (ADEC) for the fiscal year ending in 2023. The ADEC for FY 2024 is the mathematical contribution amount that would fund the system using the Board's assumptions adopted on January 28, 2021, and plan population and asset information as of December 31, 2021. The estimated ADEC of $0 for the fiscal year ending in 2024 is less than the 1.5 percent of monthly receipts collected pursuant to Article 1 of Chapter 161 of the N.C. General Statutes. (Statutory amounts collected were $1,213,547 in calendar year 2021 and $1,085,980 in calendar year 2020.) Additionally, the fund is over-funded with a funded ratio of 157.1% as of December 31, 2021.

Based on these facts, the monthly benefit amount could be increased. However, increasing the maximum monthly benefit would make it more likely that the ADEC in a future year would be greater than $0.

Policy Option for Consideration by the Board of Trustees. Recommend no change to the current benefit structure. ***Making no recommendation does not require a vote of the Board.***

Death Benefit Plans

Death Benefit Plan for Members of LGERS

Issue. The actuarial valuation of the Death Benefit Plan for members of LGERS as of December 31, 2021, shows that the plan has liabilities of $53.0 million. Against these liabilities, the plan has current assets of $92.1 million. Prospective contributions by the participating employers have a present value of $40.6 million. The present and prospective assets, which amount to $132.6 million, exceed the liabilities of $53.0 million by $79.7 million.

Policy Option for Consideration by the Board of Trustees. Recommend no change to the current contribution rates or benefit structure. ***Making no recommendation does not require a vote of the Board.***

Retirees' Contributory Death Benefit Plan

Issue. Benefits payable under the Retirees' Contributory Death Benefit Plan are supported entirely by the contributions of the participants and the investment earnings on those contributions. The actuarial valuation as of December 31, 2021, shows that the plan has liabilities of $1,476 million. Against these liabilities, the plan has current assets of $286 million. Prospective contributions of participants eligible for benefits have a value of $1,013 million. The total present and prospective assets amount to $1,298 million, which is less than the liabilities of $1,476 million by $178 million. The Board's consulting actuary has advised that, based on the assumptions of the actuarial valuation, the current assets and contribution rates of the plan are not adequate with the current plan provisions and contribution rates.

The consulting actuaries have consistently projected a shortfall in this plan, for a number of years. In January 2022, the Boards directed staff to engage with the consulting actuary to study a range of options to address the projected shortfall. Several such options are being presented today under another agenda item, and may form the basis of Board recommendations or further discussions. Pursuant to S.L. 2020-29, no decision of either the State Board or the Local Board related to this plan can take effect unless and until the same decision has been made and voted on by the other Board.

Policy Option for Consideration by the Board of Trustees. To be discussed in separate agenda item.

Summary of Alternatives
For Presentation to the 2023 General Assembly

Draft Prepared Under Assumption of No Benefit Enhancements. If the Board recommends any benefit enhancements, it is suggested that the Board direct staff to make any updates necessary to conform to Board decisions prior to communicating this summary to the legislature.

Retirement System	Employer Contributions	Enhance Benefits
Local Governmental Employees' Retirement System **(Actions by Board of Trustees)**	Increase employer contribution rate by 0.75% for non-LEOs and 1.00% for LEOs for a cost in the first year to employers of $60,308,275.[1]	None
Firefighters' and Rescue Squad Workers' Pension Fund	Increase appropriation for fiscal year ending 2024 by $350,000, to $20,052,208.[2]	See discussion material
Registers of Deeds' Supplemental Pension Fund	No change to employer contributions.[3]	Increases have not been requested or contemplated
Death Benefit Plans	No change	Separate decision of TSERS and LGERS Boards

FOOTNOTES:

[1]The employer contribution rates for the fiscal year ending June 30, 2023, are 12.10% for employees other than Law Enforcement Officers (non-LEOs) and 13.10% for Law Enforcement Officers (LEOs). For the fiscal year ending June 30, 2024, the Board's Employer Contribution Rate Stabilization Policy calls for contribution rates of 12.85% for non-LEOs and 14.10% for LEOs. The total estimated payroll for the 2022 Session of the General Assembly was $7,596,262,000, which includes $6,261,738,000 for non-LEOs and $1,334,524,000 for LEOs.

[2]The total appropriated employer contribution for fiscal year ending June 30, 2023 is $19,702,208. For the fiscal year ending June 30, 2024, the Board's State Contribution Rate Stabilization Policy calls for a contribution at least equal to $20,052,208, which is an increase of $350,000.

[3]The total actuarially determined employer contribution for fiscal year ending June 30, 2024 is $0 after taking into account the fund assets in excess of the actuarial accrued liability. Contributions to the fund are set by statute.