KEEPING TODAY'S PROMISES | RETIRING TOMORROW'S CRISIS
THE TIME FOR THOUGHTFUL PENSION REFORM IN N.C.

Executive Summary

Since the global stock market crash of 2008, pension values worldwide have taken a hit that has been nearly impossible to overcome. The onset of the Great Recession was catastrophic for pension fund asset values, with values decreasing from $3.5 trillion in 2007 to $2.17 trillion in 2009. As the Recession raged, pension costs increased, hammering both states and local governments at a time when revenues sharply, and swiftly, turned downward.

As a reaction to the economic shutdown, most states have passed some kind of pension reform, however varying in scope and impact. Because this wave of pension reform has washed across the United States, many features and examples of successful reforms now exist.

North Carolina, with its longtime fiscal health, AAA bond rating, and a well-funded, managed and protected constellation of seven public pension systems, has thus far seen little change. From 2009 to 2018, North Carolina has stabilized both employee contribution rates and pension benefits.

This stability is a telling sign of our state's leadership and fiscal health, and of our state's strength in the national economic space. However, the stability of our state's public pension systems are likely to increasingly weaken over the next decade, as revenues are predicted to decline, employer contributions expected to skyrocket, and as the systems absorb a large, predominately healthy class of newly retired, younger baby boomers.

Seeking sustainable, incremental pension reforms now may offset potential harm to the system in the years to come, and protect the quality of our current defined benefit system for security for retired, current and future public employees. Allowing the State to continue to offer a healthy, defined benefit pension as a tool to recruit and retain quality employees.

Every pension system is different in management, strategy, investment practices and other aspects as well, but the impact inflicted upon them from the Great Recession was egalitarian in impact, impairing public pensions with equal short- and long-term economic devastation. Because of differences in the systems, there is no boilerplate option when talking reforms. Pension reform must be tailor suited to the system seeking such modifications. North Carolina would be no exception to this.

Goals may include:

- Normalizing cost of living adjustments to abate pension value losses.
- Adequate funding of the pension system.
- Protection of our current defined benefit system.

Potential reforms to examine to achieve these goals may include:

- Review assumptions.
- Adjustments to amortization schedule.
- Adjustments in retirement ages.

Introduction

North Carolina’s pension system supports more than 900,000 current, former and retired public employees. Among the state’s seven public pensions, the Teachers’ and State Employees’ Retirement System and the Local Government Employees’ Retirement System are the two largest. The state’s other retirement systems include smaller, independent systems for legislators, judges, firefighters, registers of deeds, and national guardsmen.

Among our state’s 63,000 local government retirees, most receive benefits of $18,000 or less annually. Post-recession declines in pension values have had a significant impact upon these retirees, with a less than one percent cost of living adjustment drowning in an increased inflation of 16 percent.

For our state’s 270,000 retired teachers’ and state government employees, small incremental costs of living adjustments have given retirees slight bumps in income. But because these costs of living adjustments have not kept up with inflation, retirees have also had a 13 percent loss in pension value over the past decade.

Almost all state public pension systems are facing increased unfunded liabilities and other potential pitfalls that can diminish the integrity and value of the public pension system. As a handful of states have all but bankrupted their public pensions, North Carolina has kept steady at the helm.

Steady, yes, but with a potentially unsustainable future if continues doing “business as usual.”

In order to safeguard the strength and health of our state pension systems, there must be an examination of reforms to allow for future retirees to have defined benefit pensions and for the State to continue recruiting talented, committed employees and teachers to serve the state.

A proactive approach taken by an invested slate of stakeholders must begin, exploring ways to sustain and protect our defined benefit pension systems and protect other components of the plan. Finding and applying incremental improvements to safeguard the system, the State’s may continue to offers its employees and teachers a defined benefit pension, an attractive benefit for most workers.

Though investment gains should remain the primary method to fund pension adjustments, an alternative process to fund cost of living adjustments is critical for the financial health of pensioners, their ability to contribute to the local and national economy and to continue an attractive benefit to recruit and retain high-quality public-sector workers.

Background

The Teachers and State Employees Retirement System (TSERS) and the Local Government Employees Retirement System (LGERS) are defined benefit plans funded through employer, employee contributions and investment gains. The systems share management and investment policies, meet jointly and investment allocations are often identical. While these systems mirror each other in administration and management, there is one major difference: the North Carolina General Assembly has provided several cost of living adjustments for TSERS pensioners. However, although the General Assembly may also provide such adjustments for local government retirees, the legislature has repeatedly chosen to leave these decisions to local governments and the North Carolina Office of the State Treasurer.

North Carolina consistently has one of the highest rated pension systems, ranking among the largest in the United States and the world. The plan has almost $100 billion in assets, and fully funding percentages averages in the low to mid 90s. All employees contribute 6 percent of their gross income to the system. Employer contribution has averaged 6.43% over the last 30 years.

Nationally, improving pension funding continues to be a top issue for state executive and legislative leaders. Many state's legislatures passed reforms in the last year, including Colorado, Minnesota and Illinois.

2017 COLA: Amortization Schedule			
Fiscal Year Beginning	Beginning of Year Balance	Annual Payment (M)	End of Year Balance
12/31/2016			$430M
7/1/2018	$480M	$(59)	450M
7/1/2019	450M	$(59)	420M
7/1/2020	420M	$(59)	390M
7/1/2021	390M	$(59)	360M
7/1/2022	360M	$(59)	330M
7/1/2023	330M	$(59)	290M
7/1/2024	290M	$(59)	250M
7/1/2025	250M	$(59)	210M
7/1/2026	210M	$(59)	160M
7/1/2027	160M	$(59)	110M
7/1/2028	110M	$(59)	60M
7/1/2029	60M	$(60)	-

Problem Statement

While some states have exhausted their assets and become riddled with unfunded liabilities, North Carolina has sustained an overall healthy system.

Unfortunately, however, giving retirees' relevant cost of living adjustments continues to put increasing and ultimately unbearable pressure on the system. Though a one-time 1 percent cost of living adjustment pales in comparison to the massive whole of the state budget—the amortization on recurring cost of living adjustments, with a 12-year amortization scale, may eventually gobble a disproportionate amount of the state's revenue, putting its long-term viability in jeopardy.

Compounding the problem is the desperate need to keep these pensioners able to live on their pension benefits. While cost of living adjustments could consume an unsustainable amount of revenue in future years, retirees themselves cannot survive without these critical adjustments to offset the effects of inflation.

A cost of living adjustment is neither a “gift” nor a “raise.” Rather, it is an increase of a pensioner’s contracted benefit, to ensure that benefit retains its monetary value as inflation increases and costs of goods and services rise. Until the Great Recession of 2008, North Carolina’s retirement systems had provided regular cost of living adjustments in both the LGERS and the TSERS, keeping a close pace with inflation.

Snapshot: Challenges today—and tomorrow—for most North Carolina’s Public Pensions

- Lowering or removing costs of living adjustments is proven to materially lower accrued liability, but it compromises the quality of life and financial sustainability of its pensioners.
- The state’s contribution rate is projected to increase by $800,000,000 over the next five years, and local governments’ contribution rate is forecast to double during the same period, adding another unsustainable stressor to the system.
- Pensions continue to lose value from increasing inflation, cost of living adjustments have, to date, not been able to offset these losses.
- Contribution rates are unsustainably high.
- More retirees are drawing pensions than ever before—making it harder to improve funding ratios.
- Our current economic expansion, though with impressive gains, has not equaled the size of previous expansions.
- Many economists predict our recent economic expansion is closer to the end than beginning.

Repeated studies have shown that offering a defined benefit attracts and retains better quality employees, and that retirement quality of life is improved for those with defined benefits rather than defined contribution. Moving to a defined contribution may offset volatility in costs to the state, but it could potentially put individual retirees in financial jeopardy, as their retirements could become victim to market fluctuations or economic downturns, putting them at risk to outlive their savings.

The Problem for Our Local Government Retirees

In North Carolina, a cost of living adjustment for local government retirees remains an almost unsolvable issue. There are currently several road blocks that prohibit the LGERS pensioners from receiving cost of living increases, including:

- The lack of express authorization to adjust the contribution rate for purpose of a cost of living adjustment.
- The legislature does not normally direct local governments how to navigate their local government budgets.
- There is no alternative process to allow local governments to enact a COLA through increased contributions.

For a cost of living adjustment to occur in the LGERS system, investment gains must exceed 7.0 percent. North Carolina's conservative investment policies have generated steady gains with an emphasis on long term sustainability. Though healthy for our state and the constellation of public retirement systems it manages, the possibility of funding costs of living adjustments for local government employees evaporates. Average gains teeter around the 5 percent mark, and State Treasury actuaries predict this percentage to remain static for the foreseeable future.

With the current statutory framework and practices at LGERS, there is no alternative method to provide a cost of living adjustment.

Safe Harbor from the Storm: Finding the Right Solutions for North Carolina

Pension reform is as complex and complicated an issue as one can have in the public policy space: a process requiring top to bottom input from stakeholders and policy makers, as well as consideration of our state's current pension situation and the pending factors that may impede its future success.

One avenue that may provide structure and resources is for the legislature to provide a study of pension reform. Such a study may include working with the Legislature's Program Evaluation Division, which has a demonstrated ability to analyze complicated issues. Stakeholders should include the North Carolina State Treasurer's Office, North Carolina League of Municipalities, North Carolina Association of County Commissioners, the North Carolina Retired Governmental Employees Association and other organizations and associations representing government retirees; the pension, appropriations and finance leadership in the North Carolina General Assembly, the University of North Carolina at Chapel Hill School of Government, the American Association of Retired People, and others who are involved in the public pension discussion.

Appendix A: Two States to Learn From

Though neighboring states, their public pensions—and the future of those pensions—couldn't be more different.

A State of Failure: Illinois

- Compared to Wisconsin, Illinois' unfunded liabilities gap is larger than Wisconsin's entire pension system.
- Illinois is now in its second year without a full budget including retirement benefits. The state had its last balanced budget in 2001, some 18 years ago.
- Current estimates show that state spending in Illinois has grown 50 percent faster than taxpayer income has.
- Illinois is currently considering liquidating physical assets, real estate and using the funds to cover the state's $134 billion in unfunded liabilities.
- Illinois Gov. J. B. Pritzker is also considering tax increases and bond sales to cover pension system shortcomings.
- Illinois has the worst pension funding in the United States: 41 cents of every tax dollar collected goes to support the pension system.

The Badger State: A Beacon of Successful Reform

- Wisconsin Retirement System is 102.7 percent funded, following only South Dakota. It is the ninth largest pension in the United States and the 25 largest public or private pension fund in the world.
- Wisconsin and North Carolina share many cultural and political characteristics: both systems have had conservative investments and thresholds, well managed systems and dedicated fiduciaries, along with overall long-term healthy economies. North Carolina and Wisconsin are also similar in participants: 720,000 and 600,000 respectively.
- The two systems also share in size: North Carolina is the 14th largest pension plan in the United States and the 36th largest in the world.
- Experts say that Wisconsin's pension success is because it's legislative and executive branch are proactive in keeping the system vital through pension reforms.
- A recent Wisconsin reform is to increase retirement age for most new public workers, from 55 years old to 60 years. Public safety workers can retire at 52 instead of 50.
- Wisconsin uses a "shared risk" model that prevents taxpayers and retirees from shouldering undue financial losses from an economic downturn or recession.
- Like North Carolina, Wisconsin's basic system provides retirees with a fixed benefit based on years of service and salary at retirement.
- However, unlike North Carolina, that is not the end of the story. Because of Wisconsin's shared risk model, a retiree's benefits may ebb and flow with the tide of the financial market.