THE BOND BUYER

North Carolina Cuts Investment Assumptions Of Pension System

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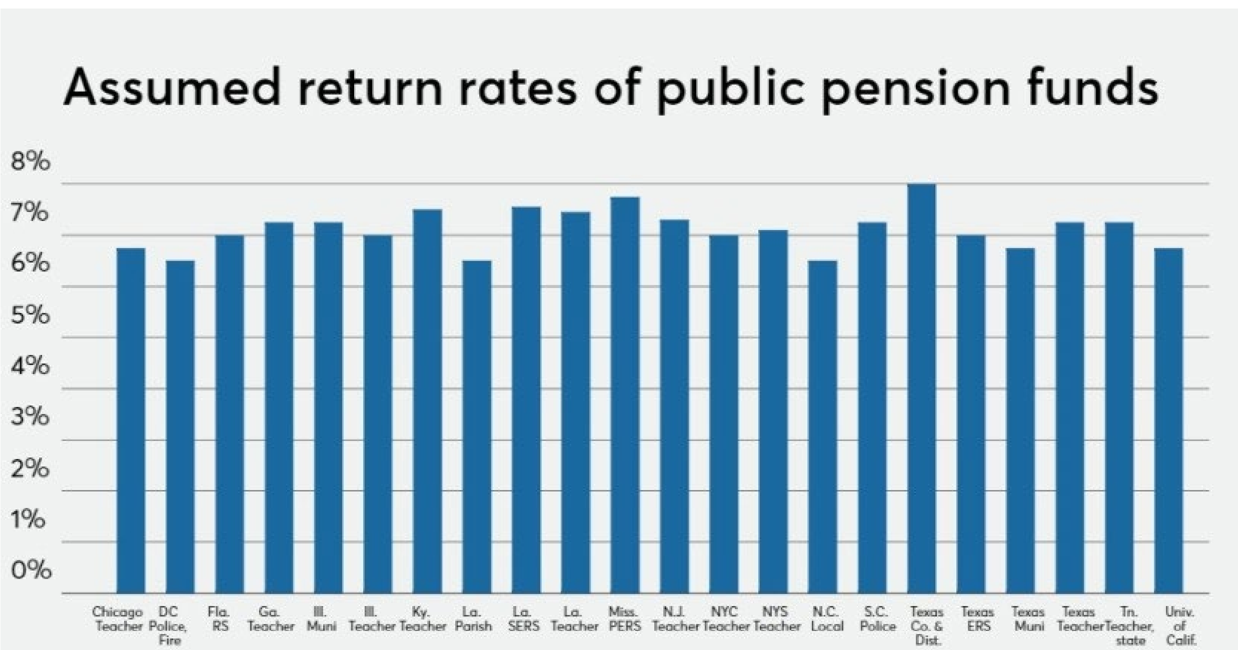
North Carolina has cut the investment return assumption for the state's main retirement systems in a move officials say provides a more realistic picture as they plan for the future.

North Carolina lowered the projected rate of return for the state's main retirement systems by 50 basis points to 6.5% from 7.0%. The Feb. 2 cut was approved by the Teachers' and State Employees' Retirement System and the Local Government Employees' Retirement System at their meeting on Jan. 28.

"The North Carolina pension fund is one of the best funded in the country," said State Treasurer Dale Folwell. "However, we need to make realistic assumptions regarding our ability to achieve expected returns in the future. Lowering this assumption will provide the best opportunity to meet the state's long-term obligations as well as maintain its triple-A bond rating."



Source: National Association of State Retirement Administrators

While the Federal Reserve's intent to keep interest rates lower for longer was the latest call to action, states have been moving to cut investment return assumptions, often referred to as the discount rate, on their defined benefit plans for several years.

Defined public pensions have had a too-high assumption rate for returns for too long, said Louis Stanasolovich, founder and CEO of Legend Financial Advisors in Pittsburgh.

“This is what everybody has missed out on for the last twenty something years, which was a big mistake,” Stanasolovich told The Bond Buyer. “This has been a long time in coming and unfortunately now it’s time to pay the piper.”

As of Sept. 30, 2020, state and local government public pension funds held assets of about $4.8 trillion, according to the National Association of State Retirement Administrators.

A survey by National Conference on Public Employee Retirement Systems showed the average assumed rate of return for fund investments was 7.26% in 2020. The inflation assumption was 2.7% while the average cost-of-living adjustment was 1.7%. The study gathered responses from 138 state and local government pension funds, which had a total of 12.8 million members and assets over $1.5 trillion. State and local funds were represented at 51% and 49%, respectively.

In 2020, funded levels for pensions rose to 75.1%, up from 72.4% in 2019, according to the survey.

Unfunded state pension liabilities totaled $4.9 trillion as of 2019, according to the American Legislative Exchange Council.

According to Pew Charitable Trusts, North Carolina is only one of eight states whose pension plans are at least 90% funded. The others are New York, Wisconsin, Tennessee, Idaho, Nebraska, South Dakota and Utah.

North Carolina’s general obligation bonds are rated triple-A by Moody’s Investors Service, S&P Global Ratings and Fitch Ratings.

The state’s retirement system is the ninth largest public pension fund in the country. It is has about $116 billion in assets and provides benefits to more than 950,000 people.

The treasurer said getting rid of an unrealistically high rate of return was part of the state’s transparent strategy to eliminate its unfunded liabilities, which total about $15 billion. In the last four years, the rate has been cut twice — in 2018 it was cut to 7% after being lowered in 2017 to 7.20% from 7.25%. The treasurer said those cuts were the first in almost 60 years.

Folwell warned that public employers will have to make higher contributions to the plan as a result of the cut. But he said that not lowering the rate now would only have kicked the can down the road and localities would have faced higher costs in the future.

"He's right," Stanasolovich said, adding that it's better to cut the assumptions now instead of dealing with it later, especially if the plans are fully funded.

“Any actuary will tell you that. But in the end that’s the solution — put more money into the funds or stretch out the benefits or make the benefits less,” he said. “Making the benefits less is like throwing down the gauntlet and saying ‘Let’s fight.’ And I think that’s not really that great for local municipalities.”

Pew said that over half of the public pension funds that it tracks have cut their assumed rates of return since 2017.

The largest U.S. public pension system, the California Public Employees Retirement System, began a plan in 2017 to incrementally drop its assumed rate of return of 7.5% to 7% by 2021. CalPERS has about $444 billion in assets as of January and is estimated to be 70.2% funded.

“Lowering the assumed rates of return can help plans reduce the risk of missing return targets and incurring unexpected costs during market downturns,” Pew said. “However, because the present value of future liabilities is typically calculated using the assumed rate of return as the discount rate, lowering the discount rate also has the immediate effect of raising calculated liabilities and contributions required from state budgets.”

Stanasolovich said the plans should also look at the type of investments they hold.

“It depends on the plan, but if they had a lot of fixed income in their plan, about the best they could expect is maybe one or two percent over the next decade,” he said.

“At some point in time, in the longer run of things, much like in 2000 when the stock market was so propped up in terms of investment expectations and price earnings ratios, going forward you're going to have a really lousy return and indeed they did,” Stanasolovich said. “This time is a little bit different because interest rates are so low. So the fact that the interest rates are so low will probably help the returns on stocks.”

Louis Stanasolovich of Legend Financial Advisors says public pensions have had too high assumed return assumptions for their investments.

Last week, New York City Chief Actuary Sherry Chan proposed changes to the city’s pension fund actuarial assumptions and methods for fiscal 2021. She said the changes would better reflect current experiences and further strengthen the funding of the pension plans.

Chan wants to cut the actuarial interest rate to 6.8% from the current 7% per year.

She also urged lowering the consumer price index assumption to 2.3% from 2.5% and reducing it 0.05% each year for four years starting from back on June 30, 2019. Additionally, she urged the cost of living assumption be cut to 1.3% from 1.5% per year.

Chan also wants the funds to update their post-retirement mortality assumptions to use the latest improvement scale from the Society of Actuaries, which she said would reflect a more accurate projection of life expectancies.

The city's pension funds have almost $240 billion in assets as of November 2020 with more than 700,000 members, making it the fourth largest public pension plan in the U.S. The city’s $38 billion of outstanding GOs are rated Aa2 by Moody’s, AA by S&P and AA-minus by Fitch.