CalPERS
P.O. Box 942709
Sacramento, CA 94229-2709
888 CalPERS (or **888**-225-7377)
Telecommunications Device for the Deaf
No Voice (916) 795-3240
www.calpers.ca.gov

Date: August 25, 2009
Reference No.:
Circular Letter No.: 200-056-09
Distribution: I, IA, IIB, VI
Special:

Circular Letter

TO: **ALL PUBLIC AGENCIES**

SUBJECT: **IMPACT OF ECONOMIC ENVIRONMENT ON EMPLOYER RATES AND NEW BOARD APPROVED SMOOTHING MODIFICATIONS**

ATTENTION: **FINANCE DIRECTORS, HUMAN RESOURCE DIRECTORS, PUBLIC AGENCY DECISION MAKERS**

CalPERS is sending this circular letter as a result of the CalPERS Board of Administration's decision at its June meeting to take steps to mitigate the impact of recent investment market declines on our public agencies' employer contribution rates.

BACKGROUND

As you are no doubt aware the past 18 months have seen significant investment market volatility and asset value declines for all investors, CalPERS included. In an effort to provide an early warning of potential employer rate increases CalPERS issued Circular Letter 310-050-08 on October 6, 2008 in order to inform public agencies of the CalPERS investment policy and strategy during the market decline. That Circular Letter also addressed the impact of financial market volatility on employer contribution rates and on the security of retiree benefits. The dramatic projected increase in employer contribution rates prompted CalPERS to examine our current approach and provide alternatives for consideration that might phase in the impact of investment losses while also allowing some time for the economy to recover.

Although our investment horizon is long term we recognize that investment returns over the short term fluctuate and lead to volatile employer contribution rates. To counter this, CalPERS employs a rate smoothing approach which spreads investment returns over a 15 year period. In addition excess returns or shortfalls and other gains and losses to our pension plans are paid for over a 30 year period which resets annually. We do this because we expect these deviations from the long term average to cancel each other out over time.

FISCAL YEAR 2008/2009 INVESTMENT RESULTS

CalPERS has released preliminary (net of fees) investment returns for the 2008/2009 fiscal year of negative 23.4%. The final return for the year will not be known until October when our final Real Estate and Alternative Investment Management (AIM) investment returns are available. Both the Real Estate and AIM returns lag one quarter as is industry standard. Such an extraordinary one-time event has put enormous strains on our economy, businesses, individuals, and local governments. While our smoothing approach works well during normal economic cycles and has produced very stable employer contribution rates, such a unique event calls for a deviation from the usual approach.

Rest assured that, despite the downturn, retirement benefits are secure and CalPERS has more than enough assets on hand to pay benefits well into the future. CalPERS continues to manage a well diversified portfolio and maintain a prudent, long term investment strategy in order to ensure the financial security for those we serve.

WHAT IS CALPERS GOING TO DO?

To deal with this one time event the CalPERS Board has approved an enhancement to our current smoothing methodology.

- Use a 3-year phase in of the 2008 – 2009 investment loss and allow some time for the economy to recover. This phased in approach will be achieved by temporarily relaxing the constraints on the smoothed value of assets around the actual market value. This corridor which constrains the smoothed value of assets will be allowed to expand and then contract with the following conditions.

    1. Increase the corridor limits for the actuarial value of assets from 80%-120% of market value to 60%-140% of market value on June 30, 2009 which impacts the 2011 – 2012 contribution rate

    2. Reduce the corridor limits for the actuarial value of assets to 70%-130% of market value on June 30, 2010 which impacts the 2012 – 2013 contribution rate

    3. Return to the 80%-120% of market value corridor limits for the actuarial value of assets on June 30, 2011 and thereafter which impacts the 2013 – 2014 and fiscal years beyond contribution rates

- Isolate the asset loss outside of the 80% - 120% corridor and pay for it with a disciplined fixed and certain 30 year amortization schedule. It is prudent for 2008-2009 Fiscal Year investment losses to be subject to a more stringent funding schedule and that they should be paid for in full at the end of the 30 years. In this way we will not rely on future investment returns to pay for 2008-2009 investment losses.

HOW WILL THIS AFFECT YOUR AGENCY?

Below we provide a table that can be used to gauge your agency's expected increase in employer contribution rate under the new smoothing approach due to the recent investment losses. (Note that the increase in employer contribution rates below would be added to your current rate.)

The illustrated rates are for a generic public agency based on its volatility index. The volatility index (VI) is the agency's assets divided by payroll and provides a measure of how sensitive an agency's contribution rate will be due to investment returns. (For pooled plans the VI is the volatility index of the entire pool). Your agency's volatility index is provided in your annual actuarial report but a rule of thumb is that a typical miscellaneous plan has a volatility of between 2.5 and 5, an AB616 formula (2.5% @ 55, 2.7% @ 55 and 3% @ 60) miscellaneous plan between 4 and 6 and that of a safety plan between 5 and 10. The chart below shows the projected increase in employer contribution rates for fiscal years 2011-2012 through 2014-2015 assuming CalPERS earns 7.75% after 2008-2009. As an extreme example we have included a plan with a volatility index of 15.

Projected Increase in Employer Contribution Rate for Public Agencies

Fiscal Year	VI of 4	VI of 6	VI of 8	VI of 10	VI of 15
2011 - 2012	1.0%	1.5%	1.9%	2.4%	3.7%
2012 - 2013	1.6%	2.5%	3.3%	4.1%	6.1%
2013 - 2014	1.7%	2.6%	3.4%	4.3%	6.4%
2014 - 2015	0.2%	0.3%	0.4%	0.6%	0.8%

Again, these increases are cumulative. For example, suppose your agency's plan has a volatility index of 4. Referring to the table above, under the VI of 4 column, you can expect to see a 1.0% of payroll increase in your current employer contribution rate for FY 2011-2012, an additional 1.6% increase in FY 2012-2013, another 1.7% increase in FY 2013-2014. The cumulative expected increase in your employer contribution rate at the end of the three fiscal years is the sum of these individual increases or 4.3% in this case. Because of our 15 year smoothing method, additional losses will continue to be recognized, but not as severely as the first three years. Without future investment gains, your rate will continue to increase by about .2% per year for 15 years.

As identified above, preliminary investment returns do not include the quarter lag for Real Estate and Alternative Investment Management (AIM). However, we have built additional conservatism into the chart above to reflect additional losses which we anticipate will be incorporated into the final return. We have used a negative 28% return to generate the chart above.

Please be aware these are only estimates and we do not know the final return on investments. Your employer rate will also differ due to your own demographic experience or if you are in a pool, due to the pool's demographic experience.

As of the most recent actuarial valuation there are only three public agencies with volatility indexes greater than 15. If your particular agency has a volatility index greater than 15 or if you have other questions you may want to contact your CalPERS plan actuary.

In short the new method will provide short-term relief to local government and school employers while strengthening the long-term financial health of the pension fund.

If you wish to discuss these issues further, please contact your CalPERS actuary at **888 CalPERS** or (**888**-225-7377).

Ronald L. Seeling, Chief Actuary
Actuarial & Employer Services Branch