CalPERS

Finance and Administration Committee

Agenda Item 6a

November 14, 2023

Item Name: Annual Review of Funding Levels and Risk Report

Program: Actuarial Office

Item Type: Information

Executive Summary

This annual report provides a comprehensive summary of the current funding levels of the system and the near-term outlook for required contributions. In addition, the report provides important information regarding the risks faced by the system in the near and long-term. By understanding these risks, CalPERS and its agencies can effectively consider whether additional measures can be taken to further reduce risk and increase sustainability of the system.

As discussed in this report, factors such as 1) investment losses for the year ending June 30, 2022, 2) continued high inflation, and 3) potentially unfavorable near-term economic conditions, may result in CalPERS' employers experiencing difficulty making required near-term contributions, particularly if those required contributions increase due to any of these factors.

Strategic Plan

This item is presented as part of the regular ongoing workload of the Actuarial Office and supports the Strategic Plan goal of Pension Sustainability.

Background

To assist the Finance and Administration Committee with its oversight of the financial soundness of the overall CalPERS system, the Annual Review of Funding Levels and Risks Report was developed. Included in this report are various system level actuarial results and risk measures that can be used to assess the effectiveness of funding policies, actuarial assumptions and methods.

CalPERS must ensure that the pension fund is sustainable over multiple generations. This is done by taking an integrated view of assets and liabilities and taking steps designed to mitigate risks over the long-term. The CalPERS asset allocation and actuarial assumptions are continually monitored and reviewed every four years during the Asset Liability Management

(ALM) cycle. The most recent cycle was completed in late 2021 through early 2022. The Annual Review of Funding Levels and Risks report tracks the emerging experience of the system through this four-year cycle and highlights relevant risks.

Analysis

Current Actuarial Results

The unfavourable investment returns during the year ending June 30, 2022, resulted in decreases to the funded ratios for CalPERS plans. The total PERF funded status decreased from 81% as of June 30, 2021 to 71% as of June 30, 2022. The investment return for the year ending June 30, 2023 was just under the expected return of 6.8%. However, the estimated funded status of the system increased from 71% to 72% as of that date. Each plan has its own funded ratio based on the assets and accrued liabilities of that plan. Some plans are better funded than the PERF average and others are not. Employer contribution levels are expected to increase over the next several years for most plans due primarily to the investment loss for the year ending June 30, 2022.

COVID–19 Pandemic

The pandemic has affected the experience of the retirement system over the last few years. The number of deaths among CalPERS retirees was higher over the last three years than expected. In addition, various aspects of the pandemic affected the behavior of many active members, in particular, with respect to retirement decisions. Going forward it remains to be seen if there will be any lingering impact on the experience of the system. The actuarial valuations performed as of June 30, 2022 showed minimal impacts attributable to the pandemic (excluding inflation, if current inflation levels can be attributed to some extent to the pandemic). During the next Experience Study, we will examine whether there is sufficient evidence to change any of the actuarial assumptions based on experience up to that point.

Other Risks

Over the next several years there is the potential for various factors to either further increase required contributions or add additional financial strain on employers and their ability to make required contributions. Two of these factors are inflation and near-term economic decline.

After recently reaching a 40-year high the Federal Reserve has taken actions to lower inflation which have been somewhat successful. However, inflation was higher than expected over the last 2-3 years and it is unknown how much longer that may persist. CalPERS and its members are potentially impacted by high inflation in several ways. Many retirees have received higher cost-of-living adjustments (COLAs) but likely still lost purchasing power. Higher COLAs result in higher contributions for employers. In addition, employee wages generally keep pace with inflation over the long-term. It is possible some members pay will increase faster than currently expected. The valuations for the year ending June 30, 2022 showed that between higher COLAs and higher than expected pay increases for the prior year, actuarial losses of 2% or less were generally seen for many of our plans. Due to higher-than-expected inflation for the year ending June 30, 2023, COLAs for many retirees will again be somewhat higher than expected. The report provides the estimated impact of this which will be formally measured in the June 30, 2023 valuations.

Some forecasters are predicting an economic slowdown in the near future. This could lead to potentially lower investment returns, increased investment volatility, and higher unemployment. Much of the discussion within this report is devoted to projecting funded ratios and contribution levels under various scenarios for future investment returns. If the system experiences lower than expected investment returns, the potential impact on required contributions, combined with the possible impacts of high inflation, could push contribution rates to levels that would prove challenging for some employers.

The inability to make required contributions puts a plan at risk for termination. The termination policies and processes currently in place mitigate risks to the system. However, if an employer is under severe financial stress, the termination policies cannot fully protect the benefits of members that have served that employer. Ultimately, the members' benefits are only secure if the employer continues to make the required contributions.

Budget and Fiscal Impacts

This section is not applicable to this agenda item.

Benefits and Risks

This agenda item and the attached report should enhance the understanding of the risks inherent in the funding of the system. Such an understanding is necessary for effective management and mitigation of those risks.

Attachments

Attachment 1 – 2023 Annual Review of Funding Levels and Risk Report

Attachment 2 – Annual Review of Funding Levels and Risks Presentation

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