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Circular Letter

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TO: **ALL PUBLIC AGENCY EMPLOYERS**

SUBJECT: **EMPLOYER RATE INCREASES DUE TO AMORTIZATION AND SMOOTHING POLICY CHANGES**

The purpose of this Circular Letter is to inform you of recent changes to the CalPERS amortization and smoothing policies. **These changes are expected to increase employer contribution rates in the near term but result in lower contribution rates in the long term.**

Background

At the April 17, 2013 meeting, the CalPERS Board of Administration approved a recommendation to change the CalPERS amortization and smoothing policies. Prior to this change, CalPERS employed an amortization and smoothing policy which spread investment returns over a 15-year period with experience gains and losses paid for over a rolling 30-year period. After this change, CalPERS will employ an amortization and smoothing policy that will pay for all gains and losses over a fixed 30-year period with the increases or decreases in the rate spread directly over a 5-year period.

The new amortization and smoothing policy will be used for the first time in the June 30, 2013 actuarial valuations. These valuations will be performed in the fall of 2014 and will set employer contribution rates for the Fiscal Year 2015-16.

Analysis

The current amortization and smoothing policy was designed to reduce volatility in employer contribution rates. The policy has accomplished this goal fairly well since its adoption, however a number of concerns have developed:

- The use of an actuarial value of assets corridor can lead to significant single year increases to rates in years when there are large investment losses.
- The use of long asset smoothing periods and long rolling amortization periods result in slow progress toward full funding.
- The use of an actuarial value of assets requires the disclosure of two different funded statuses and unfunded liability numbers in actuarial valuation reports. This adds confusion and inhibits transparency.
- The use of rolling amortization and long asset smoothing periods makes it difficult for employers to predict when contribution rates will peak and how high that peak will be.

- The use of rolling amortization and asset smoothing periods may result in additional calculations for the new accounting standards. These calculations would be avoided with a quicker funded status recovery.

The adoption of the new smoothing and amortization policies will change future employer contribution rates. Changes are as follows:

- Funding levels will improve, which will reduce the funding level risk. The new methods will put your plan on a path to be fully funded in 30 years.
- Your plan will experience more rate volatility in normal years, but a much reduced chance of very large rate increases in years when there are large investment losses.
- Contribution rates in the near term will increase.
- Long term contribution rates will be lower.
- There will be greater transparency about the timing and impact of future employer contribution rate changes.
- The new policy eliminates the need for an actuarial value of assets. As a result, there will be only one funded status and unfunded liability in actuarial reports.
- There will be less confusion when the new accounting standards are implemented since there will be no need for extra liability calculations.

Expected Rate Increases Due to Changes

The following table can be used to gauge your agency's expected increase in employer contribution rates under the new amortization and smoothing policy.

The illustrated rates are based on public agency asset volatility ratios. The asset volatility ratio (AVR) is an agency's assets divided by their annual payroll. This ratio provides a measure of how sensitive an agency's contribution rate will be due to investment returns. For pooled plans, the AVR is the asset volatility ratio of the pool. Your plans AVR is provided in the risk analysis section of your annual actuarial report. The table shows the projected increases in employer contribution rates for Fiscal Years 2015-16 through 2019-20, assuming CalPERS earns 7.50 percent after 2011-12. Projections for Fiscal Year 2014-15 are not affected. As an extreme example, we have included a plan with an AVR of 15.

Cumulative Projected Increase in Employer Contribution Rate beyond the Projected Fiscal Year 2014-15 Rate

Fiscal Year	AVR of 4	AVR of 6	AVR of 8	AVR of 10	AVR of 15
2015 – 2016	1.1%	1.7%	2.2%	2.8%	4.2%
2016 – 2017	2.2%	3.4%	4.4%	5.6%	8.4%
2017 – 2018	3.3%	5.1%	6.6%	8.4%	12.6%
2018 – 2019	4.4%	6.8%	8.8%	11.2%	16.8%
2019 – 2020	5.5%	8.5%	11.0%	14.0%	21.0%

For example, suppose your agency has an estimated 2014-15 contribution rate of 14.5 percent and an AVR of 4. Referring to the table above, under the AVR of 4 column, you can expect to see a 1.1 percent increase in your current employer contribution rate for 2015-16 resulting in a 15.6 percent rate, a 2.2 percent increase for 2016-17 for a 16.7 percent rate, and so forth until the rate reaches an expected maximum of 20.0 percent in Fiscal Year 2019-20.

Be aware these are only estimates since we do not know the final return on investments beyond June 30, 2012. Your employer rate will also differ due to your own plans demographic experience, or if you are in a pool, due to the pool's demographic experience.

Overall, these contribution increases will result in your plan being better funded in time and will ultimately result in lower contribution rates.

If you have any questions, please call our CalPERS Customer Contact Center at **888 CalPERS** (or **888**-225-7377).

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