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June 17, 2009

AGENDA ITEM #14

TO: MEMBERS OF THE BOARD OF ADMINISTRATION

I. SUBJECT: Impact of Economic Environment on Employer Rates and Possible Smoothing Modifications (Second Reading)

II. PROGRAM: Retirement

III. RECOMMENDATION:

That the full CalPERS Board approves the adoption of the following smoothing changes:

- Increase the corridor limits for the actuarial value of assets from 60%-120% of market value to 80%-140% of market value on June 30, 2009
- Reduce the corridor limits for the actuarial value of assets to 70%-130% of market value on June 30, 2010
- Return to the 80%-120% of market value corridor limits for the actuarial value of assets on June 30, 2011 and thereafter
- Isolate and amortize all gains and losses during fiscal year 2008-2009, 2009-2010 and 2010-2011 over fixed and declining 30 year periods (as opposed to the current rolling 30 year amortization)

IV. ANALYSIS:

At the May 2009 meeting, the CalPERS Board approved as a first reading modifications to the smoothing methods to phase in the impact of the investment loss in 2008-2009 over 3 fiscal years. Attachment 1 contains a copy of the May 2009 agenda item and all of its attachments.

Smoothing methods rely on the fact that over time one would expect gains and losses to cancel one another. As mentioned last month, we believe that the global market decline that has taken place in fiscal year 2008-2009 is a unique event. For this reason, we believe that this year should be handled differently and that it should be paid separately and outside the smoothing process. We do not want to rely on future investment returns to pay for the 2008-2009 investment losses.

Following is a table comparing the proposed method to the current method.

Comparison of Proposed and Current Methods

Valuation Date and Contribution Year	Current Method		Proposed Method	
	Corridor	Amortization	Corridor	Amortization
June 30, 2009 Valuation 2010-2011 rates State & Schools 2011-2012 rates Public Agencies	80%-120% of market value of assets	Rolling 30 Year Amortization of 08-09 Gains and Losses	60%-140% of market value of assets	Fixed 30 Year Amortization of 08-09 Gains and Losses
June 30, 2010 Valuation 2011-2012 rates State & Schools 2012-2013 rates Public Agencies	80%-120% of market value of assets	Rolling 30 Year Amortization of 09-10 Gains and Losses	70%-130% of market value of assets	Fixed 30 Year Amortization of 09-10 Gains and Losses
June 30, 2011 Valuation 2012-2013 rates State & Schools 2013-2014 rates Public Agencies	80%-120% of market value of assets	Rolling 30 Year Amortization of 10-11 Gains and Losses	80%-120% of market value of assets	Fixed 30 Year Amortization of 10-11 Gains and Losses
June 30, 2012 and all Future Valuations 2013-2014 rates and beyond for State & Schools 2014-2015 rates and beyond for Public Agencies	80%-120% of market value of assets	Rolling 30 Year Amortization of 11-12 and all Future Gains and Losses	80%-120% of market value of assets	Rolling 30 Year Amortization of 11-12 and all Future Gains and Losses

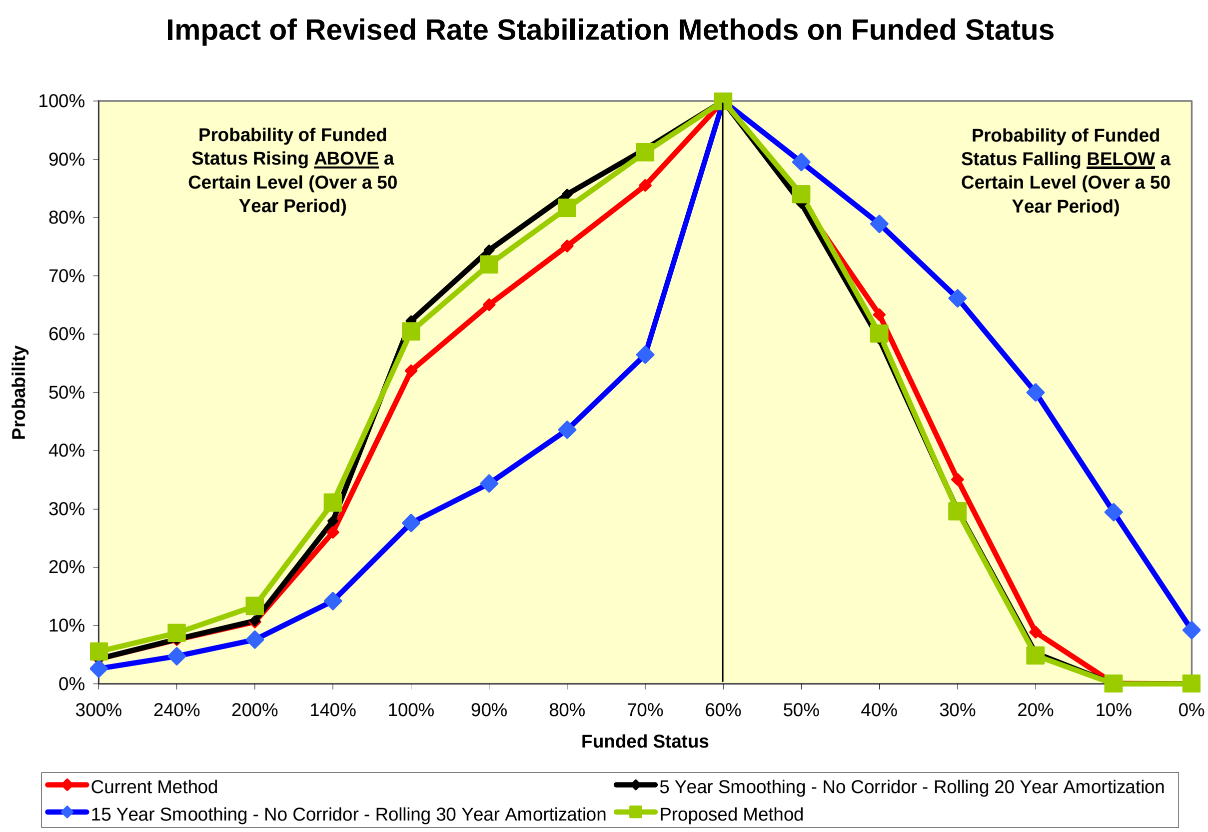
The May 2009 agenda item illustrated how plans with different asset to payroll ratio would be impacted differently by the decline in investment market. Attachments 2 thru 4 provide a side by side comparison of future employer rates over the next 5 fiscal years under the current and proposed methods for three sample employers with asset to payroll ratio of 4, 7 and 10 assuming a -30% investment return for 2008-2009 and reverting back to earning 7.75% in future years.

As can be seen in these three tables, to the extent CalPERS earns its assumed 7.75% investment return in the future, the employer rates are going to increase to levels we would see under the current methods but two years later. It is important to note that unless the investment markets recover, delaying increases in contribution rates means that rates after the three year period would have to be tenths of a percent higher.

<u>Impact on Funded Status</u>

Whenever changes to smoothing are considered, one of the most important risk measures to look at is the funded status of the plan. As was done back in 2005, the proposed change in the smoothing method was tested by developing the probability that the funded status will drop below certain levels and or increase above certain levels.

Below is the same graph that was included in the May 2009 agenda item. This is a graph showing the cumulative probability distribution of the funding status either falling below or increasing above the current level at any time over the next 50 years. Note that this graph was prepared assuming a -28% return for 2008-2009 which would result in CalPERS having a funded status slightly below 60% on June 30, 2009.



Another way of comparing the proposed method to the current method and the impact on the funded status is to look at the difference in expected funded status under both methods. If the Board was to approve the proposed smoothing changes instead of staying the course with the current method, the funded status would be expected to be greater over time compared to the current method. In fact, under the assumption that the 2008-2009 investment return would be -30% and 7.75% each year thereafter, the funded status 35 years from now under the proposed method for a sample plan with an asset to payroll ratio of 7 would be about 10% above what it would be under the current method.

V. STRATEGIC PLAN:

This item is not a specific product of the Strategic or Annual Plans but is part of the regular and ongoing workload of the Actuarial & Employer Services Division.

VI. RESULTS/COSTS:

See Above.

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