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December 16, 2009

AGENDA ITEM 15

TO: MEMBERS OF THE BOARD OF ADMINISTRATION

- I. SUBJECT:** Proposed Changes to the Smoothing Methods for the State Plans
- II. PROGRAM:** Retirement
- III. RECOMMENDATION:**

That the Board approves the adoption of the following funding changes for all the State plans:

- 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
- 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)
- Affirm that the Board's policy is to allow any employer, State, School or local agency to make additional voluntary employer contributions up to a maximum contribution that would make their plan superfunded (i.e. assets equal to the Present Value of Projected Benefits)

It is also recommended that staff be directed to bring back in February, 2010 a new agenda item to establish a required additional minimum contribution for any plan, State, Schools or local agencies with cash flows that prohibit adequate funding progress under the already adopted phase-in approach.

IV. ANALYSIS:

At the June 2009 meeting, the CalPERS Board approved temporary modifications to the smoothing methods for local agencies and schools to phase-in the impact of the investment loss in 2008-2009 over 3 fiscal years. During that meeting, the Chief Actuary was asked to work with the Department of Personal

Administration (DPA) and the Department of Finance (DOF) to explore alternative smoothing and funding approaches for the State plans.

Over the course of the summer, staff met with representatives of DPA and DOF and presented six alternatives. The alternatives included the phase-in approach adopted by the Board for schools and local agencies as well as five other alternatives that would result in the accelerated payment of the 2008-2009 investment loss and prior unfunded liabilities.

DOF and DPA have informed CalPERS Actuarial staff that they wish to contribute in accordance with one of the alternatives presented to them. It is important to note that the alternative the State desires to utilize was developed based on criteria established by the State. The criteria included an initial contribution amount in the neighborhood of \$4.5 to \$4.8 billion and a goal of having a funded status of about 80% to 85% in 30 years. As a result, the approach the State desires to utilize involves increasing contributions at a pace faster than the methods approved by the Board for Schools and local agencies. In fact, under the desired approach, the State's contributions rates would be much higher in the first few years and decrease later on. Because contributions would be "front loaded", the funded status is expected to improve at a faster pace.

It is important to realize that when the CalPERS Board approves contribution rates for the State, it sets a minimum required contribution rate that does not preclude the State from sending additional contributions. The same applies as well to Schools and local agencies. All employers can send additional contribution to CalPERS to the extent the assets on hand do not exceed the present value of benefits i.e. additional contributions cannot make a plan become more than "superfunded".

Staff recommends that the Board approve the same smoothing modifications that were adopted for local agencies and Schools with the understanding that staff will bring back in February, 2010 a new agenda item to establish a required additional contribution for any plan, State, Schools or local agencies with cash flows that prohibit adequate funding progress under the already adopted phase-in approach.

Because each plan has different cash flows, each plan will be impacted differently. For example, State Miscellaneous benefit payments in 2010-2011 are expected to be near \$3.8 billion and total member and employer contributions under the phase-in approach are expected to be near \$2.3 billion. Therefore, \$1.5 billion of investment return in 2010-2011 is needed to pay benefits rather than improve funded status. Such a negative cash flow for this plan prevents the funded status from improving rapidly unless contributions are increased at a faster pace. Under the phase-in approach adopted by the Board, the funded status of State Miscellaneous would only increase from 60.8% to about 65% in 30 years.

As a comparison, State Safety benefit payments in 2010-2011 are expected to be near \$225 million while total member and employer contributions under the phase-in approach are expected to be near \$470 million. For that plan, the funded status is expected to increase from 61.4% to about 86% in 30 years.

For this reason, we believe it to be more prudent to require additional contributions for plans like State Miscellaneous in order to increase the funded status at a faster pace. Staff is investigating ways to set such an additional contribution in a manner that can be applied equally to any plan with these cash flow issues. As mentioned above, staff will bring back an agenda item to the Board in February 2010.

Attached to this agenda items are several exhibits. Attachment 1 shows the estimated contribution rate for each State plan for the next 30 years, Attachment 2 shows the estimated dollar contribution amount for each State plan for the next 30 years and Attachment 3 shows the estimated funded status for each State plan over the next 30 years.

The three exhibits compare the results under the Board methods prior to the 3 year phase-in changes, the 3 year phase-in approach recommended by Staff and the approach the State has indicated it would like to follow. As can be seen, because the State desired approach involves paying for the unfunded liability over an accelerated schedule, the funded status is expected to be higher in 30 years than under the 3 year phase-in and the current methods.

Note that the numbers in these exhibits were estimated based on a -24% investment return for 2008-2009 and assuming CalPERS would earn 7.75% each year thereafter and also assuming all other actuarial assumptions would be realized from year to year. One of these assumptions is that the payroll for each State plan would continue to increase at 3.25% per year.

Graphs for State Miscellaneous and State Safety are also included to better illustrate what was described above. Attachment 4 is a graph showing the estimated contribution rates for State Miscellaneous over the next 30 years under the Board methods prior to the 3 year phase-in changes, the rates under the 3 year phase-in recommended by staff and also under the method desired by the State. Attachment 5 is a graph showing the funded status over the next 30 years for State Miscellaneous under all three methods. Attachment 6 and 7 are two graphs that provide the same information for State Safety.

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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