Risk Pooling Background and Education

Agenda

- What is Risk Pooling?
- Why Risk Pooling?
- Implementation of Risk Pooling
- Review of Risk Pooling

What is Risk Pooling?

A type of Insurance Arrangement

- Spreads demographic risks
- Purpose is to avoid large liability losses
- Serves to smooth the employer contribution rate

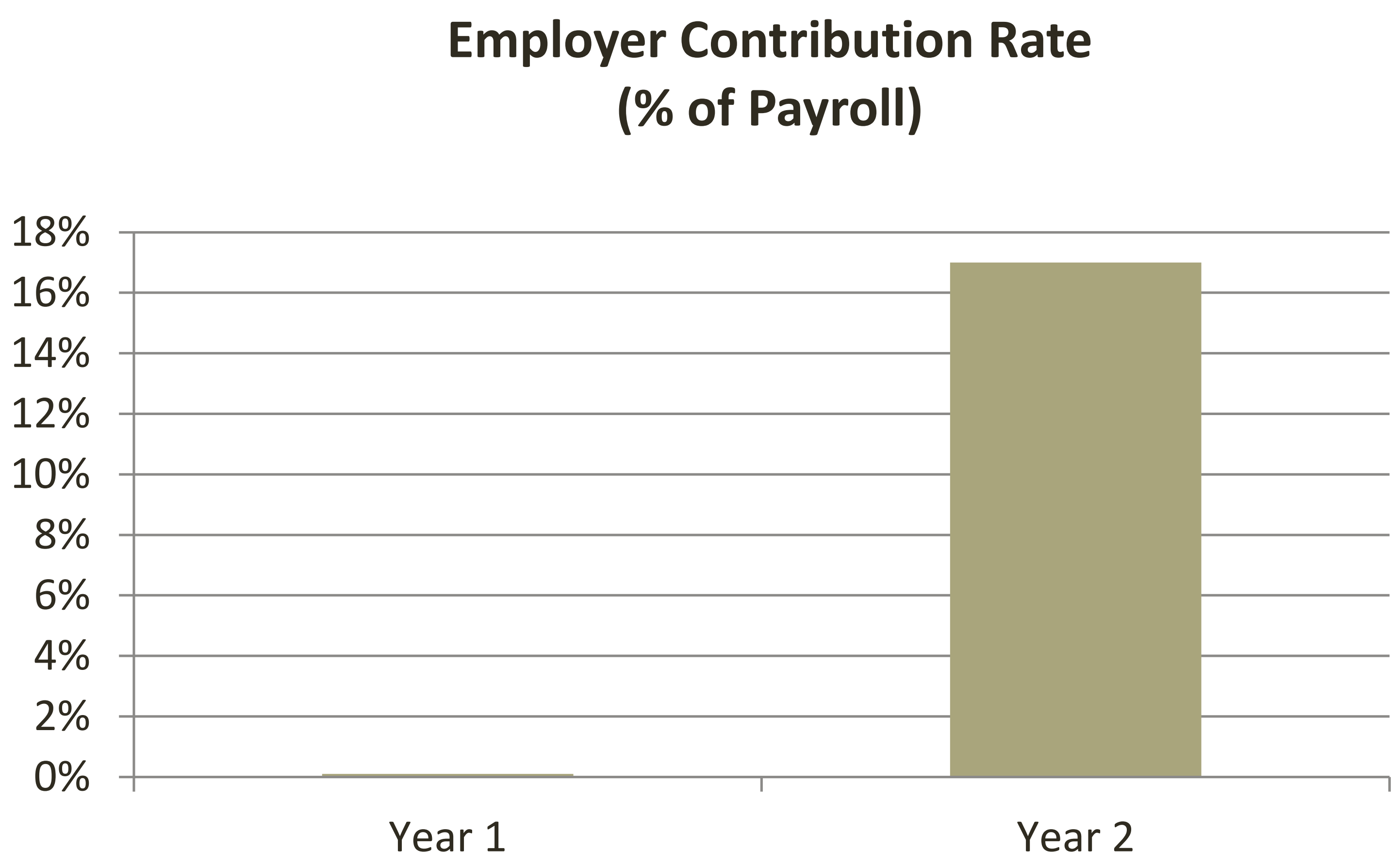
Brief History of Pooling

- Over 30 years ago, all local miscellaneous members were pooled.
- In 1989, Section 20815 of the Government Code discontinued the public agency miscellaneous pool.
- Between 1999 and 2002, Sections 20225.5, 20840, 20841 and 20842 of the Government Code were added to give statutory authority to the CalPERS Board to create pools and mandate them available as a contract option.
- Risk Pooling for local agencies was re-introduced effective with the June 30, 2003 Actuarial Valuations.

Why was Risk Pooling Created?

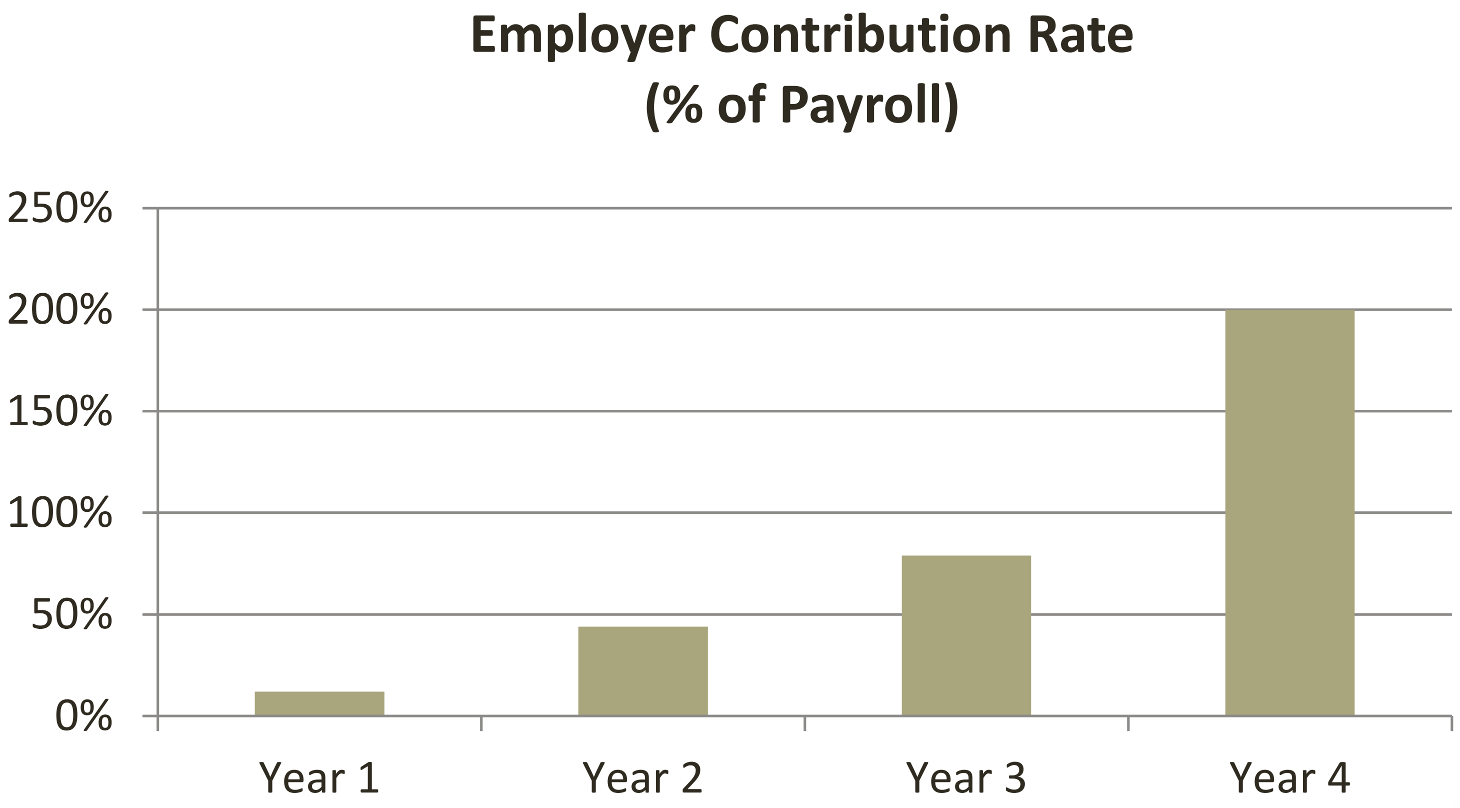
- To Eliminate Large Employer Rate Increases Caused by Demographic Events
- Examples of Demographic Events
  - Work Related Disability
  - Work Related Death
  - Service Retirement

Example 1 – Work Related Disability
Small Safety Plan

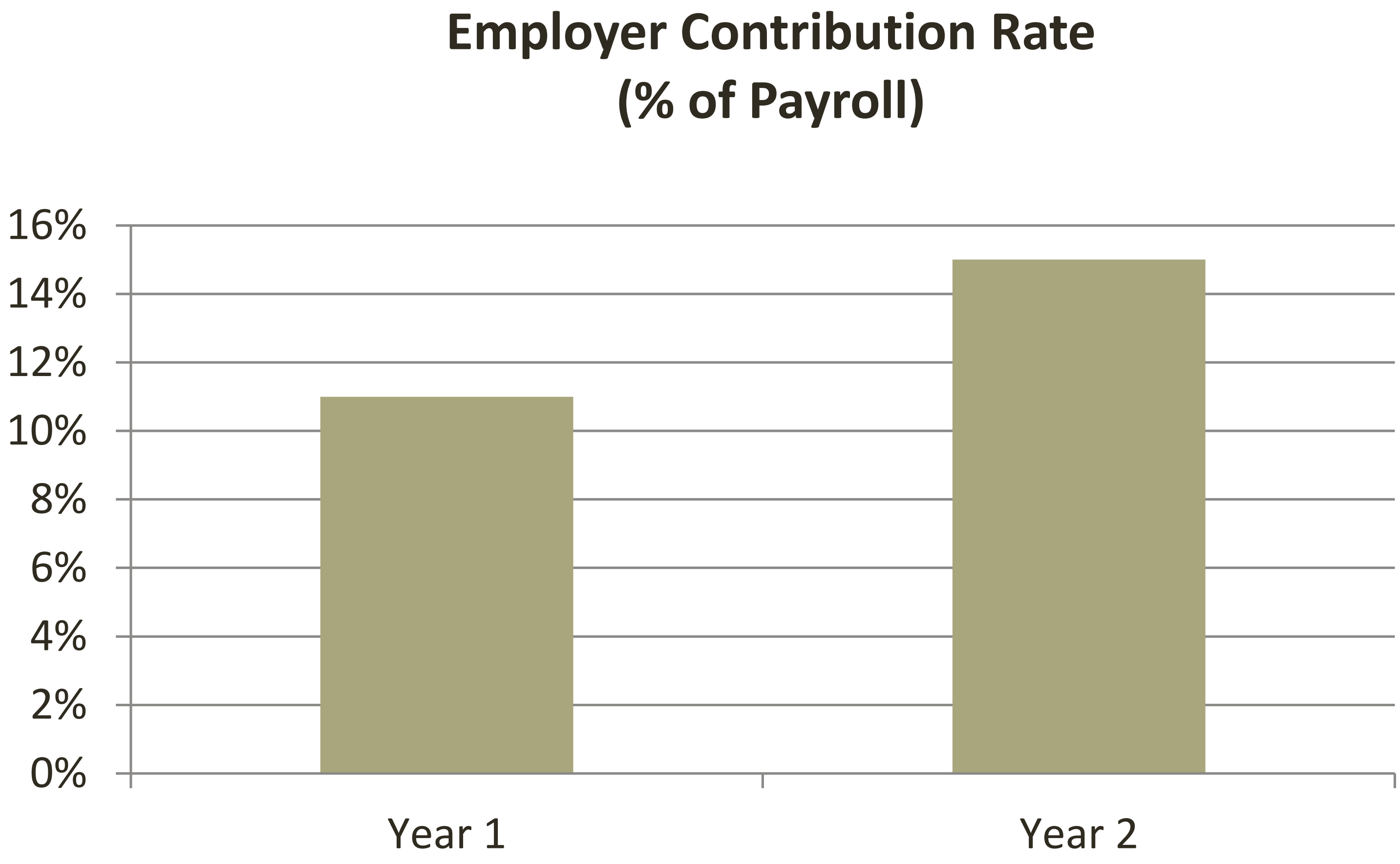


Example 2 – Work Related Disability and Work Related Death

Small Safety Plan



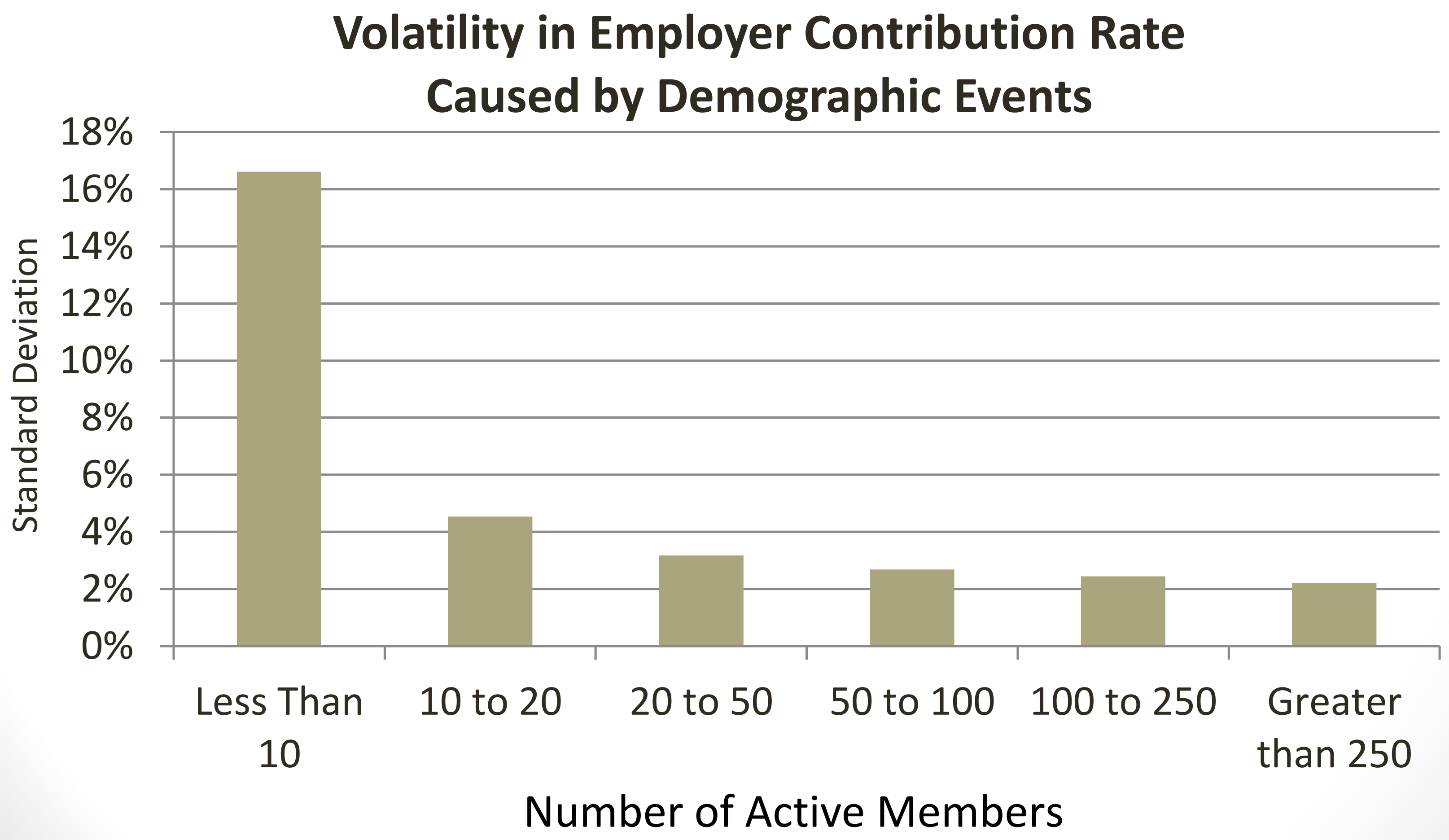
Example 3 – Service Retirement
Small Miscellaneous Plan



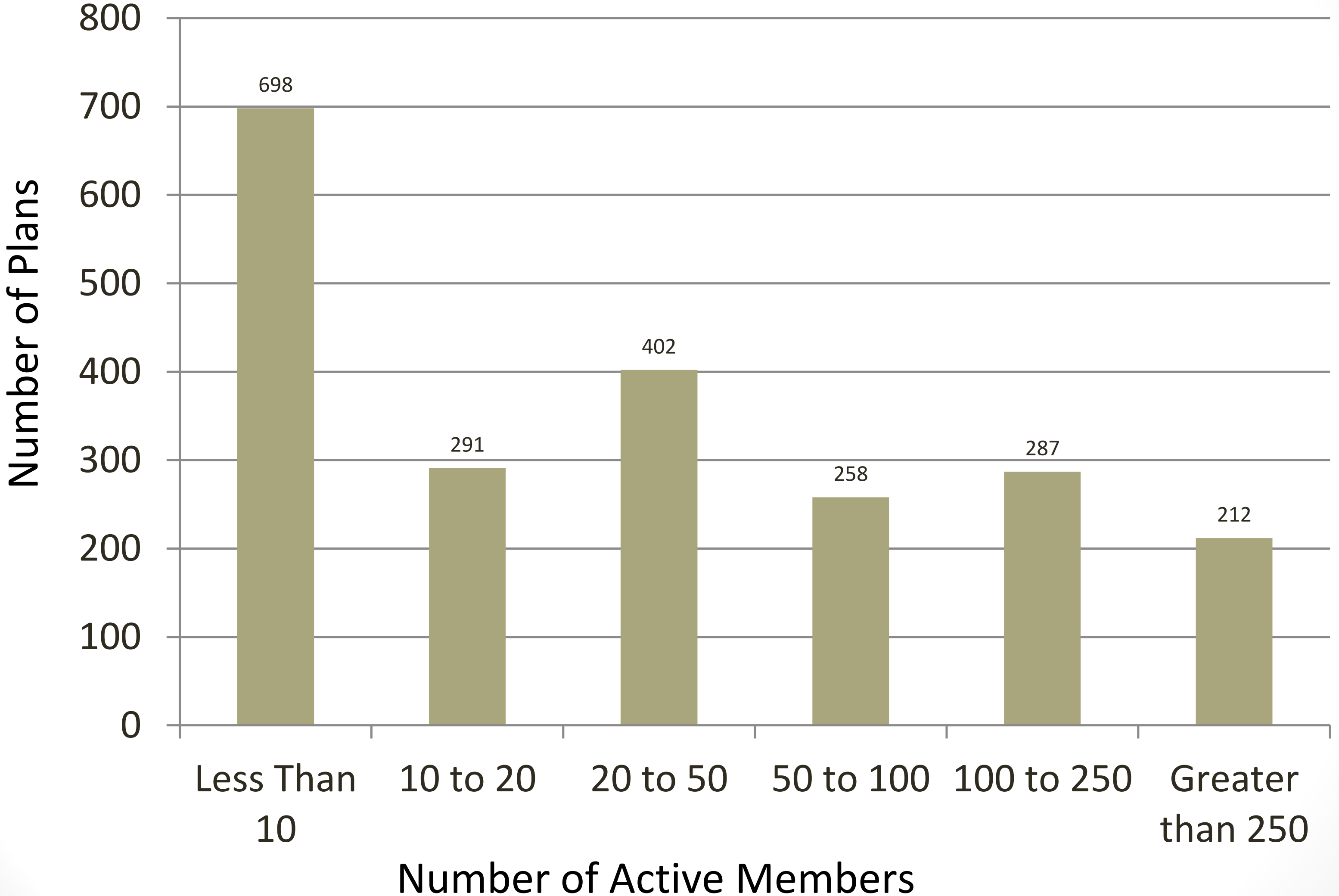
Why was Risk Pooling Created?

- To Help Small Employers
- Actuarial Assumptions do Not Work for Small Employers
  - A 5% probability for someone to retire does not work well with a 5 person agency
  - You need large numbers for assumptions to work

Financial Risk Carried By Small Employers



Distribution of Plans by Active Members as of June 30, 2010



Implementation of Risk Pooling

- Every pension plan is unique
- Plans have varying characteristics
  - Funding levels
  - Benefits
  - Demographics

Implementation of Risk Pooling

- Not an easy task
- Three key criteria:
  - Equity
  - Simplicity
  - Effectiveness
- These criteria often worked against one another

Who Joined Risk Pools?

- To be effective, risk pools had to be large in size
- Participation was mandated on small Employers
  - Plans with Less than 100 Active Members
- Voluntary Participation for other plans
  - Very few have elected
- Once in, no option to leave

How Many Risk Pools?

- At one point 32 pools were considered
- For simplicity and effectiveness, pools were created based on the most common benefit formula
    - 5 Miscellaneous Risk Pools
    - 4 Safety Risk Pools

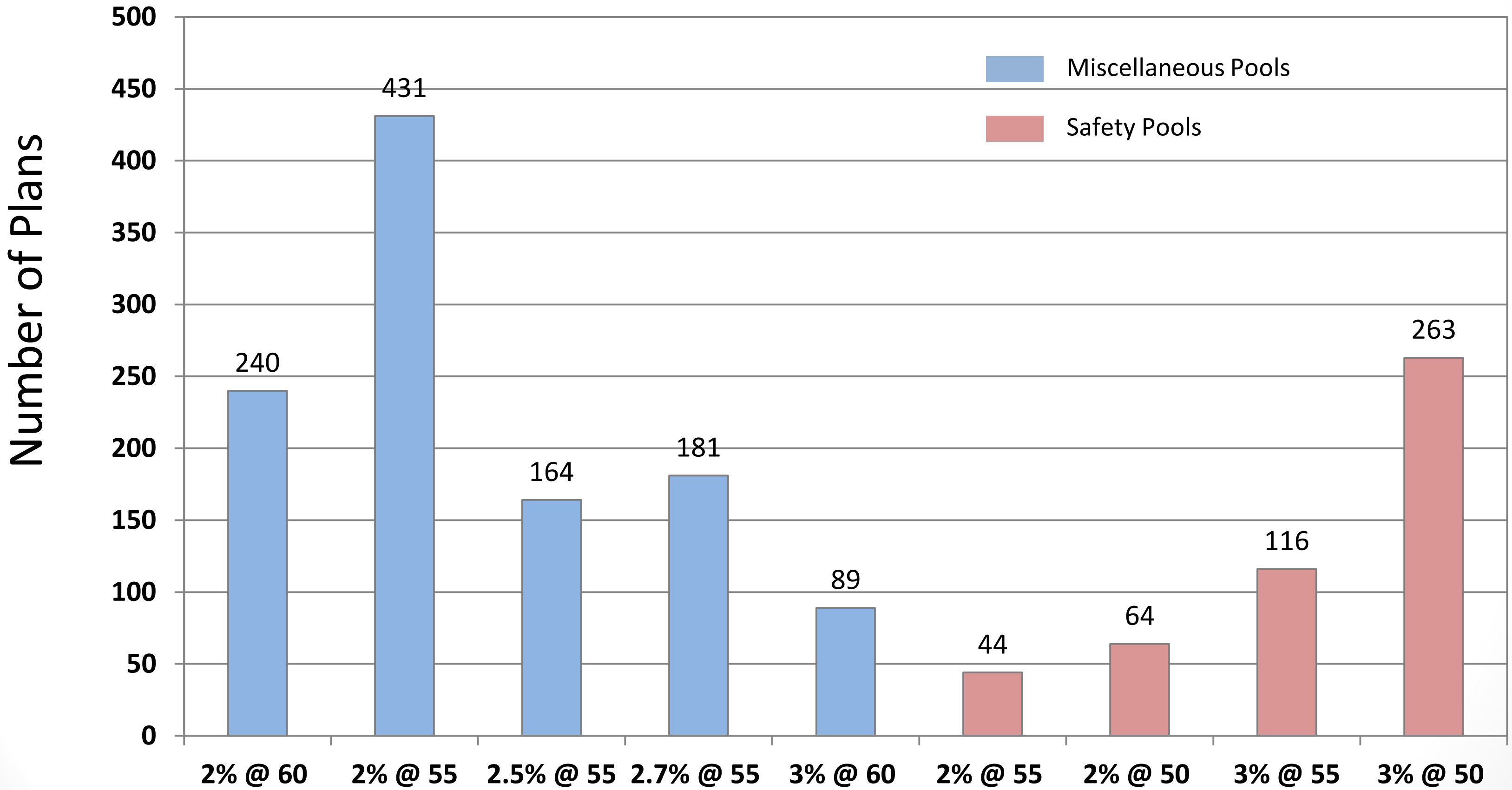
Miscellaneous Risk Pools

Pool	Benefit Formula
1	2% at 60
2	2% at 55
3	2.5% at 55
4	2.7% at 55
5	3% at 60

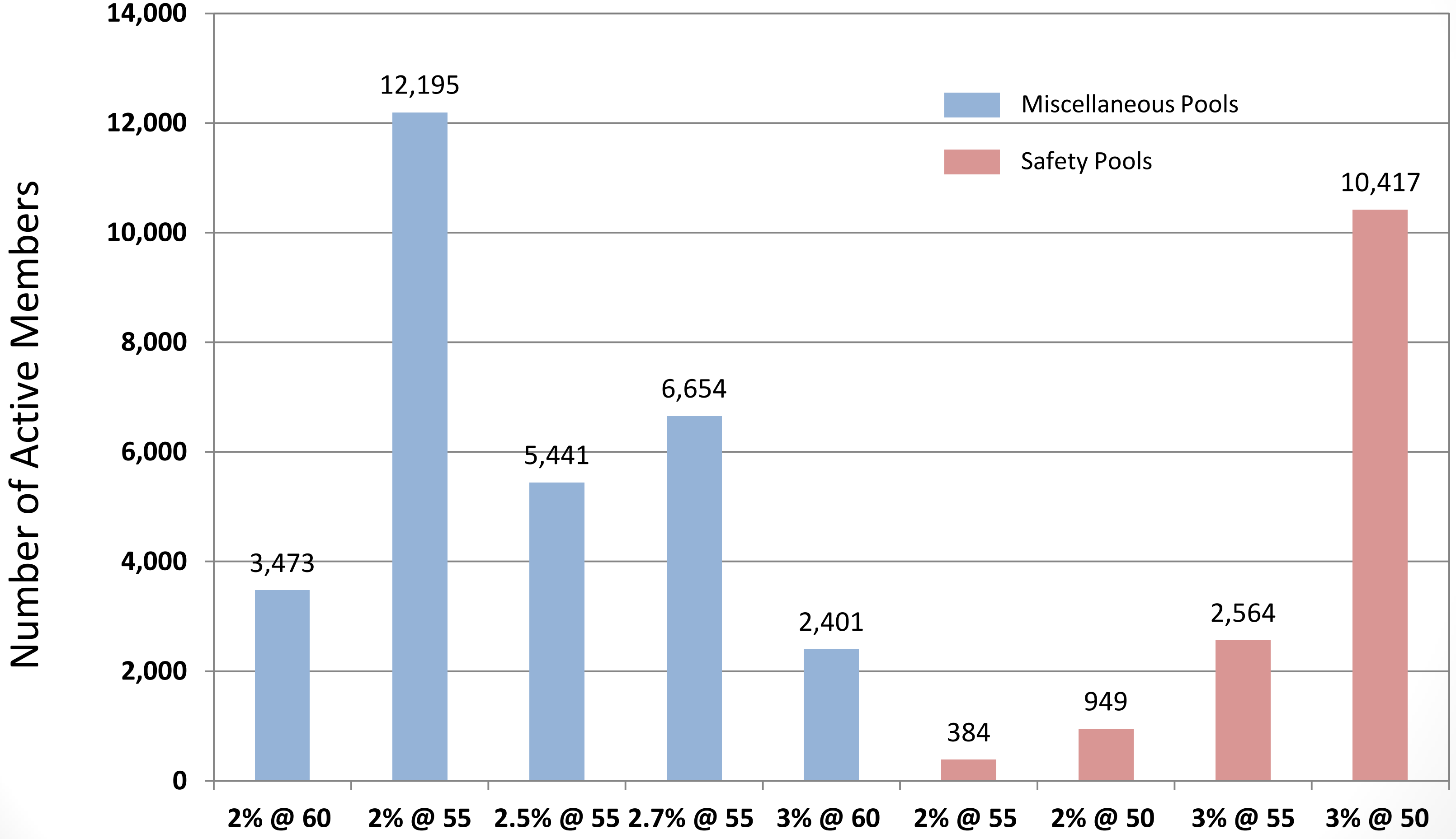
Safety Risk Pools

Pool	Benefit Formula
6	2% at 55
7	2% at 50
8	3% at 55
9	3% at 50

Number of Plans in Each Risk Pool



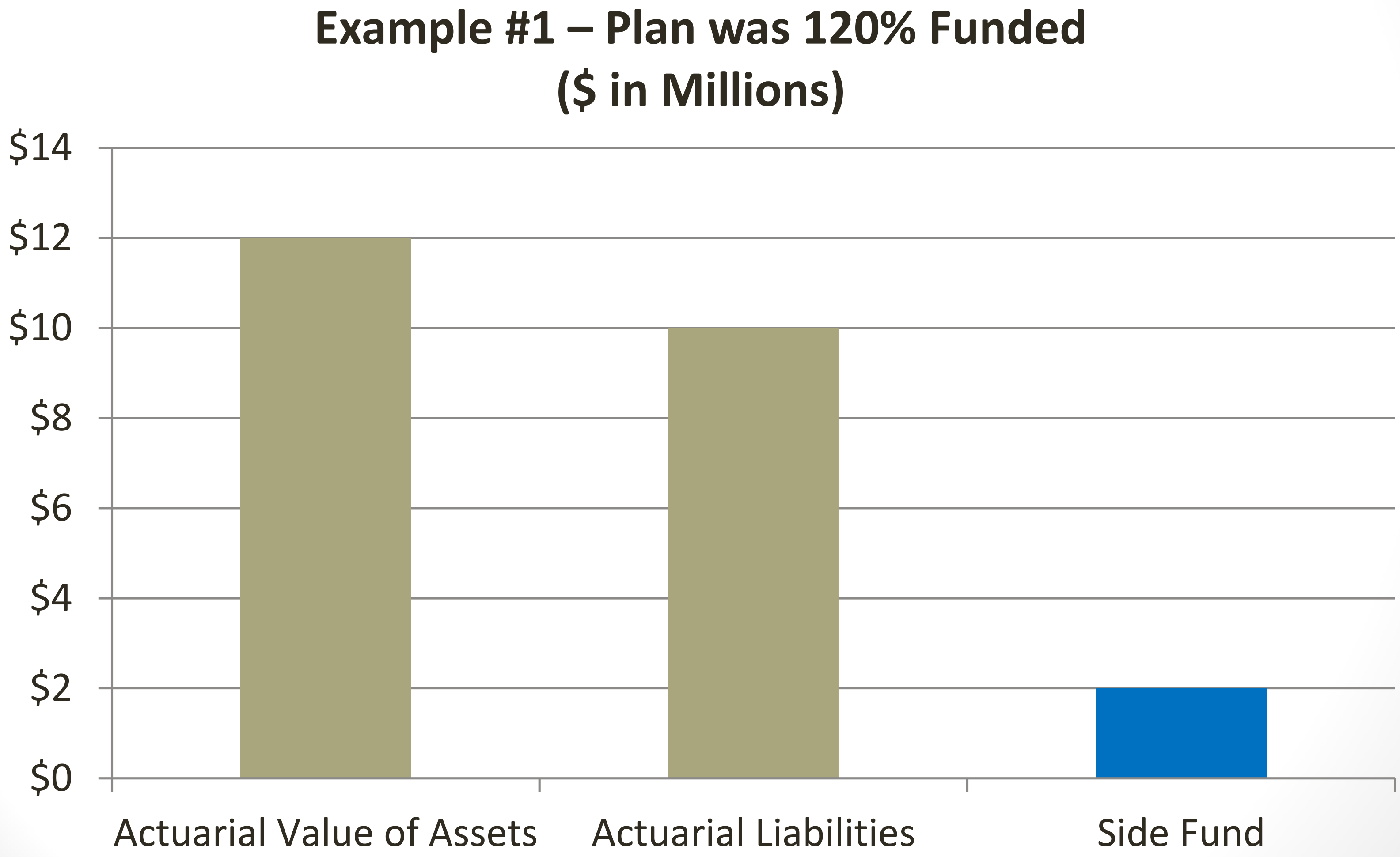
Number of Active Members in Each Risk Pool



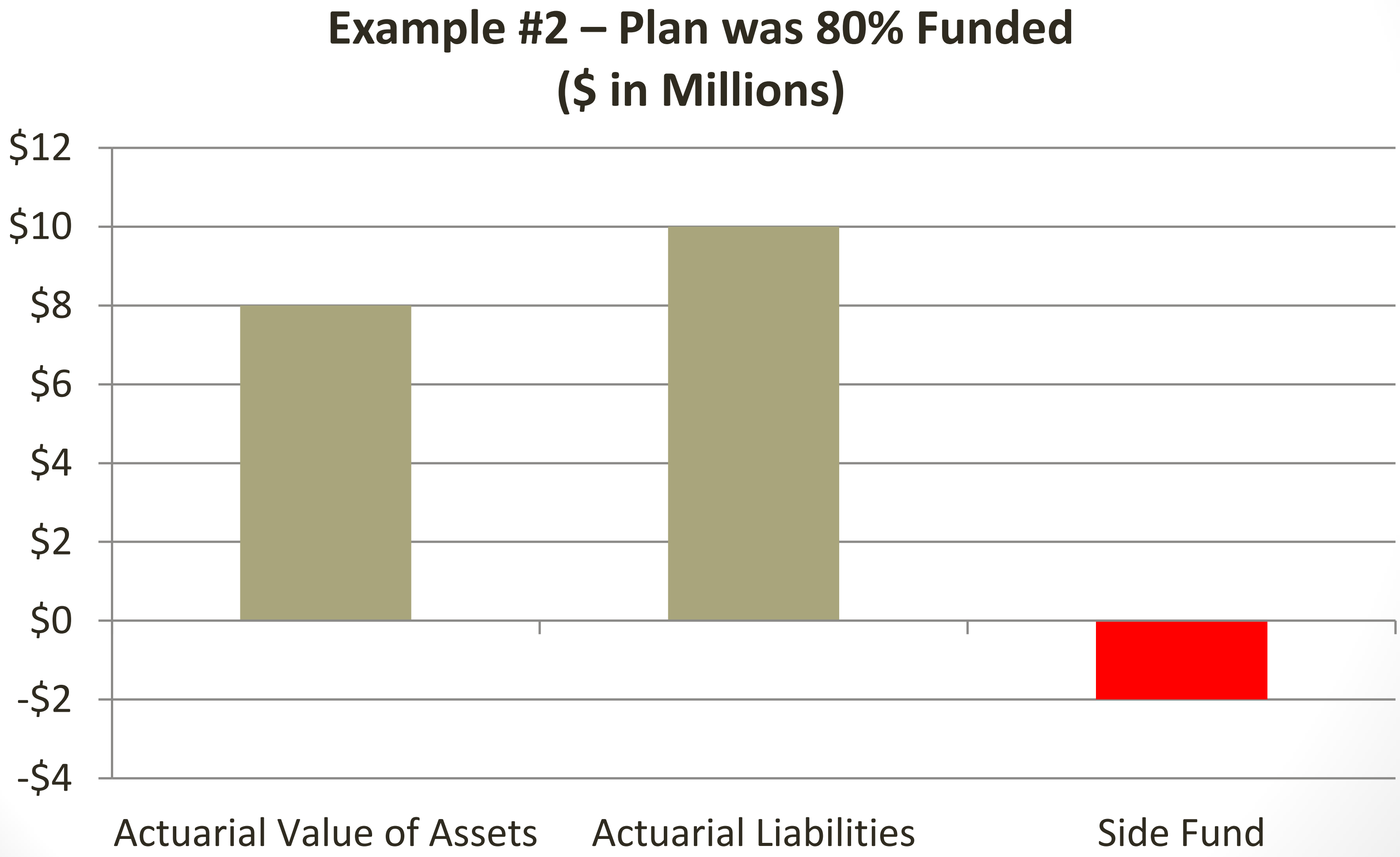
How We Handled Different Funding Levels

- Every Plan had different funding levels
  - Some had a surplus
  - Some had an unfunded liability
- For equity reasons, a side fund was created for each plan
  - Positive for a surplus
  - Negative for an unfunded liability
- Side fund is adjusted for benefit improvements

How We Handled Different Funding Levels



How We Handled Different Funding Levels



How We Handled Ancillary Benefits

- Every Plan had different ancillary benefits
- Benefits are allowed to vary by employer within risk pools
- Ancillary benefits were divided in classes
  - Class 1 - more expensive e.g. final compensation, higher COLA
  - Class 2 - one time increase in liability e.g. golden handshake
  - Class 3 - less expensive e.g. death benefits

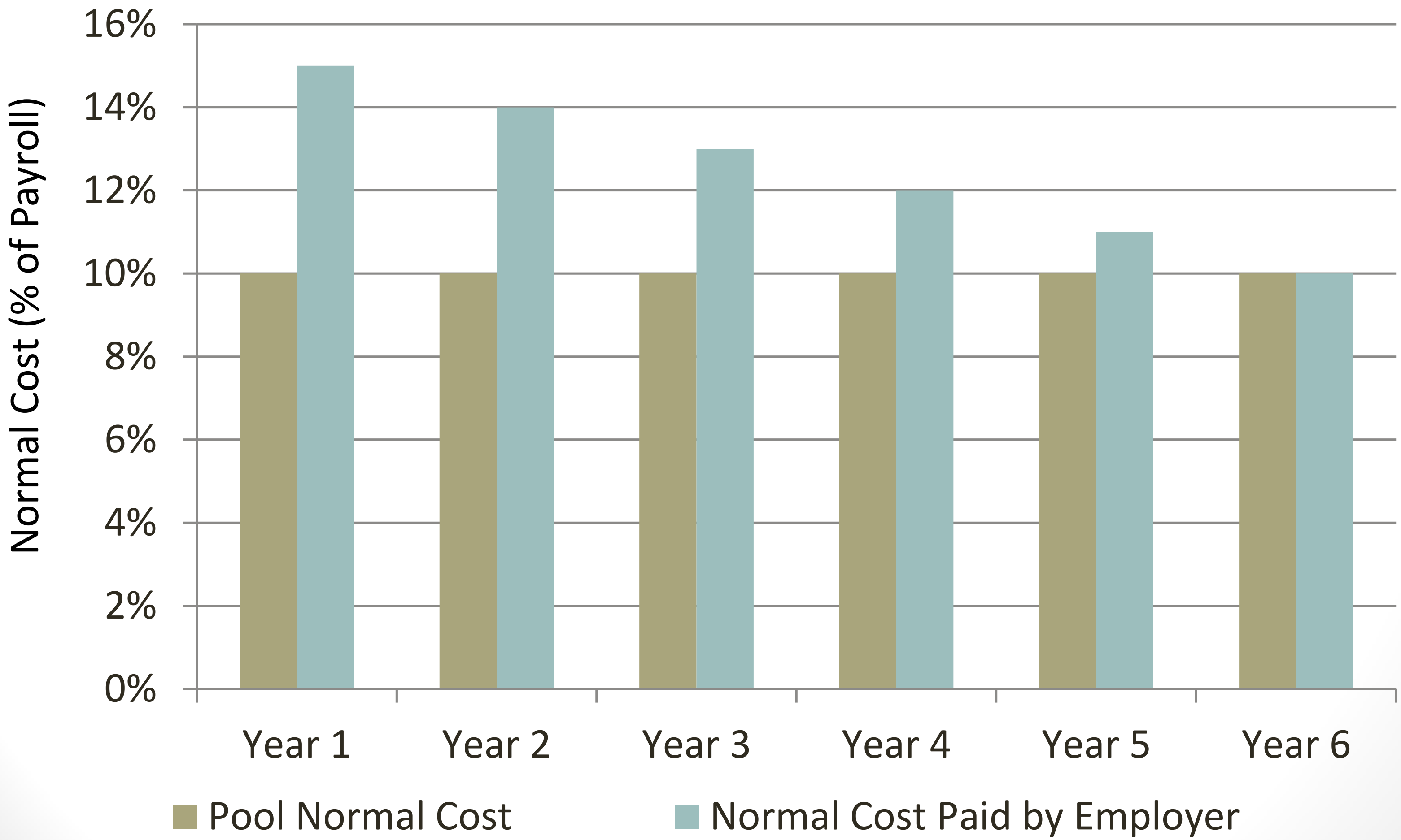
How We Handled Ancillary Benefits

- Class 1 benefits
  - Pooled employers pay a surcharge
  - Side fund is adjusted if a new class 1 benefit is added
- Class 2 benefits
  - Side fund is adjusted if a new class 2 benefit is added
- Class 3 benefits
  - No additional charges
  - Equity versus simplicity

How We Handled Varying Demographics

- Plan demographics affect normal cost
  - Lower age at hire ⇨ Lower normal cost
  - higher age at hire ⇨ Higher normal cost
- Every plan had a different normal cost
- Board adopted a 5 year phase-in

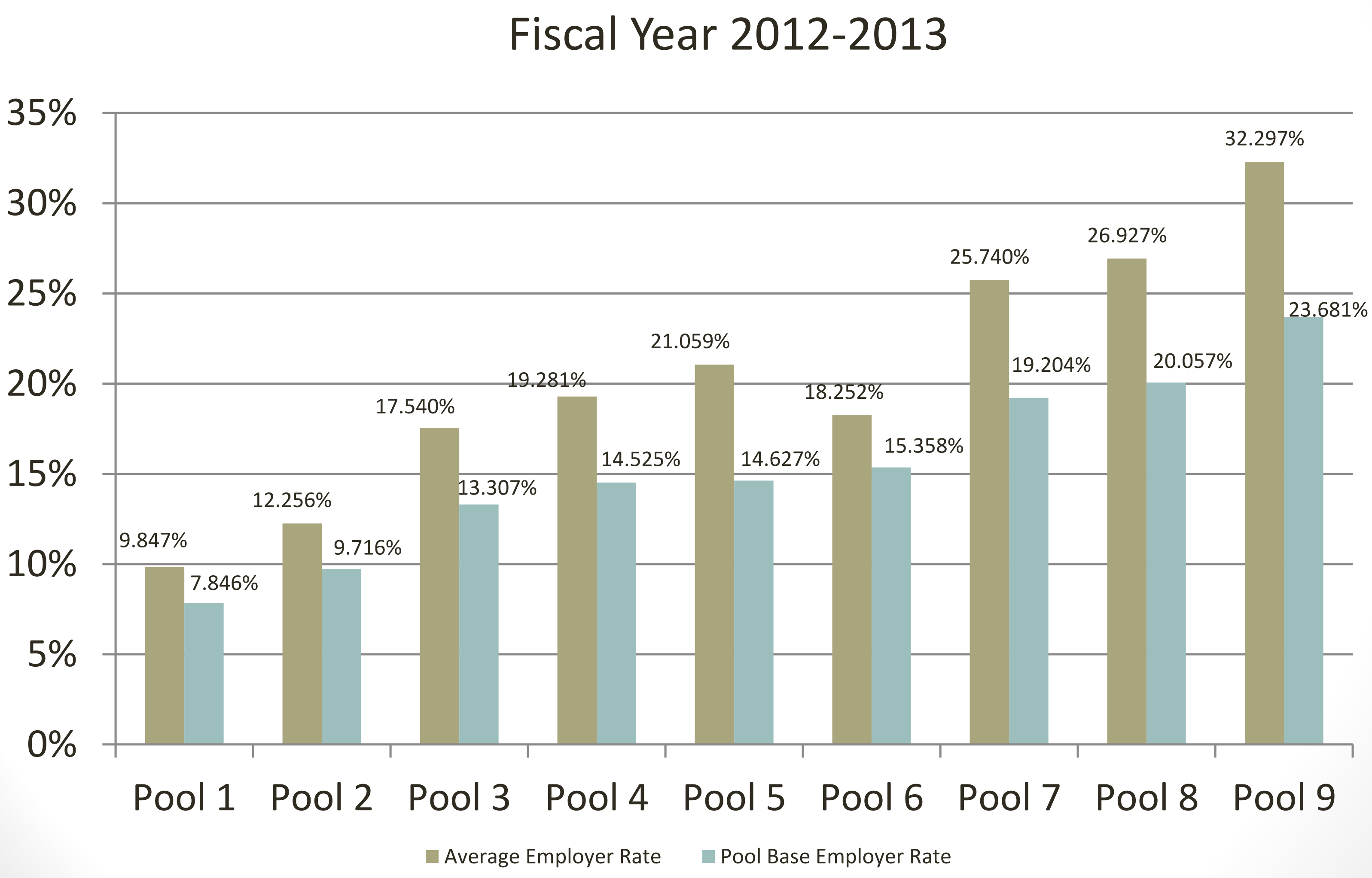
5 Year Phase-In



Do Employers All Pay the Same Contribution Rate?

- No
- Same Risk Pool Employer Rate
- Rate is Adjusted for Benefit Levels
- Rate is Adjusted for Side Fund
- Rate is Adjusted for Phase-in
  - 5 year phase-in has ended for most employers

Risk Pool Contribution Rate Versus Employer Rate



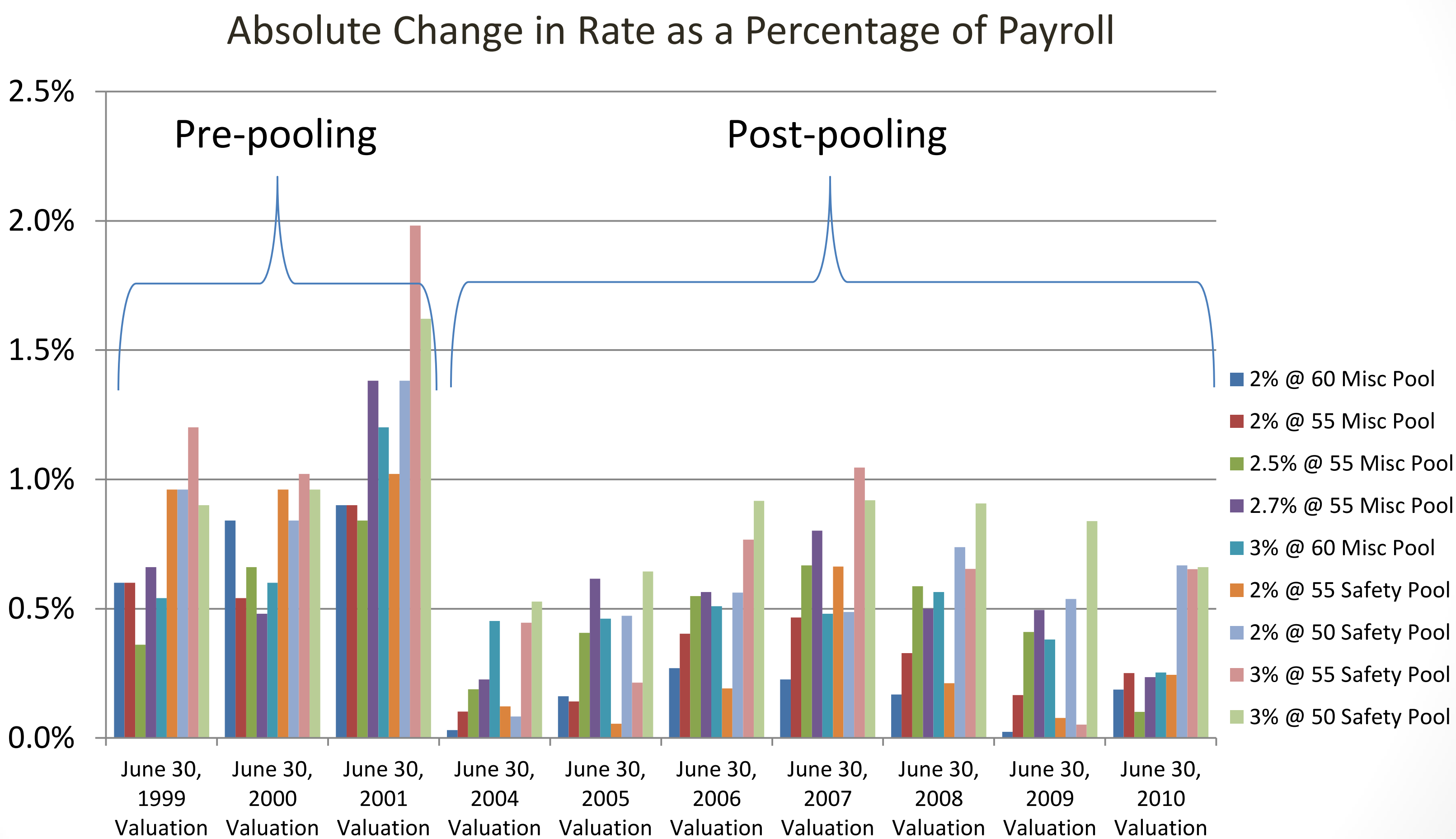
Review of Risk Pooling

- Pools have been in place 8 Years
- Time for Review
  - Always Room for Improvements
- 2011-2012 CalPERS Business Plan under Objective 2.1
  - Develop recommendations for the Board on improvements to risk pooling, including allocation of salary experience by June 30, 2012

What has Been Working Well?

- As designed, employer rate volatility has been minimized

Impact of Risk Pooling on Rate Fluctuation



Where can Improvements be Made?

- Main areas of concern
  - Movement toward lower retirement benefits
  - Employers Joining a Risk Pool
  - Anti-Selection
  - Valuation Administration

Movement Toward Lower Tiers of Benefits

- CalPERS Received over 700 requests to provide cost information related to lower tiers in the last two years.
- So far, over 200 employers have acted and adopted a lower tier.

Number of Agencies Adopting Second Tiers Over Last Two Years

	Lower Benefit Formula Only	Lower Final Compensation Only	Lower Benefit Formula & Lower Final Compensation
Miscellaneous Plans	68	6	51
Safety Plans	43	2	41

Movement Toward Lower Tiers of Benefits

- Currently Impacts Risk Pools with Higher Benefit Formulas
  - Safety 3% at 50 Pool
  - Miscellaneous 2.5% at 55 Pool
  - Miscellaneous 2.7% at 55 Pool
  - Miscellaneous 3% at 60 Pool
- Pension Reform could close all existing pools

Movement Toward Lower Tiers of Benefits

Implications

- Increase in Employer Rate Volatility
- Potential Inadequate Funding

Employer Joining Risk Pools

- New Employers Contracting with CalPERS must pay toward pool unfunded liability
- A Side Fund is created for new plan to reflect the funding level of the plan and the risk pool
- Works well ***except for employers with no prior service***
- Problem has been made worse with the 2008-2009 investment loss

Anti-Selection

- Several perceived areas of anti-selection are being reviewed
- They include:
  - Salary increases
  - Prepayment of annual employer contributions
  - Work Related Disability i.e. Industrial Disability Retirements (IDR)
  - Charges for Benefit Improvements
    - Golden Handshakes
    - Benefit Formula Improvements
    - Cost-of-Living Adjustment (COLA)

Valuation Administration

- Reviewing actuarial procedures and calculations that apply to:
  - Establishment of side fund for plans joining risk pools
  - Plans transferring between pools
  - Changes in circumstances that affect the payment toward the side fund

Path Forward

- June Agenda Item
  - Results of our review of risk pooling
  - Review of current Board Policies on Risk Pooling
  - Will include some recommended changes that can be implemented immediately
  - Some areas may need additional analysis or legislative/regulation changes

- Pension Reform could have a major impact on risk pools. We will likely have to re-evaluate once the details of pension reform are known.

Questions?