Agenda Item 7

June 12, 2012

ITEM NAME: Review of Risk Pooling and Related Board Policies

PROGRAM: Actuarial Office

ITEM TYPE: Action

RECOMMENDATION
Adopt the following:

- Amend Board of Administration (Board) Resolution No. 04-02-AESD regarding phasing-out the difference in employer's contribution rates upon joining the risk pooling structure.
- Rescind Board Resolution No. 03-04-AESD regarding the criteria to establish the classification of optional benefits available in risk pools

EXECUTIVE SUMMARY
Staff reviewed and prepared a report on risk pooling including all Board actuarial policies related to risk pooling, risk pooling practices, internal procedures, laws and regulations to assess what has worked and what can be improved. See Attachment 1 for a copy of the report.

The review of risk pooling demonstrated that the key objective of risk pooling has been realized. As designed, employer rate volatility caused by unexpected demographic events has been minimized for small employers.

The review also revealed that some improvements can be made in the manner in which new employers joining the risk pooling structure are handled. To improve the process, staff proposes amending an existing Board policy to provide for a phase-out of the difference between the employer's individual rate and the employer's rate in the pool over a five year period.

The recent movement toward lower levels of benefits over the last two years combined with anticipated pension reform proposals could have a significant impact on risk pools at CalPERS. At this time, we will wait until additional details regarding pension reform are available before we make new decisions or recommendations in this area.

BACKGROUND
Risk Pooling was implemented effective with the June 30, 2003, actuarial valuations to protect small employers (those with less than 100 active members) against large fluctuation in employer contribution rates caused by unexpected demographic events.

The environment today is different than it was eight years ago. Concerns about compensation practices from employers like City of Bell and City of Vernon have raised issues regarding risk pooling. The recent recession and the impact it had on investment returns at CalPERS caused a drop in funded status for most plans. Risk pools were 100 percent funded when first created in 2003. Most are now between 70 percent and 80 percent funded. In addition, the recent focus on pension reform and lower benefits for new hires will impact the way risk pooling is administered.

As a result of the changing environment of pension plans, it was time to review risk pooling to ensure its effectiveness and identify opportunities for improvement. This review completes objective 2.1 of the CalPERS 2011-2012 Business Plan.

ANALYSIS

The Actuarial Office spent the last year reviewing risk pooling. The review included a separate review of three Board policies that had been adopted by the Board in prior years regarding the administration of risk pooling.

Overall, the review of risk pooling has demonstrated a realization of the main risk pooling objective. As designed, unexpected demographic events now have a minimal effect on employer rates. The goal of reducing rate volatility for small employers has been achieved.

When the review of risk pooling began, we identified several areas that needed further review to address, validate or disprove concerns regarding the administration of risk pooling. These concerns were divided into four areas. They are:

- Movement toward lower retirement benefits
- Joining a risk pool for the first time
- Anti-selection
- Valuation administration

The first concern relates to the recent movement by employers toward offering lower levels of pension benefits to new hires to achieve long term savings. Over the last two years, the Actuarial Office has received approximately 1,500 cost analysis requests to quantify potential savings that could result from the adoption of lower pension benefits for new hires, that is, creating a second tier. From these requests, we had over 200 employers adopt new second tiers; most of them involving a lower benefit formula applicable to new hires.

The movement toward lower benefit formulas for new hires creates several concerns for existing risk pools. The first concern is over time some of the risk pools offering a more expensive benefit formula may become closed to new hires. This will result in greater volatility in contribution rates for employers that remain in these pools. It could also result in inadequate funding. Additionally, pension reform proposals could close all existing risk pools and may exacerbate the problem. We will review the details of any pension reform proposal to determine its impact on risk pooling. Several ideas that could solve some of these issues have been studied. They include changes to the current amortization policy as well as combining risk pools.

The second concern relates to the contribution rate employers pay after joining a risk pool for the first time. New employers currently contribute toward the unfunded liability of the pool the moment they join the pool. A process has been in place for years that involves the creation of a side fund. This process minimizes the probability of new employers contributing toward the unfunded liability of the risk pool. This process works well in most situations. However, inequities can occur when an employer first joins a risk pool with no prior service. To address this concern, staff proposes amending an existing Board policy to provide for a phase-out of the difference between the rate the employer would pay inside and outside of risk pooling.

The third concern relates to anti-selection. Anti-selection refers to the ability of employers acting in a way that would benefit them to the detriment of other employers participating in the same risk pool. Several possible areas of anti-selection were reviewed. They are:

- Salary increases
- Prepayment of annual employer contributions
- Work related disability
- Charges for benefit improvements

Overall, none of the areas studied, including the more controversial area of salary increases granted by employers, revealed a pattern of anti-selection or revealed a need for a change.

The fourth area of review is referred to as valuation administration. This area included a review of the methodologies and calculations that have been used since risk pooling was created to determine any improvements or efficiencies. Staff will be making minor changes and improvements related to three areas of the administration of risk pooling. They are:

- Establishment of side fund for plans joining risk pools
- Plans transferring between pools
- Changes in circumstances that affect the payment toward the side fund

No Board action is required to implement these changes.

For more details on the review of risk pooling including details on proposed changes, please refer to the attached risk pooling review report.

Review of Risk Pooling Board Policies
The risk pooling review was combined with the on-going review of the Board's actuarial policies that began last fall to ensure that all actuarial polices are current and consistent with the CalPERS mission and core values.

When risk pooling was adopted, CalPERS adopted three separate Board policies specific to risk pooling. They were:

- Board Resolution No. 04-02-AESD regarding phasing-out over five years the difference between the risk pool normal cost and an individual employer normal cost for employers new to risk pooling
- Board Resolution No. 03-04-AESD regarding the criteria for the classification of optional benefits available in risk pools
- Board resolutions No. 03-03-AESD related to the number of risk pools offered to employers

Board Resolution No. 04-02-AESD was adopted as a way to minimize the initial impact on contribution rates for employers mandated to participate in a risk pool. As noted earlier in this agenda item, the review of risk pooling led to the conclusion that amendments to this policy are needed to expand the definition of phase-out of contribution rates. As amended, this policy will include a phase out of the difference between the risk pool contribution rate and the employer contribution rate for those employers joining the risk pool structure for the first time. To accomplish this, staff propose amending this Board policy and are recommending that this Committee recommend to the Board the adoption of the proposed changes to Board Resolution No. 04-02-AESD. Please refer to Attachment 2 for a red line version of this policy and Attachment 3 for the proposed final policy.

Board Resolution No. 03-04-AESD was created in 2003 when the Board established the criteria for assigning each optional benefit into one of the three classifications. Following the adoption of this Board resolution, the criteria were incorporated in the Regulations and as a result this Board policy has been superseded and is no longer needed. Staff recommends the Board rescind this policy. Please refer to Attachment 4 for a copy of Board Resolution No. 03-04-AESD.

Board Resolution No. 03-03-AESD, created 11 risk pools. Nine risk pools were created for plans with active members. These risk pools were created based on the benefit formula. In accordance with that policy, there are currently five Miscellaneous Pools and four Safety Pools. In addition, there are two risk pools for plans with no active members, the inactive risk pool and the terminated agency pool. The inactive risk pool was created for plans with no active members that still have an active contract with CalPERS. The terminated agency pool exists for members whose employer has terminated their contract with CalPERS. Staff reviewed this policy and recommends no change to this policy at this time. As noted earlier, pension reform could impact this policy and require future changes if a decision is made to combine risk pools as a way to handle the movement toward lower levels of benefits for new hires. Please refer to Attachment 5 for a copy of the existing Board Resolution No. 03-03-AESD.

BENEFITS/RISKS

Risk pooling benefits small employers by providing protection against large increases in contribution rates that may occur in the event of an unexpected demographic event.

Risk pooling is designed similarly to an insurance product where several risks are brought together to mitigate against loss. As with any insurance product, there is a risk that some employers may act in ways that benefit themselves to the detriment of other employers. The review of risk pooling has demonstrated that this risk is not having a material adverse effect on the system. Even so, it is not possible to fully eliminate the risk that some employers may select against the system so continued vigilance will be required.

In this agenda item, staff is recommending changes to an existing Board policy that will address some of the equity and anti-selection risks associated with the administration of risk pools. The risk of not adopting the recommendations is that known fairness and equity issues for employers will remain.

ATTACHMENTS

Attachment 1- Risk Pooling Review Report
Attachment 2- Board Resolution No. 04-02- AESD (red line version)
Attachment 3- Board Resolution No. 04-02-AESD (final version)
Attachment 4- Board Resolution No. 03-04-AESD
Attachment 5- Board Resolution No. 03-03- AESD

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