Agenda Item 5

September 11, 2012

ITEM NAME: Long-Term Care Program Options and Long-Term Care Program Discount Rate

PROGRAM: CalPERS Long-Term Care Program

ITEM TYPE: Action

RECOMMENDATION
Staff recommends the adoption of a new Long-Term Care (LTC) Program discount rate of 5.75 percent.

EXECUTIVE SUMMARY
The purpose of this agenda item is to present the proposed discount rate and supporting information for the CalPERS LTC Program.

The LTC Program changed the strategic asset allocation of the LTC Fund to a more conservative asset mix at the Investment Committee meeting held during April 2012. A required step following a change in asset allocation strategy is the determination of an appropriate discount rate as the rate should reflect the expected investment returns. An election to a more conservative asset mix and the associated change in the discount rate is part of the comprehensive LTC Program restructuring strategy. The proposed rate changes resulting from the election of a 5.75 percent discount rate will be brought to the Pension & Health Benefits Committee (PHBC) in October 2012 as a recommendation to be implemented prior to the 2013 ongoing 5 percent rate increase.

BACKGROUND
The currently approved discount rate for the LTC Fund is 6.25 percent for projection years 1 through 10, and 7.60 percent for years 11 onward. This discount rate was adopted as an interim rate at the November 2011 Health Benefits Committee meeting while stabilization efforts continue. The strategic asset allocation supporting this discount rate was adopted in May 2011 by the Investment Committee which included an asset mix that contained 44 percent in global equities.

The Investment Committee directed staff to return in one year to re-evaluate the asset allocation given the ongoing program restructuring. Since that time, LTC Program staff conducted a Long-Term Care Program Market Study presented at the February 2012 Pension & Health Benefits Committee (PHBC). This study indicated:

- The CalPERS LTC Fund is invested in a much larger share of equities than is insurance industry standard which may lead to less stable, consistent and predictive portfolio returns.

- The CalPERS LTC Fund uses a higher discount rate assumption than is typically seen in the insurance industry due to the more aggressive investment strategy and expected return.

During the April 2012 Investment Committee meeting, a revised strategic asset allocation was adopted for the LTC Fund which included an immediate move to a 15 percent equity allocation. The target portfolio mix included 15 percent in equities, 67 percent in fixed income investments, 12 percent in Real Estate Investment Trusts, and 6 percent in commodities. To be consistent with the decision the Investment Committee made in April 2012, we are recommending a discount rate of 5.75 percent.

Approximately 76 percent of all long-term care policies are LTC1 and LTC2 series offerings with the Inflation Protection feature. The level of premiums for these policies are insufficient verses the actual and projected benefits, which is one of the reasons for the ongoing 5 percent premium rate increases. The ongoing 5 percent increases was a Health Benefits Committee decision alternative to a substantially higher rate increase that would have been due in full in 2010.

ANALYSIS

The proposed discount rate for the LTC Fund is a level 5.75 percent, and this discount rate reflects the revised investment mix and the revised long-term inflation rate of 2.75 percent, which was recently reduced from 3 percent.

The proposed discount rate for the LTC Fund was developed by and relies upon the CalPERS Actuarial Office's methodology utilized for the Pension Program(s). Similar to the Pension Program(s), select-and-ultimate discount rates were developed, and the discount rates were 4.75 percent for projection years 1 through 9 and 6.50 percent for projection years 10 onward. A level discount rate was calculated to produce similar projection results to the select-and-ultimate approach, and the equivalent level discount rate was 5.78 percent. The final step to develop the proposed discount rate was to round down to the nearest quarter of one percent resulting in the recommended 5.75 percent level discount rate. See Attachment 1 for details on the methodology in setting the discount rate.

The following differences between CalPERS LTC Program and Pension programs are worth noting:

1. The LTC Program has a different proposed asset mix.

2. The LTC Program uses best-estimate (i.e., 50th percentile) returns for the discount rate and does not include provision for expenses or any margin in this rate. The LTC Program expenses and margin are explicitly provided for elsewhere.

Change in Funding Status to the LTC Program
The margin and funded ratio as of the December 31, 2011, valuation of the LTC Program was presented to the PHBC in April 2012. The margin was 13.56 percent with a funded ratio of 116 percent. These calculations used the previously approved discount rate of 6.25 percent for projection years 1 through10, and 7.60 percent for years 11 onward. Using this same valuation projection but discounting the cash flows at the new proposed level discount rate of 5.75 percent results in a projected deficit of (12.03) percent with a funded ratio of 88 percent. Attachment 2: CalPERS Long-Term Care Program - provides additional background and illustrates the need to make proactive changes to ensure the long-term solvency of the LTC Fund.

Implications to the Program
In October, staff will present program changes and rate increase options. To assist the Committee in evaluating the implications of the change in the discount rate, we offer the following observations:

- Rate increases for some or all of the plan levels will be necessary beyond the current 5 percent annual rate increases.
- Rate increases are expected to range between 3 percent and 77 percent.
- There are programmatic changes that can be implemented to offer a less expensive, but still protective benefit level, for those members currently in the most expensive categories:

    - Offering a 9-year plan combined with Retained Inflation (RI) benefit to existing policyholders would allow those with lifetime benefits an option to decrease their coverage amount to a defined benefit amount in their same plan/year product offering. Currently, lifetime policyholders can only decrease to a 3-year or 6-year comprehensive or facilities only plan, or move to a 1-year or 2-year Partnership plan.

    - Offering RI to all policyholders (excluding Partnership policies that require built-in inflation), regardless of their policy term, would allow policyholders with built-in inflation protection the option to drop their built-in inflation protection but maintain the inflated coverage amounts they have accrued and paid for over the years. The RI option may reduce premium and LTC1 policyholders with lifetime and built-in inflation protection might not be subject to the ongoing 5 percent premium increase. Currently, when policyholders drop their built-in inflation protection they revert to their original Daily Benefit Amount (DBA).

- Policyholders electing to drop their built-in inflation protection would be eligible for the Benefit Increase Offer (BIO). The LTC Program currently offers the BIO every three years to all policyholders that do not have built-in inflation protection, and allows them the opportunity to increase their benefit amounts without going through underwriting. Accepting the offer would result in a premium increase.

- The Optional DBA benefit could be offered to policyholders who previously elected to decrease their coverage by either dropping built-in inflation protection or lowering DBA as a means of reducing their premium. This benefit would allow those policyholders that dropped their built-in inflation protection and converted back to their original DBA, or those policyholders that decreased their DBA, to repurchase 100 percent of their inflated DBA at the time of their coverage change.

BENEFITS/RISKS

If the recommendation is not approved, the LTC Fund's revised asset allocation and discount rate would be inconsistent. This could result in future LTC Program valuations lacking accuracy by utilizing a discount rate that does not reflect the strategic asset allocation adopted by the Board in April 2012.

ATTACHMENTS

Attachment 1: Development of the Long-Term Care Recommended Discount Rate
Attachment 2: CalPERS Long-Term Care Program

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