Agenda Item 6a

November 14, 2012

ITEM NAME: Creation of Two New Risk Pools due to the Public Employees' Pension Reform Act

PROGRAM: Actuarial Office

ITEM TYPE: Action

RECOMMENDATION
Staff recommends the adoption of the following:

- Amend Board Policy No. 03-03-AESD (Rev.) to create two new pension risk pools for local agencies due to Public Employees' Pension Reform Act.

EXECUTIVE SUMMARY
The Governor signed Public Employees' Pension Reform Act on September 12, 2012. This action created four new retirement formulas, one (2% at Age 62) for miscellaneous members and three (2% at Age 57, 2.5% at Age 57, and 2.7% at Age 57) for safety members.

To accommodate these four new formulas staff recommends creating two new pension risk pools for local agencies. One pool will be for miscellaneous members subject to the 2% at Age 62 formula and one pool will be for safety members subject to any of the three new safety formula (2% at Age 57, 2.5% at Age 57, and 2.7% at Age 57).

STRATEGIC PLAN
This item is being brought to the Board to modify the pension risk pooling structure in order to implement changes made by Public Employees' Pension Reform Act.

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 fluctuations in employer contribution rates caused by unexpected demographic events.

With the passing of Public Employees' Pension Reform Act, four new retirement formulas were created, one (2% at Age 62) for miscellaneous members and three (2% at Age 57, 2.5% at Age 57, and 2.7% at Age 57) for safety members. The existing rate setting structure will handle these new formulas for non-pooled agencies, the State plans and the Schools pool. However, for pooled public agencies, it will be necessary to either create new pension risk pools for these formulas or implement them within existing pension risk pools.

ANALYSIS

Government Code Section 20840 gives the Board the authority to create, combine, and eliminate risk pools for miscellaneous members and safety members.

Originally when risk pooling for pension began, nine risk pools were created for plans with active members. These risk pools were created based on the most common benefit formula. There are currently five Miscellaneous Pools and four Safety Pools. Some of the existing pools cover more than one benefit formula. In these cases, employers with a formula different than the base formula are subject to a surcharge that accounts for the different benefit level.

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.

Last June, the Actuarial Office presented to the Board a Risk Pooling Review Report. As part of the review of risk pooling, staff studied the impact lower tier benefits have on risk pools and identified to the Board that changes may be needed to the risk pooling structure if changes were made to retirement benefits as part of pension reform.

Due to the tight timeframe to implement Public Employees' Pension Reform Act, staff is not recommending an overhaul of the risk pooling structure and instead is recommending minor changes now with potential bigger changes later. The Actuarial Office has examined two viable modifications to risk pooling that would accommodate Public Employees' Pension Reform Act by January 1, 2013. A third Option that was considered was the Board taking no action. This is not recommended and is not viable as no pools would be created and hence the Actuarial Office would not be able to calculate employer rates for the January 1st, 2013 implementation which complicates the administration of the retirement system. The two options considered are:

- Option 1
  - Create the 2% at Age 62 miscellaneous risk pool for miscellaneous members subject to the 2% at age 62 formula
  - Create the 2.7% at Age 57 safety risk pool for safety members subject to the 2% at Age 57, 2.5% at Age 57 or 2.7% at Age 57 formula. The base employer contribution rate for that pool will be based on the 2.7% at Age 57 formula since this formula is expected to apply to 95% of our pooled employers. Employers with members under one of the two lower formulas

will have a negative surcharge applied to their employer contribution rate that will ensure they pay an employer contribution rate that reflects the benefit level provided to their members.

- Option 2
  - Add the members subject to the 2% at Age 62 miscellaneous formula into the existing 2% at age 60 miscellaneous risk pool
  - Add the members subject to the 2% at Age 57 safety formula into the existing 2% at age 55 safety risk pool
  - Add the members subject to the 2.5% at Age 57 safety formula into the existing 2% at age 50 safety risk pool
  - Add the members subject to the 2.7% at Age 57 safety formula into the existing 2% at age 50 safety risk pool
  - Employers will have a negative surcharge applied to their employer contribution rate that will ensure they pay an employer contribution rate that reflects the benefit level provided to their members.

Of the two options, staff is recommending Option 1 as it requires essentially the same amount of work as Option 2 but does not mix the Public Employees' Pension Reform Act formulas with the closed benefit formulas within some of the risk pools. By not mixing the formulas, future solutions can affect only the closed pools. For this reason, staff is recommending that the Board approve the amendments to Board Resolution No. 03-03-AESD (Rev.) to create two additional local agency risk pools. Please refer to Attachment 1 for the proposed Board Resolution No. 03-03-AESD (Rev.). The changes and additions to the Resolution are underlined.

In the future, a decision will have to be made regarding the existing risk pools. With the passage of Public Employees' Pension Reform Act, employees that meet the definition of new members will be subject to the new benefit formula established by Public Employees' Pension Reform Act. As a result, existing pools are expected to see their active memberships decline over time since all existing risk pools will essentially be closed to new members. Only the new employees not considered new members under Public Employees' Pension Reform Act would be able to join one of the existing risk pools. Over time, the existing risk pools will see their membership transform from a mix of active and retired members to mainly retired members. This will result in greater volatility in contribution rates for employers that remain in these pools. It could also result in inadequate funding.

BENEFITS/RISKS
In this agenda item, staff is recommending changes to an existing Board policy that will add two new risk pools due to Public Employees' Pension Reform Act. Staff has outlined the risks of:

1) not taking action,
2) the risks and benefits of adopting Option 1 and,

3) the risks of adopting Option 2, there are no known benefits over Option 1 in comparison.

The risks of not taking any action is that small employers will have no defined risk pool destination and no defined employer and employee rates beginning January 1, 2013. The consequence of this are that, in addition to not initially funding the plans due to no rate calculations until data is received, small employers' employees may be placed in standalone plans which would then cause them to be subject to large contribution rate fluctuations that may occur in the event of an unexpected demographic event. If new destination pools are not created, legal analysis would be required to determine where to place these new employees hired in plans with less than one hundred active members after January 1, 2013, the effective date of Public Employees' Pension Reform Act.

The likely risks of adopting Option 1 are the Actuarial Office will be required to continually, both now and over the course of the existing risk pools lifetime, develop effective solutions dealing with amortizing and allocating experience gains/losses to handle the closure of the existing risk pools. Also, the new pools created here may have the risk of rate fluctuations associated with having small active membership. We do not expect this to be an issue as the pools should grow to a sufficient size within a few years. The benefits of adopting Option 1 are that all existing risk pools' issues may be handled in a one-time one-size fits all methodology.

The likely risks of adopting Option 2 are identified in the results of the Actuarial Office's June 2012 Risk Pooling Review Report. The Report identified that 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. The movement toward lower benefit formulas for new hires creates several concerns for existing risk pools. The first concern is that, over time, some of the risk pools offering a more expensive benefit formula will become closed to most new hires causing the pools' payroll growth rate to vary from our actuarial assumed payroll growth rate. This will result in greater volatility in contribution rates for employers that remain in these pools. It could also result in inadequate funding. Public Employees' Pension Reform Act has exacerbated this problem by essentially closing all existing risk pools to new members. Several ideas that could solve some of these issues have been studied. They include changes to the current amortization policy and billing required contributions as a dollar amount, as well as combining risk pools. If Option 2 is selected it is most likely that the existing risk pools that are combined with Public Employees' Pension Reform Act mandated formulas will experience inequitable allocation of gains and losses due to the membership growth dynamics between plans within that risk pool. In addition, virtually the same amount of work under Option 1 will need to be applied to the other risk pools that are not combined with a Public Employees' Pension Reform Act formula.

The Actuarial Office will continue to review and monitor the impact that Public Employees' Pension Reform Act has on the risk pools. Additional recommendations in this area are likely to ensue.

ATTACHMENTS

Attachment 1- Proposed Board Resolution No. 03-03-AESD (Rev.)

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