Agenda Item 7b

December 17, 2013

ITEM NAME: Impact on Pension Risk Pools as a Result of Pension Reform

PROGRAM: Actuarial Office

ITEM TYPE: Information

EXECUTIVE SUMMARY
Staff has identified some unintended consequences resulting from the interaction of the Public Employees' Pension Reform Act of 2013 (PEPRA) and existing Board policies on risk pools. Changes will be necessary to ensure the proper funding of these pools.

Two alternatives are discussed. The first alternative includes changes to the financing of the risk pools. The second alternative looks at combining risk pools as well as some financing changes. Both alternatives preserve the essential pooling of risks needed to prevent demographic events from causing significant rate shocks for small plans.

Staff expects to come back in the spring of 2014 with a formal recommendation to adopt the second alternative – to combine risk pools and make some financing changes.

STRATEGIC PLAN
This agenda item is not part of our strategic plan but rather is a response to changes in the external environment that staff is responding to as part of the ongoing workload of the Actuarial Office.

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.

In June 2012, staff delivered a review 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. The review demonstrated that the key objective of risk pooling had been realized, i.e. risk pooling has protected small employers against large changes in employer contribution rates due to unexpected demographic events. In the report, it was noted that the pension reform proposals under consideration at the time could close all existing risk pools and have a significant impact on the risk pools at CalPERS.

Pension reform legislation was enacted in 2012 through the passage of PEPRA. PEPRA effectively closed the existing pools at that time. As the effective date of the legislation was after the effective date of the June 30, 2012 actuarial valuations staff did not make any changes to those valuations. In November 2012, the Board approved adding two new risk pools due to the formulas created by PEPRA to be able to implement PEPRA on January 1, 2013.

However, it is now necessary to consider the appropriate treatment of the effective closure of the risk pools for the “Classic” formulas – those in existence prior to the passage of PEPRA.

ANALYSIS

In an open pension plan, a fundamental underlying assumption is that there will be an ongoing influx of new employees to replace those employees that exit due to retirement, disability, turnover or death. Actuarial policies in place at CalPERS, including those covering risk pooling, were developed assuming pension plans would remain open to new entrants and experience a growth in payroll over time. The current Board approved payroll growth assumption is 3% per year. This future employer payroll growth assumption has a significant impact on employer contribution rates, resulting in a lower contribution rate in the early year of the amortization of any unfunded liabilities.

The Issues

PEPRA has closed all existing active risk pools to new public employees hired on and after January 1, 2013 except for classic members. Accordingly, it can no longer be considered a reasonable assumption that payroll of the risk pools for the classic formulas will continue to grow at 3%. When a pension plan becomes closed to new entrants, attrition will begin the process of reducing the number of active employees toward ultimately having a pension plans with no active employees.

Several issues have arisen as a result of PEPRA for the risk pooling structure. They can be categorized as funding, equity and employer contribution rate volatility issues.

Funding issue

Contributions for pools are collected as a contribution rate expressed as a percentage of payroll. When setting the contribution rates, the actuarial office uses the payroll information from the data used in the actuarial valuation. The payroll information is three years prior to the fiscal year when the contribution rate will apply. As a result, the payroll is projected forward for three years under the assumption it will grow by 3% per year.

With the closing of pools to new PEPRA hires, the payroll is most likely going to increase at a rate lower than 3% and even possibly decline over that time period. When a pool experiences smaller payroll growth than assumed, it can lead to an underfunding of the plan.

Let’s use the 3% at 50 Safety Risk Pool June 30, 2011 annual valuation as an example. Total employer contribution toward unfunded liability and side fund was set to be $137 million dollars, which was expressed as 13.220% of a payroll that was projected for three years after the valuation assuming a 3% payroll growth per year. If the payroll of the pool were to remain level instead of growing at 3% per year, the employer contributions toward unfunded liability and side fund will be about 9% less than expected. In this example, the lower payroll would translate into a 12 million dollars contribution loss to the pool. The long-term impact of contribution losses will be significant to all classic pools and potentially lead to underfunding of the system unless changes are made.

Equity issue

Under the current risk pooling structure, the existing unfunded liability as well as future gains and losses are currently allocated to plans in each risk pool based on the payroll of the plan. This structure works well to the extent the payroll of each plan is expected to grow at about the same rate. With the closing of the pools to new hires, the payroll of plans will decline over time. Since every employer participating in risk pooling has different demographic characteristics, their active members will retire or exit the plan at different times leading to some plans experiencing a faster decline in payroll than others.

Since gains and losses of the entire pool are currently allocated based on payroll, plans with larger payroll will be asked to contribute more toward the pool’s unfunded liability than plans with smaller payroll. As the number of active members decline in the pool, the payments toward the unfunded liability will disproportionally be shifted to those plans having the largest number of remaining active members resulting in an inequitable allocation of costs. Changes are need to how we allocate cost in the risk pools to address this equity issue.

Volatility issue

When PEPRA was enacted and closed all classic active pools to new PEPRA hires, the unfunded liability for the classic pools remained unchanged. Under current Board policies, payments to the amortization of unfunded liabilities and side funds are expressed as a percentage of payroll. Even if the unfunded liability decreases over time as employers pay the unfunded liability down, the employer contribution rates (which are the amortization payment divided by payroll) will increase eventually to an alarming stage. This is going to be difficult for employers to budget and could lead to perception issues related to the cost of pension benefits.

Possible Solutions

The Actuarial Office studied two alternatives for the future of risk pooling to address these issues without sacrificing the considerable benefit to contribution rate stability for smaller employers that risk pooling provides.

Alternative 1

Alternative 1 includes keeping the current pooling structure of 9 closed active pools, 1 inactive pool and 2 open active PEPRA pools and modifying current funding and amortization methods to address the funding and equity issues with the least amount of change to our current pooling structure. Alternative 1 will result in higher employer contribution rates and amounts immediately for almost all **of the** 1,625 plans in classic risk pools. For this reason, alternative 1 is not the preferred approach.

The modifications proposed under alternative 1 are:

- Collect employer contributions toward the unfunded liability and side fund as dollar amounts instead of contribution rates. This will address the funding issue. This will result in a major change in how contributions are collected from employers.
- Apply the current Board Amortization policies that states that when the payroll of a plan cannot be expected to increase at 3% per year that the unfunded liability and side fund be amortized as a level dollar rather than as a level percentage of an increasing payroll. Simply applying our existing policy will result in higher contributions short term from all pooled employers. This will address the funding and volatility issue.
- This alternative may potentially require a change to a shorter amortization period in the future to reflect the remaining average working lifetime of the pool, this will further address the funding issue but result in higher contribution requirements.
- Allocate the pool's unfunded liability to each individual plan based on the plan's total liability instead of by individual plan payroll. This will address the equity issue but will result in some employers having to pay more toward the unfunded liability of the pool and some paying less.

The changes proposed under alternative 1 will result in almost all pooled employers having to contribute more. We expect that about 90% of the Miscellaneous plans in the classic risk pools will experience employer rate increases between 0-3% of payroll and about 75% of the Safety plans will experience increases of 2-5% of payroll. In addition to the contribution increases, change of the allocation of the pool's unfunded liability will further increase or decrease individual employer contribution rates. See Attachment 1 for a distribution of the expected impact on employer rates.

Under this alternative, we will need to monitor the funding of the risk pool carefully. It is possible that we may have to eventually modify our funding approach to reflect the demographics of the closed groups which would further increase contributions. This is not the preferred alternative.

Alternative 2
Staff also reviewed another alternative which is combining all pools into two active pools, one for all miscellaneous groups and one for all safety groups. This is the more complex solution and will involve structural change. By combining almost all pooled plans into two risk pools, the payroll of the risk pools and employers within the pools can once again be expected to increase at the assumed 3% annual growth, addressing some of the issues that resulted from having a declining active population in the pool. Therefore we will be able to keep our current level percent of pay amortization schedule which will avoid the necessity of immediate increases to employer contributions that is the hallmark of alternative 1.

Under alternative 2, we would recommend the following modifications:

- Collect employer contributions toward unfunded liability and side fund as dollar amounts instead of contribution rates, this will address the funding issue that would still arise from the declining population under the classic formula. This will result in a major change in how contributions are collected from employers. Note that several employers have approached CalPERS over the last few months proposing that we no longer collect contributions for the unfunded liability as a percentage of payroll but rather invoice them for the amount needed each year to pay the unfunded liability down. The normal cost contribution would continue to be expressed as a percentage of payroll.
- Allocate the pool's unfunded liability to each individual plan based on the plan's total liability instead of by individual plan payroll. This is a change that many pooled employers have been asking for. For the last few years, many pooled employers have been asking for the ability to pay down their share of the pool's unfunded liability. This is not possible unless we start allocating the unfunded liability of the pool to each employer on an annual basis. Making this change will address the equity issue and allow employers to pay down their share of the pool's unfunded liability but will result in some employers having to pay more toward the unfunded liability of the pool and some paying less.

Under this approach, there is no overall increase in employer contributions. Some employers will have higher contributions while other employers will have lower contributions. Employer rates for mature plans with high liabilities and high retiree to active ratios are expected to increase while rates for plans with lower liabilities and lower retiree to active ratios are expected to see a decrease. A preliminary analysis performed by staff showed that almost half of the plans will see a rate change – positive or negative of less than 1% of payroll. About 85% of the plans will experience rate changes between -3% to +3% of payroll. However, there are a few plans with large retiree to active ratios that will experience rate increases in excess of 3% of payroll. See Attachment 2 for a distribution of the expected impact on employer rates.

This solution will require a significant effort to program and design the required database changes to our existing system. Modifications to Board policies, as well as legislative and regulation changes may be needed. Staff is still analyzing the changes that would be needed.

This alternative is also likely to pose additional challenges in the future when an assumption change occurs. Staff will be looking at various ways to handle future assumption changes. Any solution would have to consider fairness among employers and ability of our current computer systems to handle.

BUDGET AND FISCAL IMPACTS

This item was not anticipated in the strategic or business plan and has not been built into the budget. Given the time constraint to implement the changes outlined in this agenda item, it is anticipated that any work associated with the issues described herein will have to be completed with existing staff and absorbed within current budgets although this may be revisited in a future agenda item. Unless action is taken, contributions from employers will have to be accelerated and impose additional strain on employers' budgets.

ATTACHMENTS

Attachment 1 – Estimated Impact of Alternative 1 on Employer Contribution Rates
Attachment 2 – Estimated Impact of Alternative 2 on Employer Contribution Rates

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