Agenda Item 10a

October 20, 2015

ITEM NAME: Multiple Asset Allocation Concept Update

PROGRAM: Asset Liability Management

ITEM TYPE: Information

EXECUTIVE SUMMARY
In February 2015, a workshop was conducted for the Board to provide an overview of the risks faced in the funding of the Public Employees' Retirement System, how these risks are changing, and introduced several concepts that could be applied to address these risks. One of these concepts reviewed was the Multiple Asset Allocation Choice (MAAC) option.

This risk mitigation concept would consider an asset allocation choice for employers looking to lower their funding risk and whose circumstances could accommodate a lower discount rate. The Financial Office consulted with the Actuarial, Investment and Legal offices during this analysis and came to the consensus that implementing such a program would have substantial costs and increased complexity associated with its creation and maintenance.

High costs and complexity associated with implementation, the needed participation to make this a cost effective option as well as additional costs and expertise required by the employer, led to Staff's conclusion that the implementation of the MAAC is not operationally feasible or prudent at this time. Alternatively, Staff will be introducing a Funding Risk Mitigation Policy during the 2015 October Board meeting which will provide an enterprise wide solution for reducing risk for employers. In addition, employers can currently elect to lower their funded status risk by periodically paying down their liability.

STRATEGIC PLAN
This agenda item supports Strategic Plan Goal A – to improve long-term pension and health benefit sustainability. It specifically addresses the objective to fund the system through an integrated view of pension assets and liabilities.

BACKGROUND
All of the assets for active employers in the Public Employees' Retirement Fund (PERF) are currently invested with a single asset allocation investment model. However some employers have expressed interest in the possibility of having a multiple asset allocation choice within the PERF. This option would potentially

provide the opportunity to use less volatile investment allocations at the expense of higher contribution rates. Thus, individual employers might be able to better align their risk profile with the investment strategy used on their assets.

During the 2015 February workshop, a MAAC was briefly reviewed as providing one or two alternative allocation choices to fit employer circumstances and funding risk. Staff was directed by the Board to undertake an assessment of this risk mitigation option and to bring back a report of the findings.

ANALYSIS

An assessment was performed by Staff to determine the impacts of adopting a multiple asset allocation choice program. A summary of high level impacts related to increased costs, complexity and risk are detailed as follows:

1. **Extensive programming changes required for major information technology systems.**
   Several of the major information technology systems used for processing, calculating and storing information related to the creation and maintenance of system data would be affected by the implementation of a MAAC, including the Actuarial Valuation System (AVS), myICalPERS, PeopleSoft Financials and State Street Bank system (SSBS). Examples of the extensive changes needed include:
   - Additional functionality to AVS for multiple discount rates for processing funding valuations, amendments, various other actuarial calculations as well as GASB 68 valuations.
   - Additional functionality to the myICalPERS system to tag and calculate different individual calculations such as service purchases, optional forms of benefits and new PEPRA IDR factors based on asset allocations.
   - Modifications to myICalPERS required to track member and employer data by the different categories along with the investment earnings.
   - Major modifications to SSBS required to accommodate multiple asset allocation plan options.
   - Accounting changes to PeopleSoft Financials would need to be implemented to align to the modifications made in the SSB and myICalPERS systems.

2. **Actuarial restructuring would be required for risk pooling and employer/member transactions.**
   Multiple discount rates within a risk pool causes a host of valuation challenges since pooling is designed to be amongst “like” plans and therefore, risk pools would have to be completely re-structured to reflect the MAAC approach.

3. **Development of investment vehicles to allow ownership segmentation.**
   The implementation of the MAAC would involve the unitization of all asset class and strategy categories. This would require the converting of the current CalPERS portfolio into commingled funds, estimated to be a 2 to 3 year effort. Included in this

effort would be the development of a strategy to fairly allocate ownership, risks and returns for private assets across multiple plans given vintage year investment differences. The potential transfer of wealth issues and the requirement to unitize each separate private investment would need to be considered and addressed to be able to implement MAAC.

4. **Perform asset allocation analysis and establish asset class rebalancing parameters for each alternative.**
   To support MAAC on an individual employer basis, asset allocation analysis would need to be performed for each asset class as well as rebalancing parameters developed for each alternative. This includes individual calculations of efficient frontier analysis, asset allocation alternatives, adjustment to benchmarks, change to asset portfolios and the identification of illiquid asset pricing and cross trading procedures.

5. **Modifications and implementation of the accounting treatment for the PERF based on the different options.**
   All financial reporting would require modifications as a result of MAAC implementation, including how investment assets, employers' assets and the risk pools are accounted for currently. In unitizing all the asset classes, dividing the PERF into separate entities to be able to account for the different options would also be required.

6. **Changes to GASB 67 and 68 reporting.**
   Current reporting for GASB 67 and 68 would have to be redesigned as well as the necessary accounting changes supporting the GASB information. Changes to GASB 68 would impact information provided to employers, requiring additional communication and outreach to stakeholders.

7. **Legal and Legislation considerations**
   In additional to the specific modifications to technology systems, processes, and actuarial, financial and investment functionality, changes to legislation and any significant legal considerations would need to be evaluated and addressed prior to proceeding with the implementation of the MAAC.

8. **Increased employer education and stakeholder outreach to implement the MAAC.**
   A thorough communication plan would be required to ensure that all employers and stakeholders fully understand the options, risks and impacts on their potential decisions in participating in the MAAC. Costs associated with needed expertise and education for employers to implement would be in addition to the costs incurred by CalPERS.

Staff has projected a 5 to 7 year period to perform analysis, planning, design and implementation functions of a MAAC program for employers. During this period, significant resources would need to be reallocated and dedicated to the project across the organization due to the expansive requirements necessary for staff to implement this complicated risk mitigation strategy.

As viable alternatives to reducing funding risks in the system, Staff will be introducing a Funding Risk Mitigation Policy during the 2015 October Board meeting which will provide an enterprise wide solution for reducing risk for employers. In addition, employers can currently elect to lower their funded status risk by periodically paying down their liability.

BENEFITS/RISKS

The benefits of having multiple asset allocation choices include:

- Employers looking to lower their funding risk would have multiple options for selection one of which may fit their specific needs and circumstances.

The risks of having multiple asset allocation choices include:

- Employers who choose a lower discount rate will increase contribution cost as well as lower their funded status.
- PEPRA members would see changes to their own contribution rates based on their current employer's asset allocation. It is even possible that employers could move to a lower asset allocation and in the meantime reduce their contribution rate by passing all of the increased costs to their employees.
- CalPERS would invest a great deal of money, time and effort to implement multiple allocation options and the expectation is that a low number of employers will adopt one of these options. The cost/benefit may be unacceptable.

BUDGET AND FISCAL IMPACTS

Although the cost is not known at this time, there will be a large monetary impact to implement a MAAC program. There will be extensive technology costs as well as staffing costs. There could also have detrimental impacts to other projects as these other projects may have to be put on hold, delayed or deferred during the implementation of the MAAC program.

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