Finance & Administration Committee

California Public Employees' Retirement System

Agenda Item 10b

October 20, 2015

ITEM NAME: Funding Risk Mitigation Policy

PROGRAM: Asset Liability Management

ITEM TYPE: Information

EXECUTIVE SUMMARY

Based on direction from the CalPERS Board of Administration ("Board") in August 2015 during an Asset Liability Management ("ALM") special session, the proposed Funding Risk Mitigation Policy ("Policy") has been developed by staff to govern the practices related to the establishment and oversight of risk mitigation for the funding of the pension system.

The proposed policy is provided as Attachment 1. This policy is being presented to the Finance and Administration Committee for initial review as a first reading.

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

In February 2015, a workshop was conducted by staff for the Board to provide an overview of the funding 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 mitigate these risks. During the discussion that took place at the workshop, the Board expressed a desire to further explore two possible risk mitigation strategies. In a May 2015 workshop, staff provided detailed information on the two risk mitigation strategies.

In August 2015, additional information was presented by staff related to the two risk mitigation strategies under consideration by the Board, including an update on the outreach and engagement activities conducted to ensure feedback from stakeholders. Staff received direction from the Board of Administration on the risk mitigation strategy and for the development of a policy to be brought back to the Finance and Administration Committee in October 2015.

ANALYSIS

Reducing the risk in the funding of the system involves the tradeoff between short and long-term considerations. Over the course of the last seven months, staff presented two mitigation strategies that could be used to reduce risk. During the August 2015 special session with the CalPERS Board, staff were directed to develop a policy that would incorporate the attributes of the flexible glide path – lowering the discount rate and expected investment volatility following a great investment return – with reviews to allow the ongoing monitoring and assessing of the progress toward reducing risk and investment volatility in the funding of the pension system.

The proposed policy provides the mechanism for a discount rate reduction when investment performance significantly outperforms the discount rate. The parameters set out in the proposed policy also provide for the threshold amount required – the actual investment return in excess of the discount rate needed to lower the discount rate. Periodic reviews of the funding risk mitigation actions taken provide the necessary checkpoints for the review and assessment by the Board of the progress that has been made. The proposed policy provides that the reduced discount rate would be included in employer actuarial valuations effective as of June 30th in the fiscal year in which the funding risk mitigation event occurred. Member calculations (including service credit purchases) would not reflect the reduced discount rate until October 1st of the following fiscal year.

Staff has continued to engage and brief stakeholders on the work underway to reduce risk and volatility in the fund and in the discussion of the development of a draft risk mitigation policy. In September and early October, we held meetings with the leaders of our member and employer organizations, and with the Department of Finance. Staff also made presentations at conferences for the California Special Districts Association, California League of Cities, and the Public Retirement Journal Forum.

Based on feedback from our stakeholders, refinements have made to the draft risk mitigation policy such as the further definition of terms as well as clarification that notification of action would be taken pursuant to the policy prior to actual implementation to allow time for education and discussion as appropriate and necessary. It should be noted that in our discussions, SEIU has requested that the policy include an affirmative vote by the Board to proceed with risk mitigation after a funding risk mitigation event occurs to allow for consideration of other market or external factors that may exist. Staff believes that this discretion is already part of the Board's authority and can be addressed if needed following a funding risk mitigation event.

BUDGET AND FISCAL IMPACTS

Not applicable.

BENEFITS/RISKS

As stewards of the pension funding system, CalPERS must ensure that the pension fund is sustainable over multiple generations by taking steps to mitigate risks over the long-term through an integrated view of our assets and liabilities. Benefits of a risk mitigation strategy include:

- Strengthens the long-term sustainability of the fund and security of future benefit payments
- Protects the fund from volatility of short-term investment returns or changing demographics that could reduce CalPERS long term funded status
- Reduces the level of future risk in the investment portfolio
- Reduces the volatility in contribution rates for employers

Risks associated with a risk mitigation strategy include:

- Reducing the CalPERS discount rate will increase employer contributions
- Increases to member contributions over time, specifically those covered under PEPRA.

ATTACHMENT

Attachment – Funding Risk Mitigation Policy

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Chief Actuary

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Chief Investment Officer