Agenda Item 6a

November 17, 2015

ITEM NAME: Funding Risk Mitigation Policy (Second Reading)

PROGRAM: Asset Liability Management

ITEM TYPE: Action

RECOMMENDATION

Staff recommends the Board adopt a Funding Risk Mitigation Policy. As requested in the October 2015 meeting of the Finance and Administration Committee, two policies have been developed for review.

EXECUTIVE SUMMARY

Based on direction from the CalPERS Finance and Administration Committee during the October 2015 meeting, staff has developed a second Funding Risk Mitigation Policy (Policy) with an update of the first threshold level that would trigger a risk mitigation event from 4% to 2%. The original proposed Funding Risk Mitigation Policy with a 4% threshold remains unmodified from the draft reviewed during the October meeting.

The proposed policies are provided as Attachment 1 and 2. These policies are being presented to the Finance and Administration Committee for consideration.

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.

During the October 2015 Finance and Administration Committee meeting, staff presented the draft policy for the 1st reading. Based on feedback from the Board, staff was directed to develop a second policy with an update of the first threshold level that would trigger a risk mitigation event from 4% to 2%. Both policies would be presented for a 2nd reading during the November 2015 Finance and Administration Committee for review and approval of one policy.

ANALYSIS
Staff has completed the analysis and the change from 4% to 2% has the following impacts:

- The pace of risk mitigation would increase slightly. The probability of reaching an 8% level of volatility (6.5% discount rate) in 30 years using 4% as the initial threshold is 91%. With a 2% initial threshold it would be 96%, and the average time to reach an 8% level of volatility would be 19 years instead of 21 years.

- In the original proposed policy, assuming a drop in volatility levels to 8%, PEPRA miscellaneous members would see their contributions rise by approximately 1.5% (3% for safety) over a 30-year period. These levels would not change under the 2% threshold, but members could expect to see the increases sooner depending on the pace of risk mitigation.

- With a 2% initial threshold, employers would see modest increases in rates as compared to the 4% proposal, but those are expected to be less than 0.3% for miscellaneous and 0.5% for safety in any given year during risk mitigation.

- The only time the 2% initial threshold would produce a difference in a risk mitigation event would be when there is an investment return between 2-4% above our discount rate at that time. Based on our modeling, this happens about 6.6% of the time, or about once every 15 years.

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 1 – Funding Risk Mitigation Policy – Original 4% Threshold
Attachment 2 – Funding Risk Mitigation Policy – 2% Threshold

CHERYL EASON
Chief Financial Officer

ALAN MILLIGAN
Chief Actuary

THEODORE ELIOPOULOS
Chief Investment Officer