Agenda Item 8a

November 17, 2015

ITEM NAME: Annual Review of Funding Levels and Risks Report

PROGRAM: Asset Liability Management

ITEM TYPE: Information

EXECUTIVE SUMMARY

Public pension plans at CalPERS and across the nation have been maturing. This maturation means that more assets are being accumulated relative to employers' payrolls. The higher asset to payroll ratios, combined with expected investment volatility will produce substantial contribution volatility. Current risk mitigation efforts are directed at reducing the strain that would otherwise affect employers.

As in the prior year, current contribution levels are high relative to historical levels and are scheduled to increase further. The report shows that most plans are between 70 and 90 percent funded on a going concern basis as of June 30, 2014. These levels are expected to decrease somewhat as a result of the investment result in the 2014-15 fiscal year.

In contrast to the longer-term trend to increasing levels of risk described above, a number of factors have resulted in an improvement in one of the most important risk measures – the probability of reaching low funded status. These factors include:

- Actions by the Board with respect to actuarial assumptions and methods,
- Generally good investment markets since the first funding levels and risks report 3 years ago, and
- The passage of pension reform.

While still high, these steps have significantly reduced the probability of reaching very low funded status.

In addition, to address the risks in a balanced manner that is sensitive to the needs of all stakeholders, the Board has indicated that it will adopt a Funding Risk Mitigation Policy, the final details of which are currently under consideration. This policy will result in a gradual shifting of the asset allocation in a way that would lower investment risk which in turn means accepting lower expected returns and a lower discount rate. In time, the policy will result in a lowering of the level of risk faced by employers and, ultimately, by members.

STRATEGIC PLAN

This agenda item supports Strategic Plan Goal A which is to improve the long-term pension and health benefit sustainability. It specifically addresses two of the objectives under that goal: to fund the system through an integrated view of pension assets and liabilities and to educate employers and other stakeholders to make informed decisions about retirement security and health care.

BACKGROUND

A few years ago, the Board conducted a review of its own governance and adopted a number of structural changes that significantly enhanced the oversight of risk. In particular, the Board delegated to the Finance & Administration Committee the authority to oversee the financial soundness of the overall CalPERS system.

In order to assist the Committee with this oversight, the Annual Review of Funding Levels and Risks was developed. This is the fourth review. Earlier reviews showed that the way the System was being funded, including both the funding policies and the actuarial assumptions and methods, when combined with changes in the external environment entailed significant risks.

Responding to this increased awareness of risk, staff brought a series of agenda items and workshops to the Board looking at the risks inherent in the funding of the System. This culminated in a direction from the Board to staff to bring back a proposal for a Funding Risk Mitigation Policy. The proposal was brought to the Board as a first reading at its October Finance and Administration Committee meeting. It is being brought back, with an alternative requested by the Board, at the November Finance and Administration Committee – the same meeting at which this report will be presented.

ANALYSIS

A number of CalPERS Pension Beliefs are relevant to this agenda item. These include:

- *Pension Belief 1 – A retirement system must meet the needs of members and employers to be successful.* In order to meet the needs of the members, the funds needed to pay the benefits must be properly funded and the funded status measures in the report address this issue. In order to meet the needs of employers, contributions must be affordable and not change too quickly for employers' budgets to absorb. This is reflected in the risk measures in the report.
- *Pension Belief 5 – Funding policies should be applied in a fair, consistent manner, accommodate investment return fluctuations and support rate stability.* This agenda item is essentially an examination of the extent to which the funding policies accommodate investment return fluctuations and support rate stability.

- *Pension Belief 9 – Sound understanding and deployment of enterprise-wide risk management is essential to the ongoing success of a retirement system.* By measuring and reporting on funding levels and risks, this report is intended to enable management of the risks associated with the funding of the system.

In addition to information about risk levels, this report presents information on the results of the June 30, 2014 annual actuarial valuations. For public agencies, these valuations set the required contribution rates for the 2016-17 fiscal year. These results form the foundation on which the discussion of risk is based.

Contributions Levels

Contribution levels have continued to increase over the last year. While most employers saw relatively modest increases in their required contributions, some employers in risk pools with high retiree to active member ratios saw significant increases in their required contributions. This was the result of the combining of risk pools in response to the Public Employee Pension Reform Act (PEPRA).

In addition, many employers have been reducing their payrolls. Since the required contribution to pay off the unfunded liability is not related to their payroll, this is having the effect of increasing the contribution towards the unfunded liability as a percent of the (reduced) payroll.

Most employers who saw significant increases in their contribution rates were affected by one of these two factors.

The report shows that current contribution levels are high and, for almost all employers, scheduled to increase further as our amortization policies phase in previous asset losses. For many plans, the contribution rates have never been as high as they are now. Current contribution levels already exceed 30 percent of payroll for over 80 miscellaneous plans. Safety plans generally have higher contribution levels with over 135 plans having contribution levels of more than 40 percent of payroll. Some employers have reported that these contribution levels are putting significant strain on their budgets and limiting their ability to provide services to the people in their jurisdictions.

Funded Status

As of June 30, 2014, the system was about 76 percent funded. As a result of the 2.4 percent investment return in 2014-15, staff estimates the funded status to be about 73% percent on June 30, 2015[1]. Most plans in the system were between 70 percent and 90 percent funded as of June 30, 2014.

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[1] The estimated funded status as of June 30, 2015 reflects changes to actuarial assumptions for the Schools Pool and the known investment loss in 2014-2015.

The funded status on a hypothetical termination basis as of June 30, 2014 was, for most plans, in the 40 percent to 60 percent range. This is expected to decline mainly as a result of the less than expected investment return in 2014-15.

Risk Measures

The asset to payroll ratio for most miscellaneous plans is between 4 and 5 but there are a significant number of plans with ratios above this level. For many safety plans the asset to payroll ratio is between 7 and 9. This shows a significant exposure of employer contributions levels to investment volatility.

The Asset Liability Management risk measures show that there remains considerable risk in the funding of the system. There is a substantial risk that, at some point over the foreseeable future, there will be periods of low funded status and high employer contribution rates. Should this coincide with a period of financial weakness for employers or if such a period occurs before we recover from the current funding shortfall, the consequences will be very difficult to bear.

Changing Pension Environment

Public pension plans, both at CalPERS and more generally across the United States, continue to mature. The report shows the ratio of active members to retirees has fallen and is expected to continue to fall in the future. This means that contribution volatility will continue to increase in the absence of offsetting changes.

The occurrence of municipal bankruptcies a few years ago and other anecdotal evidence had shown that employers were under high levels of financial stress in the aftermath of the Great Recession. However, there was a more positive tone at the CalPERS' Education Forum last month. This more positive tone has also been reflected in a significant interest on the part of many employers in making additional payments to pay down their unfunded liabilities. It seems that many employers are in a healthier financial state but staff remains concerned that some employers remain stressed.

Changes to accounting standards (GASB Statement 68) were implemented over the last year. These changes may bring a greater awareness to current level of risks associated with the sponsoring of a defined benefit pension plan. This may result in pressure to change their risk profile by making changes to actuarial or investment policies and/or benefit levels.

Many public pension systems have made changes to their discount rate in recent years. It is likely that this is a result of the same factors that have resulted in changes at CalPERS: a general lowering of expectations about the level of future investment returns for a given level of risk and a concern about the level of risk being taken.

Risk Mitigation
In recent years, a number of factors lowered the probability of reaching very low funded status. These factors include:

- The Public Employees' Pension Reform Act (PEPRA) became effective on January 1, 2013. By limiting benefits for new hires and requiring a minimum contribution equal to the normal cost, this bill reduced the risk to the funding of the system.
- In April 2013, the CalPERS Board approved new amortization and smoothing policies that were aimed at returning the System to fully funded status within 30 years[2].
- In February 2014, the CalPERS Board adopted a new asset allocation and changes to actuarial assumptions. Inclusion of projected mortality improvements in the future helps to ensure that the system is appropriately funded.
- Some employers have voluntarily accelerated funding of their unfunded liability to mitigate their risk on an ad-hoc or more systematic basis.

In addition to the above actions, the Board directed staff to develop a Funding Risk Mitigation Policy. This policy was presented, as a first reading, in October 2015 and incorporates a flexible glide path which will lower funding risk by changing the target asset allocation to lower expected investment volatility. Changing the asset allocation in this way will result in a lower expected return and a lower discount rate. The proposed policy also provides for the ongoing monitoring and assessing of the progress toward reducing risk and investment volatility in the funding of the pension system.

It is anticipated that, should the policy be adopted, this report will be one of the methods by which this monitoring will be done.

The policy will be presented for second reading and possible adoption at the same Finance and Administration Committee meeting this month.

Conclusion
Overall, the report highlights that employers are exposed to a considerable amount of contribution rate volatility and a risk of further changes in funded status. Contribution rates are expected to remain high for an extended period unless there is a period of exceptional returns in the markets.

[2] While the policies are aimed at returning the system to fully funded status in 30 years, this still requires that all assumptions, including the investment return assumption, are met. There is significant risk associated with achieving full funding as outlined in the attached report. And even if full funding is achieved, there would still be significant risk in the system – as was demonstrated between June 30, 2007 and June 30, 2009 when funded status fell by 40%.

The proposed Funding Risk Mitigation Policy will address risks in a reasonable and balanced way that is sensitive to the needs of all stakeholders. If adopted, it will gradually lower the investment volatility – the major source of funding risk. This in turn will improve the soundness and sustainability of the System.

BENEFITS/RISKS

This agenda item and the attached report should enhance the understanding of the risks inherent in the funding of the system. Such an understanding is necessary for effective management and mitigation of those risks.

ATTACHMENTS

Attachment 1 – Annual Review of Funding Levels and Risks

ALAN MILLIGAN
Chief Actuary

CHERYL EASON
Chief Financial Officer

THEODORE ELIOPOULOS
Chief Investment Officer