MEETING

STATE OF CALIFORNIA

PUBLIC EMPLOYEES' RETIREMENT SYSTEM

BOARD OF ADMINISTRATION

FINANCE & ADMINISTRATION COMMITTEE

ROBERT F. CARLSON AUDITORIUM

LINCOLN PLAZA NORTH

400 P STREET

SACRAMENTO, CALIFORNIA

TUESDAY, NOVEMBER 17, 2015

8:00 A.M.

JAMES F. PETERS, CSR
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A P P E A R A N C E S

COMMITTEE MEMBERS:

Mr. Richard Costigan, Chairperson

Ms. Dana Hollinger, Vice Chairperson

Mr. Richard Gillihan

Mr. J.J. Jelincic

Mr. Henry Jones

Mr. Bill Slaton

Ms. Betty Yee

BOARD MEMBERS:

Mr. Rob Feckner, President

Mr. John Chiang, represented by Mr. Grant Boyken

Mr. Ron Lind

Ms. Priya Mathur

Ms. Theresa Taylor

STAFF:

Ms. Anne Stausboll, Chief Executive Officer

Ms. Cheryl Eason, Chief Financial Officer

Mr. Ted Eliopoulos, Chief Investment Officer

Mr. Doug Hoffner, Deputy Executive Officer

Ms. Donna Lum, Deputy Executive Officer

Mr. Doug McKeever, Deputy Executive Officer

Mr. Brad Pacheco, Deputy Executive Officer

A P P E A R A N C E S C O N T I N U E D

STAFF:

Mr. Matthew Jacobs, General Counsel

Mr. Alan Milligan, Chief Actuary

Ms. Liana-Bailey-Crimmins, Chief Information officer

Ms. Tanya Black, Committee Secretary

Ms. Flora Hu, Senior Life Actuary

Mr. Gary McCollum, Senior Life Actuary

Ms. Kristin Montgomery, Controller

ALSO PRESENT:

Ms. Christy Bouma, California Professional Firefighters

Mr. Neal Johnson, Service Employees International Union Local 1000

Mr. Jai Sookprasert, California School Employees Association

Mr. Eric Stern, California Department of Finance

I N D E X

I N D E X   C O N T I N U E D

P R O C E E D I N G S

CHAIRPERSON COSTIGAN: Good morning, we're going to call to order the November 17th meeting of the Finance and Administration Committee. Madam Secretary, please call roll.

COMMITTEE SECRETARY BLACK: Richard Costigan?

CHAIRPERSON COSTIGAN: Here.

COMMITTEE SECRETARY BLACK: Dana Hollinger?

VICE CHAIRPERSON HOLLINGER: Here.

COMMITTEE SECRETARY BLACK: Richard Gillihan?

COMMITTEE MEMBER GILLIHAN: Here.

COMMITTEE SECRETARY BLACK: J.J. Jelincic?

COMMITTEE MEMBER JELINCIC: Here.

COMMITTEE SECRETARY BLACK: Henry Jones?

COMMITTEE MEMBER JONES: Here.

COMMITTEE SECRETARY BLACK: Bill Slaton?

COMMITTEE MEMBER SLATON: Here.

COMMITTEE SECRETARY BLACK: Betty Yee?

COMMITTEE MEMBER YEE: Here.

CHAIRPERSON COSTIGAN: Okay. All members are here. So Ms. Eason, you're first up with the executive report, please.

CHIEF FINANCIAL OFFICER EASON: Thank you. Good morning, Mr. Chair and Committee members. Cheryl Eason, CalPERS staff.

Today's agenda includes the following action items: The draft 2014-15 basic financial statements, the first reading of the 2015-16 mid-year budget revisions, long-term care valuation report, and the second reading of the funding risk mitigation policy.

Staff requests that information item 8a, Annual Review of Funding Levels and Risk Report, be heard prior to action item 6a, the Funding Risk Mitigation Policy. The report will provide analysis on the funded status and risk mitigation efforts leading up to today's discussion on the second reading of the risk mitigation policy.

Based on direction from the CalPERS Finance and Administration Committee during the October 2015 meeting, staff have developed a second funding risk mitigation policy with an update of the first threshold level that would trigger a risk mitigation event from four percent to two percent. The original proposed funding risk mitigation policy with a four percent threshold remains unmodified from the draft reviewed during the October meeting.

Several information items will also be presented, including the self-funded health plans report, annual cost efficiencies report, my|CalPERS functional optimization update, and the service credit installation payment resumption. The next Finance and Administration Committee meeting is scheduled for December 15th, 2015 and will include the second reading of the 2015-16 mid-year budget revisions, a review of actuarial policies, specifically the cost methods policy, and the Finance and Administration strategic measures.

Thank you, Mr. Chair. This concludes my report, and I'd be pleased to take any questions.

CHAIRPERSON COSTIGAN: All right. Seeing none.

I do just want to acknowledge that clearly this must be a very exciting hearing this morning, because we are joined by a majority of the Board. We must have some interesting items this morning.

So anyway, let's move on to the consent item, action --

COMMITTEE MEMBER JELINCIC: Just a majority?

CHAIRPERSON COSTIGAN: Well, I was going to acknowledge we have a full Board with the exception of one member.

So item number 3 is the approval of the October 20th, 2015 meeting. Is there a motion?

COMMITTEE MEMBER JONES: Move it.

COMMITTEE MEMBER YEE: Second.

CHAIRPERSON COSTIGAN: It's moved by Jones, seconded by Yee.

Any questions?

All those in favor?

(Ayes.)

CHAIRPERSON COSTIGAN: Opposed?

Motion carries.

Consent item, Item 4, any issues?

All right. I have been given a note, if I can read the writing, Info Consent 4L --

COMMITTEE MEMBER JELINCIC: B.

CHAIRPERSON COSTIGAN: -- or 4B. And there's an error in it. Mr. Jelincic.

COMMITTEE MEMBER JELINCIC: Yeah.

CHAIRPERSON COSTIGAN: Hang on a second. You have to push your mic.

Yes, Mr. Jelincic.

COMMITTEE MEMBER JELINCIC: On the '16 calendar for February, we show the notice of election for -- and election schedule for State, school, and public agencies. And I think the only election that year is the retiree. I just think it ought to be corrected.

CHIEF FINANCIAL OFFICER EASON: That's correct. That was pointed out at the briefing and we'll make that change to the calendar for the next month. Thank you for that.

CHAIRPERSON COSTIGAN: Thank you. All right -- and we'll see that next month.

All right. Informational item.

Next item, Ms. Eason, is Item 5.

CHIEF FINANCIAL OFFICER EASON: Thank you. We -- Kristin Montgomery, Controller for CalPERS will be joining me on this item. And we just wanted to give you the highlights of the 2014-15 basic draft financial statements. You do have in your package the handouts of the PowerPoint that we'll be going through.

(Thereupon an overhead presentation was presented as follows.)

CHIEF FINANCIAL OFFICER EASON: So let me just start with some highlights. For the PERF, the total net assets increased slightly to 302.8 billion from 301.8 billion in the previous year. For financial reporting purposes, we disclose money-weighted rate of return, which was 2.2 percent or 6.6 billion for the PERF. Real estate and private equity had strong rates of return this year, followed by the global equity asset class.

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CHIEF FINANCIAL OFFICER EASON: As I mentioned, the net position of 302.8 billion is at its highest level, and represents a 69 percent increase since the 2009 financial crisis.

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CHIEF FINANCIAL OFFICER EASON: Let me turn this over to Kristin. She'll go through the next few slides.

CONTROLLER MONTGOMERY: Good morning. Kristin Montgomery, CalPERS staff.

Additions to the PERF's net position includes employer and member contributions and investment income. Employer contribution rates increased resulting in a 14.8 percent increase from prior year. Investment income is comprised of interest income, dividend income, and net appreciation/depreciation and fair value of investments. There was a modest gain for the fiscal year. Deductions to the PERF are comprised of benefit payments and refund of contributions. Retirement and survivor benefits increased by 6.5 percent from the prior year. Administrative investment expenses decreased about 19 percent from the prior year.

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CONTROLLER MONTGOMERY: This depicts the distribution of investment assets for the PERF as of June 30th. Global equity is the biggest percentage at 51 percent, which is in line with our asset allocation.

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CONTROLLER MONTGOMERY: Investment income is made up of net appreciation/depreciation of investments, interest income, and dividend income. As the chart shows, real estate and private equity had the largest gains, while global equity having a small amount as well. Investment returns in real estate, private and global equities were offset by negative returns in global debt securities and short-term investments.

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CONTROLLER MONTGOMERY: Investment return is comparable between time weighted and money weighted. Time weighted is the standard for the investment performance. And as Cheryl said, the money weighted is a GASB requirement. The money weighted rate of return for the perch was 2.2 percent.

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CONTROLLER MONTGOMERY: This depicts the funded ratio over the past 10 years. For 2015, we are projected to slide back to 73.3 percent, mostly due to the poor investment returns.

Now, I'll turn it back over to Cheryl.

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CHIEF FINANCIAL OFFICER EASON: Also included in the CAFR is some program information that I think is worth noting here, because it is something we've been discussing about the maturing of the plan. So before you are just some statistics on membership. And it's relative, as I mentioned, to the characteristics of the CalPERS plan as we discussed in our risk mitigation.

So for 2015, the total number of active and retired members actually grew by 73,000, or six percent. And we actually saw growth in both active and retiree members.

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CHIEF FINANCIAL OFFICER EASON: If you look at this same data from the previous slide, but now looking at it as a ratio of active to retired members, you see that there is a slight increase in the number of active to retirees. However, the long-term trend continues to show a decrease in the active -- of the ratio of actives to retirees as the pension plan continues to mature.

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CHIEF FINANCIAL OFFICER EASON: We've talked about this maturing as impacting cash flows, and this trend of negative cash flows. And here you can see that there are more benefits paid than contributions received. And there continues to be a gap between those incoming and outgoing cash flows currently at the gap being 5.1 million for the 2014-15 -- sorry, billion for the 2014-15 fiscal year. And the difference, or the gap, is covered by investment earnings to ensure that the benefits are paid to retirees and their beneficiaries.

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CHIEF FINANCIAL OFFICER EASON: The investment and administration costs I think are worth noting. They decreased from 2014. In 2015, the total was 343 -- or the decrease, sorry, was 343 million, or 20 percent, mainly due to the reduction in external management fees as INVO continues to transition assets from external managers to internal management, as well as lower investment returns in 2015 compared to 2014 contributed to that decrease.

Administrative costs also decreased by 40 million, or 10 percent, due to continued efforts to reduce IT consulting costs and increase operating efficiencies, while maintaining high levels of customer service and satisfaction.

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CHIEF FINANCIAL OFFICER EASON: And just next steps. Today we are seeking a recommendation from the Committee for the Board to approve the 2014-15 annual financial statements. We will be finalizing the Comprehensive Annual Financial Report, or CAFR, upon review and approval of the basic financial statements. We are also working on some GASB changes for the upcoming year.

The first is GASB 74. That's for fair value measurement and application. And this is effective for the fiscal year 2015-16. This will provide more transparency and reporting of investments that are measured at fair value. And we've already begun working in earnest with the Investment Office over the past year in preparation of implementing this standard for our upcoming fiscal year-end.

If we look farther out to fiscal years 2016-17 and 17-18, GASB standards for other post-employment benefits, or OPEB, will be implemented. GASB standard 74 and 75 are the equivalent to GASB 67 and 68 standards, but for other post-employment benefits. These standards will see unfunded OPEB liabilities recognized on the face of the financial statement balance sheet.

GASB 74 is effective for 2016-17 for the CalPERS plan, while GASB 75 is effective 2017-18 for reporting by employers.

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CHIEF FINANCIAL OFFICER EASON: And with that, Kristin and I will answer any questions you may have on the basic financial statements for 2014-15.

CHAIRPERSON COSTIGAN: Okay. So we've got a couple, but I've got one just to start with. So just on slides 10 and 11 - I'm just trying to reconcile - which is number of active and retired members, and then the ratio of active to retired members. So if you look at the chart, we've seen a growth of 54,000 positions between '14 and '15. So you've gone from 776 to 830. And then you've only had a increase of 19,000 in number of active retirees, which if I do my math right is a spread of 35,000 positions or additional people in the system, yet we're still seeing a growth of the 1.6 on the next slide.

So one is do we know where -- if I'm reading the charted right, where are the majority of these active employees now? I assume that growth is in local government. And if we don't have the details, that's fine. I was just curious.

CONTROLLER MONTGOMERY: Yeah, I'd have to come back to you.

CHAIRPERSON COSTIGAN: Because if you just look at the chart you've netted -- this is what I'm just confusing, starting in '12, you have netted more job growth. That seems to have outpaced the number of retirees, yet our percentage is continuing to grow. So I don't -- it's a net of 35,000 positions just in '15.

Anyway, just a little observation.

CHIEF FINANCIAL OFFICER EASON: I would just note that the greater increase in the actives is what's driving on slide 11 why you're seeing the ratio of actives to retirees grow just that slight amount. So that's a reflection of the difference between '14 and '15.

CHAIRPERSON COSTIGAN: And you're -- I'm sorry, Ms. Eason, I actually read it in the reverse. I was looking at the number of retirees to actives is going up. It was the reverse. Thank you. But I would be curious as to know where the growth is.

Mr. Jelincic.

COMMITTEE MEMBER JELINCIC: Looking at the footnotes particularly on investments, we report a lot of the investments net of fees and management fees and costs. I recognize that GAAP permits that. It doesn't require it, but permits it. I would also point out that CEM has said it's really not the best way to report it. It is consistent with GAAP.

Part of the problem I have is that, as you know, I'm pushing to bring more and more of it in-house, and so if -- it helps us to actually identify how much we are spending on outside managers, so that we can show the reduction relative to the incremental costs of adding staff, but it is consistent with GAAP, and I will acknowledge that.

And I will move that we accept it.

CHAIRPERSON COSTIGAN: All right.

Ms. Yee.

COMMITTEE MEMBER YEE: Thank you, Mr. Chairman.

I had a question with regard to local employers, and that is the switch in the actuarial method from the community rating exemption to the adjusted -- to the age adjusted rates. Has that switch already started and on a pretty good clip?

CONTROLLER MONTGOMERY: Yes, the switch has started. It is effective for this coming fiscal year, but we had some early adopters in our employers that their valuation has included that.

COMMITTEE MEMBER YEE: Okay. Okay. And I guess with that, are we going to expect to see a higher rate of deposits into the OPEB Trust fund as a result?

CONTROLLER MONTGOMERY: I'm not sure. I mean, that's speculative, so. Maybe. I don't know.

COMMITTEE MEMBER YEE: Okay. And then with respect to our own implementation of the GASB rules to come, any anticipated implementation issues that you see?

CONTROLLER MONTGOMERY: We are just starting the planning for this. I can do lessons learned with 67, 68. It was a lot of planning, a lot of coordination, a lot of communication. And I see the same thing happening with these two changes.

COMMITTEE MEMBER YEE: Okay. Good. If my office can be a resource, please feel free to reach out.

Thank you.

CHAIRPERSON COSTIGAN: Mr. Gillihan.

COMMITTEE MEMBER GILLIHAN: Thank you, Mr. Chair. I don't have any particular concerns with this agenda item, but I do have a process concern relative to -- I understand we're going to hear from our external auditor -- is it the external auditor or internal auditor, at Risk and Audit Committee on their views of this particular agenda item. So it seems a little awkward that we're going to be voting on it as a committee now, only to hear what our external auditor thinks about it later. So I would just encourage us to think that through in our future scheduling of these items.

Thank you.

CHAIRPERSON COSTIGAN: Ms. Eason, would you like to respond. I know we talked about planning.

CHIEF llFINANCIAL OFFICER EASON: So it is -- the financial statements are a representation of management, and therefore they require approval by the Finance and Administration Committee. What the Risk and Audit Committee will be hearing will be accepting the auditor's report -- the independent auditor's report on those financial statements.

So the basic financial statements are included, but what's being approved at the Risk and Audit Committee is actually the opinion of the external auditor, or the independent auditor. So that's the difference between the two approvals. This is to approve the basic financials, Risk and Audit is to approve the report being offered by the independent auditor's on the financial statements.

COMMITTEE MEMBER GILLIHAN: Right. And I can appreciate the distinction, but I guess the point is it seems like our action today would be informed by the auditor's opinion of the quality of the financial statements. That's the point I'm making.

Thank you.

CHAIRPERSON COSTIGAN: So Mr. Gillihan does raise a good point. Mr. Jacobs, I'm going to look to you for a second. And I guess from a process standpoint -- or Mr. Feckner as the Board President, would it be more prudent to move forward with this Committee, recess it at the end, wait for Risk And audit to take its action, and then come back and adopt it with what Mr. Gillihan is raising or are you comfortable with what Mr. Gillihan has raised?

CHIEF FINANCIAL OFFICER EASON: Well, I would just point out, and I don't want to speak on behalf of the independent auditors, but they have reviewed the financial statements. And so unless there were changes to the financial statements, I think those changes would take effect in this Committee. And what would be -- what would be required in the Risk and Audit Committee is if there were any comments to their actual -- to their actual recommendations. But their -- we work very closely with the independent auditors. And so these financial statements are the same as what they're presenting.

CHAIRPERSON COSTIGAN: All right. I think what we will do is just move forward today, but it raise -- with Mr. Gillihan's suggestion at the next time we do this is let's sequence it a little bit differently.

Mr. Jelincic.

COMMITTEE MEMBER JELINCIC: I actually had a question and then a comment.

I made a motion to accept.

CHAIRPERSON COSTIGAN: The staff recommendation.

COMMITTEE MEMBER JELINCIC: I notice the staff recommendation was to approve. And if approved is more appropriate, I would like to substitute that word in the motion.

I have met with the independent auditors. They actually spoke very highly of Kristin and Cheryl. They said that they actually had an easier time getting the information this time than they have previously. And so they spoke very highly of you, and I want to acknowledge that.

CHAIRPERSON COSTIGAN: Thank you.

Mr. Boyken.

ACTING BOARD MEMBER BOYKEN: Thanks. I would just point out that the action we take today comes back to the full Board tomorrow, and we've read the independent auditor's report, clean unmodified opinion, so I'm perfectly comfortable with -- the Treasurer is not on this Committee, but I'm perfectly comfortable with the Committee taking action to accept or approve today.

CHAIRPERSON COSTIGAN: All right. Thank you, all. With that, it has been moved by Jelincic. Is there a second?

VICE CHAIRPERSON HOLLINGER: Second.

CHAIRPERSON COSTIGAN: Seconded by Hollinger.

All those in favor?

(Ayes.)

CHAIRPERSON COSTIGAN: Oh, wait a second.

COMMITTEE MEMBER JELINCIC: Did we decide whether it's "approve" or "accept"?

CHAIRPERSON COSTIGAN: We'll go with Mr. Jelincic's -- the recommendation is that the Board of Administration -- or this Committee, Finance and Administration, approve the draft of the CalPERS 2014 basic financial statements, is that is, Mr. Jelincic?

COMMITTEE MEMBER JELINCIC: That's fine.

CHAIRPERSON COSTIGAN: So it's been moved by Jelincic --

VICE CHAIRPERSON HOLLINGER: Second.

CHAIRPERSON COSTIGAN: -- seconded by Hollinger.

All those in favor?

(Ayes.)

CHAIRPERSON COSTIGAN: Opposed?

Motion carries. Thank you.

Next item, Ms. Eason, Mid-Year Budget Revision.

CHIEF FINANCIAL OFFICER EASON: Thank you again. Cheryl Eason, CalPERS staff.

Agenda Item 5b is an action item and represents the first reading of the 2015-16 mid-year budget revisions to the 2015-16 annual budget. In April of this year, the Board approved the total annual budget for 2015-16 of $1.819 billion.

If the proposed mid-year budget revisions are accepted by the Committee today, and approved by the Board, the 2015-16 total CalPERS budget will decrease to 1.808 billion, which represents a reduction of 12.1 million or 0.7 percent.

The total number of authorized positions at CalPERS remains unchanged at 2,765. Page one of the agenda item details the budget categories and the mid-year changes recommended.

The recommendation includes an increase of 1.2 million to administrative operating costs, offset by a decrease to the third-party administrator fees budget of 13.3 million for a net decrease of 12.1 million. Administrative operating costs include technical adjustments of 4.6 million related to salaries, retirement, and health benefits offset by 1.1 million in savings related to the Board member election and 2.3 million due to a small increase in vacancies from the targeted 5 percent to 6.6 percent.

The net decrease of 13.3 million relates to third-party administrator fees for the long-term care and self-funded health programs. This includes a reduction of 15 million in the self-funded health program due to the move to UnitedHealthcare Medicare Advantage as the carrier in 2016 to replace Blue Cross as administrator for Medicare plans.

The reduction is offset by Long-Term Care Program fees increasing by 1.7 million due to a previously Board approved contract amendment, which includes additional service fees for open application, website maintenance, and a transitional care program pilot.

This includes -- this concludes the overview of the mid-year revisions to the 2015-16 budget, and I would be happy to answer any questions.

CHAIRPERSON COSTIGAN: No questions? All right. So, first, I would like to really give a lot of credit to Chairwoman Mathur and to Doug McKeever for the highlight on the reduction in fees. I mean, again, you guys, and Cheryl back to you again on the budget transparency. The fact that we continue to recognize, even in the budget process this is member money and continue to find a way to continue to drive down costs. So very great there and great news.

I still don't like the vacancy rate, but we'll work on that going forward. So I do note that we're getting it down. And also to Ted great work in your shop in trying to continue to reduce the vacancy rate, so -- Mr. Jones.

COMMITTEE MEMBER JONES: Yeah. Thank you, Mr. Chair. Yeah on that issue of vacancy rate, however, you know, it's a concern, but I do thank you for recognizing the impact of the vacancy rate by reducing the overall budget with a credit to recognize the vacancy rate. And I think that's prudent, so that money is just not sitting there unused.

So with that, I'll move the recommended approval of this item.

CHAIRPERSON COSTIGAN: It's been moved by Jones.

VICE CHAIRPERSON HOLLINGER: Second.

CHAIRPERSON COSTIGAN: Seconded by Hollinger.

All those in favor?

(Ayes.)

CHAIRPERSON COSTIGAN: Opposed?

Motion carries. Thank you.

All right. Our next ITEM, 6a. Are we talking out of order?

CHIEF FINANCIAL OFFICER EASON: Yes. If we could do the information item first, 8a, the Annual Review of Funding Levels add Risk Report. Alan, our Chief Actuary, will cover that.

CHAIRPERSON COSTIGAN: Any objections?

CHIEF FINANCIAL OFFICER EASON: And then we can got into the second reading of the policy.

CHAIRPERSON COSTIGAN: That would be. Great Thank you.

Mr. Milligan.

CHIEF ACTUARY MILLIGAN: Thank you. Alan, Milligan, CalPERS staff. Good morning. This is an exciting day, and I am glad to be before you today.

This is the fourth annual review of the funding levels and risks report, which is a report that we prepare every year to assist the Board and this Committee in the assessment and management of the risks inherent in the funding of the system.

This report is for the valuations as of June 30th, 2014, and reflects experience in the 2013-14 fiscal year. This report also serves to report on the results of the most recent set of actuarial valuations. It's really two different purposes. And they're closely linked, so it makes sense to report on them together.

I'd like to report on the results of the valuations first. We're still in the process of completing the public agency valuations, so this is a bit of a change from past practice, since in previous years we've waited until we have the final results before preparing the report.

This year, we have been delayed in completing our annual actuarial valuations due to the implementation of the new governmental accounting standard GASB 68. However, at this point, we're far enough along in the process to be confident that the results we are presenting are accurate in total. Some individual plan results may differ, but the overall distribution is accurate.

I should add that the actuarial staff really did an extraordinary job in getting this together in time for this meeting. It's been a very stressful time, but they really rose to the occasion in getting this report together, and we felt it was important that this report be ready, given the other agenda item before you up next.

This report shows that the funded status of plans at CalPERS remain generally below 100 percent with the bulk of plans in the 70 to 90 percent funded range. This should not be surprising as the overall funded status is about 76 percent.

One somewhat surprising result is the number of plans at or above 100 percent. There are about 300 of these non-PEPRA plans. The actuaries tell me that these tend to fall into two categories, second tier plans created after the financial crisis of 2008-2009, and plans where the employer has made additional contributions over and above the minimum contributions that we set.

In addition to these plans, a lot of new PEPRA plans, which were also created after the financial crisis, are also above 100 percent funded status.

At this point, I should point out that I have been talking about the funded status on a going concern basis. On a hypothetical termination basis, most plans are between 40 and 60 percent funded. This is reflective of the very low rates of return on treasury securities recently.

Employer contributions are increasing in general, but these increases are usually fairly modest. Most employers are seeing contribution changes that range from a reduction of less than two percent of pay to an increase of up to four percent of pay. The underlying details are fairly complex due to the number of plans per employer. We have simplified it in the report by looking at all of an employer's plans as if it were a single plan. Increases to employer contributions were anticipated and usually were along the lines of the projected contribution levels that we included in last year's actuarial report.

At this point, I'm going to switch to the risk analysis contained in the report. In the report, we discuss a number of changes in the pension environment that will affect how risks will evolve in the future. The most significant factor is the ongoing maturing process that we have discussed with you a number of times. This continues to evolve and is making plans more sensitive to investment volatility.

This year, we have also highlighted the trend towards lowering the discount rate amongst public pension plans. This trend has been going on for quite a few years how, but has accelerated in the last few years. It is likely that the reductions in the discount rates reflect the same factors that have influenced changes at CalPERS. A general lowering of the expectations about future investment returns for a given level of risk and a concern about the level of risk being taken.

All of this means that asset levels will increase relative to the underlying payrolls, and plans will be more sensitive to investment and demographic volatility.

Sorry, I think I missed something here. I got myself out of order.

The risk -- the report shows that risk levels are hire and have generally increased from the prior year. That is primarily due to the investment returns of 2.4 percent last year. This was less than was assumed than the assumed investment return and will result in lower funded status and higher future contributions when we complete next year's annual valuation.

While this lower return is not built into employer rates in the valuations that we are finalizing right now, it is built into the projected contribution rates that will be shown in the reports, so employers will see the effect of this return in their reports.

While the risk levels remain high, they are significantly lower than they were in the first report on funding levels and risks three years ago. This is due to Board action with respect to the strengthening of our funding methods and our assumptions, due to generally good investment returns, and due to the passage of pension reform. We have made progress.

However, risk levels will increase in the future if we do not take action. As I mentioned already, the maturing of plans will mean that we have more retirees relative to the number of active members. Also, we expect funded status to increase gradually over time. This means that asset levels will increase relative to the underlying payrolls, and plans will be more sensitive to investment and demographic volatility.

Our model predicts that plans will be most sensitive to investment volatility in 20 to 30 years. So risk levels are high and plans are becoming more sensitive to risk. What should we do about it?

Under your direction, staff developed a funding risk mitigation policy, which was presented last month and is back before you for a second reading this month. This policy only addresses the investment and actuarial side, because that is what the Board controls. This policy does not address, because the Board does not have control over, benefit changes or member contribution rate changes.

If adopted, the policy will address the risks of low funded status and the risk of large increases in employer rates. It will be less impactful on the risk of high contribution rates. There is a cost to lowering risk, and this cost offsets the improvements in this aspect of funding risk.

One key decision in -- is the pacing of the proposed funding risk mitigation plan. Staff have tried for the Goldilocks zone, not too hot and not too cold. In this case, we're trying for risk mitigation that is not too slow, leaving the fund exposed for too long, and not too fast, causing significant short-term increases in contribution rates. I look forward to the discussion on that agenda item.

In summary, this report shows that funding levels remain low and contributions and risk levels remain high. This is to be expected. Retirement systems are long-term commitments and are funded over very long periods of time. Absent some extraordinary occurrence in the financial market, it takes time to significantly change the funding levels and risks of a retirement system.

But we should not be complacent. This report reveals the need to address the risks in the funding of the system. Due to the Board's leadership, there is an agenda item this month to address those risks.

That concludes my presentation, and I'd be happy to take any questions.

CHAIRPERSON COSTIGAN: Mr. Jelincic.

COMMITTEE MEMBER JELINCIC: I kind of enjoy the irony that the more assets we have, the more volatile the contribution becomes. And at the same time, we're adopting a mitigation strategy to reduce the volatility of the employer contributions. We could do that by having lower assets, but then we've got a problem that we do have to pay benefits. But I do enjoy the irony and want to point it out.

In the -- in your report on the executive summary, first paragraph, you say that the return for fiscal 2013-14 was 17.7. You know, last year, we reported at 13.8. Can you explain that? And if it is a change, why didn't we note it?

CHIEF ACTUARY MILLIGAN: I think last year we reported it at 18.3 not 13.8.

COMMITTEE MEMBER JELINCIC: Oh, I'm sorry, you're right. 18.3. Okay, but it's still a change from 18.3 to 17.7 is, you know, chunk of change when you're at $300 billion. Why the change and why was it not pointed out?

CHIEF ACTUARY MILLIGAN: That was a change in the -- in what we reported in the financial statement.

Cheryl, do you want to take that one?

CHIEF FINANCIAL OFFICER EASON: Yes, I believe it was an adjustment to some opening balance numbers that we discovered after this report had been issued, but as part of the work that we did for this year. So I think that's the reason for the discrepancy.

COMMITTEE MEMBER JELINCIC: Okay. And if we're -- if we've decided we've made a mistake previously, we're changing the number, I just think we ought to note the change, because some people will go and look at the old report and say, well, you know, what's going on? You know, so it's a reconciliation issue.

CHIEF FINANCIAL OFFICER EASON: We've made a change in the CAFR where we will be footnoting that for this year's CAFR.

COMMITTEE MEMBER JELINCIC: Thank you.

CHIEF ACTUARY MILLIGAN: I should also point out that, at this point, we're using the time weighted rates of return. With the change to the GASB standard and the availability of the money weighted rates of return, we will probably be changing that in the report in the future, because the money weighted rate of return is actually a more useful number for this purpose.

COMMITTEE MEMBER JELINCIC: Okay. And so I would suggest if you're going to change it next year, you know, note that you made that change.

Thank you.

CHAIRPERSON COSTIGAN: Okay. So I just have a couple questions of Mr. Eliopoulos, not to put you on the spot. But more or along the lines in the conclusion, I am just curious do you have an opinion, when they come to the conclusion where we have rates are expected to remain high for an extended period of time, unless there is a period of exceptional returns in the market.

Mr. Milligan, when you come with that conclusion, is there a target we're looking at for a period of time? I mean, I know in our next -- the next issue we're going to take up actually deals with this, but at least your conclusion on this one, and given the volatility of the market, what is the time frame we're looking at? And if you don't have an answer, that's fine. I just was looking at your conclusion.

CHIEF ACTUARY MILLIGAN: It would take -- you know, it depends on just how extraordinary it is. You know, a fairly lengthy period of, you know, significantly above average, but not extraordinary returns would do it, but, of course, that would be somewhat unprecedented. The markets are never that calm and consistent.

You know, so it kind of depends. The markets can occasionally return very large rates of return. It's not unprecedented in historical -- you know, in the history of what the markets have returned, but it's not something that we can count on.

CHAIRPERSON COSTIGAN: But what -- I just want to make sure what, I understand, you are at least alluding to is if you look over the last 30 years, if I am correct, we've averaged and 8 percent return, although the calendar marches forward. We're actually talking about the need to exceed those rushes for a longer period of time.

CHIEF ACTUARY MILLIGAN: We're talking about needing to exceed those rates of return. If you get a couple of years in the 30 percent plus range, you'd be really -- it would really help the system, but those are extraordinary and not something that your should be counting on.

CHIEF INVESTMENT OFFICER ELIOPOULOS: The only point I would add to that, Mr. Costigan, is that over that 20-year period, the interest rate environment was dramatically different than the interest rate environment that we're presently at. In other words, interest -- the wind was at our back the last 20 years with interest rates declining over that period. And we're now at a very low interest rate period, so I wouldn't want to give the impression that we can expect the same pattern of returns going forward. And the stochastic modeling that Alan's team and our team did in looking at the risk mitigation strategy is probably the best way to analyze the randomness of the patterns of return that could happen over the future.

But as Alan said, we shouldn't expect or rely on a long period of exceptional returns to play out. Although, it is possible.

CHAIRPERSON COSTIGAN: Well, and I think Alan made the point, even with the 8 percent over 30 years, you look at significant increases in the market. And then as you also talk about from the standpoint of interest rates. Even if we see a modest increase, we -- they will continue to be historically low for years to come.

On that, one last point, and then Ms. Hollinger we'll go to you. Alan, on -- in the attachment, I'm just trying to reconcile. In our earlier report, we see a growth in the number of employees on page 10, but on nine of 32, if I look at it, in addition many employers have been reducing their payrolls.

So in our report, we talk about reductions, or that payrolls are reducing, but on our chart, we see a net of 39,000. So at some point, I would like to just have a reconciliation as to what's referenced in the attachment -- in the -- it's the second paragraph -- or third paragraph from the bottom on page nine, just many employers have been reducing their payroll, and -- but our other chart shows that that is, in fact, going in a different direction.

CHIEF ACTUARY MILLIGAN: That is likely due to discrepancy in the timing. My data, because we have to do it for the actuarial report, we have to scrub the data for our purposes tends to be a little bit older. And I believe that the data that we used on the other chart was more current.

CHAIRPERSON COSTIGAN: Okay. All right.

Ms. Hollinger.

VICE CHAIRPERSON HOLLINGER: Yeah. I know we're talking about upside here and benchmark levels. You're saying 8 percent that we need to make, but I also think --

obviously, you're making an excellent point that with the maturing of the population, I also think in a risk mitigation strategy that we need to understand that that has almost an exponential impact on the downside when you're paying out more and then let's say you experience a bad year in the market.

CHIEF ACTUARY MILLIGAN: Yes.

VICE CHAIRPERSON HOLLINGER: Could you speak to that?

CHIEF ACTUARY MILLIGAN: Yes. What we're -- what the modeling is showing is that the level of assets relative to employer payrolls are expected to continue to increase, both because of the demographic shift, as well as because of improving funding, as well as -- which is kind of the ironic point that Mr. Jelincic made -- as well as the actual pattern of benefit changes.

A good portion of our current retiree base retired under older formulas. The current new retirees and many active employees are under somewhat more generous formulas. And then the newest group of employees are under the lower benefit formulas put in place by the Public Employees Pension Reform Act, PEPRA.

So all of this combines to cause a -- as more and more of the retiree population gets into the more generous formulas, and more and more of the active population comes under the less generous formulas, you will see -- that will also exacerbate this trend. And it's kind of all of these three factors together that have shown up in our modeling that have caused those risk levels to be what they are. And so all of this stuff is built into our risk modeling.

So I wanted to -- I don't want to overstate that the risk -- you know, our risk levels that we're looking at already incorporate that, but it is true that the actual employer contributions will become more sensitive to investment volatility than they have been in recent years. And that's kind of -- that's causing us some concern, and we're wanting to really get at that issue with the risk mitigation policy.

CHAIRPERSON COSTIGAN: Mr. Jelincic.

COMMITTEE MEMBER JELINCIC: I really appreciate the pessimism on the investment returns we're going to get over the next few years, because the markets are really, really good at making whatever -- doing whatever it has to to make most people wrong. So I appreciation the pessimism.

In your funding level, one of the changes we made was new actuarial assumptions on how long people were going to live. I remember seeing something recently where the actuary says, well, gee, maybe we overdid it. And I was wondering if you can comment on that? I'm not proposing we change it today, but...

CHIEF ACTUARY MILLIGAN: Certainly. I would love it -- first off, I would absolutely love it if the markets made a fool out of me by giving us that extraordinary string of returns that put us back into a really healthy status. That would be -- I would love to be made a fool of by the markets.

COMMITTEE MEMBER JELINCIC: I think we all would.

CHIEF ACTUARY MILLIGAN: On the mortality issue, yes, there was a report recently that indicated that the most recent mortality improvement scale that was released by the Society of Actuaries may have shown higher rates of mortality improvement than more recent data is showing.

That's -- you know, so that does mean that future mortality improvements may not be as much as was expected. We actually adopted our mortality improvement scale just a short period of time before that table came out. So we adopted a mortality -- a slightly older mortality improvement scale.

So we're trying to -- trying to take a look at it, but we know that the difference, if there is a difference, will not be as much for us, because we hadn't adopted the more aggressive mortality improvement assumptions that were built into the most recent table, because it wasn't available at the time we did our -- took our action.

COMMITTEE MEMBER JELINCIC: How big a change are they making in the guess?

CHIEF ACTUARY MILLIGAN: It's -- it will -- it will not -- even if we had adopted the newest table, the level of change that we saw when we adopted our last assumption was fairly large, because we were going from no mortality improvement to a fairly significant level of mortality improvement. This will be significantly smaller than that. And, in fact, it may -- it could go either way. We simply can't make -- you know, we will have to do a lot more analysis, which we will do as part of our next experience study to really get at that issue, but it should be quite a bit smaller than the change that we experienced when we adopted the mortality improvement back in -- a couple years ago.

COMMITTEE MEMBER JELINCIC: So we'll have less assets and therefore less volatility.

Thank you.

CHAIRPERSON COSTIGAN: Mr. Jones.

COMMITTEE MEMBER JONES: Yeah. Thank you, Mr. Chair. Yeah, Alan, I'm looking at page 10 of 32, and it's page 220 in the iPad. And it talks to changes in employer rates as a percentage of payroll. And I was focusing on the 0 to 2 and then the 4 and then the more than 4, because that's the majority of the plans fall in those several categories.

But when I looked at the numbers, I only come up with about 1,500 plans. So where are the rest? I know you on the subsequent chart, you say you compressed the safety into the miscellaneous, is that the same thing that's happening here?

CHIEF ACTUARY MILLIGAN: That is precisely what's happening here.

COMMITTEE MEMBER JONES: Okay. Okay. Thanks. So the second part of the question is looking at the increase in the 0 to 2 percent, do you have a sense of how many of those almost 600 are at the upper end of that bracket?

CHIEF ACTUARY MILLIGAN: I do not. I believe they're fairly distributed across the -- I don't think that they're all -- they're concentrated at the higher end, but I would have to get back to you if you want more detail.

COMMITTEE MEMBER JONES: That's okay. I'm just -- I'm trying to get understanding of information for our next report.

Thank you

CHAIRPERSON COSTIGAN: All right. I see no further questions or discussion. Thank you, Mr. Milligan.

CHIEF ACTUARY MILLIGAN: Thank you.

CHAIRPERSON COSTIGAN: And that was an information. So now we're going to move back to Item 6a. Just very quickly for those who want to speak, please go ahead and sign up in the back. We've only got a couple folks. So anyway.

Cheryl.

CHIEF FINANCIAL OFFICER EASON: Thank you. So we're back onto the 6a Funding Risk Mitigation Policy, Second reading. And based on direction from the Committee, two policies have been developed for your review today. The original proposed policy with the 4 percent threshold remains unmodified, and a second policy with a 2 percent threshold has been included.

Based on staff's analysis, a 2 percent initial threshold would increase the pace of risk mitigation by providing for a risk mitigation event when there is an investment return between 2 to 4 percent above the discount rate at that time.

Modeling estimates that that would be an additional event every 15 years. A 2 percent threshold compared to the 4 percent threshold would also reduce the average time to reach an 8 percent level of volatility from 21 years to 19 years.

Modest increases in employer's contribution rates compared at the proposed 2 percent threshold would be less than 0.3 percent for miscellaneous plans, and 0.5 percent for safety plans in any given year during risk mitigation.

Stakeholder outreach with leaders of our member and employer organizations has taken place since the first reading of this policy in October. Feedback from the League of Cities indicates support for both policies at 2 percent and 4 percent. This does not include going from a 7.5 to 6.5 percent discount rate immediately.

Member organizations generally continue to support the original 4 percent risk mitigation policy proposed in October. Feedback from Department of Finance staff supports a more aggressive schedule in reducing the discount rate from 7.5 to 6.5 percent.

To begin preparations for implementation of a risk mitigation policy, staff requests the Committee recommend approval of one of the policies being presented today.

This concludes my portion of the remarks for this item, we'd -- Ted, Alan, and I, and Anne would be happy to answer any questions you may have regarding the draft funding risk mitigation policy.

CHAIRPERSON COSTIGAN: So before we get to questions, Mr. Eliopoulos, Ms. Stausboll, any comments?

You don't have to have any.

All right. So now we're going to hear, because I have no other questions up here, we're going to ask the folks who have -- wanted to speak on this publicly to come on down. We'll do -- there's four of you all, so if you all come down to my left.

First, we'll start with Eric Stern from the Department of Finance, and then Christy Bouma representing the California Professional Firefighters, and then Mr. Johnson with SEIU 1000 and then Jay, if you want to come on down as well. Jai, you're signed up. You can come on down as well.

MR. STERN: Good morning. My name is Eric Stern with the California Department of Finance. Thank you for giving me the opportunity to address the Committee and the Board today on this important topic.

Over the last couple days I've been thinking about how to reframe this issue in a little bit of a different way. Part of my job at Department of Finance is to look at the bill we get from CalPERS, the contribution rates, and figure out how to work it into the State budget. And the bill -- the annual bill we get from CalPERS is about $5 billion a year today. And it's really broken into two parts, as you all know, normal costs and unfunded liabilities.

And the normal costs are really supposed to represent the expected cost of the pension benefits. You tell us how much we're supposed to set aside every year, and a given amount to pay for those future benefits. And those -- it's based on -- based on assumptions that the Board sets, including the ones that we're talking about today.

Now, the one thing that we know about assumptions is that they're always wrong. And so therefore, we have an unfunded liability that will emerge, and on rare occasions a surplus, that we -- to cover those gaps from the normal costs when the assumptions are incorrect.

But when we look at the bill that we get from CalPERS today, that $5 billion, more than half of that total cost is actually unfunded liabilities. So it means that the amount that we expect to pay, the normal cost, isn't just a little bit off. It's more than 100 percent wrong of what we're -- of what we should be expecting to pay, based on the assumptions.

And so we're in that situation because of what we're talking about today. So we have a volatile asset mix. It's high risk and high reward. A little bit less risk and a little bit less reward does mean that we'll have to set aside more money and budget money every year in State budget to pay for these benefits ahead of time.

But it also means we won't have to face big spikes in our contribution rates in the future, because we've been underestimating that bill for many, many years.

What we need, as employers, and what I think employees want also, is that stability and predictability and certainty, and also honesty and transparency with how much these benefits actually cost. There seems to be general agreement on getting to that goal at some point. And once again, we'd urge the Board to take an approach that's more aggressive, sooner rather than later, to reach that goal and ensure we are adequately funding our pension benefits that we've promised for our employees and our retirees.

So we believe that a third option should be put on the table, and that's the most prudent course is to adopt the target discount rate of 6.5 percent, and do that today, and use the existing funding policies that the Board already has in place to ramp up those contribution rates over the next five years.

Thank you.

CHAIRPERSON COSTIGAN: Thank you.

Ms. Bouma.

MS. BOUMA: Thank you, Mr. Chair.

CHAIRPERSON COSTIGAN: Hang on a second, your mic is not on yet.

There it is.

MS. BOUMA: Mr. Chairman, members of the Finance and Administration Committee. Christy Bouma on behalf of the California Professional Firefighters. I won't open my remarks, with all due respect to Mr. Stern, and insulting Mr. Milligan as always being wrong in his assumptions, but I know that is part of the game.

I'm here on behalf of the firefighters to urge that the Committee adopt the original proposed risk mitigation policy with a four percent trigger.

CalPERS, notwithstanding what Mr. Milligan said, is not following a national trend, but rather you're leading on the risk mitigation discussion. And for that, you all should be commended. It's a bold policy, and it's a result of 18 months to 2 years of stakeholder engagement. And for that, you are to be commended.

Time will certainly tell if the bold moves that you're making in the next few days will attract followers or critics. I hope it's the former. I am not here to take a position on behalf of the firefighters about whether a gradual or immediate reduction of the discount rate is appropriate for this system, and the best course for employers and employees. But we are here to support what is a sincere effort by this Board to protect the retirement security of my members, the firefighters of

California.

As for the alternate proposal, it sort of disregards all of the deliberations and engagement that the staff has undertaken at the Board's direction. And I would also like to say that under the 4 percent trigger policy, it remains the purview of the Board to take a more aggressive or less aggressive action on discount rate or trigger decisions based on the current conditions of the fund, of our economy, et cetera.

And so while this is a programmatic, almost a pre-programmed, policy that will operate on its own should you choose to adopt it, there is always an opportunity under your plenary authority to make the changes that are appropriate for the system.

And so I will close my remarks by again just urging you to adopt the well vetted proposal with the 4 percent trigger.

Thank you for your time.

CHAIRPERSON COSTIGAN: Thank you for coming this morning.

Jai

MR. SOOKPRASERT: Good morning, Mr. Chairman and members.

Jai Sookprasert with the California School Employees Association. We are also here in opposition to any changes that's being put on the table for two basic reasons. One, the original proposal had already been vetted. Everyone has had their chance. And the other, you know, you've done a lot of reforms and the State has enacted a lot of reforms here. Let's give it a chance. We all understand the need to really be careful about the future. And that's what this Board is here to do is to watch carefully.

And so give that -- give all the different reforms a chance to kind Of go in place first, so that we can see whether even this risk mitigation policy is the direction that's, you know, going to help the fund over the long run. For all those reasons, we would urge you to adopt the original proposal and not make any changes.

Thank you.

CHAIRPERSON COSTIGAN: Thank you.

Mr. Johnson

MR. JOHNSON: Neal Johnson SEIU Local 1000. We support the initial proposal of a set -- establishing the mitigation policy with a trigger that is 4 percent above the assumed discount -- or 4 percent above the discount rate or assumed investment rate, which currently is -- the discount rate is 7.5 percent. So something over 11.5 percent in the current time would trigger the start of the risk reduction policy. That has been vetted for a while.

While we may have some problems with the specifics of it, it is a reasonable compromise, and that should go forward.

Other moving to 2 percent I think makes it a little -- you know, we would discuss volatility in a number of forums, including yesterday in the Investment Committee. And I think that the 2 percent sort of goes into why volatility creates problems, but it really is exacerbating the volatility problem I think.

With respect to where the Department of Finance wants to go, while we appreciate their concern, it becomes inconsistent with that two-year process of the ALM that set the investment rate, and we will come back in a couple years with that whole discussion of investment returns, risk allocation, et cetera, and whether -- and at that point, whether a discount rate of 7.5, 7.1, whatever is appropriate it really should come out of that, rather than this immediate rush to judgment.

You know, clearly the employer, because of unfunded liabilities, has large pension contributions, but those are things that also come out of employee compensation -- the whole employee compensation package. And really rushing to judgment I don't think serves either party at the present time.

Thank you.

CHAIRPERSON COSTIGAN: Thank you, Mr. Johnson.

So before we get to questions, I just do want to commend staff and the witnesses for all being here and for the comments given.

Again, this continues CalPERS march forward on a additional transparency and the discussions that we have in getting the information out. And I know that we're not always going to agree on the final conclusion, but I do want to commend the Board and staff for the fact that we're having this discussion, and the thoughtfulness.

With that, I will first go to Mr. Gillihan.

COMMITTEE MEMBER GILLIHAN: Thank you, Mr. Chair.

So I've talked about this topic from the dais before. You know, we all, on some level, agree that there needs to be risk reduction or we wouldn't be having this conversation. The plan that's before us, while it's probably better than where we are today, it links any risk reduction to exceptional market performance, which again is highly unlikely on a consistent basis or we wouldn't be having this discussion, and we're just kicking the can down the road.

So we think it's time to get serious about this. And with that, I'd like to offer a counter motion at this time.

CHAIRPERSON COSTIGAN: Make a motion.

COMMITTEE MEMBER GILLIHAN: Or I'd like to make a motion, excuse me, that the Board immediately adopt a 6.5 percent discount rate using existing Board policies to phase in and amortize that over -- under the existing schedules.

And related to that motion, I'd like to ask Mr. Milligan to comment on if the Board were to take this -- or the Committee were to take this action and it were ultimately adopted by the Board tomorrow, what year would those changes begin to be realized from both the State and the public agency perspective?

CHIEF ACTUARY MILLIGAN: So if we were to -- if the Board were to adopt that today, the first set of valuations that I could get the new discount rate into would be the June 30th, 2015 valuation, which we will be working on next calendar year. It would impact the State contribution rates in 16-17, and public agency contribution rates in 17-18.

The risk reduction would, of course, happen pretty much as soon as we change the asset allocation to lower the investment risk. The impact on contributions would be phased in over five years starting in the years I indicated. The impact on the normal cost under our policies is not phased in. And that's probably about half of the total impact. The remaining impact would be the impact on the normal -- on the unfunded liability payment would be phased in over five years under current Board policies. And so starting in the year I indicated for the different groups.

Schools -- for the school members -- the school plan, the impact would be this -- the timing would be the same as the State.

COMMITTEE MEMBER GILLIHAN: Thank you.

CHAIRPERSON COSTIGAN: So we have a motion before us. I'm going to call on Ms. Yee. Do you want to speak on this motion?

COMMITTEE MEMBER YEE: No.

CHAIRPERSON COSTIGAN: Okay. Does anybody want to speak on make Mr. Gillihan's motion?

I'll second Mr. Gillihan's motion.

So there are no questions on -- Ms. Taylor, do you want to speak to the motion.

COMMITTEE MEMBER TAYLOR: My only --

CHAIRPERSON COSTIGAN: Hang on a second. Wait a second. Let me go first to Mr. Boyken raised his hand, so -- and then we'll come to you, Ms. Taylor.

ACTING BOARD MEMBER BOYKEN: Thank you. So first of all, I want to reiterate Mr. Costigan's comments, we appreciate the staff's work on working on this risk mitigation plan. The Treasurer is very much in favor of adopting risk mitigation of some sort of policy.

The Treasurer is not a voting member of this Committee, but I did feel the need to say that the Treasurer is supportive. I do think that suddenly going -- I understand that a 6.5 percent -- or 6.5 percent assumed discount rate would be phased in over time, but I also think that's sort of sharp and sudden and should -- dropping the discount rate should be part of probably a capital markets assumption study.

But, I mean, at the same time, I do -- I mean, I have to say to Mr. Jelincic's skepticism about the need for risk mitigation policy, I remember in 2007 I gave a presentation to a Governor's commission on they were looking at pension and retiree health benefit issues. And I did a survey of retirement system funded status for public funds in the State of California, and they were all doing very well. And I said their focus should be on OPEB benefits rather than on pension benefits.

Mr. Milligan's predecessor spoke afterwards and said -- you know, announced the returns for that year for CalPERS, and said that we were at 100 percent, and then came 2008/2009. So clearly, risk mitigation is important. But the Treasurer wouldn't be supporting a motion to move the discount rate to 6.5 percent.

CHAIRPERSON COSTIGAN: Thank you. Ms. Taylor, on the motion?

BOARD MEMBER TAYLOR: So I certainly appreciate the hard work that's gone into this. And I really appreciate you guys going back and doing the extra work to look at the 2 percent above the market rate. On the motion, I'm going to have to say I couldn't possibly support an immediate 6.5 percent reduction. As Mr. Boyken said, we've had really good years. We've had -- recently, we -- you know, 2008 hit and we are in this situation now. I think we need to be a little more measured rather than reactionary. Having worked for the State for a very long time, I know that the State tends to be very reactionary to situations. But this would harm the members and this would harm our municipalities in terms of what people can afford and what our employers can afford to contribute, and the State of California. I think it's unwise to commit that much money right now.

And finally, I think that we have already settled on our mitigation policy and to roughshod this through seems to not be what we all agreed on and what we did our outreach and made an agreement with everyone on. So that would be my comments on this.

CHAIRPERSON COSTIGAN: Thank you, Ms. Taylor.

Mr. Jelincic.

COMMITTEE MEMBER JELINCIC: Well, at least it's not a motion to go to 4 percent. I don't -- you know, this would do the Governor a great deal of favor in his budget. He would have to negotiate with the legislature a whole lot less on what they spend the money on. But the extraordinarily -- the extraordinarily significant reduction in the likelihood of us getting to 110 percent funded, given this assumption, is just mind-boggling. I think it's -- I think it's way too aggressive. You know, if it's -- and in some ways it's a halfway measure, because I can make an argument we ought to use a 4 percent. But no, I certainly am going to vote against the Governor's motion.

CHAIRPERSON COSTIGAN: Mr. Jones, you want to speak on the motion?

COMMITTEE MEMBER JONES: No.

CHAIRPERSON COSTIGAN: Okay. Ms. Mathur, do you want to speak on this motion?

BOARD MEMBER MATHUR: Yes.

CHAIRPERSON COSTIGAN: Thank you.

Ms. Mathur.

BOARD MEMBER MATHUR: Thank you.

In a way, I think we're talking about two different things, although related. This -- what's before us today is sort of a ongoing policy that would reduce risk over time in the portfolio. We already have a process for adopting our discount rate. That is our asset liability management process. That is something that we already have scheduled on our calendar. And I certainly think it's appropriate, as part of that process, to revisit what the actual discount rate ought to be. And as part of that whole process is a whole lot of information around capital market assumptions, and also actuarial assumptions. And it all comes together in one process that drives us to a decision around a particular discount rate.

So while I think it's totally appropriate for us to have a discussion about that, I think it has to be held with all of the relevant information and the full sort of process behind it.

So I guess I would urge this Committee and the Board to consider the policy that is before us today, the funding risk mitigation policy, and to take up the discount rate question at another time as part of the assets liability management process.

CHAIRPERSON COSTIGAN: Thank you.

Mr. Slaton, do you want to speak to the motion?

COMMITTEE MEMBER SLATON: Yes.

CHAIRPERSON COSTIGAN: Okay. Mr. Slaton.

COMMITTEE MEMBER SLATON: Thank you, Mr. Chair.

I'm pretty conflicted on this particular motion, because as other Board members know, I've been an advocate for quite some time for a more systematic approach for risk mitigation. My original concept was 5 basis points a year over 20 years, and we'd get -- end up getting to 6.5. But I'm conflicted on this motion because this seat represents local government employers, and in the earlier report, we heard one of the items in there was we have 80 -- over 80 miscellaneous plans for local government where the contribution rates are over 30 percent of payroll. We have over 135 safety plans with over 40 percent of payroll.

So I think that the challenge here is that if we were able to have two PERFs, one for the State and one for locals, then I think we'd be having a different discussion. But I think the impact on local government, given the stresses and given the other mitigations that we've done, create a situation where this one just would drive -- in my opinion, would drive those contribution rates in the relatively short-term, in the five-year time period, to a level that would be difficult to sustain.

So I reluctantly will be voting no on this motion.

CHAIRPERSON COSTIGAN: Mr. Lind, to the motion.

BOARD MEMBER LIND: Yes.

Thank you. So to use Alan's Goldilocks analogy, this one is way, way too hot, in my opinion. And I even think that the two percent proposal is too hot. As some of the speakers pointed out, we had a long process and got a lot of stakeholder involvement and engagement. And we got to a point where we had a -- we're going down the road of this 4 percent issue. And while we had not unanimous Board direction around that, we had a majority Board direction.

And, you know, the staff did a lot of work in preparing that four percent. So I just have a whole -- on the 2 percent issue a whole process issue. But, you know, also we -- as we saw in Alan's report, we've already done a lot of work around -- and that's being implemented now around the amortization schedules and around the mortality tables. And all those things are impacting employer rates.

And there is a long-term risk here in continuing to drive those rates. As we saw the ratios of retirees to active, you know, employers who are reducing their payrolls. And if that exacerbates, that adds to our problem.

So I would urge the Committee to reject this motion and to, at the end of the process, go with the original proposal around the 4 percent trigger.

CHAIRPERSON COSTIGAN: Thank you, Mr. Lind.

Mr. Feckner.

PRESIDENT FECKNER: Thank you, Mr. Chair. I want to echo the comments of some of my other Board members here. I, too, think that we've taken a lot of time and a long process. I want to thank staff for taking on a topic that wasn't very sexy, wasn't thrilling for a lot of people. In fact, it was a lot of consternation for folks, but yet we worked through it. Months and months, we worked through it. We had stakeholder meetings. We met with members. We had a workshop. Put all these plans together with different options, came forward, and like we heard last month changed little bit between the 2 percent and the 4 percent.

But from my perspective, after going through all that with all that outreach, having another option showing up at the 11th hour I think is unfortunate. And part of me thinks it's disrespectful to the staff who have done all this work to get to this point, because people were included in the process up till now and didn't offer that.

I'm with Mr. Lind that I think you should vote down this proposal and go back to the 4 percent that we started with. Thank you.

CHAIRPERSON COSTIGAN: Thank you, Mr. Feckner.

Mr. Jones.

COMMITTEE MEMBER JONES: Yeah. Thank you, Mr. Chair. Yeah, we need to put this in perspective I think that the employers grant the benefits to CalPERS members, and in turn CalPERS is responsible as the trustee for creating a fund to pay those benefits. And through a very prudent administration and investments of the retirement fund.

And as result of that, we -- after the 2008 financial crisis, we started to talk about how we might mitigate the impact of another downturn by adopting some form of risk mitigation.

We -- I know a number of us we were at off-sites discussing this matter. For almost over two years ago now we started this discussion and trying to find a way how we could mitigate the risks that are associated with the high rate of returns that were driving the contribution rates. And we reached a conclusion, as a majority of the Board, to adopt the 4 percent and that's what I continue to support is that 4 percent.

I think it's also important to note that in the previous report we just read that the -- some of the comments that our Chief Actuary made was that the current contribution rates are high relative to historical levels, and for almost all employers, and it's scheduled to increase based on actions that have already been taken.

So I think we need to make sure that we incorporate those transactions or those actions that have already occurred that is going to increase the contribution rate for employers as we go forward.

So for that reason, I cannot support this 6.5 discount rate, and I will continue to support the 4 percent original proposal. And I also want to thank staff for all the work that went into providing the information, the stakeholder outreach that occurred over a long period of time. And it wasn't easy to coordinate those efforts, and ultimately get the buy-in that has occurred. And I think it would not be in our best interest to now, after we've had all of this agreement and this buy-in, and the majority of the Board agreeing on a 4 percent to now turn around and do something different.

So with that, I cannot support this motion.

CHAIRPERSON COSTIGAN: Thank you, Mr. Jones.

Mr. Boyken.

ACTING BOARD MEMBER BOYKEN: Again, the Treasurer is not on this Committee and I've already spoken on this motion once, but I felt the need to chime in one more time. Mr. Slaton mentioned a goal of getting to 6.5 percent discount rate. And to Ms. Mathur's point, I think at least the way that I read the policy, what we're really doing is going for a target volatility rate of 8 percent. And to me, the discount rate is something we set through a process, the asset liability management process, and the study of the capital market assumptions. So thanks.

CHAIRPERSON COSTIGAN: Ms. Hollinger.

VICE CHAIRPERSON HOLLINGER: Yeah, thank you. I want to thank staff, and I want to thank also our stakeholders who we worked with really closely in coming to some resolution on this issue. We all recognize that there is a cost to lowering risk. And while I may agree conceptually that 6.5 percent is more prudent and obviously easier for -- to achieve in this economic environment, I believe that our stakeholders and our participating employers are already faced with increasing contributions. And to add more strain to them could actually compromise the system, because to the extent that they couldn't meet those projections could put them into bankruptcy, in which case, then we're jeopardizing DB plans going forward.

So I want to honor the negotiations that we've entered into with the stakeholders and I would not be voting to support 6.5 percent.

CHAIRPERSON COSTIGAN: Thank you, Ms. Hollinger.

Mr. Gillihan.

COMMITTEE MEMBER GILLIHAN: Thank you, Mr. Chair. So I just wanted to respond to some of the comments I've heard from other Board members. And this notion that this is not a process to deal with the discount rate that other processes exist for that discussion to happen, I think is a bit disingenuous because this is a process by which if we adopt this -- the proposal that's on the table, not the motion I made, the staff -- or the 2 or 4 percent package that we've been talking about, I acknowledge that, it absolutely links changes in the discount rate to market performance. And so it's all about the discount rate.

Regardless, if we want to pretend like this isn't the forum to have this discussion, I believe it is, and again, I'm going to support the motion I made.

CHAIRPERSON COSTIGAN: That's good to support your motion.

(Laughter.)

COMMITTEE MEMBER GILLIHAN: Somebody has to do it.

(Laughter.)

CHAIRPERSON COSTIGAN: All right. So there's no further discussion, debate. Anything from staff? I know we still have a few more.

So all those in favor of Mr. Gillihan's motion, aye?

(Ayes.)

CHAIRPERSON COSTIGAN: Opposed?

(Noes.)

CHAIRPERSON COSTIGAN: Motion fails.

Thank you very much.

Now, we will move back on to Ms. Yee, you're up.

COMMITTEE MEMBER YEE: Thank you, Mr. Chairman. Before I speak, I would like to move the 4 percent option for the risk mitigation strategy.

And I'm just going to probably echo what some of the comments have been so far. First of all, I want to just congratulate this Board for even tackling this issue, because it's essential that we look at a risk mitigation strategy. I want to thank the staff and the outreach that's been done. Obviously, these are tough conversations to have, but I also have, and Mr. Boyken can attest to the Treasurer's position in this, I sit in a unique position of receiving all of the financial transaction reports for our municipalities and special districts and school districts, and even though we had a letter from the League of California Cities indicating neutrality with respect to the two options, not all cities are alike.

And Ms. Hollinger Is absolutely right, there are some cities that are still struggling. And frankly, in terms of where the State has had to go to balance its budget, it's been on the backs of local governments in the past years. And there is just not a lot of capacity there.

And so I think we have to be fiscally prudent, not only with respect to the State's position, but also with respect to our employers as well. And so with that, I think the 4 percent strategy really begins to have us take the essential step, but also, as was stated earlier, we have many opportunities to revisit this policy.

And I do think the conversation about the discount rate is one where we need a whole lot more information than there is a process for considering that.

So with that, I would move adoption of the 4 percent risk mitigation strategy.

COMMITTEE MEMBER JONES: Second.

CHAIRPERSON COSTIGAN: It has been moved my the Controller and seconded by Mr. Jones that we adopt the 4 percent.

Before we do that, we're going to move to Mr. Slaton.

COMMITTEE MEMBER SLATON: Thank you, Mr. Chair. I want to offer, no surprise, a substitute motion to adopt the 2 percent alternative. And the reason is -- and I do appreciate that we didn't spend as much time vetting this as the original proposal, and I compliment the staff for all this work that's gone on for many months on this, but the fact is this is a modest adjustment.

And the reason for this adjustment, when I look at risk mitigation and, you know, we're all involved in risk mitigation in our lives. My first experience in risk mitigation was as a ten year old trying to convince my mom that I could play football. I lost that one battle, and I may lose this one also.

But I think that by moving to 2 percent -- and I appreciate the analysis from staff here, it's a very modest change. It's a modest change for employers, and it's a modest change for members, but it sends a signal. And the signal it sends is an important one, and that signal is that in this environment with the maturity of this plan that when you -- as you weigh priorities, risk mitigation should take precedence, not to the point where it's impossible to do, but it should be the first thing we look at. And that's what a 2 percent does, because as I understand from Mr. Milligan, that if we hit that particular threshold, all of the adjustment goes to risk mitigation rather than be divided, which is what would happen when you hit the 4 percent threshold.

So I think it's a very modest change, but one that allows us to emphasize the fact that we need to reduce the risk of this fund, because at the end of the day -- and I want to compliment all of the Board members here and the staff and our stakeholders in that we're all coming around realizing that risk reduction is very important and that we need to do it, because we all want the benefits to be there for our members. That's what this agency is about.

We may disagree on the strategy to get there, and that's fair, but I would encourage you to support the 2 percent alternative as a signal of how important risk mitigation is to this fund.

And with that, that's my motion -- substitute motion.

CHAIRPERSON COSTIGAN: It has been moved by Mr. Slaton. Is there a second?

VICE CHAIRPERSON HOLLINGER: Second.

CHAIRPERSON COSTIGAN: Second by Hollinger.

Okay. We're going to move to -- on this motion, Mr. Feckner.

PRESIDENT FECKNER: Yeah. Thank you, Mr. Chair. And while I agree with Mr. Slaton that it is a modest change. It's a modest change from 4 to 2, but we're going from nothing to 4, which is a huge change for the employers and employees. So the comment that it's a modest change, it is between 4 and 2. But to go from nothing to 2 is a huge difference versus nothing to 4. Although that's a stretch for employers and employees, it's at least something, through our conversations, we think that they can get to. And I think the rest of it is that the larger stretch is that quote unquote modest piece, which is, but not in the big scheme of things.

CHAIRPERSON COSTIGAN: Controller Yee.

COMMITTEE MEMBER YEE: Thank you. I think everyone has gotten the signal. I mean, between the increase GASB disclosures and just the very fact that we've had this conversation over this last period of time, and other pressures that are on employers, I mean, as much as I think the change is modest on paper, they really result in some real practicalities for a lot of our employers.

And so with that, I do think the 4 percent is a -- it's something that's been shared with our stakeholders. It's -- I think there's preparation for looking at how to implement that by the staff. And again, there's an opportunity to revisit this should the need arise. But I think really, as Mr. Feckner says, going from 0 to 4, and with all the other factors that are affecting employers now, I think the signal has been very well recognized.

CHAIRPERSON COSTIGAN: Ms. Mathur.

BOARD MEMBER MATHUR: Thank you.

You know, it's been said, but, you know, our staff has spent -- and we have spent more than 18 months now vetting various options thinking through the issues, talking to stakeholders, ensuring that they provide input. And I just think it's really important for us, at this point, to respect that process and the outcome of that process, which was a couple of options which we considered both in August and then last month.

And so I guess I would just -- I think that at this time, it's really important that we stick with the options that were considered by all of us together. And so I would not support the 2 percent target. I don't think it makes such a meaningful difference that it's worth sort of throwing out all of the hard work and outreach efforts that we undertook over the past almost two years.

CHAIRPERSON COSTIGAN: Okay. I see no further questions from the Board.

Any comments?

You don't have to comment. I just want to make sure.

Okay. So on Mr. Slaton's motion, all those in favor?

(Ayes.)

CHAIRPERSON COSTIGAN: Opposed?

(Noes.)

CHAIRPERSON COSTIGAN: Motion carries. Thank you.

4-3, unless you want a roll call.

COMMITTEE MEMBER JELINCIC: Please.

CHAIRPERSON COSTIGAN: Oh, you want a roll? Well, you have to ask for it. So you're asking for a roll call?

COMMITTEE MEMBER JELINCIC: Yes.

CHAIRPERSON COSTIGAN: Okay. Can you turn on?

Tell me when they're on?

(Thereupon an electronic vote was taken.)

CHAIRPERSON COSTIGAN: Yeah, motion carries.

Mr. Feckner, any --

PRESIDENT FECKNER: No.

CHAIRPERSON COSTIGAN: We're okay?

PRESIDENT FECKNER: Yeah.

CHAIRPERSON COSTIGAN: Okay. Thank you.

All right. Next item.

Thank you, Ms. Eason. Thank you, Mr. Milligan, Mr. Eliopoulos.

All right. Ms. Eason, we're on Item 9 -- 7.

CHIEF FINANCIAL OFFICER EASON: 7a, Long-Term Care Valuation Report, back to the last action item.

CHAIRPERSON COSTIGAN: Okay.

CHIEF ACTUARY MILLIGAN: Good morning. Alan Milligan. This is the long-term care actuarial valuation. To present this, I have our long-term care actuary Flora

Hu.

SENIOR LIFE ACTUARY HU: Hi. Good morning. Flora Hu, CalPERS staff. As of June 30th, 2015, the Long-Term Care Program status -- funded status was 111 percent. The margin was 14.44 percent. Over the last year, the funded status decreased by 12 percent, and the margin decreased by about 9 percent.

The biggest contributor to the decrease in both the funded status and the margin is the lower than expected investment return in fiscal year 2014-15. The program's investment return was negative 0.93 percent in last fiscal year, which was much lower than the assumed 5.75 percent.

That resulted in a decrease to the margin by 9.79 percent. Another contribution to the margin decrease was -- is the change in the morbidity assumption in the 2015 valuation. We increased the claim cost by about 3 percent in the morbidity assumption based on emerging experiences and that change decreased margin by 6.15 percent.

In October 2012, the CalPERS Board approved the stabilization plan to help improve the financial position of the Long-Term Care Program. The stabilization plan included premium increases for some participants and permitted policy conversions to a less expensive policy.

The actual conversion in 2015 kept turning higher than expected. And that favorable conversion improved the margin by 4.76 percent.

The table on page four of the agenda item shows a detailed breakdown of the reasons for the change in margins between 2014 and '15. Even though the margin decreased over last year, the margin of 14.44 percent as of June 30th, 2015 is still higher than the Board approved 10 percent margin requirement.

That concludes my report. I'm happy to answer any questions.

CHAIRPERSON COSTIGAN: Thank you very much.

Any questions?

We have one. Push your mic, please. I'm not getting -- he's not lighting up over here. Can you turn on J.J.'s mic, please?

COMMITTEE MEMBER JELINCIC: Okay. This isn't really a question as much as it's an editorial comment. When I look at your report, page two, page four are both blanks. And I think it would -- going forward, it would just be helpful if it said intentionally blank, because I look -- I look at a lot of stuff and what's missing?

SENIOR LIFE ACTUARY HU: Okay. Thanks. We'll do that.

COMMITTEE MEMBER JELINCIC: Thank you.

CHAIRPERSON COSTIGAN: Ms. Yee.

COMMITTEE MEMBER YEE: Thank you, Mr. Chairman. Just one question. Given the volatility that we've seen both in the funded status and the margin since 2011, I just wanted to kind of get your sense about how well the stabilization plan that was adopted in 2012 is working, and whether -- I guess, how -- obviously the ski is not falling yet, I'm sure, but is there some thought that we may have to revisit some changes to that?

SENIOR LIFE ACTUARY HU: Okay. Overall, we can see that in three years in a row we have higher than probably the 10 percent required margin. So that's as good a sign we can see that the stabilization plan do help stabilize the program. The most volatile factor in the last three years is the investment return. As you can see in last year, in 2014, we had much higher than expected investment return. That did improve the funded status a lot.

But last year, in 2014 -- fiscal year 2014-15, we had a really poor investment return. So we'll keep probably monitoring the investment return in the next two or three years to see if any changes will be needed.

COMMITTEE MEMBER YEE: Thank you.

CHAIRPERSON COSTIGAN: Ms. Mathur.

BOARD MEMBER MATHUR: Thank you, Mr. Chair.

You know, one of the things that we saw in the annual report -- the financial report is that where the investment returns were really hit was in the more conservative, less risky asset classes actually, so fixed income and short-term assets, so -- and this is -- we have taken a much less risky approach to investing the long-term care funds.

I guess what this raises for me is a concern if we still think there's going to be weaknesses in those areas moving forward next year, if that -- if we -- you know, I know nobody has a crystal ball, but whether we're concerned that that might further impact the returns in the stability of the fund moving forward?

SENIOR LIFE ACTUARY HU: As you can see that currently we still have a hire percentage of equities in the investment portfolio compared to the private insurance investment portfolio. The -- nowadays, the return for the fixed return -- fixed income is still low is probably hovering -- is much lower than the five percent to give percent. So some private insurance actually they take kind of a more aggressive investment. So that's actually what CalPERS is doing right now. So I don't know for the investment side, Alan, you have anything else to stay?

CHIEF ACTUARY MILLIGAN: I think that we will need to continue to monitor this program. I don't think that -- nothing I'm seeing, at this point, says that we need to kind of take it out -- sort of out of the regular process. But as part of the regular process, we should be keeping an eye on the investment volatility and the impact of that on this program, and we will continue to do so.

BOARD MEMBER MATHUR: And clearly, this is an area of concern for the Board, for the staff, for all of our members in this program, because we've had -- it's been such an unstable fund, and we feel -- I feel like we've gotten onto some surer footing. But I'm certainly very cognizant that we've -- that while the margin is still above our threshold, it's going -- the fact that it's moving down is not a positive sign.

CHIEF ACTUARY MILLIGAN: We've made a lot of progress in this program. I think that the actions that have been taken over the last few years and are continuing have been very helpful.

BOARD MEMBER MATHUR: Okay. Thank you.

CHAIRPERSON COSTIGAN: Okay. Thank you.

And that was just an informational item, so any other questions?

Thank you.

All right. Ms. Eason.

CHIEF ACTUARY MILLIGAN: I think it was --

CHAIRPERSON COSTIGAN: It was an action item.

CHIEF ACTUARY MILLIGAN: -- actually an action item. We were requesting --

CHAIRPERSON COSTIGAN: I'm sorry. You're right. I didn't read my notes.

CHIEF ACTUARY MILLIGAN: -- acceptance of the report.

CHAIRPERSON COSTIGAN: That's right.

COMMITTEE MEMBER JONES: I'll move by the report.

CHAIRPERSON COSTIGAN: It's been moved by Jones.

VICE CHAIRPERSON HOLLINGER: Second.

CHAIRPERSON COSTIGAN: Seconded by Hollinger.

All in favor?

(Ayes.)

CHAIRPERSON COSTIGAN: Opposed?

Motion carries. Thank you.

Okay. We're moving on to Item 9.

CHIEF FINANCIAL OFFICER EASON: 9a is the next item.

CHAIRPERSON COSTIGAN: 9a, Mr. McCollum.

DEPUTY EXECUTIVE OFFICER McKEEVER: Good morning, Mr. Chair, members of the Committee. Doug McKeever, CalPERS staff. Before I turn it over to Gary McCollum to present the item, I just wanted to note a couple of things on the trend report of note.

Overall, the trend report is fairly favorable, especially on the medical side. But I do want to emphasize, which I'm sure Gary will as well, the ongoing challenge that we have in the area of pharmacy spend. As you can note in the agenda item itself, on our self-funded plans, with the exception of PERSCare, we're looking at mid double digit increases in pharmacy for the period of this report.

I also want to note as of yesterday, there was an article that came out relative to the hepatitis C drug that's been out there. We've been talking about the specialty drug issues that are impacting CalPERS and others throughout this country. Yesterday, Medicare came out, their spending for Hep C drugs is going to surpass $9 billion in 2015. That is a 96 percent increase over the prior year.

So again, just putting into context as we communicate the trend reports for us, how important it is for us to keep a spotlight and shine a light on the issue of pharmacy drugs as we move forward in this program.

And with that, I'll turn it over to Gary.

SENIOR LIFE ACTUARY McCOLLUM: Good morning, members of the Board. Gary McCollum, CalPERS staff.

This is Agenda Item 9a, the semi-annual self-funded health plans report. In the past, this report provided the Committee with an update on the financial status for the CalPERS self-funded PPO health plans. As you remember, beginning in 2014, CalPERS members had several new HMO health plan options added. They included Anthem Blue Cross, Health Net, Sharp, and UnitedHealthcare.

These plans provided coverage for over 22,000 covered lives in 2014, and in 2015 enrollment in those plans increased to almost 66,000 In addition, Blue Shield and Kaiser were also made available.

We implemented the new funding arrangement called flex funding for all the HMO plans, except Kaiser starting in 2014. This report summarizes, as of June 30th, 2015, the financial results for the HMO plans except in Kaiser and for the PPO plans.

So I'll start with the PPO plans. Attachment 1 summarizes the results. Actual reserves for the PPO plans are currently at 673 million, which is a decrease of 26 million from the assets at the end of 2014. Required reserves are at 503.6 million. So actual reserves above the actuarial reserve requirements are currently 169.7 million. That is a funded ratio of -- or, excuse me, a ratio of assets to reserves of 134 percent.

Now, currently for the first part of the year, medical costs are trending favorably. But as Doug just pointed out, pharmacy claim costs continue to experience double digit trends, and again, as he said, except for CalPERS Care basic. And I want to point out that one of the big reasons that PERSCare basic looks so much better is that we had a large change in population to that plan starting in 2014. A much younger population came in when risk adjustment was implemented. And so the results on CalPERS on the PERSCare basic plan will look favorable as the numbers adjust to the lower population -- or the lower average age of the population.

The other plans Choice basic and Select basic the pharmacy claims are currently in the 13 and 17 percent range. And the Medicare plans are currently in the 11 to 12 percent range, and specialty drugs are fueling those large increases.

Total enrollment increased by a small amount, 1 percent. But because of the risk adjustment, which I mentioned, enrollment has shifted in the plans, where PERSCare basic continues to increase. It's up to 25,000 now. And PERS Select is decreasing by a little over 10 percent from 2014 to 2015, and PERS Choice is remaining pretty basic -- pretty stable.

Okay. We'll move to the HMO plans now. Attachment 2 summarizes the results for the HMO plans. In that funding arrangement, the flex funding that I mentioned that started in 2014, the premium for those HMO plans is now retained by CalPERS. An amount equal to the capitation payments is passed back to the plans for payment to their providers. The remainder is deposited into the Health Care Fund and is used to pay the administrative expenses and the fee-for-service claims when the plan submits an invoice.

As of June 30th, 2015, the assets for the HMO plans totaled 23 -- just a little over 23 million. This is a big improvement from the negative asset position that existed at the end of 2014. But we still have an issue with the two Blue Shield plans experiencing unfavorable claims experiences. The other plans are all showing positive results for this six-month period.

Now, medical and pharmacy claims costs are shown on pages three through six of Attachment 2. There's a large variation in claim costs that you'll notice, and those reflect the demographics of the populations that entered those different plans, and also the regions that they live in.

So this concludes my report. I'll answer any questions.

CHAIRPERSON COSTIGAN: Thank you.

Any questions?

Hang on a second. Let me -- Mr. Jelincic.

COMMITTEE MEMBER JELINCIC: On the Medicare pharmacy, those costs are going up. And I -- given, you know, that Medicare picks up most of it, and then the -- I don't understand why we're seeing that increase?

SENIOR LIFE ACTUARY McCOLLUM: Well, there's a, what they call, a doughnut hole in Medicare pharmacy. And the plan picks up those costs. As pharmacy costs go up, more and more people hit that doughnut hole, so that the plan picks up more of those costs.

COMMITTEE MEMBER JELINCIC: Okay. So we've got more people going into the doughnut hole, and then spending more while they're in there, and that's where it's coming from?

SENIOR LIFE ACTUARY McCOLLUM: Correct.

COMMITTEE MEMBER JELINCIC: Okay. Thank you.

CHAIRPERSON COSTIGAN: Okay. I see no further questions. Thank you both very much.

Next item, 9b, Annual Cost Efficiency and Effectiveness Report. Ms. Eason and Ms. McAuiliffe.

CHIEF FINANCIAL OFFICER EASON: Thank you. Cheryl Eason, CalPERS staff.

I will be very brief on this item, because I know we're running long. It is an information item. It provides a summary of the efforts made by CalPERS staff to reduce costs and improve the overall effectiveness in services we provide to our members and employers. It is the second annual report being presented and it incorporates the cumulative cost efficiencies and savings over the last four years.

We think it's important to note that the cost savings and effectiveness efforts total $564.6 million in savings over the past four years, and those are broken down in -- we've broken that down into three program areas. Investments, health, and operational all contribute to those savings.

The Investment Office represents 305 million of those savings. And in year-ending 2004-5, those savings were mainly due to the winding down of the absolute return strategy program, cost effective portfolio management, continued reduced reliance on external consultants, and contract renegotiation with more favorable cost terms.

In the health benefits area, we're seeing a large cost savings, 237.8 million over the last four years. Specifically, in the last year, we've seen more savings as a result of our dependent eligibility verification audits, reductions in administrative fees with the new flex funded health plans, hip and knee replacement negotiations with health plan partners and various efficiencies related to drugs and medication options.

And finally, the operational program has also contributed 21.8 million in cost efficiencies. That includes our information technology services division reduction in IT consultants, reduced computer hardware costs, and savings related to automating process analysis within soft -- PeopleSoft upgrade.

There are numerous efficiency improvements that we've mentioned in the report, including efficiencies found in travel and overtime cost savings, bringing more training in-house, reducing call response times, and automation related to time sheets, on-line applications, and procurement.

And always pleased to be able to show the hard work and efforts of the staff in saving costs. And I'd be happy to take any questions.

CHAIRPERSON COSTIGAN: And again, I just want to give a lot of credit to Ms. Mathur and to Mr. McKeever and to his predecessor Ann Boynton. When you look at the success of the $237.8 million in savings in health plans is quite a coup. Mr. Hoffner, we'll get to you as well --

(Laughter.)

CHAIRPERSON COSTIGAN: -- on what you've been doing on the governance side. But again, Ms. Eason, a great report. And really, I think you guys should take a lot of pride as we continue to control costs. And the dependent eligibility verification audit just big coup there. And really I know the savings were substantially more than had been expected. So with that, I see no other questions or comments.

So thank you very much.

Next item. Ms. Lum, you are up.

(Thereupon an overhead presentation was presented as follows.)

CHIEF INFORMATION OFFICER BAILEY-CRIMMINS: Good morning, Mr. Chair and members of the Committee. Liana Bailey-Crimmins, CalPERES staff.

Today's information item is an executive update on the my|CalPERS functional optimization project. Joining me today is Donna Lum, Deputy Executive Officer and also the executive co-project sponsor.

Last year, CalPERS leveraged the open bid procurement process and we successfully awarded the contract and kicked off the project in January of 2015.

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CHIEF INFORMATION OFFICER BAILEY-CRIMMINS: Over the past 11 months, CalPERS has made significant accomplishments through its strong business and technology partnership. Today's agenda highlights three things. It does -- it provides a highlight to the new CalPERS IT project delivery framework, which was optimized by using best practices, and leveraging the PIER Plus findings.

Two, we want to share our accomplishments and new system functionality which directly benefits CalPERS members, employers, and internal staff.

We also lastly want to provide you insight to our knowledge transfer and provide you our succession how we strengthen -- I just turned off my mic.

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CHIEF INFORMATION OFFICER BAILEY-CRIMMINS: Over time, our customers needs evolve and technology advances. We want my|CalPERS to be just as relevant in three, five, and 10 years as it was the day it went live. Therefore, CalPERS has adopted an optimization mindset, which continues to leverage our technology investments with a focus on improved customer service, operational efficiencies, streamlined processes, and improved business workflow.

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CHIEF INFORMATION OFFICER BAILEY-CRIMMINS: The my|CalPERS functional optimization project enhances business processes across the entire enterprise. For example, the 1995 Survivor pool's functionality was implemented on behalf of the Actuarial Office. And Shannon Taylor from Actuarial Office was kind enough to provide the following quote:

"The concerted effort by CalPERS IT staff and our vendor partner to understand the business needs and collaborate through all phases has been key to the success of the functional optimization project".

Shannon's quote reminds me of another famous quote about team work from Henry Ford, "Coming together is the beginning, keeping together is progress, and working together is success".

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CHIEF INFORMATION OFFICER BAILEY-CRIMMINS: In February of 2015, Grant Thornton presented the PSR Post-Independent Evaluation Report Plus, which is also known as PIER Plus, and provided a look ahead for my|CalPERS. CalPERS was already on a journey to improve its business and technology processes. And by leveraging best practices and the PIER Plus findings, we implemented numerous advancements and improvements. But in the respect of time, I'm going to highlight three of them.

We've enhanced our service request process to evaluate business benefits up front and post-implementation to ensure that our focus remains on realizing new functionality that delivers high business value.

Two, for software development projects such as my|CalPERS, CalPERS now utilizes a hybrid time and materials and a deliverable based fixed price agreement.

This model contains costs and minimizes amendments.

And three, CalPERS invests in our State workforce, and is seen as a destination employer. We have the most robust knowledge transfer program that I have ever seen. We provide staff opportunities to gain knowledge and give them time to utilize these new skills and strengthen our in-house abilities.

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CHIEF INFORMATION OFFICER BAILEY-CRIMMINS: A project by definition has a beginning and end with a set of clear goals. Our goal is to build for the future. Therefore, CalPERS has optimized its IT project delivery framework to include the following:

We now use blended consultant and State staff teams. What does this mean? It means that knowledge transfer is happening continually. You don't have a project team and consultant sitting in a separate suite or building that has to be reacclimated into the organization. They're sitting side by side and knowledge transfer is happening real time.

We also do agile builds, no big bang. Every seven weeks we release new functionality, which means business doesn't have to wait months or years for new functionality to be added to the system.

And we perform iterative lessons learned. Each enhancement and new functionality is an opportunity to improve. We conduct lessons learned sessions on an ongoing basis in order to strengthen our delivery model and improve customer service.

Because we have full partnership across all CalPERS programs and support areas, we have and will continue to provide improved self-service functionality. Here to share with you our recent successes and discuss our advancements is Donna Lum.

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DEPUTY EXECUTIVE OFFICER LUM: Good morning. Donna Lum, CalPERS staff. As Liana noted, I'd like to share with you some of the key accomplishments that we've achieved so far. And I also wanted to express that it does cut across multiple programs throughout CalPERS. We've been able to implement several enhancements that benefit our employers, our members, and our staff. And in choosing our top priorities, we focused on efficiencies and improved customer service.

So while I'll be highlighting a few of our major efforts, we've also achieved several smaller optimization efforts across the organization.

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DEPUTY EXECUTIVE OFFICER LUM: So turning to our member summary page, we implemented changes to the memory -- or the member summary page for our agents to utilize each time a member contacts us through the phone. By analyzing the most frequently accessed information, the call center agents are able to interact with the customers in a way in which all of the information that is needed to service the customer is readily available based on views that the agents have and the preferences that they need.

And this minimizes the time that they experienced in the past where they had to flip through multiple screens to be able to answer a member's question.

Just to give you some context with that, during September and October -- or September, we had a very high volume of calls in the contact center, over 97,000 calls came in. So if you can imagine our ability to shave off anywhere from two to three to five to 10 seconds per member per call, it really does create some efficiencies, and certainly improves the overall customer experience.

Another area where we saw great efficiencies is related to our returned warrants. In this area, the vast majority of the processing currently is done manually. And with the optimization project, we took the vast majority of the manual processes and we automated them.

This enabled us to take -- to completely eliminate some temporary resources that we had that were processing this work. And it also enabled us to redirect additional permanent resources to other areas within the branch and the division that needed to -- we needed to improve our service levels.

These returned warrants happen on a weekly and a monthly basis. And with the optimization, we've been able to significantly increase the processing time and ensure that the warrants are getting to the members in a more timely fashion.

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DEPUTY EXECUTIVE OFFICER LUM: As you know, during this last open enrollment question, we also implemented the new UnitedHealthcare Medicare Advantage Plan going to single Medicare. And in order to be able to prepare for this past open enrollment, we launched this effort. And it took across the span of about the July/August time frame to do the build. The analysis for this was done a little bit earlier than that. But I emphasize that, because the implementation of this piece of automation was a critical milestone as we entered into the open enrollment. And the flexibility and the stability of the my|CalPERS system enabled us to make these changes in a much faster and shorter time frame than we would have been able to do within our older legacy systems.

Another area that we are seeing some improvements and efficiencies on with functional optimization is centered around our workflow management. Workflow is a very critical tool to the organization. It helps to route and track our member and employer casework. And although, the original implementation of workflow with the my|CalPERS launch was serviceable at the time of implementation, our workload, our work processes, and the amount of increased volume that we're seeing in work load has changed over the last couple of years.

With the new workflow management, we're able to design a system that improves the efficiencies of our line staff and our managers, and we're also experiencing an improved performance in the ability of our staff to customzie their workflow and to ensure that we're getting the work done in a more efficient and quicker manner.

And again, in the past, this is work that would have required a number of technical resources in the information technology branch to assist. So there's been some transition and some capabilities within the program staff again -- that we're starting to be able to take on.

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DEPUTY EXECUTIVE OFFICER LUM: In looking ahead, we have several new and large initiatives that are going to be implemented. These initiatives focus on new requirements and also again on efficiencies to better provide services to our customers.

As you recall in September, the Board approved moving forward with the interest regulations. In anticipation that these regulations would be implemented in the early part of 2016, we began analyzing and building in and are prepared to implement the new functionality to include interest on benefit payments that were delayed.

Here again, I can't underestimate or underemphasize how critical it was that, based on this magnitude of change in our system, the flexibility that my|CalPERS has provides enables us to build this type of functionality much quicker and faster than we would have seen in the past.

We're also going to be implementing changes that are going to streamline our retirement compensation review. In retirement compensation new areas, we're scheduled to implement enhancements that will reduce the number of manual touchpoints between program areas and the need for manual calculations. Again, these types of changes will streamline the retirement process and it will also maintain current process levels despite any anticipated increases in retirements and downstream processes.

With regard to Medicare enrollment. In the Medicare area, we're planning to automate, what we call, the Medicare aged in-process for our members. So the way the process works today is we currently rely on members to let us -- to provide us with Medicare enrollment information. And once we receive that information, we key that information manually. And again, it's very dependent on members letting us know that they're making this change.

However, we do have experience in the past where we did not receive that information from our members, and subsequently canceled them, only to learn later that they had actually made the change and we were not aware of it.

So by taking advantage of the voluntary data sharing agreement, we'll be able to electronically receive Medicare enrollment information from the Centers of Medicare and Medicaid Services. And ultimately, that will population the my|CalPERS system, and it will reduce and, I believe, eliminate instances where members in the past may have been canceled. By not notifying us of this change, we will know of it through this automated process. This will ensure that members experience no lapse in their coverage and are able to continue to access their current physician and prescription drug coverage.

And then lastly, we are going to be implementing a change that will provide on-line health statements. This will provide our members the ability to access their annual health plan statement through our member self-service capabilities. As you know, we currently have this capability for our annual member statements. It is widely used by our membership. We are sending out less than 25 percent of all the annual member statements. And we anticipate that by implementing these health statements on-line, we'll see a similar utilization of the on-line services versus the paper services.

We anticipate that by implementing this we will save about a million dollars in the postage and printing costs that is normally associated with mailing and printing these statements. And again, it will enable us to ensure that we are targeting the right type of -- and timeliness of the health statements to be accessible by our members.

So hopefully, you can see and envision that some of these tangible benefits of the project are providing our staff greater capabilities. We do know that with some of the things that we've implemented we are seeing a greater level of member and employer satisfaction. That's evident with the number of surveys that we've been administering. And as we watch the trend, we continue to see that the levels of satisfaction are increasing

So, at this time, I'd like to turn it back to Liana, and she'll discuss how the knowledge transfer efforts are working, as well as our project, and the next steps.

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CHIEF INFORMATION OFFICER BAILEY-CRIMMINS: Thank you, Donna. So in addition to all the great accomplishments that Donna just covered, I do want to just touch a little bit about the knowledge transfer program here at CalPERS.

So our goal was that State staff have the opportunity to deliver their services and build their in-house skills. And as I mentioned earlier, we use blended teams. Extremely important this new approach that we have here at CalPERS, not only for the optimization project, but for all projects moving forward.

In addition, we do individualized training plans. No one person is the same. They come with unique skills and we need to have training plans that meet them where they're at. So what do we do? We do manager assessments, self-assessments, we do computer based training, vendor-led training, and we also have an opportunity for staff to teach classes as a part of a graduation exercise. There's nothing better than when you actually are teaching a class, you actually reinforce the things that you just learned.

And as a result, we have achieved 100 percent knowledge transfer from our system integrator, which also known as Accenture last September. And we are on track to complete the two-year my|CalPERS KT effort this coming June of 2016. Amazing accomplishment. And as a reminder, knowledge transfer is required in all of our current contracts, and we have also established a training library. Because of retention, we know that we need to have those resources available for people that come in today, so they still have those opportunities to get that valuable knowledge that's been shared with others as we go along on our journey on the project.

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CHIEF INFORMATION OFFICER BAILEY-CRIMMINS: And just as a recap, we remind ourselves that opportunities to increase innovation, solve new challenges, and address new regulations will continue to present themselves. These opportunities and our ability to address them for years to come requires continual investment.

Because we invest and build for our future, the project is continuing to deliver increased core services, functionality on behalf of our members, employers, and internal staff. And we at CalPERS focus on our greatest assets, our people, to ensure that they have the expertise to maintain and enhance the business technology solutions we support, and our opportunity to enable and deliver innovative solutions that support and sustain the Pension and Health Benefits and services our members count on.

Thank you, Mr. Chair. This concludes our presentation, and we'd be happy to answer any questions you may have.

CHAIRPERSON COSTIGAN: Controller Yee.

COMMITTEE MEMBER YEE: Thank you, Mr. Chairman.

I just wanted to compliment the staff, because this has been a long journey to get here, and -- but I have to say that I've been hearing from numerous employers about just how beneficial this has been to them. And it wasn't without some rocky starts in terms of your relationship with the employers, but also with respect to the PIER evaluation that was done. I just wanted to offer that it really is being considered as a model now for the legislature and other policymakers with respect to, you know, just how we approach projects like this.

It's probably the evaluation that's the most full and robust with respect to the project from beginning to this point to where we weren't afraid to articulate lessons learned. And I think that's just going to be so beneficial for so many other projects in State government. So just kudos to all of you.

Thank you.

CHAIRPERSON COSTIGAN: Mr. Jelincic.

COMMITTEE MEMBER JELINCIC: And I just want to commend you on the acknowledge transfer. Keep pushing it. Let's get all of them out of here. But I do want to acknowledge that we're making serious progress there. Thank you.

CHAIRPERSON COSTIGAN: All right. Thank you very much.

Ms. Eason, before we go to the next item, because we've come up on two hours and four minutes, how long do you think the next item go?

DEPUTY EXECUTIVE OFFICER LUM: Mr. Chair, I anticipate it will take a very quick two to three minutes. I have just a very quick update.

CHAIRPERSON COSTIGAN: Okay. We'll keep the court reporter here.

Thank you. Let's go on to the next item then.

Item 10a, Service Credit Installation Payment Resumption

DEPUTY EXECUTIVE OFFICER LUM: Thank you. Again, Donna Lum, CalPERS staff. So Agenda Item 10, it's an information item, and it's related to the resumption of installment payments for delinquent service credit accounts. We've identified that there are approximately 2,250 accounts that have become -- service credit accounts that have become delinquent due to a system error.

Just to give you some background, it does cover all of the 53 types of service credit purchases that we have. It does not only cover just the air time service. The impacted members are both active and retired and inactive members. And the impacted accounts also did cut across schools, public agencies, and the State.

The member's installation payments will resume, and the missed payments will be added to the end of the payment schedules. It's important to note that the members will pay for the original amount of principal and interest to what they originally agreed to when they made their election. There will be no additional interest added to these accounts.

We are sending customized letters to each of the individual affected members explaining the situation, and letting them know that the installment payments will resume. And we will be doing this in advance of any payments being automatically deducted.

We are taking steps. We do know what the issue is. We've isolated the problem. We've been able to identify what the changes are that need to be implemented to ensure that the stoppage of payments does not continue in the future.

We're working with our information technology staff to do the implementation. In the meantime, while that is being worked on, we do have processes in place that will assure us that any account that becomes delinquent for any reason, we will be notified timely and ensure that the payments do resume.

So this concludes my update, and I'm available to answer any questions that you may have.

CHAIRPERSON COSTIGAN: Mr. Jelincic.

COMMITTEE MEMBER JELINCIC: She had answered my question.

CHAIRPERSON COSTIGAN: Thank you, sir.

Mr. Gillihan.

COMMITTEE MEMBER GILLIHAN: Thank you, Mr. Chair. Just a couple questions.

So the -- you said we discovered what the issue was. Can you shed a little bit of light on it without going into too much detail on what the nature of the problem was?

DEPUTY EXECUTIVE OFFICER LUM: Yeah, two-fold. There were some change -- there were some system issues that apparently were in our legacy system that were not identified when we cut over to the my|CalPERS system, so some of these accounts were delinquent prior to my|CalPERS.

And then there were some changes that we implemented in and about the June of 2000 time frame that, if you want to call it, kind of stepped on a process that created the situation in which some of these accounts started to become delinquent.

But as I mentioned, we've identified the triggers or the criteria of those types of processing where the accounts can become delinquent. We've isolated those. We know what they are, so that we can correct it going forward.

COMMITTEE MEMBER GILLIHAN: Thank you. And regarding the $9 million that this cost us. I assume that's going to be spread across the relevant employers that these 2,700 people work for or how is the system going to recoup that or does it just become unfunded liability and that is spread across all employers? Just curious.

CHIEF ACTUARY MILLIGAN: The way this is going to show up is in lost investment income. And so it will automatically show up as an experienced loss on the investment side, and be built into rates through that pro -- through the rate actuarial process.

COMMITTEE MEMBER GILLIHAN: Allocated to the actual employer of these individuals or --

CHIEF ACTUARY MILLIGAN: Yes.

COMMITTEE MEMBER GILLIHAN: Okay. Thank you.

CHAIRPERSON COSTIGAN: Okay. Any other

questions?

Ms. Lum, thank you.

DEPUTY EXECUTIVE OFFICER LUM: Thank you.

CHAIRPERSON COSTIGAN: Ms. Eason, as always, a great Committee hearing today. So just a couple of announcements. Public comment, do we have any?

Okay. So Risk and Audit will meet at 10:25, in 15 minutes. We will then break for lunch after Risk and Audit. And then for those of you that are waiting for Pension, Benefits, and Health Committee, it will convene at around 1:45. Although, I might encourage you to get back a little bit sooner.

We still have four Committee hearings for the rest of the day. So thank you very much. With that, this meeting is adjourned.

(Thereupon the California Public Employees' Retirement System, Board of Administration, Finance & Administration Committee meeting adjourned at 10:09 a.m.)

C E R T I F I C A T E O F R E P O R T E R

I, JAMES F. PETERS, a Certified Shorthand Reporter of the State of California, do hereby certify:

That I am a disinterested person herein; that the foregoing California Public Employees' Retirement System, Board of Administration, Finance & Administration Committee meeting was reported in shorthand by me, James F. Peters, a Certified Shorthand Reporter of the State of California;

That the said proceedings was taken before me, in shorthand writing, and was thereafter transcribed, under my direction, by computer-assisted transcription.

I further certify that I am not of counsel or attorney for any of the parties to said meeting nor in any way interested in the outcome of said meeting.

IN WITNESS WHEREOF, I have hereunto set my hand this 21st day of November, 2015.

JAMES F. PETERS, CSR
Certified Shorthand Reporter
License No. 10063