CalPERS

Finance and Administration Committee

Agenda Item 8c

September 20, 2016

Item Name: Annual Review of Funding Levels and Risk Report

Program: Actuarial

Item Type: Information

Executive Summary

As a result of the performance of the capital markets in the 2015-16 Fiscal Year, the funded status of the system has fallen to about 68%. The decline in funded status has generally aggravated the risk that plans will fall to low funding levels but this has been offset to some extent by the adoption of the Funding Risk Mitigation Policy.

The Funding Risk Mitigation Policy has been in place for a single year and no risk mitigation event was triggered in the 2015-16 Fiscal Year. The fact that a risk mitigation event was not triggered in the year should not cause concern about the effectiveness of the policy. An event is only triggered when the actual investment return exceeds the discount rate by at least 4 percentage points.

Maturation of plans and financial stress on some employers remains of concern. Termination policies should mitigate risk to the system but the members employed by those employers under stress are at risk if the employer fails to stand behind its promise of retirement benefits to its employees.

Recent economic conditions have seen continuing declines in long term government bond interest rates that serve as the foundation of capital market returns. This has increased the risk of achieving the current 7.5% expected rate of return, at least over the medium term. It is increasingly clear that some change to the expected rate of return is going to need to be considered by CalPERS.

Overall, this report shows that risks remain high. In the absence of explicit risk targets and tolerances, it is not clear whether the risk mitigations in place currently have brought risks to the levels that the Board considers acceptable. The Board may wish to take additional actions to address the level of funding risk.

Strategic Plan

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

Background
In order to assist the Finance and Administration Committee with its oversight of the financial soundness of the overall CalPERS system, the Annual Review of Funding Levels and Risks was developed. Earlier reviews showed that the way the System was being funded, including both the funding policies and the actuarial assumptions and methods, when combined with changes in the external environment entailed significant risks.

Responding to this increased awareness of risk, in November of 2015, the Board adopted the Funding Risk Mitigation Policy. This policy is currently in place and expected to result in a lowering of investment volatility over time. The goal of the policy is to reduce the risk to members' benefits that could result from investment volatility impacting funded status and required contribution rates. Although the policy has not yet triggered any changes to CalPERS asset allocation, some effect of having the policy in place can be seen in this report.

CalPERS must ensure that the pension fund is sustainable over multiple generations. This is done by taking an integrated view of assets and liabilities and taking steps designed to mitigate risks over the long-term. The CalPERS asset allocation and actuarial assumptions are continually monitored and reviewed every four years in what is known as the Asset Liability Management (ALM) cycle. The Annual Review of Funding Levels and Risks report tracks the progress through this four year cycle and highlights relevant risks in conjunction with emerging experience. The next 18 months represents the culmination of the ALM cycle where the issue of the appropriate asset allocation and expected return will be addressed by the Board.

Analysis

- **Funded Status**

  As of June 30, 2015, the system was about 73 percent funded. As a result of the 0.6 percent investment return in 2015-16, staff estimates the funded status to be about 68 percent on June 30, 2016.

  The funded status on a hypothetical termination basis as of June 30, 2015 was, for most plans, in the 30 percent to 50 percent range. This is expected to decline mainly as a result of the less than expected investment return in 2015-16.

- ***Risk Measures***

  The various risk measures show that considerable risk remains. Anecdotal evidence indicates that at least some employers are under significant strain already and we are anticipating an increase in employer contributions. These high contribution levels mean that it is very difficult to lower the overall risk in the funding of the system.

- ***Changing Pension Environment***

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

Concerns about the near-term investment horizon have increased. This is evidenced by a continuing trend towards lower expected returns and discount rates amongst other public pension systems. It is increasingly clear that some change in our expected rate of return should be considered. As part of the ALM cycle, the asset allocation, capital market assumptions and discount rate will be reviewed over the next 18 months. Should this review result in a lowering of the rate of return assumption, it will indicate that the risks levels are actually **higher** than we are showing in this report.

- ***Risk Mitigation***

  The Funding Risk Mitigation Policy has been in place for a single year. The actual investment return in the 2015-16 Fiscal Year was not sufficient to trigger a risk mitigation event, but the implementation of the policy is having a beneficial effect on current risk measures. The probability of the funded ratio falling below 40% has improved from a year ago despite the fact that the funded ratio itself has declined.

Budget and Fiscal Impacts
There are no budget and fiscal impacts associated with this information item.

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

Attachments
Attachment 1 – 2016 Funding Levels and Risks Report

____
ALAN MILLIGAN
Chief Actuary

____
CHERYL EASON
Chief Financial Officer

____
TED ELIOPOULOS
Chief Investment Officer