



## Finance & Administration Committee

California Public Employees' Retirement System

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### Agenda Item 5a

May 20, 2014

**ITEM NAME:** Changes to Pension Risk Pools as a Result of Pension Reform

**PROGRAM:** Actuarial Office

**ITEM TYPE:** Action

#### RECOMMENDATION

Staff recommends that the Board adopt changes to the risk pooling structure by adopting the following:

- Changes to Board resolution ACT-96-05E regarding amortization and smoothing policies
- Changes to Board resolution ACT-99-03 regarding employer contributions in excess of actuarially determined rate
- Changes to Board resolution 03-03-AESD regarding the list of available risk pools
- Changes to Board resolution 04-02-AESD regarding the phasing-out of normal cost for employers joining the risk pooling structure
- Changes to Board resolution 05-02-AESD regarding smoothing of employer rate and the minimum employer contribution rate for plans with a surplus
- Create new Board resolution ACT-14-01 regarding the allocation of pool's unfunded accrued liability

#### EXECUTIVE SUMMARY

Last month, staff brought an item to this Committee identifying some unintended consequences resulting from the interaction of the Public Employees' Pension Reform Act of 2013 (PEPRA) and existing Board policies on risk pools. Changes necessary to ensure the proper funding of these pools were identified in this agenda item. At that time, the Board was asked to delay by one month a vote to change the risk pooling structure to allow for additional stakeholder outreach.

The stakeholder outreach has shown that there is general support for the approach recommended by staff. It has also identified one area of possible concern as described in the section on outreach.

Staff is therefore recommending the *same changes* that were recommended last month. The following summarizes the key recommended changes:

1. Combine all active and inactive risk pools into two risk pools, one for all miscellaneous plans and one for all safety plans.
2. Allocate the pool's unfunded accrued liability proportionately to each individual plan based on each plan's total liability instead of plan payroll.

3. Collect employer contributions toward the unfunded accrued liability and Side Fund for plans participating in a risk pool as dollar amounts instead of contribution rates expressed as a percentage of payroll.
4. Change the way existing employers will see their rate phased into the pool's rate when first joining a risk pool.
5. Clarify how additional contributions sent by employers to pay down an unfunded accrued liability will be applied and toward which portion of their unfunded accrued liability these additional contributions will first be used.

The proposed changes preserve the essential pooling of risks needed to prevent demographic events from causing significant rate shocks for small plans. Although the proposed changes will not change the amount of contribution needed to properly fund the risk pools, the proposed changes in the cost allocation methods will result in some employers having to contribute more and some employers having to contribute less. Additional information is provided later in the agenda item and the attachments.

### **STRATEGIC PLAN**

This agenda item is not part of our strategic plan but rather is a response to changes in the external environment that staff is responding to as part of the ongoing workload of the Actuarial Office.

### **BACKGROUND**

Risk Pooling was implemented effective with the June 30, 2003 actuarial valuations to protect small employers (those with less than 100 active members) against large fluctuations in employer contribution rates caused by unexpected demographic events.

In June 2012, staff delivered a review report on risk pooling including all Board actuarial policies related to risk pooling, risk pooling practices, internal procedures, laws and regulations to assess what has worked and what can be improved. The review demonstrated that the key objective of risk pooling had been realized, i.e. risk pooling has protected small employers against large changes in employer contribution rates due to unexpected demographic events. In the report, it was noted that the pension reform proposals under consideration at the time could effectively close all existing risk pools and have a significant impact on the risk pools at CalPERS.

Pension reform legislation was enacted in 2012 through the passage of PEPR. PEPR effectively closed the existing pools at that time. Since the effective date of the legislation was after the effective date of the June 30, 2012 actuarial valuations, staff did not make any changes to those valuations. In November 2012, the Board approved adding two new risk pools due to the formulas created by PEPR to be able to implement PEPR on January 1, 2013.

It is now necessary to consider the appropriate treatment of the effective closure of the risk pools for the "Classic" formulas – those in existence prior to the passage of PEPRRA.

## **ANALYSIS**

In an open pension plan, a fundamental underlying assumption is there will be an ongoing influx of new employees to replace those employees that exit due to retirement, disability, turnover or death.

PEPRRA has closed all existing active risk pools to new public employees hired on and after January 1, 2013 except for classic members. When a pension plan becomes closed to new entrants, attrition will begin; reducing the number of active employees toward ultimately having a pension plan with no active employees.

Several issues have arisen as a result of PEPRRA for the risk pooling structure. These issues were discussed in detail in an agenda item to this Committee last December. These issues can be categorized as funding, equity and employer contribution rate volatility issues.

### **Funding issue**

Contributions for pools are collected as a contribution rate expressed as a percentage of payroll. When setting the contribution rates, the Actuarial Office uses the payroll information from the data in the actuarial valuation. The payroll information is three years prior to the fiscal year when the contribution rate will apply. As a result, the payroll is projected forward for three years under the assumption it will grow by 3% per year, the current Board approved payroll growth assumption.

With the closing of the pools to new PEPRRA hires in the near term, covered payroll is most likely going to increase at a rate lower than 3% or even decline. When a pool experiences smaller payroll growth than assumed, it can lead to an underfunding of the plan. Changes must be made to the current pooling structure to avoid this potential underfunding.

### **Equity issue**

Under the current risk pooling structure, the existing unfunded accrued liability and future gains and losses are currently allocated to plans in each risk pool based on the payroll of the plan. This structure works well to the extent the payroll of each plan is expected to grow at about the same rate. With the closing of the pools to new hires, the payroll of plans will decline over time. Since every employer participating in risk pooling has different demographic characteristics, their active members will retire or exit the plan at different times leading to some plans experiencing a faster decline in payroll than others.

Since gains and losses of the entire pool are currently allocated based on payroll, plans with larger payroll will be asked to contribute more toward the pool's unfunded

accrued liability than plans with smaller payroll. As the number of active members decline in the pool, the payments toward the unfunded liability will disproportionately be shifted to those plans having the largest number of remaining active members resulting in an inequitable allocation of costs. To address this equity issue, changes are needed on how costs are allocated within each risk pool.

### **Employer Contribution Rate Volatility issue**

When PEPRA was enacted, it closed all classic active pools to new PEPRA hires. The unfunded accrued liability for the classic pools remained unchanged. Under current Board policies, payments to the amortization of the unfunded accrued liabilities and side funds are expressed as a percentage of payroll. If the unfunded accrued liability decreases over time as employers pay down the unfunded accrued liability, employer contribution rate volatility will eventually increase to an alarming level. This is going to be difficult for employers to budget and could lead to severe hardship for some employers.

### **Possible Solutions**

At the April 2014 Board meeting, staff presented to the CalPERS Board two alternatives for the future of risk pooling to address these issues without sacrificing the considerable benefit to contribution rate stability for smaller employers that risk pooling provides. The two alternatives are described in more details below.

#### ***Alternative 1***

Alternative 1 includes keeping the current pooling structure of 9 closed active pools, 1 inactive pool and 2 open active PEPRA pools and modifying current funding and amortization methods to address the funding and equity issues with the least amount of change to our current pooling structure. Even though the payroll of employer is still open and can be expected to grow over time, the same is not true of the groups covered under the classic formula.

The changes proposed under alternative 1 will result in almost all pooled employers having to contribute more in the near term. We expect that about 90% of the Miscellaneous plans in the classic risk pools will experience employer rate increases between 0-3% of payroll and about 75% of the Safety plans will experience increases of 2-5% of payroll. In addition to the contribution increases, a change of the allocation of the pool's unfunded accrued liability will further increase or decrease individual employer contribution rates. Attachment 1 shows a distribution of the estimated impact of changes to risk pooling on employer rates for alternatives 1 and 2.

Under this alternative, we will need to monitor the funding of each risk pool carefully. It is possible that we may have to modify our funding approach to reflect the demographics of the closed groups which would further increase contributions.

Alternative 1 is not the preferred approach. More details on Alternative 1 can be found in agenda item 7b to this Committee last December.

***Alternative 2***

Staff reviewed another alternative which is combining all pools into two pools, one for all miscellaneous groups and one for all safety groups. This is the approach that staff is recommending and requires structural changes. By combining all pooled plans into two risk pools, the payroll of the risk pools and employers within the pools can be expected to increase at the assumed 3% annual growth, addressing some of the issues that resulted from having a declining active population in the pool. Therefore, we will be able to keep our current level percentage of pay amortization schedule to avoid the necessity of immediate increases to employer contributions.

In addition to combining all existing risk pools into two risk pools, staff is recommending that we start collecting employer contributions toward unfunded accrued liability and side fund as dollar amounts instead of contribution rates. Implementing this change will address the funding issue that would arise from the declining population under the classic formula. This will result in a major change in how contributions are collected from employers. Anecdotally, employers seem to be supportive of this approach. Several employers have approached CalPERS over the last several months proposing that we no longer collect contributions for the unfunded accrued liability as a percentage of payroll but rather invoice them for the amount needed each year to pay down the unfunded accrued liability. The normal cost contribution would continue to be expressed as a percentage of payroll.

Staff is also recommending changes to the method to allocate cost to plans in risk pools. Staff's recommendation is to allocate the pool's unfunded accrued liability to each individual plan within the pool based on the plan's total liability instead of based on the plan's payroll. This is a change for which many pooled employers have been requesting. Additionally, many pooled employers have been asking for the ability to pay down their share of the pool's unfunded accrued liability. This is not possible unless we allocate the unfunded accrued liability of the pool to each employer on an annual basis. Making this change will address the equity issue and allow employers to pay down their share of the pool's unfunded accrued liability. Although the recommended changes to the cost allocation method will not change the amount of contribution needed to properly fund the risk pools, the changes in the cost allocation methods will result in some employers having to contribute more and some employers having to contribute less. An analysis performed by staff showed that almost half of the plans will see a change – positive or negative of less than 1% of payroll. About 80% of employers will experience changes between -3% to +3% of payroll. However, there are a few plans with large retiree to active ratios that will experience increases in excess of 3% of payroll.

Attachment 1 shows a distribution of the estimated impact of changes to risk pooling on employer rates for alternatives 1 and 2. This comparison shows that under

alternative 2 most employers will see a smaller rate increase than under alternative 1. Attachment 2 shows a distribution of the difference in employer contributions rates between alternative 1 and alternative 2. Most employers will see a smaller increase in contribution rate under alternative 2 compared to alternative 1.

The solution for alternative 2 will require a significant effort to program and design the required database changes to our existing system. If adopted by the Board, these changes will be reflected in the June 30, 2013 actuarial valuations that will be performed later this summer and will be used to set the employer contribution rates for fiscal year 2015-16.

To implement these changes, modifications are necessary to five existing Board policies as is the creation of one new policy. The policies being modified or created are the following:

- Board resolution ACT-96-05E: modified to ensure amortization and smoothing policies properly reflect the proposed changes. See Attachment 3 for a copy of the final recommended version of the Board resolution. The proposed changes highlighted in the redline version was provided in the April agenda item.
- Board resolution ACT-99-03: modified to reflect employers with pooled plans will be asked to contribute both a rate and a dollar amount to fund their plans. See Attachment 4 for a copy of the final recommended version of the Board resolution. The proposed changes highlighted in the redline version was provided in the April agenda item.
- Board resolution 03-03-AESD: modified to combine existing pools and reflect that only two risk pools will be administered going forward for employers that contract with CalPERS. See Attachment 5 for a copy of the final recommended version of the Board resolution. The proposed changes highlighted in the redline version was provided in the April agenda item.
- Board resolution 04-02-AESD: modified to properly reflect that normal cost of plans will need to be taken into account when phasing in an existing plan joining a risk pool for the first time. See Attachment 6 for a copy of the final recommended version of the Board resolution. The proposed changes highlighted in the redline version was provided in the April agenda item.
- Board resolution 05-02-AESD: minor changes to ensure consistency with the proposed changes. See Attachment 7 for a copy of the final recommended version of the Board resolution. The proposed changes highlighted in the redline version was provided in the April agenda item.
- Board resolution ACT-14-01: new policy being created to establish the process used to allocate the pool's unfunded accrued liability to each plan on an annual basis. See Attachment 8 for a copy of the proposed new Board resolution.

## **Outreach**

As reported to the Board last month, staff requested delaying Board action on this item in order to provide additional outreach to our public agency employers so they could fully understand the impact on their agencies. Staff made available an analysis of the estimated impact of the proposed changes to risk pools on each employer's contributions under the two alternative solutions. In addition CalPERS staff has participated in meetings with various employer organizations to provide information and answer questions. Furthermore, the Actuarial Office delivered a webinar hosted by the League of Cities on Wednesday April 30, 2014 that was made available to all pooled employers affected by the proposal. Over 250 employers signed in to listen to the webinar.

In addition to the webinar, the various employer organizations have reached out to their membership to survey them on the two alternatives being considered to address the issues identified in this agenda item. At the time of writing this agenda item, staff had not yet received a formal letter summarizing the results of the survey but based on discussions staff had with representatives of the League of Cities, the vast majority of the employers that responded to the survey were in favor of Alternative 2. Staff will provide additional detail at the Committee meeting if available. It has been brought to our attention that a small group of employer had concern over the proposal to start billing the payment required to pay down an unfunded liability as a dollar amount rather than as a percentage of payroll. The concern seems to be over the fact that in some instances, specific MOU language refers to the CalPERS contribution rate and there was a concern of the impact on these MOUs of setting a lower rate combined with a dollar amount for the unfunded portion of the rate. We have been in communications with employers on this subject and staff intends to continue provide in the valuation report for information purposes what the contribution rate would have been had we set a rate for the unfunded liability component of the contribution. Charging a specific dollar amount to pay down the unfunded liability is a change that is necessary to preserve equity and ensure fairness among the employers participating in risk pools. Continuing to bill as a contribution rate to pay down the unfunded liability would result in a shifting of cost anytime an employer's payroll does not increase at a rate of exactly 3% per year. Staff is working with the stakeholders to determine how much of an issue this will be and will provide additional information at the Committee meeting. Staff is working with the stakeholders to determine how much of an issue this will be and will provide additional information at the Committee meeting.

## **BUDGET AND FISCAL IMPACTS**

This item was not anticipated in the strategic or business plan and has not been built into the budget. Given the time constraint to implement the changes outlined in this agenda item, it is anticipated that any work associated with the issues described herein will have to be completed with existing staff and absorbed within current

budgets although this may be revisited in a future agenda item. Unless action is taken, contributions from employers will have to be accelerated and impose additional strain on employers' budgets.

## **BENEFITS/RISKS**

As stated earlier, several issues have arisen as a result of PEPR for the risk pooling structure. These issues can be categorized as funding, equity and employer contribution rate volatility issues.

Staff is recommending changes to address some of these issues. If the Board were to not adopt changes to the risk pooling changes, the issues identified in this agenda item would remain in place and could have a drastic impact in a few years.

Staff presented two alternatives to address some of these risks. Alternative 1 has the benefit of being the easiest one to implement from a perspective of system and program changes needed. However, it still does not eliminate all of the issues identified. The risk in implementing alternative 1 is that first it would result in all pooled employers having to pay more at a time when budgets are already strained. In addition, is not likely to fully eliminate the funding, equity and employer contribution rate volatility issues we are facing. This alternative may necessitate future changes to our funding approach to reflect the demographics of the closed classic groups which would further increase employer contributions. As stated earlier, this is not the preferred alternative.

Alternative 2 is the solution recommended by staff to address the issues listed above. Alternative 2 preserves the essential pooling of risks needed to prevent demographic events from causing significant rate shocks for small plans. This alternative is more complicated to implement and will require significant changes to systems, policies and procedures. Under this alternative, there is no overall increase in employer contributions although some employers will have higher contributions and some lower. The risk of not implementing this approach would be that the funding, equity and employer contribution rate volatility issues would remain in place and would require some action in the future. The risk in implementing this change is some employers will see increases in contributions at a time when budgets are already strained.

Another option that was not considered as viable was the elimination of risk pools at CalPERS and returning each plan to a stand-alone basis. This path would reintroduce the risk of large increases in contribution rates caused by demographic events for small plans that was eliminated with the creation of risk pools. Dismantling risk pools would re-introduce risks that have been eliminated by their creation and would impact contribution rates in a similar fashion to how Alternative 2 is expected to impact rates.



**ATTACHMENTS**

- Attachment 1 – Estimated Impact of Changes to Risk Pooling on Employer Contributions: Comparison of Alternative 1 to Alternative 2
- Attachment 2 – Estimated Impact of Changes to Risk Pooling on Employer Contributions: Difference in Rate Between Alternative 1 and Alternative 2
- Attachment 3 – Board Resolution ACT-96-05E - Final Recommendation
- Attachment 4 – Board Resolution ACT-99-03 - Final Recommendation
- Attachment 5 – Board Resolution 03-03-AESD - Final Recommendation
- Attachment 6 – Board Resolution 04-02-AESD - Final Recommendation
- Attachment 7 – Board Resolution 05-02-AESD - Final Recommendation
- Attachment 8 – Board Resolution ACT-14-01 - Final Recommendation

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