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August 17, 2010

AGENDA ITEM 3B

TO: MEMBERS OF THE BENEFITS AND PROGRAM ADMINISTRATION COMMITTEE

I. SUBJECT: Actuarial Valuation Policy on Recognition of Plan Design Changes

II. PROGRAM: Retirement

III. RECOMMENDATION:

That the Board approve the adoption of a policy that authorizes changes in retirement benefits and member contribution rates to be reflected in the employer contribution rates for the State plans immediately upon the effective date of the changes or as soon thereafter as can be accomplished given the Board's meeting schedule.

IV. ANALYSIS:

For years, CalPERS' practice for the State plans has been to recognize benefit changes in the first actuarial valuation following the effective date of the benefit changes. This practice is allowed under the federal rules that apply to non-public retirement plans and it is common practice in the private sector.

As you are aware, there are several tentative agreements between labor representatives and the State ("labor agreements"). These labor agreements include lower retirement benefits for new hires and higher member contribution rates for all existing members and new hires. At the time this agenda item is being drafted, the labor agreements are still subject to ratification and adoption by the Legislature.

If CalPERS' current practice of reflecting benefit or member contribution changes for the State Plans in the first actuarial valuation following the effective date of the changes were to remain in place, the State would not realize savings from the pension changes included in the labor agreements, assuming they are ratified and adopted, until the 2012-2013 fiscal year.

In this agenda item, we consider implementing a policy change so that changes to the benefits or member contributions for the State plans are reflected in employer contribution rates on the effective date of the change or as soon thereafter as possible. In the event there are changes in benefits or member contribution rates this fiscal year, the Board would be asked to approve new 2010-2011 rates for the State plans during the course of the fiscal year to modify those that were approved by the Board in June.

In considering the proposed policy change, several issues should be considered:

- What is best practice?
- Is a change consistent with the Board's legal and fiduciary responsibilities?
- Is the proposed practice consistent with similar practice in other areas?
- What will be the impact of the change?
- What are the practical considerations?

This agenda item is not recommending and should not be interpreted as CalPERS taking a position as to actions that have been or should be taken in collective bargaining or by the legislature.

We address each of these issues below.

What is Best Practice?

Best practice would be to recognize all changes in plan provisions as soon as practical. By doing so, plan funding responds promptly to changes in benefits and member contribution levels. This helps to ensure that new benefits are funded promptly and reduces the incentive to game the system in various ways[1].

Is a Change Consistent with the Board's Legal and Fiduciary Responsibilities?

Staff and internal and external legal counsel have reviewed the tax and fiduciary duty implications of this policy change. A brief memorandum will be provided to the Board under separate cover.

Is the proposed practice consistent with similar practice in other areas?

For local agencies that initiate plan changes (voluntary changes that the employer can plan for) by amending their contract with CalPERS we reflect those changes in their contribution rate immediately upon the effective date of the contract amendment. However, for changes due to legislative action (involuntary

[1] For example, under our current practice, if the State were to pass legislation that would reduce the member contribution rate for a one year period only, the lower contributions would not result in an immediate change to the employer contribution but rather in an actuarial loss which would be paid in future years. This would effectively allow the State to increase members' take-home pay in one year and not impact the budget for that year but it would be doing this at the expense of the appropriate funding of the system.

changes that the employer may not have been able to plan for) we reflect the impact on the local agency's rate in the first annual valuation coincident with or next following the effective date of the legislative change.

Our current practice for the State is consistent with what we do for local agencies in that all changes for the State require legislative change. However, it is not clear that changes that are negotiated should really be viewed the same way as other legislative changes. These changes are functionally more similar to the changes that local agencies make by amending their contract – they are deliberate acts of the employer to change plan terms rather than external changes that are being imposed on them.

Current practice for the Schools Pool is the same as the current practice for the State Plans – reflect changes due to legislative action in the School Pool's rate in the first annual valuation coincident with or next following the effective date of the legislative change. We believe that almost all changes to the benefits provided by, or member contributions to, the Schools Pool are involuntary and hence this treatment is appropriate.

What Will Be the Impact of the Change?

The combined impact of adopting this policy change with the proposed increases in member contributions would not have any impact on the CalPERS fund nor will it impact the funded status of the State plans. We would still expect to collect the same total amount of member and employer contributions in fiscal year 2010-2011.

CalPERS actuarial staff has performed an analysis of the potential savings from a permanent increase in member contribution of 5% for all members. If all members were required to contribute an additional 5% to CalPERS for retirement benefits effective July 1, 2010, potential savings to the State General Fund in fiscal year 2010-2011 could be in the $400 to $500 million range.

In future years, the proposed policy change will result in fewer instances where changes to benefits or to member contribution rates result in gains and losses. Currently these gains and losses occur due to the delay in changing employer contribution rates.

What are the Practical Considerations?

The policy would require Board action to modify the employer contribution rate each time that benefits or member contributions are changed for the State plans. Because the State pays employer contributions on a quarterly basis (in arrears), the modifications made during the fiscal year would be implemented prospectively by changing employer contribution rate for the remaining quarterly contribution payments for the fiscal year commencing with the quarterly payment for the first quarter following the Board's action to change the rate. For example, if the member contribution modifications were approved by the Legislature and the Governor in time for the Board to take action at its September meeting, then the Board would be asked to modify the employer contribution rate for the three quarters commencing with the second quarter. A delay until the October meeting would mean that the rate change would not take effect until the third quarter of the fiscal year. Changes in the employer contribution rate would not be brought to the Board until the new plan terms have actually been enacted into law.

The proposed policy will result in changes in the contribution rate for the State employer in the middle of a fiscal year. We have contacted the State Controller's Office to confirm that it would be able to change the contribution rate in mid-year and it has confirmed that it will be able to implement such a change.

The Department of Finance and the Legislative Analysts Office have been working on legislation that would facilitate changing the State's contribution rate should the pension changes included in the labor agreements be ratified and adopted. It is not clear that these legislative changes are needed. Staff have been involved in an attempt to ensure that any legislative change explicitly recognizes the Board's constitutional authority to set the employer contribution rate.

Recommendation

Staff recommends the Board adopt a policy to reflect changes to retirement benefits and member contribution rates in the employer contribution rates for the State plans immediately upon adoption of the changes or as soon thereafter as can be accomplished given the Board's meeting schedule.

This would be a permanent policy change that would apply to all future benefit changes and any further changes in member contributions, whether increases or reductions.

V. STRATEGIC PLAN:

This item is not a specific product of the Strategic or Annual Plans but is part of the regular and ongoing workload of the Actuarial & Employer Services Branch.

VI. RESULTS/COSTS:

See Above.

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