CalPERS

Finance and Administration Committee
Agenda Item 9a

February 14, 2017

Item Name: Funding Risk Mitigation Policy

Program: ASSET LIABILITY MANAGEMENT

Item Type: Action

Recommendation
Staff recommends the California Public Employees' Retirement System ("CalPERS" or the "System") Board adopt the revised Funding Risk Mitigation Policy ("Policy"), which has been updated per the Board's instructions at the December 2016 meetings of the Finance and Administration Committee ("FAC") and of the Board.

Per the Board's additional instructions, staff recommends that the Board suspend the implementation of the Policy until Fiscal Year 2020-21 because of the Board's decision at the December 2016 meeting to lower the Discount Rate pursuant to a phase-in schedule through Fiscal Year 2019-20.

Executive Summary
The Board's action to lower the Discount Rate has implications for the Policy, which prescribes how the Discount Rate is to be lowered if the Public Employees Retirement Fund ("PERF") achieves an investment return in a fiscal year that exceeds the Discount Rate. As a result of its deliberations, the Board directed staff to revise the Policy by lowering the first threshold for the percentage by which the actual investment return exceeds the discount rate in any fiscal year in order to trigger a discount rate reduction from 4% to 2%, as depicted in the table below:

Table 1: Funding Risk Mitigation Event Thresholds and Impacts

Excess Investment Return	**Reduction in Discount Rate**	**Reduction in Expected Investment Return**
If the actual investment returns exceed the discount rate by:	*Then the discount rate will be reduced by:*	*And the expected investment return will be reduced by:*
2.00%	0.05%	0.05%
7.00%	0.10%	0.10%
10.00%	0.15%	0.15%
13.00%	0.20%	0.20%
17.00%	0.25%	0.25%

All other excess return thresholds and rate reductions remain the same as in the current Policy.

The Board also directed staff to revise the Policy to state that member calculations, including optional factors and service credit purchases, shall reflect the reduced Discount Rate effective immediately upon the occurrence of a Funding Risk Mitigation Event rather than on October 1 of the Fiscal Year following the Funding Risk Mitigation Event Year.

With respect to revising the Policy, CalPERS has implemented a new standard policy format, and the Policy has been updated to comply with this format.

Finally, at its December 2016 meeting the FAC discussed introducing a motion to the Board to suspend the implementation of the Policy until Fiscal Year 2020-21 because of the Board's decision to lower the Discount Rate pursuant to a phase-in schedule through Fiscal Year 2019-20.

Strategic Plan

This agenda item supports the following strategic plan goals:

- Goal A – Improve long-term pension … sustainability by funding the System through an integrated view of pension assets and liabilities and actively assessing and managing funding risk through an asset liability management framework to guide investment strategy and actuarial policy.
- Goal B – Cultivate a high-performing, risk-intelligent and innovative organization.

Background

In February 2015, a workshop was conducted by staff for the Board to provide an overview of the risks faced in the funding of the System and how these risks are changing, and introduced several concepts that could be applied to mitigate these risks. During the discussion that took place at the workshop, the Board expressed a desire to further explore two possible risk mitigation strategies. In a May 2015 workshop, staff provided detailed information on the two risk mitigation strategies.

In August 2015, additional information was presented by staff related to the two risk mitigation strategies under consideration by the Board, including an update on the outreach and engagement activities conducted to ensure feedback from stakeholders.

During the October 2015 FAC meeting, staff presented the draft policy for the 1st reading. Based on feedback from the Board, staff was directed to develop a second policy with an update of the first threshold level that would trigger a risk mitigation event from 4% to 2%. Both policies were then presented for a 2nd reading during the November 2015 FAC meeting for review and approval of one policy. The FAC adopted the Policy with the initial threshold of 4%.

At the December 2016 meetings of the FAC and the full Board, the Board directed staff to amend the Policy to lower the initial threshold to 2% and to make the other changes as outlined above.

Analysis

Staff presented the following analysis of the difference between using a 2% initial threshold versus 4% when the current policy was adopted November 2015. Using the 2% threshold:

- The pace of risk mitigation would increase slightly. The probability of reaching an 8% level of volatility (6.5% discount rate) in 30 years using 4% as the initial threshold is

91%. With a 2% initial threshold it would be 96%, and the average time to reach an 8% level of volatility would be 19 years instead of 21 years.

- In the original proposed policy, assuming a drop in volatility levels to 8%, PEPRA miscellaneous members would see their contributions rise by approximately 1.5% (3% for safety) over a 30-year period. These levels would not change under the 2% threshold, but members could expect to see the increases sooner depending on the pace of risk mitigation.
- With a 2% initial threshold, employers would see modest increases in rates as compared to the 4% proposal, but those are expected to be less than 0.3% for miscellaneous and 0.5% for safety in any given year during risk mitigation.
- The only time the 2% initial threshold would produce a difference in a risk mitigation event would be when there is an investment return between 2-4% above the discount rate at that time. Based on modeling, this happens about 6.6% of the time, or about once every 15 years.

Budget and Fiscal Impacts

There are no budget or fiscal impacts at this time.

Benefits and Risks

As stewards of the System, CalPERS must ensure that the pension fund is sustainable over multiple generations by taking steps to mitigate risks over the long-term through an integrated view of assets and liabilities. Benefits of a risk mitigation strategy include:

- Strengthens the long-term sustainability of the fund and security of future benefit payments
- Protects the fund from volatility of short-term investment returns or changing demographics that could reduce CalPERS long term funded status
- Reduces the level of future risk in the investment portfolio
- Reduces the volatility in contribution rates for employers

Risks associated with a risk mitigation strategy include:

- Increases financial stress on employers as a result of increased contributions when the discount rate is reduced

Attachments

Attachment 1 – Current Funding Risk Mitigation Policy

Attachment 2 – Proposed Revised Funding Risk Mitigation Policy with Key Changes Highlighted

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