Finance and Administration Committee

Agenda Item 7a

April 18, 2017

Item Name: Asset Liability Management Policy (Second Reading)

Program: Asset Liability Management

Item Type: Action

Recommendation

The Financial Office ("FINO") recommends the California Public Employees' Retirement System ("CalPERS" or the "System") Board adopt the Asset Liability Management ("ALM") Policy ("Policy"), which was presented for first reading at the February 2017 meeting of the Finance and Administration Committee ("FAC").

Executive Summary

ALM is the balancing of investment assets and contributions to appropriately match the level of benefits that have been promised to employees by employers who contract with CalPERS for pension benefits. An effective ALM Program ("ALMP") is important to ensuring that contributions, plus investment returns, are sufficient to pay the benefits and expenses of the System.

This Agenda Item puts forth the proposed Statement of Policy for Asset Liability Management ("Policy") to be reviewed by the FAC for approval. Many policies approved by the Board address elements of ALM (see list of ALM-related policies in the Related Documents section of the proposed ALM Policy, Attachment 1). This Policy addresses how the various ALM activities covered by the ALM-related policies are to be coordinated and managed in concert with each other.

The Policy has been updated from what was presented to the FAC in February to incorporate:

1. updated language from the 2017-2022 Strategic Plan, which the FAC approved at its February meeting, and
2. reference to the Actuarial Contribution Allocation Policy, which was approved at the February FAC meeting.

Strategic Plan

This agenda item supports the following strategic plan goals:

- Strengthen the Long-Term Sustainability of the Pension Fund
    - Fund the System through an integrated view of pension assets and liabilities
- Cultivate a Risk-Intelligent Organization

Background

Per the CalPERS Actuarial Assumptions Policy, the actuarial office ("ACTO") is to conduct an investigation of actuarial assumptions every four years and report its results to the Board. Such investigation shall include significant demographic factors, such as mortality and retirement rates, as well as significant economic factors, such as future wage and price inflation, applicable to CalPERS members and persons receiving benefits. Per the CalPERS Total Fund Investment Policy, the investment office ("INVO") is to provide a comprehensive strategic asset allocation analysis coincident with the review of actuarial methods and assumptions for review and approval by the Board of policy target asset class allocations and ranges. These combined actuarial and asset allocation activities may be referred to as the Four-Year ALM Cycle ("ALM Cycle"). The last such ALM Cycle took place with a Board ALM Workshop in November 2013, followed by a review with the Committee of the CalPERS actuarial experience study and actuarial assumptions in December 2013, and then followed by adoption by the Board of the actuarial assumptions and the target, or policy, investment portfolio in February 2014. INVO then began implementing the new strategic asset allocation on July 1, 2014.

Since the 2013-14 ALM Cycle, staff has continued to work and regularly update the Board on ALM-related areas, including the following:

- Monthly updates on actual investment portfolio allocations versus policy targets and ranges, as well as investment portfolio returns and risks (i.e., volatility).
- Annual actuarial valuations of the Public Employees Retirement Fund ("PERF") and Affiliate Funds and the funded status of each, including risk metrics for the PERF regarding the percentage likelihood that during a defined period:
  - funded status will fall below certain % thresholds;
  - contribution rates will increase to certain % thresholds; and
  - contribution rates will increase by certain % thresholds in any one year.
- Periodic Board workshops regarding investment portfolio priorities, which represent an important building block leading to the ALM Cycle in 2017-18.
- Development of the Funding Risk Mitigation Policy, which is designed to reduce CalPERS funding risk over time by establishing a mechanism whereby CalPERS investment performance that significantly outperforms the discount rate triggers adjustments to the discount rate, expected investment return, and strategic asset allocation targets. This is intended to reduce the volatility of investment returns and increase the long-term sustainability of CalPERS pension benefits for members.
- Formation by staff of an Asset Liability Management Advisory Committee ("ALMAC"), chaired by the Chief Financial Officer ("CFO") and made up of representatives from the financial office ("FINO"), INVO, ACTO, legal office ("LEGO") and communications and stakeholder relations ("CSR").
- A mid-cycle asset allocation update with the Investment Committee ("IC") in July 2016, where the IC voted to leave the current policy portfolio allocation unchanged.
- A review by the Board of the CalPERS discount rate in December 2016, where the Board voted to reduce the discount rate from 7.5% to 7.0% over a three year period.

The ALMAC meets regularly to review ALM issues and to ensure that ALM activities are well coordinated among the various divisions within CalPERS. The ALMAC has already initiated the next ALM Cycle in 2017-18. Adoption of a comprehensive ALM Policy is important to this initiative in terms of providing overall guidance on what topics are to be addressed and what recommendations are to be presented to the Board for approval.

Analysis

The ALMAC has identified the following activities that comprise a comprehensive ALM Program:

1. Coordination of the detailed ALM planning cycle every four years as well as the mid-cycle Board update.

2. The recommendation to the Board of the actuarial assumptions and employer/employee contribution rates.

3. The recommendation to the Board of the discount rate to be used.

4. The recommendation to the Board of the target, or policy, portfolio, including all capital market assumptions.

5. Monitoring actual asset allocations versus the targets and ranges established by the Board.

6. Annual review of funding levels and risks to be reported to the Board.

7. Implementation of the Funding Risk Mitigation Policy. This policy shall also be reviewed on a periodic basis with any recommended changes taken to the Committee.

8. The review and update, as necessary, for presentation to the responsible Board Committees, of the ALM aspects of all ALM-related policies.

9. Monitoring of the key ALM metrics and the status of ALM-related initiatives reported to the relevant Board Committees as prescribed by Board policies.

10. Oversight of communications and outreach with employers and key stakeholders with respect to ALM-related issues, including, but not limited to, actuarial assumptions, funded status and the setting of contribution rates.

This Policy addresses how these activities are to be coordinated and managed in concert with each other and establishes clear roles and responsibilities, enhancing overall governance.

Budget and Fiscal Impacts

There are no budget or fiscal impacts at this time.

Benefits and Risks
A comprehensive ALMP addresses a key strategic plan goal of strengthening long-term pension fund sustainability by funding the System through an integrated view of pension assets and liabilities. Implementation of the Policy is intended to result in more risk-intelligent decision-making and increase the likelihood that key portfolio priorities are achieved:

1. Protect the Funded Ratio (*mitigate severe drawdowns*).
2. Stabilize Employer Contribution Rates (*manage overall volatility*).
3. Achieve Long-Term Required Rate of Return.

The risk of not having a comprehensive, well-coordinated Program is that the three portfolio priorities above are not achieved, adversely impacting long-term pension sustainability.

Attachments
Attachment 1 – Statement of Policy for Asset Liability Management
Attachment 2 – Statement of Policy for Asset Liability Management, redlined to show changes from the draft presented at the February 14, 2017 first reading.

____
SCOTT TERANDO
Chief Actuary

____
THEODORE H. ELIOPOULOS
Chief Investment Officer

____
MARLENE TIMBERLAKE D'ADAMO
Interim Chief Financial Officer