CalPERS

Finance and Administration Committee
Agenda Item 8b

November 14, 2017

Item Name: Amortization Policy (First Reading)

Program: Actuarial Office

Item Type: Information

Executive Summary

This agenda item is the first reading of the Actuarial Office's recommended changes to the Actuarial Amortization Policy. This policy is being examined in conjunction with the Asset Liability Management (ALM) process to study the impact of proposed policy changes on projected funded status, contribution volatility, and contribution levels. The proposed changes would shorten the amortization periods in some cases, modify the direct rate smoothing method and change the escalation rate from level percentage of payroll to level dollar amortization. The proposed changes to the policy also include additional provisions for employers that no longer have any active members.

This is a first reading, with a second reading and adoption of the proposed changes to the amortization policy scheduled for December. The updated policy would be reflected in the June 30, 2017 annual valuations which impacts contributions for the State plans and the Schools pool in Fiscal Year 2018-19 and impacts local agencies starting with Fiscal Year 2019-20. The changes to the policy will be implemented on a prospective basis. The amortization bases established prior to the June 30, 2017 annual valuations, for plans with active members, would continue as originally scheduled.

Strategic Plan

This agenda item supports the Fund Sustainability Goal and the Reduce Complexity Goal of the CalPERS 2017-2022 Strategic Plan.

Background

In September 2017, the Actuarial Office informed members of this Committee that the amortization policy would be reviewed with the ALM process. The CalPERS amortization policy was last revised in April 2013 to replace open amortization periods with closed periods for gains and losses. The policy utilizes a level percentage of payroll approach for open (active) plans and a level dollar approach for closed (inactive) plans. The policy was also modified to add 5-year "direct rate smoothing" for certain unfunded liability bases. This change was primarily made to allow for gradual recognition of investment gains and losses which was formerly accomplished through asset smoothing.

While the policy adopted in 2013 improved sustainability for the system and reduced contribution volatility over the prior policies, there are concerns with the current amortization policy with regard to negative amortization, actuarial industry guidance and intergenerational equity. There are also growing concerns over the amortization of the unfunded liability for inactive employers.

Analysis

Negative amortization occurs when the payments on a loan are not sufficient to cover the interest accrual. Under the current amortization policy, the combination of longer amortization periods, direct rate smoothing and the payment escalator contribute to the negative amortization experienced in the earlier years of the amortization base.

The current amortization policy uses a 30-year amortization period for gains and losses and a 20-year period for assumption, method, and benefit changes other than golden handshakes. Golden handshakes are amortized over 5 years. The recommended change to the amortization policy is to reduce the amortization period for gains and losses from 30 years to 20 years. Longer amortization periods provide a lower annual contribution to that layer but greater cumulative contributions due to interest costs. Reducing the amortization period for certain sources of unfunded liability would be expected to increase future average funding ratios, provide faster recovery of funded status following market downturns, decrease expected cumulative contributions and improve concerns over intergenerational equity. Reducing the amortization period may, however, increase the likelihood of contribution changes that exceed a threshold.

Actuarial assumptions are intended to be long-term assumptions and are not likely to be exactly realized in any given year. The costs associated with the difference in actual experience from assumed experience emerges as gains or losses which impact the unfunded liability. To control contribution volatility, the current amortization policy uses a form of direct rate smoothing that phases in costs over a 5-year period and phases them out again during the last 5 years of the amortization period. This is especially important with respect to investment gains and losses.

Using this phase-in approach, the initial payment is one-fifth of the full payment, which results in negative amortization. Shortening the ramp may increase contribution volatility but would reduce negative amortization and total contributions over the life of the amortization base. Removal of the down ramp at the end of the schedule does not materially impact contribution volatility but, in the case of a market downturn or other actuarial loss, would slightly reduce the ultimate amortization payment. The recommended change to the amortization policy is to remove the use of direct rate smoothing for all sources of unfunded liability except for investment gains and losses, as investment return volatility tends to be the largest contributor to contribution volatility. Based on staff's analysis, shortening the ramp did not materially reduce overall contributions or significantly improve the average funded status of the plans to merit the increase to the contribution volatility. The recommended amortization policy does not reflect changes to the length of the direct rate smoothing period but does remove the down ramp at the end of the schedule.

Required employer contributions are currently calculated with the goal of remaining level as a percentage of payroll, at least for active plans. To achieve this goal, the application of the amortization policy produces a payment which begins with a lower initial payment that increases year after year by the payroll growth assumption, currently 3 percent. Amortizing without an escalator, as is currently done for inactive plans, would reduce interest costs and eliminates negative amortization by requiring higher payments in the earlier years. In exchange, the payments beyond the first year would remain the same throughout the remainder of the amortization period, assuming no changes to the discount rate or amortization methods occur. Amortizing without an escalator also reduces the wealth transfer issue.

Pension reform effectively closed many pooled classic public agency plans to new entrants. Using an assumption that payroll will grow on a plan-by-plan basis no longer produces a payment that will maintain a level percentage of payroll. CalPERS also recently began billing public agencies for their unfunded liability as a dollar amount. This change no longer ties the contribution amount to payroll for public agency employers. State and school employers continue to be billed using a contribution rate. Regardless of how unfunded liability payments are billed to employers, the amortization payment escalation rate can be eliminated.

Several organizations have released guidance on amortization policies for public sector pension plans. These include the California Actuarial Advisory Panel (CAAP), the Conference of Consulting Actuaries (CCA), the Government Finance Officers Association (GFOA), and the Society of Actuaries (SOA) Blue Ribbon Panel. The CAAP paper generally recommends the use of a level percent of pay approach rather than a level dollar amortization and layered fixed periods by source. The general recommendations for the length of the amortization period vary by source but indicate a period of 15 to 20 years for gains and losses, a period of no longer than twenty-five years for assumption changes, and a period of the lesser of expected future service or 15 years for benefit changes that impact active members. The CAAP paper also provides that the amortization policy should reflect explicit consideration of the level and duration of negative amortization as well as supporting policy objectives of accountability and transparency. The recommended changes to the amortization policy will bring the policy along the lines of the CAAP recommendations.

Analysis has also been performed regarding the amortization policies employed by other major retirement systems in California and the United States. Many systems have adopted shorter amortization periods than are employed in the current policy, especially with regard to the 30-year period that CalPERS currently uses for gains and losses.

The CAAP paper also considers transition policies, that is, how to handle existing amortization layers when amending the amortization policy. To avoid undue disruption to a sponsor's budget, the CAAP suggests that existing layers may be allowed to continue as originally scheduled, and the new policy only be applied to new layers. The recommendation is to implement the changes to the policy starting with new amortization layers in the June 30, 2017 valuation. Amortization bases that were established prior to that valuation would continue as scheduled under the current policy.

Inactive employers

There is growing concern over having a more prudent funding policy for employers that no longer have active members. Currently, the amortization policy for active employers is applied to inactive plans with the exception that inactive plans are amortized as a level dollar amortization rather than a level percentage of pay. The periods used to pay down the unfunded liability are sometimes longer than the duration of the liability. In this case, it is possible that once the liability is exhausted, an unfunded liability may exist. The recommended change to the policy is to require a maximum 15-year level dollar amortization of the unfunded liability for employers with no active members in any of their pension plans and discretion for the actuary to reduce the period based on the demographics of the plan.

Budget and Fiscal Impacts
Not applicable.

Benefits and Risks
The adoption of the proposed changes to the policy will result in a policy that is consistent with industry best practice and reduces the amount of negative amortization. Adopting the changes may result in higher peak contribution rates, in the case of an actuarial loss, which may put more strain on employers' budgets. Implementing the change on a prospective basis is in line with the CAAP paper and will provide minimal changes to contributions in the near-term than if the current amortization bases were modified under the new policy.

Not adopting any changes and keeping our existing policy in place maintains the current issues with negative amortization and intergenerational equity and falls outside of industry guidance.

Attachments
Attachment 1 - Amortization Policy (PowerPoint)
Attachment 2 - Actuarial Amortization Policy

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