Finance and Administration Committee

Agenda Item 9a

February 13, 2018

Item Name: Establishment of the Long-Term Care Discount Rate Assumption

Program: Actuarial Office

Item Type: Information

Executive Summary

The purpose of this agenda item is to present the proposed discount rate and supporting information for the CalPERS Long-Term Care (LTC) Program.

During the June 2015 Investment Committee meeting, a continuance of the current strategic asset allocation was recommended and approved. The target portfolio mix included 15 percent in equities, 67 percent in fixed income investments, 12 percent in Real Estate Investment Trusts, and 6 percent in commodities. During the June 2017 Investment Committee meeting, a revised set of Capital Market Assumptions were adopted. To be consistent with the decisions of the Investment Committee made in both June 2015 and June 2017, we are recommending a discount rate of 5.25 percent.

Strategic Plan

This agenda item supports the Strategic Plan Goal A - Improve long-term pension and health benefit sustainability. This item further supports the Strategic Plan by providing stakeholders with information about the expected course of current and future investment returns.

Background

The current discount rate for the LTC program was approved in October 2012. During that review, the board adopted the current strategic asset allocation. In June 2015, the strategic asset allocation was reviewed and remained unchanged from the prior asset allocation. In June 2017, a new set of Capital Market Assumptions were adopted which affect the calculation of the discount rate.

The current discount rate for the LTC fund is 5.75 percent. This is a blend of the previous expected rates of return of 4.92 percent for the first 9 years and 6.52 percent for years 10 and beyond. With the recently adopted Capital Market Assumptions, the proposed discount rate of 5.25 percent is a blend of the current expected rate of return of 4.21 percent for the first 10 years and the expected rate return of 6.67 percent for years 11 and beyond.

Analysis
The proposed discount rate for the LTC Fund is a level 5.25 percent. This discount rate reflects the current investment mix and the revised long-term inflation rate of 2.50 percent. The long-term inflation rate was lowered from 2.75 percent in the December 2017 Board Meeting.

The proposed discount rate for the LTC Fund was developed by the CalPERS Actuarial Office's methodology utilized for the Pension Program(s). First, select-and-ultimate discount rates were developed and blended to come up with a single level discount rate. This level discount rate was calculated to produce similar projection results to the select-and-ultimate discount rate projection. The equivalent level discount rate was 5.32 percent. This level discount rate was based on a blend of an expected rate of return of 4.21 percent for projection years one through 10 and 6.67 percent for projection years 11 onward. The final step to develop the proposed discount rate was to round down to the nearest quarter of one percent resulting in the recommended 5.25 percent level discount rate. See Attachment 1 for details on the methodology in setting the discount rate.

The following differences between CalPERS LTC Program and CalPERS Pension programs are worth noting:

1. The LTC Program has a different proposed asset mix.

2. The LTC Program uses best-estimate (i.e., 50th percentile) returns for the discount rate and does not include provision for administrative expenses or any margin in this rate. The LTC Program administrative expenses and margin are explicitly provided for elsewhere.

3. The LTC program includes liabilities which are offset by future premiums and future investment income.

Further analysis can be viewed in attachment 2, which shows the projected cash flows with the select-and-ultimate discount rate, as well as a level discount rate of 5.00, 5.25, and 5.50 percent.

Change in the Funding Status to the LTC Program

Using liabilities for the long-term care fund estimated as of June 30, 2017, the current discount rate of 5.75 percent results in a margin of 12.13 percent and a funded status of 107 percent. Using a discount rate of 5.25 percent results in a margin of -1.45 percent and a funded status of 99 percent. For a history of the margin and funded status, as well as the returns for the last five years, please see Attachment 2.

Budget and Fiscal Impacts
Not Applicable

Benefits and Risks
This proposed decrease to the 5.75 percent discount rate change is a result of the change in the capital market assumptions during the June 2017 board meeting. Using a discount rate which is inconsistent with the asset allocation and the capital market assumption could jeopardize the health and sustainability of the LTC Program.

Attachments
Attachment 1 – Development of the Long-Term Care Recommended Discount Rate and information based on the 6/30/2017 projected cash flows
Attachment 2 – History of Funded Status and Margin

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