CalPERS

Finance and Administration Committee

Agenda Item 7a

November 14, 2018

Item Name: Proposed Revision to Amortization Policy Regarding Financial Necessity (Second Reading)

Program: Actuarial Office

Item Type: Action

Recommendation

Adopt the proposed modifications to the Financial Necessity section 10 (within the Amortization Policy) provided in Attachment 1. The primary changes include:

1. Addition of a required financial analysis by the Pension Contracts and Prefunding Program (PCPP) with their recommendation to the Chief Actuary
2. Change the extension of the amortization period from 30 years under the current policy to a standard period of 25 years (up to 30 years in cases of extreme financial necessity)
3. Change the standard method of amortization for approved cases of financial necessity from "level percent of pay" to "level dollar" (level percent of pay only allowable for extreme cases of financial necessity)
4. Addition of a minimum payment toward unfunded liability, for approved cases of financial necessity, equal to interest on the unfunded liability at the valuation interest rate
5. Addition of a restriction to apply for a subsequent extension of the amortization period for five years after being granted an extension

Executive Summary

This is the second reading of the Actuarial Office's recommended changes to the section of the Amortization Policy that addresses the possible extension of the amortization period due to financial necessity. The first reading was provided at the September Finance and Administration Committee meeting.

Strategic Plan

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

Background

The Amortization Policy establishes the amortization methods to eliminate positive or negative unfunded liabilities in a manner that maintains benefit security for the members while minimizing substantial variations in employer contribution rates. Item 10 of the Amortization Policy provides guidelines for evaluating and implementing requests by employers for an extension of the amortization period due to financial necessity.

In February 2018, the Board adopted modifications to the Amortization Policy. However, the financial necessity section was not modified at that time. In general, the adopted changes result in faster amortization of future increases or decreases in unfunded liability. The changes will be effective for the June 30, 2019 actuarial valuations. Unfunded liability created prior to June 30, 2019 will be amortized under the previous rules.

Should a plan experience a future actuarial loss, such as investment performance lower than the 7 percent assumption, the required annual amortization payment toward the actuarial loss will be greater under the new policy than under the previous policy. Given the changes to the Amortization Policy and some concern among stakeholders that the new policy could result in required amortization payments that would present financial difficulties, a review of the financial necessity section was performed. Significant stakeholder feedback and input was gathered through this process.

A first reading of the proposed changes was presented at the September FAC meeting. Comments from committee members and the public were considered in the drafting of the final language.

Analysis

The current guidelines for extension of the amortization period under a financial necessity include the following:

- Authority by the Chief Actuary to grant or deny the application based on the following:
    - Is there a financial necessity?
    - Is there potential long-term harm to the plan?
    - Is the agency able to continue to make required future contributions?
    - Any other facts or circumstances that are deemed necessary
- If granted, the amortization period is extended to 30 years

The team considered the following main factors of a financial necessity as part of its analysis:

1. The process for determining if financial necessity exists and whether the agency can sustain the plan if the amortization period is extended
2. The possible options for the extension of the amortization period and/or adjustment to the amortization method

Regarding the financial analysis in item 1 of the recommendation, the Actuarial Office worked closely with the Pension Contracts and Prefunding Programs division (PCPP). The PCPP currently uses a process for evaluating the financial position of agencies wishing to contract with CalPERS, using recent financial reports and budget forecast information. This evaluation process, currently used by PCPP, will be utilized in evaluating whether a requesting agency has a financial necessity and whether it is likely the agency could maintain the submission of annual required contributions if the amortization period was extended. However, final approval of the agency's request will reside with the Chief Actuary.

If the financial analysis concludes the agency is a candidate for extension of the amortization period, the Chief Actuary must then determine how the unfunded liability will be amortized. The options considered for extending the amortization period are based on the recent changes to the Amortization Policy, input provided by stakeholders, Actuarial Standards of Practice (ASOPs) and current actuarial guidance.

Under the old Amortization Policy, actuarial gains and losses, which decreased or increased the unfunded liability, were amortized over 30-year periods. Amortization periods of 30 years were more common in the past and considered reasonable and appropriate. The provisions under the old policy provided for an extension of the amortization period for all unfunded liability to 30 years.

Under the current Amortization Policy, approved by the Board in February 2018, the longest amortization period is now 20 years for any type of new unfunded liability (starting June 2019). This reduction in amortization periods is based on current actuarial guidance and more consideration given to intergenerational equity and benefit security. The current Amortization Policy also requires amortization of new unfunded liability as a “level dollar” amount rather than a “level percent of payroll”. This change also results in somewhat faster amortization of unfunded liability.

The main decision points for determining the amortization method under a financial necessity are:

1. What should be the maximum amortization period allowed?
2. Should the amortization method be a “level dollar” or “level percent of payroll”?

Given the concern over 30-year amortization periods that drove the decisions to modify the Amortization Policy in February 2018, the team has concerns about using such a period even in situations of financial necessity. Therefore, we propose that the standard period to be used in future financial necessity cases is 25 years or less using a “level dollar” method of amortization.

However, in extreme cases, provided it is anticipated that the agency will be able to maintain the submission of future required contributions, the Chief Actuary may consider using a “level percent of payroll” amortization method and/or an extension of the period to a maximum of 30 years.

For plans of Inactive Agencies (agencies with no active members), the standard amortization method and period for financial necessity cases shall be a level dollar method using a period of 20 years or less.

<u>Modifications After September FAC</u>

Originally the team proposed that the chief actuary would review the financial condition after 3-5 years and possibly require re-amortization of the remaining unfunded liability, over a period of 20 years as a level dollar amount, Based on feedback from FAC members and stakeholders, the new proposal retains the financial review 3-5 years after the extension but any changes to the amortization schedule will be at the request of the agency.

Included in the guidelines is an estimated time-frame of 2-3 months for completion of the review and decision by the chief actuary from the date a request is received.

Budget and Fiscal Impacts

Not applicable

Benefits and Risks

An agency experiencing a financial necessity may not have the ability to make required amortization payments toward its plan(s) unfunded liability. Where appropriate, the extension of the amortization period will lead to lower near-term required payments which may allow the agency to meet contribution requirements and still maintain the appropriate level of benefit security for the members. This extension may prevent a termination of the contract and benefit reductions for members.

The risk associated with extending the amortization period is that if the plan is terminated in the future with insufficient assets to pay all benefits, retirees would have been paid full benefits through the termination date, drawing down assets that would otherwise have been available for payment of benefits for future retirees. Alternatively, if the plan had been terminated immediately, existing plan assets would have been divided equally between current and future retirees.

Attachments

Attachment 1 - Proposed Actuarial Amortization Policy

Attachment 2 - Current Section Regarding Financial Necessity

Attachment 3 - Guidelines for Approval of Financial Necessity Requests

Attachment 4 - Financial Questionnaire for Approval of Financial Necessity Requests

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