Finance and Administration Committee

Agenda Item 7a

November 17, 2020

Item Name: Annual Review of Funding Levels and Risk Report

Program: Actuarial Office

Item Type: Information

Executive Summary

This report shows that while the funding position and the risk of falling to low funding levels in the future have slightly improved since last year's results, employer contributions are projected to increase over the next few years and risks remain in the system. In addition, the Asset Liability Management (ALM) process scheduled for 2021 will review the asset allocation and expected long-term investment return of the PERF. If this process leads to a necessary reduction to the long-term investment return expectation, the discount rate will be reduced which would result in additional increases to PEPRA member and employer contributions. The potential of a reduction to the discount rate increases the concern over whether all employers will have ability to make future required contributions. Consideration of risk targets and/or tolerances during the ALM process will be of critical importance in determining the subsequent asset allocation and funding policies.

Strategic Plan

This item is presented as part of the regular ongoing workload of the Actuarial Office and supports the Strategic Plan goal fund sustainability, strengthening the long-term sustainability of the pension fund.

Background

To assist the Finance and Administration Committee with its oversight of the financial soundness of the overall CalPERS system, the Annual Review of Funding Levels and Risks was developed. Included in this report are various system level actuarial results and risk measures that can be used to assess the effectiveness of funding policies, actuarial assumptions and methods.

The Board adopted the Funding Risk Mitigation Policy in November of 2015 in response to an increased awareness of risk. This policy is expected to result in a lowering of investment volatility. The goal of the policy is to reduce the risk to members' benefits that could result from investment volatility impacting funded status and required contribution rates. Based on its implementation timeline and criteria, however, the policy has never had an affect on the discount rate.

CalPERS must ensure that the pension fund is sustainable over multiple generations. This is done by taking an integrated view of assets and liabilities and taking steps designed to mitigate risks over the long-term. The CalPERS asset allocation and actuarial assumptions are continually monitored and reviewed every four years in what is known as the Asset Liability Management (ALM) cycle. The Annual Review of Funding Levels and Risks report tracks the progress through this four-year cycle and highlights relevant risks in conjunction with emerging experience.

Analysis

COVID–19 Pandemic

This pandemic has the potential to alter the experience of the retirement system in several different areas. These include, investment returns, inflation, deaths, retirements, terminations, disability retirements, pay increases, etc. Experience in these areas will impact future actuarial valuation results and required contributions. We do not expect to have enough relevant data to predict the overall impact of the pandemic on retirement system experience for another year or so.

A larger concern is the impact of the pandemic on the budgets of CalPERS employers and their ability to continue to make required contributions to CalPERS. Even before the pandemic, employers' ability to make future required contributions was a concern. Decreased revenues resulting from the pandemic have added to this concern.

Funded Status Improvement

The funded status of the PERF has seen a slow increase since 2016 from 68 percent to just under 71 percent projected as of June 30, 2020, despite the lowering of the discount rate to 7.0 percent. The funded status varies slightly among the different plans, with plans for miscellaneous members having on average higher funded status than safety plans. We are seeing fewer plans with required unfunded liability payments that are less than interest on the unfunded liability (negative amortization). Furthermore, the recent changes made to the amortization policy reduce the likelihood of negative amortization in the future. This is expected to reduce the risk of decreases in the funded status and increase the speed at which underfunded plans reach full funding.

Changing Pension Environment

Public pension plans, both at CalPERS and more generally across the United States, continue to mature. The report shows the ratio of retiree accrued liability to total accrued liability has increased and is expected to continue to increase in the future. In addition, asset volatility ratios continue to increase as well. This means that contribution volatility will continue to increase in the absence of offsetting changes. However, the increasing share of PEPRA members in the system will put downward pressure on these risk measures in future years.

In addition, concerns about the near-term investment horizon have increased. This is evidenced by a continuing trend towards lower expected returns and discount rates among other public pension systems.

System Risks

The improvement in funded status and recent modifications to the amortization policy have generally reduced the risk that plans will fall to low funding levels. However, employer contribution levels are climbing, and this is potentially increasing financial stress on some employers. When combined with some of the environmental changes discussed in the report, this is an area of concern for the future. In addition to the overall level of the contributions, sudden sharp increases in employer contribution rates remain a concern as well. The greatest risk continues to be the ability of employers to make their required contributions. However, with few exceptions, employers are currently up-to-date with their contribution requirements.

The termination policies and processes currently in place mitigate risks to the system. However, if an employer is under severe financial stress, the termination policies cannot fully protect the benefits of members that have served that employer. Ultimately, the members' benefits are only secure if the employer continues to make the required contributions.

Budget and Fiscal Impacts

There are no budget and fiscal impacts associated with this information item.

Benefits and Risks

This agenda item and the attached report should enhance the understanding of the risks inherent in the funding of the system. Such an understanding is necessary for effective management and mitigation of those risks.

Attachments

Attachment 1 – 2020 Annual Review of Funding Levels and Risks Report

Attachment 2 – Annual Review of Funding Levels and Risks Presentation

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Randall Dziubek
Deputy Chief Actuary

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Scott Terando
Chief Actuary