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Circular Letter

August 19, 2011

TO: **ALL PUBLIC AGENCIES**

SUBJECT: **CHANGES TO THE TERMINATED AGENCY POOL**

ATTENTION: **FINANCE DIRECTORS, HUMAN RESOURCE DIRECTORS, PUBLIC AGENCY DECISION MAKERS**

CalPERS is sending this Circular Letter as a result of the CalPERS Board of Administration's decision at its August meeting to take steps to protect member benefits and to mitigate funding risk to the Terminated Agency Pool (Pool).

Background

When a contracting agency terminates its CalPERS contract, the assets and liabilities of the agency are merged into the Pool. Similarly, when a contracting agency terminates a portion of its CalPERS contract, the assets and liabilities associated with the terminated portion of the contract are merged into the Pool. The Pool is part of the Public Employees' Retirement Fund (PERF) and pools those PERF assets used to pay benefits to members who are credited with service rendered as employees of terminated agencies.

As of June 30, 2009, the market value of assets attributable to the Pool was $144 million, and the funding value of actuarial liabilities attributable to the Pool was $60 million. At that time the Pool was 240% funded. Benefit payments attributable to the Pool exceed $5.4 million annually.

Due to the current economic environment and budget issues faced by public agencies, there is increasing pressure on public agencies to amend or terminate pension plan contracts. Although currently the Pool is well funded, the termination of a large employer (or several small employers) would cause the funded status of the Pool to be significantly diluted. For example, if a plan (or collection of plans) with $535 million in assets and $500 million in liabilities is merged into the Pool, the funded status of the Pool would likely drop from 240% to 121%.

Should the Pool become underfunded, CalPERS has limited funding sources available to increase the funded status of the Pool. This is because terminated agencies generally do not make ongoing contributions (other than a fixed schedule of payments established at the time of contract termination). Therefore, the Pool could be at risk should it become underfunded. Since the Pool is currently well funded, an opportunity exists to mitigate this risk before it is realized.

How Can CalPERS Minimize This Risk?

In light of the risk discussed above, the Board has adopted, in concept, an investment policy and asset allocation strategy that reflects the characteristics of future expected benefit payments that will be paid out of the Pool. By implementing a specific investment policy and asset allocation strategy, CalPERS is taking steps to increase benefit security and mitigate the Pool's funding status risk.

Change to Investment Policy, Income Allocation and Other Actuarial Assumptions

The assets of the Pool will be invested in a way that reflects the characteristics of future expected benefit payments. The Pool will continue to be part of the PERF and will be allocated income in accordance with this investment policy and asset allocation strategy. Over the next few months, CalPERS will establish the investment policy and asset allocation strategy to better match the liabilities and assets of the Pool.

To ensure that the most appropriate actuarial assumptions are used at the time a public agency terminates its contract with CalPERS, the Board has adopted an interim method to determine the discount rate, inflation assumption and other related economic assumptions to be used when calculating the liabilities of terminating agencies and to be used in the annual actuarial valuation of the Pool entitled "Method to Determine the Discount Rate, Inflation Assumption and Wage Growth Assumption for Termination Calculations," a copy of which is attached.

The interim method will be used to set the discount rate, inflation assumption and other related economic assumptions for contract terminations (and partial contract terminations) with a termination date on or after August 18, 2011. In addition, this method will be used to set the discount rate and other actuarial assumptions for the June 30, 2010, actuarial valuation of the Pool that will be performed later this fall. It is expected that there will be changes to the interim method when an investment policy and asset allocation strategy are adopted, and thereafter from time to time to reflect changes to the investment policy and asset allocation strategy.

Impact on Liabilities in the Pool and Agencies Contemplating Termination of a Contract with CalPERS

In light of the current benefits attributable to the Pool, and using the US Treasury rates in effect as of June 30, 2011, and the new termination calculation method described above, the discount rate for valuation of the Pool as of June 30, 2011, would be 3.8%. Using this rate, actuarial liabilities attributable to the Pool increases from $60 million to close to $92 million, resulting in a decrease in surplus assets of the Pool from $84 million to $52 million.

Going forward, if an agency terminates its contract, or a portion of its contract, a similar increase in the value of actuarial liabilities at the time of termination (compared to the value of actuarial liabilities as an active agency with ongoing contributions) can be expected assuming rates remain at 3.8%. Note that as rates fluctuate in the market, the value of actuarial liabilities at the time of termination will also fluctuate. Employers should be aware that under the current interest rate environment this new termination calculation method will increase the amount of assets that employers will need to leave behind when they terminate; if there is insufficient assets in the employer's account at CalPERS, the employer will be required to make up the shortfall.

In order to ensure transparency and provide relevant information, the CalPERS Actuarial Office expects to be able to provide employers with hypothetical information regarding their termination liabilities as part of the regular annual actuarial valuation report. At this time, we expect this information to be available, at the earliest, in the June 30, 2011, actuarial valuation report that will be mailed in October of 2012.

If you wish to discuss these issues further, please contact your CalPERS actuary at **888 CalPERS** or (**888**-225-7377).

ALAN MILLIGAN, Chief Actuary
Actuarial Office

Enclosure
Method to Determine the Discount Rate