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Circular Letter

March 10, 2014

TO: **ALL PUBLIC AGENCY EMPLOYERS**

SUBJECT: **EMPLOYER RATE IMPACT DUE TO CHANGES IN ACTUARIAL ASSUMPTIONS**

The purpose of this Circular Letter is to provide information regarding recent changes adopted by the CalPERS Board to the CalPERS strategic asset allocation and actuarial assumptions and the impact these changes are expected to have on employer contribution rates.

At the CalPERS Board of Administration meeting held in Sacramento on February 18, 2014, the Board adopted new actuarial assumptions based on a recently completed experience study and adopted an asset allocation mix that lowers the CalPERS investment risk but largely keeps its investment strategy unchanged, holding the fund's long-term assumed rate of return at 7.5 percent.

These assumption changes will result in increases in employer contribution rates at a time when many budgets are already strained. In order to assist employers in preparing and planning for these changes, the Board adopted staff's recommendation for local public agencies to first reflect the change in assumptions in the 2016-17 Fiscal Year with the cost spread over twenty years with the increases phased in over the first five years and ramped down over the last five years of the twenty year amortization period.

<u>Background</u>

The changes adopted by the Board represent the culmination of nearly two years of work on the asset liability management (ALM) process. ALM is an integral part of the CalPERS 2012-17 Strategic Objective to fund the System through an integrated view of pension assets and liabilities and to improve long-term pension and health benefit sustainability. This process was conducted as a joint effort by the Investment, Actuarial and Financial offices. Throughout the entire process, and particularly over the last two to three months, CalPERS staff has engaged extensively with stakeholders to educate them on the process and the recommendations, and to obtain their input. This process included an examination of the risk/return characteristics of possible asset allocations as well as modeling the impact these asset allocations would have on the funding of the system. It also included a review of the actuarial assumptions used in the actuarial valuations that sets the funding requirements through a process called an experience study.

Discussion

On February 18 2014, the CalPERS Board made important decisions regarding the funding of pension benefits at CalPERS. Specifically, the Board adopted relatively modest changes to the current asset allocation that will reduce the expected volatility of investment returns while holding the fund's long-term assumed rate of return at 7.5 percent. The Board also adopted more significant changes to the actuarial assumptions, most importantly, the inclusion of future mortality improvements in the actuarial assumptions. Finally, the Board approved a financing method which determines when and how quickly these changes will impact employer contributions. The actuarial assumptions adopted by the CalPERS Board of Administration are designed to ensure greater sustainability and soundness of the pension fund, and will be better at predicting future experience resulting in more secure retirement benefits in the decades to come. The current experience study was based on demographic CalPERS data for years 1997 to 2011. The study focused on recent patterns of termination, death, disability, retirement and salary increases.

Findings show that CalPERS employees continue to live longer. On average men are expected to live two years longer and women a year and a half longer. The study showed higher rates of service retirement for certain member groups, including police officers and firefighters and lower rates of disability retirements for all groups. The study also showed that members with longer service receive higher salary increases. Based on the findings, the new demographic assumptions will cause the employer pension costs to increase.

The assumption causing the largest increase in rate for all plans is the proposed change in post-retirement mortality which includes the inclusion of future mortality improvements in the actuarial assumptions. Since life expectancy of male members continues to increase at a faster pace than female members, safety plans which tend to have a higher proportion of male members will be affected more by this change than the miscellaneous plans.

Throughout the entire ALM process, and particularly over the last two to three months, CalPERS staff has engaged extensively with stakeholders to educate everyone on the process and the recommendations, and to obtain their input. Several employer organizations and several individual employers provided input. Most expressed support for staff's recommending the new assumptions and the need to reflect improvement in longevity, but they also expressed concern about the potential impact the assumption changes would have on their budgets and services. Some employers expressed the desire for options to select longer periods of amortization and phase in. Others expressed a desire for options to accelerate funding. After hearing various inputs, the Board adopted staff's recommendation for local public agencies to first reflect the change in assumptions in the 2016-17 Fiscal Year with the cost spread over twenty years with the increases phased in over the first five years and ramped down over the last five years of the twenty year amortization period. CalPERS is now looking at ways to provide options in the valuation reports for employers that would like to accelerate funding of their pension benefits.

Below is a table summarizing the estimated impact the new assumptions will have on employer contribution rates beginning in fiscal year 2016-17 based on the benefit formula applicable to active members.

Category	Total Estimated Change in Total Normal Cost (% of payroll)	Total Estimated Ultimate Change in Employer Rate in 2016-17 (% of payroll)	Total Estimated Ultimate Change in Employer Rate in 2020-21 (% of payroll)
Miscellaneous			
3% at 60	0.6% to 0.7%	1.2% to 1.9%	4.0% to 6.7%
2.7% at 55	0.4% to 0.7%	0.9% to 1.9%	3.1% to 6.5%
2.5% at 55	0.2% to 0.4%	0.6% to 1.3%	2.4% to 4.8%
2% at 55	0.2% to 0.3%	0.4% to 1.3%	1.3% to 5.1%
2% at 60	0.3% to 0.4%	0.4% to 1.0%	1.0% to 3.1%
Safety			
CPO	1.6% to 2.1%	2.6% to 3.5%	7.1% to 8.7%
Fire	0.0% to 0.5%	1.2% to 1.9%	6.3% to 7.2%
Police	1.1% to 1.7%	1.9% to 3.3%	5.3% to 9.3%

The ranges listed above are expected to cover 90% of the public agency plans. The actual impact of the new assumptions on employer rates will be implemented in the June 30, 2014 actuarial valuations which will set the employer contribution rates effective on July 1, 2016.

In order to assist employers in preparing and planning, CalPERS staff will reflect the impact of these changes in the projected rates based on the 2013 actuarial valuations, one year prior to implementing them in the June 30, 2014 actuarial valuations.

The results of the study are described in detail in the 2014 experience study report which is located on **CalPERS On-Line**. If you have any questions, please call the CalPERS Customer Contact Center at **888 CalPERS** (or **888**-225-7377).

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