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Circular Letter

June 5, 2014

TO: **ALL PUBLIC AGENCY EMPLOYERS**

SUBJECT: **CHANGES TO PENSION RISK POOLS AS A RESULT OF PENSION REFORM**

The purpose of this Circular Letter is to inform you of recent changes to the risk pooling structure adopted by the CalPERS Board of Administration.

At the CalPERS Board of Administration meeting held in Sacramento on May 21, 2014, the Board adopted changes to existing pooling structure policies and a new policy for allocating the pools' unfunded accrued liability.

These changes only impact employers participating in a pension risk pool. Although the changes will not change the amount of contribution needed to properly fund the risk pools, the changes in the cost allocation methods will result in some employers having to contribute more and some employers having to contribute less. The impact of these changes will be effective for the 2015-16 employer contribution rates and will be provided later this summer/fall as part of the June 30, 2013 actuarial valuations.

Risk Pooling was implemented effective with the June 30, 2003 actuarial valuations to protect small employers (those with less than 100 active members) against large fluctuations in employer contribution rates caused by unexpected demographic events.

The changes adopted by the Board represent the culmination of nearly three years of work on analyzing the actuarial policies related to risk pooling, risk pooling practices, internal procedures, laws and regulations to assess what has worked and what can be improved. The review demonstrated that the key objective of risk pooling had been realized, i.e. risk pooling has protected small employers against large changes in employer contribution rates due to unexpected demographic events.

The review also showed that due to unintended consequences resulting from the interaction of the Public Employees' Pension Reform Act of 2013 (PEPRA) and existing Board policies on risk pools, changes were necessary to ensure the proper funding of the pools and to address some equity issues. Most of the unintended consequences resulted from the fact that existing classic pools were closed to new PEPRA hires which resulted in a decline in covered payroll for the existing classic risk pools.

Under existing policies, a decline in payroll or even a smaller payroll growth than assumed would result in an underfunding of the pools. Changes were necessary to avoid this potential underfunding.

The key changes that were adopted by the CalPERS Board to address the funding, equity and contribution rate volatility issues that were identified are:

1. All active and inactive risk pools (including PEPRA pools) were combined into two risk pools, one for all miscellaneous plans and one for all safety plans.
2. Each prior pool's unfunded accrued liability will be allocated proportionately to each individual plan based on each plan's total liability instead of plan payroll.
3. Employer contributions toward the unfunded accrued liability and Side Fund for plans participating in a risk pool will be collected as dollar amounts instead of contribution rates expressed as a percentage of payroll.
4. The method of phasing existing employers into a pool when first joining a risk pool changed.
5. The methodology of applying additional contributions sent by employers to pay a portion of the unfunded accrued liability was altered.

See agenda item 5 from the Finance and Administration Committee on May 20, 2014 for further details of the changes.

An analysis performed by staff showed that almost half of the plans will see a change – positive or negative of less than 1% of payroll. About 80% of employers will experience changes between -3% to +3% of payroll. However, there are a few plans with large retiree to active participant ratios that will experience increases in excess of 3% of payroll. These changes will be reflected in the June 30, 2013 actuarial valuations that will be performed later this summer and will be used to set the employer contribution rates for Fiscal Year 2015-16.

For employers for which the impact of the pooling changes creates a financial hardship, there is a process in place when an employer can ask for rate relief. This process is called a hardship request. It is important to realize that a hardship request does not remove the obligation from the employer to fund the benefits; it mostly results in a deferral of contributions to provide short term relief at the expense of generally higher cost long term.

CalPERS has a Board policy that allows the Chief Actuary to approve hardship request subject to a set of guidelines. The guidelines in place today make it difficult for any employers to qualify for a hardship request. At the Board meeting in May, staff was instructed by the Board to review the existing policy and guidelines to see if changes could be made that would allow more employers to qualify for a hardship request while retaining the essence of the current guidelines which is to protect the benefits of members long term.

Staff is currently in dialogue with the League of Cities and other employer organizations to develop a new set of guidelines that could be used going forward. At this time, we expect to come back to our Board in late summer/early fall of this year with a new set of guidelines that could be used for the 2015-16 fiscal year for employer seeking relief for that year.

Throughout the entire risk pooling evaluation process, and particularly over the last two months, CalPERS staff has engaged extensively with stakeholders to educate everyone on the process and the recommendations, and to obtain their input. Several organizations and several individual employers provided input. Most expressed support for staff's recommendations. Some of the agencies with the relatively large contribution requirement increases expressed concern. A survey performed by the League of Cities showed that 94% of the respondents supported staff's recommendation.

As part of the outreach performed by staff, it has been brought to our attention that a small group of employers had concerns over the proposal to start billing the payment required to pay down an unfunded liability as a dollar amount rather than as a percentage of payroll. The concern was over the fact that in some instances, specific MOU language refers to the CalPERS contribution rate and there was a concern of the impact on these MOUs of setting a lower rate combined with a dollar amount for the unfunded portion of the rate.

To address this concern, the CalPERS Board adopted staff's proposal to start billing the payment required to pay down an unfunded liability as a dollar amount rather than as a percentage of payroll but gave authority to the Chief Actuary to set a contribution rate for the payment toward the unfunded liability under certain circumstances. The criteria to determine whether or not an employer would be allowed to contribute as a rate instead of a dollar amount will be that:

1. The employer must have a current MOU that has a link between the member contribution rate and the employer contribution rate.
2. The MOU must have been signed prior to the Board meeting or have other documentation to show that the agreement had been negotiated prior to the Board meeting
3. The employer has requested that we set the required contribution as a rate
4. Not more than three years has passed

It is important to realize that switching to dollar billing for the payment toward the unfunded liability was done in order to address some equity issues that resulted when employer payroll either increased faster or slower than assumed in the actuarial valuation. For this reason, in the event an exemption is granted and that an employer is allowed to contribute toward the funded liability as a contribution rate, the policy adopted by the CalPERS Board states that any over or under contributions that resulted from contributing a rate rather than a dollar amount will be re-allocated back to the specific employer to ensure the equity issue does not re-occur in these situations.

If you have any questions, please call our CalPERS Customer Contact Center at **888 CalPERS** (or **888**-225-7377).

ALAN MILLIGAN
Chief Actuary