Finance & Administration Committee

California Public Employees' Retirement System

Agenda Item 9a

May 20, 2014

ITEM NAME: Calculation for Normal Cost for PEPRA Members

PROGRAM: Actuarial Office

ITEM TYPE: Information

EXECUTIVE SUMMARY

This agenda item addresses the calculation of the normal cost for members covered by one of the benefit formulas created by the passage of the Public Employees' Pension Reform Act (PEPRA) in 2012. While PEPRA requires that "new" members pay 50 percent of the normal cost rate rounded to the nearest one quarter of one percent, there is some ambiguity as to how the normal cost is calculated. This ambiguity was deliberate as different systems/plans may need to calculate the normal cost differently to best reflect their circumstances. This agenda item documents how staff plans to address this ambiguity and how that will impact the stability of member contribution rates.

STRATEGIC PLAN

This agenda item is not part of our strategic plan but rather is a response to changes in the external environment that staff is responding to as part of the ongoing workload of the Actuarial Office.

BACKGROUND

Assembly Bill (AB) 340 created PEPRA that implemented new benefit formulas and a final compensation period as well as new contribution requirements for new employees. In accordance with Section Code 7522.30(b), "new members … shall have an initial contribution rate of at least 50 percent of the normal cost rate." The normal cost for the plan is dependent on the benefit levels, actuarial assumptions and demographics of the plan particularly the entry age into the plan. Since the actual demographics of new members was not known during the implementation of PEPRA in December 2012, the normal cost rate was determined based on the average demographics of the members in the current 2 percent at age 55 miscellaneous risk pool and the 3 percent at age 50 safety risk pool.

ANALYSIS

CalPERS administers defined benefit (DB) plans under which a retiree receives a retirement benefit that is guaranteed for life. DB plans are funded by employee and employer contributions, and investment earnings. Employees and employers prefer stable contribution amounts. Traditionally, the employee contribution rate was a fixed percentage of pay. Generally, employers are more equipped to handle changes in contribution requirements. Therefore, employers were responsible for the remainder of the contribution requirement. With the passage of PEPRA, the employee contribution rate for new members is 50 percent of the normal cost rate which is subject to change. The employee contribution rate is now variable.

Generally for large sets of data (100+ active members), normal cost rates are stable. For smaller sets of data (fewer than 100 active members), the normal cost rate can be unpredictable even with a normal influx of new members from year to year. By way of example, staff identified two safety plans with identical benefit packages. The total normal cost for one plan is 30.511 percent while the total normal cost for the other is 26.956 percent. As noted earlier the total normal cost is highly correlated to the entry age and the average entry ages in these two plans are 29.55 and 26.63, respectively. Staff prefers adopting a methodology that will determine a stable normal cost and member contribution rate.

Staff will be performing the June 30, 2013 actuarial valuations in the upcoming months. This valuation cycle will be the first cycle that will include PEPRA members. Since the actual demographics of new members was not known during the implementation of PEPRA in December 2012, the normal cost rate was determined based on the average demographics of the members in the 2 percent at age 55 miscellaneous risk pool and the 3 percent at age 50 safety risk pool. All PEPRA members with similar benefits were determined to have the same normal cost rate regardless of whether the new member participated in a pooled or non-pooled plan.

As of June 30, 2013, there are 1,000+ active members in the PEPRA miscellaneous pool and 300+ active members in the PEPRA safety pool. Based on our criteria, there appears to be enough actives in the PEPRA pools to produce stable normal cost rates[1].

In analyzing the first set of PEPRA data, staff has become concerned that, for most employers, there is insufficient data to produce stable normal costs and member contribution rates. Further, this situation is likely to persist for a number of years as employers gradually bring on more PEPRA members. The larger employers may have sufficient PEPRA members in the first few years but other employers may not have stable rates for a number of years.

This raises the question of how to calculate the normal cost so that it is:

- Reasonably stable from year to year
- Reflective of the different hiring patterns of different employers
- Effective at splitting the cost between the employer and members as required by PEPRA

[1] This is true for the PEPRA safety pool as a whole but not true for two of the three benefit formulas within the pool. As of June 30, 2013 there were less than 100 active members with the 2% @ 57 formula and no active members with the 2.5% @ 57 formula.

A number of alternatives are possible. For a non-pooled plan, the normal cost rate could be based on:

- Only the PEPRA members in a particular non-pooled plan
- All of the members in a particular non-pooled plan
- The PEPRA members in risk pools
- All PEPRA members at CalPERS

Each of the above alternatives has different advantages and weaknesses. Which alternative results in the best balance between the different objectives is not clear and will require both analyses by staff and outreach to stakeholders.

Staff has concluded that the best approach is to repeat the process – using the normal costs based on the demographics of the risk pools – for the current valuation and work with stakeholders over the next year to determine the best long-term approach to the issue of calculating PEPRA normal costs and member contribution rates.

Outreach

Staff has engaged in a limited dialogue with employer associations and labor groups to inform them of the issue and seek their feedback. At this point, stakeholders appear supportive of the approach staff has selected. Staff is committed to working with stakeholders over the next year to develop the best long-term solution to this issue.

BUDGET AND FISCAL IMPACTS

It is anticipated that any work associated with the issues described herein will be completed with existing staff and absorbed within current budgets.

ATTACHMENTS

There are no attachments to this agenda item.

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