CalPERS

Finance & Administration Committee

California Public Employees' Retirement System

Agenda Item 8b

April 14, 2014

ITEM NAME: Changes to Pension Risk Pools as a Result of Pension Reform

PROGRAM: Actuarial Office

ITEM TYPE: Action

RECOMMENDATION

Staff recommends that the Board adopt changes to the risk pooling structure by adopting the following:

- Changes to Board resolution ACT-96-05E regarding amortization and smoothing policies
- Changes to Board resolution ACT-99-03 regarding employer contributions in excess of actuarially determined rate
- Changes to Board resolution 03-03-AESD regarding the list of available risk pools
- Changes to Board resolution 04-02-AESD regarding the phasing-out of normal cost for employers joining the risk pooling structure
- Changes to Board resolution 05-02-AESD regarding smoothing of employer rate and the minimum employer contribution rate for plans with a surplus
- Create new Board resolution ACT-14-01 regarding the allocation of pool's unfunded accrued liability

EXECUTIVE SUMMARY

Last December, staff brought an information item to this Committee identifying some unintended consequences resulting from the interaction of the Public Employees' Pension Reform Act of 2013 (PEPRA) and existing Board policies on risk pools. Changes necessary to ensure the proper funding of these pools were identified in this agenda item. Staff has completed the work necessary to implement the changes and is recommending Board policy modifications to implement those changes.

The following summarizes the key recommended changes:

1. Combine all active and inactive risk pools into two risk pools, one for all miscellaneous plans and one for all safety plans.
2. Allocate the pool's unfunded accrued liability proportionately to each individual plan based on each plan's total liability instead of plan payroll.
3. Collect employer contributions toward the unfunded accrued liability and Side Fund for plans participating in a risk pool as dollar amounts instead of contribution rates expressed as a percentage of payroll.
4. Change the way existing employers will see their rate phased into the pool's rate when first joining a risk pool.

5. Clarify how additional contributions sent by employers to pay down an unfunded accrued liability will be applied and toward which portion of their unfunded accrued unfunded accrued liability these additional contributions will first be used.

The proposed changes preserve the essential pooling of risks needed to prevent demographic events from causing significant rate shocks for small plans. Although the proposed changes will not change the amount of contribution needed to properly fund the risk pools, the proposed changes in the cost allocation methods will result in some employers having to contribute more and some employers having to contribute less. Additional information is provided later in the agenda item and the attachments.

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

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.

In June 2012, staff delivered a review report on risk pooling including all Board 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. In the report, it was noted that the pension reform proposals under consideration at the time could effectively close all existing risk pools and have a significant impact on the risk pools at CalPERS.

Pension reform legislation was enacted in 2012 through the passage of PEPRA. PEPRA effectively closed the existing pools at that time. As the effective date of the legislation was after the effective date of the June 30, 2012 actuarial valuations, staff did not make any changes to those valuations. In November 2012, the Board approved adding two new risk pools due to the formulas created by PEPRA to be able to implement PEPRA on January 1, 2013.

It is now necessary to consider the appropriate treatment of the effective closure of the risk pools for the “Classic” formulas – those in existence prior to the passage of PEPRA.

ANALYSIS

In an open pension plan, a fundamental underlying assumption is that there will be an ongoing influx of new employees to replace those employees that exit due to retirement, disability, turnover or death.

PEPRA has closed all existing active risk pools to new public employees hired on and after January 1, 2013 except for classic members. When a pension plan becomes closed to new entrants, attrition will begin; reducing the number of active employees toward ultimately having a pension plan with no active employees.

Several issues have arisen as a result of PEPRA for the risk pooling structure. These issues were discussed in detail in an agenda item to this Committee last December. These issues can be categorized as funding, equity and employer contribution rate volatility issues.

Funding issue

Contributions for pools are collected as a contribution rate expressed as a percentage of payroll. When setting the contribution rates, the Actuarial Office uses the payroll information from the data in the actuarial valuation. The payroll information is three years prior to the fiscal year when the contribution rate will apply. As a result, the payroll is projected forward for three years under the assumption it will grow by 3% per year, the current Board approved payroll growth assumption.

With the closing of the pools to new PEPRA hires in the near term, covered payroll is most likely going to increase at a rate lower than 3% or even decline. When a pool experiences smaller payroll growth than assumed, it can lead to an underfunding of the plan. Changes must be made to the current pooling structure to avoid this potential underfunding.

Equity issue

Under the current risk pooling structure, the existing unfunded accrued liability and future gains and losses are currently allocated to plans in each risk pool based on the payroll of the plan. This structure works well to the extent the payroll of each plan is expected to grow at about the same rate. With the closing of the pools to new hires, the payroll of plans will decline over time. Since every employer participating in risk pooling has different demographic characteristics, their active members will retire or exit the plan at different times leading to some plans experiencing a faster decline in payroll than others.

Since gains and losses of the entire pool are currently allocated based on payroll, plans with larger payroll will be asked to contribute more toward the pool’s unfunded accrued liability than plans with smaller payroll. As the number of active members decline in the pool, the payments toward the unfunded liability will disproportionally be shifted to those plans having the largest number of remaining active members resulting in an inequitable allocation of costs. To address this equity issue, changes are needed on how costs are allocated within each risk pool.

Employer Contribution Rate Volatility issue
When PEPRA was enacted, it closed all classic active pools to new PEPRA hires. The unfunded accrued liability for the classic pools remained unchanged. Under current Board policies, payments to the amortization of the unfunded accrued liabilities and side funds are expressed as a percentage of payroll. If the unfunded accrued liability decreases over time as employers pay down the unfunded accrued liability, employer contribution rate volatility will eventually increase to an alarming level. This is going to be difficult for employers to budget and could lead to severe hardship for some employers.

Possible Solutions
The Actuarial Office studied two alternatives for the future of risk pooling to address these issues without sacrificing the considerable benefit to contribution rate stability for smaller employers that risk pooling provides.

Alternative 1
Alternative 1 includes keeping the current pooling structure of 9 closed active pools, 1 inactive pool and 2 open active PEPRA pools and modifying current funding and amortization methods to address the funding and equity issues with the least amount of change to our current pooling structure. Even though the payroll of employer is still open and can be expected to grow over time, the same is not true of the groups covered under the classic formula.

The changes proposed under alternative 1 will result in almost all pooled employers having to contribute more in the near term. We expect that about 90% of the Miscellaneous plans in the classic risk pools will experience employer rate increases between 0-3% of payroll and about 75% of the Safety plans will experience increases of 2-5% of payroll. In addition to the contribution increases, a change of the allocation of the pool's unfunded accrued liability will further increase or decrease individual employer contribution rates.

Under this alternative, we will need to monitor the funding of each risk pool carefully. It is possible that we may have to modify our funding approach to reflect the demographics of the closed groups which would further increase contributions.

Alternative 1 is not the preferred approach. More details on Alternative 1 can be found in agenda item 7b to this Committee last December.

Proposed Solution - Alternative 2
Staff reviewed another alternative which is combining all pools into two pools, one for all miscellaneous groups and one for all safety groups. This is the approach that staff is recommending and requires structural changes. By combining all pooled plans

into two risk pools, the payroll of the risk pools and employers within the pools can be expected to increase at the assumed 3% annual growth, addressing some of the issues that resulted from having a declining active population in the pool. Therefore, we will be able to keep our current level percentage of pay amortization schedule to avoid the necessity of immediate increases to employer contributions.

In addition to combining all exiting risk pools into two risk pools, staff is recommending that we start collecting employer contributions toward unfunded accrued liability and side fund as dollar amounts instead of contribution rates. Implementing this change will address the funding issue that would arise from the declining population under the classic formula. This will result in a major change in how contributions are collected from employers. Anecdotally, employers seem to be supportive of this approach. Several employers have approached CalPERS over the last several months proposing that we no longer collect contributions for the unfunded accrued liability as a percentage of payroll but rather invoice them for the amount needed each year to pay down the unfunded accrued liability. The normal cost contribution would continue to be expressed as a percentage of payroll.

Staff is also recommending changes to the method to allocate cost to plans in risk pools. Staff's recommendation is to allocate the pool's unfunded accrued liability to each individual plan within the pool based on the plan's total liability instead of based on the plan's payroll. This is a change for which many pooled employers have been requesting. Additionally, many pooled employers have been asking for the ability to pay down their share of the pool's unfunded accrued liability. This is not possible unless we allocate the unfunded accrued liability of the pool to each employer on an annual basis. Making this change will address the equity issue and allow employers to pay down their share of the pool's unfunded accrued liability. Although the recommended changes to the cost allocation method 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. 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 ratios that will experience increases in excess of 3% of payroll. See Attachment 1 for a distribution of the expected impact on employer rates.

This solution will require a significant effort to program and design the required database changes to our existing system. If adopted by the Board, 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.

To implement these changes, modifications are necessary to five existing Board policies as is the creation of one new policy. The policies being modified or created are the following:

- Board resolution ACT-96-05E: modified to ensure amortization and smoothing policies properly reflect the proposed changes. See Attachment 2a for a copy of the Board resolution with the proposed changes highlighted in the redline version and Attachment 2b for the final recommend version.
- Board resolution ACT-99-03: modified to reflect employers with pooled plans will be asked to contribute both a rate and a dollar amount to fund their plans. See Attachment 3a for a copy of the Board resolution with the proposed changes highlighted in the redline version and Attachment 3b for the final recommend version.
- Board resolution 03-03-AESD: modified to combine existing pools and reflect that only two risk pools will be administered going forward for employers that contract with CalPERS. See Attachment 4a for a copy of the Board resolution with the proposed changes highlighted in the redline version and Attachment 4b for the final recommend version.
- Board resolution 04-02-AESD: modified to properly reflect that normal cost of plans will need to be taken into account when phasing in an existing plan joining a risk pool for the first time. See Attachment 5a for a copy of the Board resolution with the proposed changes highlighted in the redline version and Attachment 5b for the final recommend version.
- Board resolution 05-02-AESD: minor changes to ensure consistency with the proposed changes. See Attachment 6a for a copy of the Board resolution with the proposed changes highlighted in the redline version and Attachment 6b for the final recommend version.
- Board resolution ACT-14-01: new policy being created to establish the process used to allocate the pool's unfunded accrued liability to each plan on an annual basis. See Attachment 7 for a copy of the proposed new Board resolution.

BUDGET AND FISCAL IMPACTS

This item was not anticipated in the strategic or business plan and has not been built into the budget. Given the time constraint to implement the changes outlined in this agenda item, it is anticipated that any work associated with the issues described herein will have to be completed with existing staff and absorbed within current budgets although this may be revisited in a future agenda item. Unless action is taken, contributions from employers will have to be accelerated and impose additional strain on employers' budgets.

BENEFITS/RISKS

As stated earlier, several issues have arisen as a result of PEPRA for the risk pooling structure. These issues can be categorized as funding, equity and employer contribution rate volatility issues.

Staff is recommending changes to address some of these issues. If the Board were to not adopt changes to the risk pooling changes, the issues identified in this agenda item would remain in place and could have a drastic impact in a few years.

Staff presented two alternatives to address some of these risks. Alternative 1 has the benefit of being the easiest one to implement from a perspective of system and program changes needed. However, it still does not eliminate all of the issues identified. The risk in implementing alternative 1 is that first it would result in all pooled employers having to pay more at a time when budgets are already strained. In addition, is not likely to fully eliminate the funding, equity and employer contribution rate volatility issues we are facing. This alternative may necessitate future changes to our funding approach to reflect the demographics of the closed classic groups which would further increase employer contributions. As stated earlier, this is not the preferred alternative.

Alternative 2 is the solution recommended by staff to address the issues listed above. Alternative 2 preserves the essential pooling of risks needed to prevent demographic events from causing significant rate shocks for small plans. This alternative is more complicated to implement and will require significant changes to systems, policies and procedures. Under this alternative, there is no overall increase in employer contributions although some employers will have higher contributions and some lower. The risk of not implementing this approach would be that the funding, equity and employer contribution rate volatility issues would remain in place and would require some action in the future. The risk in implementing this change is some employers will see increases in contributions at a time when budgets are already strained.

Another option that was not considered as viable was the elimination of risk pools at CalPERS and returning each plan to a stand-alone basis. This path would reintroduce the risk of large increases in contribution rates caused by demographic events for small plans that was eliminated with the creation of risk pools. Eliminating risk pools would re-introduce risks that have been eliminated by the creation of risk pools and impact contribution rates in a similar fashion to how Alternative 2 is expected to impact rates.

ATTACHMENTS

Attachment 1 – Estimated Impact of Alternative 1 and Alternative 2 on Employer Contribution Rates
Attachment 2a – Board Resolution ACT-96-05E - Redline Version
Attachment 2b – Board Resolution ACT-96-05E - Clean Version
Attachment 3a – Board Resolution ACT-99-03 - Redline Version
Attachment 3b – Board Resolution ACT-99-03 - Clean Version
Attachment 4a – Board Resolution 03-03-AESD - Redline Version
Attachment 4b – Board Resolution 03-03-AESD - Clean Version
Attachment 5a – Board Resolution 04-02-AESD - Redline Version
Attachment 5b – Board Resolution 04-02-AESD - Clean Version
Attachment 6a – Board Resolution 05-02-AESD - Redline Version
Attachment 6b – Board Resolution 05-02-AESD - Clean Version
Attachment 7 – Board Resolution ACT-14-01

DAVID LAMOUREUX
Deputy Chief Actuary
Actuarial Office

ALAN MILLIGAN
Chief Actuary