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Final CalPERS Webinar on Fund Risk and Volatility Set for July 30

Additional CalPERS Rate Increases Being Considered to Reduce Volatility

If you haven't done so already, city officials will have their final opportunity this Thursday to receive a briefing by CalPERS staff on options the CalPERS Board of Administration is studying to reduce risk and volatility in the fund. Both strategies are intended to ensure the long-term sustainability of the fund and **will have impacts to member and employer contributions in the future**. It is important to note that taking no action may pose an even higher risk of rate increases in the future. *For more, see Page 2.*

Governor's Administration Releases Proposal for Modernizing Groundwater Adjudication Process

Legislation also Proposed

The primary method for solving groundwater disputes and protecting groundwater basins prior to the Sustainable Groundwater Management Act (SGMA) was litigation. When over-pumping led to a crisis, like seawater intrusion or chronic overdraft, people had little choice but to file a lawsuit, called an adjudication, in which all rights to water in a basin could be defined by a court.
For more, see Page 3.

The pension fund will be holding its final webinar July 30 at 1:00 p.m. to brief city officials about the implementation and impacts of these strategies, including an opportunity to ask questions. Register online to participate.

The League will be conducting a member survey to solicit feedback on this issue in the next few days which will be due Aug. 7. It will use the information to possibly inform its recommendation to the CalPERS Board of Administration on Aug. 19. Here is some additional information on the issue.

Introduction: CalPERS has sponsored webinars in the last few months to solicit feedback on staff proposals currently under study by the Board to reduce the “volatility” of its investments and the risk of steep employer/employee contribution rate increases caused by serious investment losses.

Overview: Pension system costs (benefits and administration) are funded by investment earnings and employer/employee contributions. When investment earnings vastly exceed the estimated rate of investment return,[1] the unanticipated excess is used to pay costs and stabilize or lower contribution rates. When the earnings are under the “discount rate,” contribution rates may have to be increased in the future. CalPERS has a goal of the system being 100 percent funded in order to weather future investment losses, keep contribution rates stable, and avoid shifting the cost of paying retiree benefits to future generations.

Impact on Cities of CalPERS Investment Losses. When CalPERS suffered a 24 percent loss in the value of its investments in 2008-09, it initially delayed increasing contribution rates. In recent years it began recovering those losses over a shorter period of time, lowered its discount rate, and adopted new retiree longevity projections. This collectively required a rate increase on average for cities of roughly 50 percent that is currently being phased-in over six years at a growing cost to city budgets. If city revenues decline due to another recession during this phase-in, the financial pressure will only increase.

How to Reduce Investment Return Volatility. Recently, the CalPERS senior staff began a discussion with the board about whether CalPERS should reduce the risk of similar future employer contribution rate spikes by shifting to a less “volatile” mix of investments, lowering its discount rate (currently at 7.5 percent compared to comparable corporate rates of 5 percent), and make up the difference through small increases in employer (and PEPRA employee) contribution rates each year over the next few decades.

More Retirees; Fewer Active Workers. Another increasing financial pressure on the system is that there will soon be more retirees drawing benefits than active workers contributing. From two active workers for each retiree in 2002, the ratio fell to 1.45 to one by 2012, and by 2023 it is expected to be 1.0 to 1.0 and to decline afterwards. Fewer active employees compared to retirees means fewer people contributing to paying the obligations of the pension system.

Reducing the Risk of Catastrophic Losses. Finally, if funding of the pension system drops below 50 percent of the projected assets needed to pay future pensions, some pension experts warn returning to full funding becomes nearly impossible since it would require such onerous contribution rates and unlikely investment returns. CalPERS staff estimate that with the current investment volatility (i.e., discount rate and investment strategy) the probability of CalPERS funding levels falling below 50 percent at any point in the next 30 years is 26 percent (miscellaneous) and 29 percent (public safety) for local agencies (see page 24 of CalPERS report). The question is whether this is an acceptable level of volatility risk? The CalPERS staff has expressed concerns about this level of risk. .

Key Questions. In its webinars and Board of Administration meeting, CalPERS is asking itself, employers and employees these questions:

[1] The estimated rate of return by CalPERS is an informed projection of future investment earnings from employer and employee contributions, discounted to its present value. Hence it is known as the “discount rate.”

A. Should CalPERS reduce the “volatility” of its investments to reduce the risk of future rate spikes and loss in funded status for the pension system by reducing its discount rate and increasing employer (and PEPRA employee) contribution rates gradually over the next few decades?

B. If “yes,” how should CalPERS do it? CalPERS staff have identified two options:

1. Flexible Glide Path Option: after a great investment year (i.e., earnings in excess of 11.5 percent) use 50 percent of the returns over the discount rate for contribution rate relief and 50 percent for risk mitigation by lowering the discount rate.

2. Blended Glide Path Option: similar to Flexible Glide Path, but it would happen in stages called checkpoints. As an example, those checkpoints could be set at four year intervals with a goal of reducing the discount rate by 15 basis points during each interval. During a checkpoint year, CalPERS would assess whether that goal had been met. If the goal had not been met, CalPERS could still move forward with reducing the discount rate, even after a bad year. This would in turn put upwards pressure on employer rates (and employee rates as well for PEPRA members). Under the blended model, the enactment of risk mitigation measures is a certainty. Under the flexible model, risk mitigation would only follow years of great earnings.

Note: for a fuller discussion of these options, see the November 2014 review of Funding Levels and Risks by the CalPERS staff or the CalPERS webinar presentation.

‘Groundwater’ Continued from Page 1…

This is an expensive and cumbersome process, sometimes lasting decades. SGMA now requires groundwater basins to be managed sustainably through local management plans, but does not define water rights. The Administration believes that this leaves a need to provide water right holders with a forum for resolving legal disputes over water rights.

Gov. Jerry Brown signed SGMA into law, committing to reforming the adjudication process. The Administration recently released its proposal and if enacted, the legislation would provide a modern, comprehensive adjudication process for all groundwater basins that are regulated under SGMA, and an option for basins that are not. The proposal seeks to make adjudications more cost-effective, provide a process to settle water right disputes, and ensure that litigants don’t misuse the court system to obstruct or delay SGMA. The League is in the process of reviewing the Governor’s proposal.

Supporting documents include:

- Summary of Administration’s Proposal for Modernizing Groundwater Adjudication Process
- Proposed Legislation Text: Administration Proposal for Modernizing the Groundwater Adjudication Process

The Legislature is also considering two bills that pertain to the adjudication process, SB 226 (Pavley) and AB 1390 (Alejo).

Visit California Groundwater for news and information on implementation of SGMA.
