SWEETWATER SPRINGS WATER DISTRICT

TO: Board of Directors **AGENDA NO. V-C**

FROM: Steve Mack, General Manager

Meeting Date: June 5, 2014

SUBJECT: PERS Unfunded Liability

RECOMMENDED ACTION:
Discussion only.

FISCAL IMPACT:
(None.)

DISCUSSION:

At our May Board meeting, we discussed the District's rate history with CalPERS and the changes PERS was proposing to make to our rate structure due to the impact of PEPRA (Public Employees Pension Reform Act of 2013). The proposed changes, dubbed "Alternative 2" by PERS, impact the risk pool structure, the rate contribution method, and actuarial methodology.

After the May meeting staff prepared a list of questions and sent them to our PERS actuary, Barbara Ware. On May 15 staff met via telephone with Barbara to go over the questions. It was apparent early in the discussion that PERS would probably adopt the changes proposed in Alternative 2 (and in fact they did on May 21). Accordingly, much of our conversation revolved around the impact of Alternative 2 on rates. A full copy of the PERS staff report on Alternative 2 is attached.

Below is a the list of questions we sent Barbara prior to the meeting, with staff's version of her answers:

1. When we get our annual valuation, we are unclear as to what asset/liability numbers are the District's own and which are the pool's numbers. Currently, all the numbers used to set rates are the pool's except for the Side Fund (we don't have one) and surcharges (we don't have any).

2. What demographic or economic factors drive changes to the normal cost rate? The two biggest factors impacting normal cost rate are entry-age (currently using the pool's entry age), and mortality assumptions. PERS may be changing the mortality assumption in the near future as experience is showing retirees are living long than the current assumption.

3. Investment returns seem to have bounced back significantly since the 2008-09 recession, yet the pool's unfunded liability rate has almost tripled. Why is that? Currently PERS methodology includes smoothing market returns to arrive at an actuarial value of assets (AVA), then a second smoothing technique to apply rate increases/decreases. Because of this double smoothing methodology, FY 2008-09 investment returns are being eased into rates over a number of years, beginning in FY 2010-11 (remember, there is a 2-year lag between investment returns and when they first impact rates).

> **3(a) What has been the specific impact of various actuarial assumptions (economic and demographic) on unfunded liability in the last few years? (For example, have stagnant payrolls had a greater negative impact on rates than investment returns have had a positive impact?)** Unfunded liability is most impacted by investment returns and mortality rates (currently, of the pool). When payrolls stagnate, liability goes down because projected benefits are less, but rates might go up because contributions are less than expected.

4. Give a specific example of how the current smoothing methodology works. Is it likely that the smoothing methodology will change if PERS adopts proposed changes to the risk pooling structure? Here is a simple example: Ignoring the current method of smoothing the value of assets (AVA) and instead using the market value of assets (MVA)*, let's say investment returns were 5% less than assumed. If the current Employer rate was 10% of payroll, the methodology to apply this 5% loss would be:

Year 1: Apply 1% - rate goes to 11%
Year 2: Apply 1% - rate goes to 12%
Year 3: Apply 1% - rate goes to 13%
Year 4: Apply 1% - rate goes to 14%
Year 5: Apply 1% - rates goes to 15%
Years 6-25: Rates stays at 15%
Year 26: Reduce 1% - rates goes to 14%
Year 27: Reduce 1% - rate goes to 13%
Year 28: Reduce 1% -r ate goes to 12%
Year 29: Reduce 1% - rate goes to 11%
Year 30: Reduce 1% - rate goes to 10%

Keep in mind that this type of smoothing will happen every year so we will have overlapping 30-year ramping up and ramping down curves that set the rates – for example, in 20 years there will be 20 curves added together plus whatever is being carried over from the past.

** One of the changes proposed as part of Alternative 2 is using the MVA instead of the AVA before applying the rate smoothing technique.*

5. When is AVA used for rate setting? When is MVA used? Which does the press most commonly refer to? Currently, PERS uses AVA. Under Alternative 2, MVA will be used. It is not known what press articles refer to, but likely MVA.

6. What is the current plan for a pool to payoff its unfunded liability? Under Alternative 2, what will be the plan for setting the rate for the unfunded liability portion? Will it be to pay off (or down) the unfunded liability under a certain set of assumptions? If so, what are those assumptions? If not, please describe the plan and what is behind it. Under what set of circumstances can the unfunded liability grow? Currently unfunded liability is charged as a rate, a percentage of payroll, and the rate reflects the pool's unfunded liability. Going forward, under Alternative 2 unfunded liability would be charged as a flat dollar amount each year, impervious to changes in an

agency's payroll. Further, going forward unfunded liability would be the agency's own versus the pool's, and would be charged based on the agency's liabilities/assets relative to the pool's. An agency's unfunded liability will grow or shrink just as it does now, based on the impact of experience on assumptions (such as investment returns and mortality).

7. Under Alternative 2 can an agency set up its own plan to pay down its portion of the unfunded liability? Yes.

8. We thought risk pools were created to minimize rate volatility for smaller agencies. If unfunded liability rates become individualized to each agency will our rate be subject to higher volatility? (Our demographics include a small and mature staff, little turnover.) What might that mean for our rates in 5-10 years? Volatility will be smoothed by the method of calculating an agency's unfunded liability: as a ratio to the pool's liabilities/assets.

9. Do you have any insight as to how other Districts are handling PEPRA implementation for their classic and new employees in their collective bargaining agreements (our expires June 30, 2015)? No.

10. What demographic risk factors (to our PERS rate) should we be aware of? Mortality rates.

11. Can we opt to return to the 2% at 60 Plan? No.

To summarize, in the past the District's unfunded liability has been the pool's unfunded liability, and charged as a percentage of payroll. It has gone up in the recent years in large part because PERS smoothing techniques spread the impact of poor investment returns in 2008-09 over multiple years. In the future with the adoption of the changes proposed in Alternative 2, unfunded liability will be an agency-specific figure calculated using the market value of assets. Further, this portion of our rates will be charged as a dollar figure rather than a percentage of payroll. Because it will be agency-specific, it can be paid down at an accelerated rate should we choose to do so. What is unchanged is that experience proves PERS assumptions wrong each year one way or the other. As we have seen, in the case of investment returns, PERS assumptions can be quite off base. Since unfunded liability is the part of our retirement rates that accounts for those inaccuracies, we should expect it to fluctuate from year to year.

* * *

The timing of this discussion is good; staff is glad the Board pushed for this. Having said that, staff concedes the ways of PERS and the intricacies of unfunded liability remain something short of crystal clear. But we know much more now than we did three months ago which is very helpful as we go into union negotiations. At this point, staff recommends further discussion be deferred until we receive an annual valuation in October of this year (setting the 2015-16 contribution rates) that will incorporate Alternative 2 changes adopted on May 21.

Glossary of Actuarial Terms

Accrued Liability *(also called Actuarial Accrued Liability or Entry Age Normal Accrued Liability)*
The total dollars needed as of the valuation date to fund all benefits earned in the past for *current* members.

Actuarial Assumptions
Assumptions made about certain events that will affect pension costs. Assumptions generally can be broken down into two categories: demographic and economic. Demographic assumptions include mortality, disability and retirement rates. Economic assumptions include discount rate, salary growth and inflation.

Actuarial Methods
Procedures employed by actuaries to achieve certain funding goals of a pension plan. Actuarial methods include funding method, setting the length of time to fund the Accrued Liability and determining the Actuarial Value of Assets.

Actuarial Valuation
The determination, as of a valuation date, of the Normal Cost, Accrued liability, Actuarial Value of Assets and related actuarial present values for a pension plan. These valuations are performed annually or when an employer is contemplating a change to their plan provisions.

Actuarial Value of Assets
The Actuarial Value of Assets used for funding purposes is obtained through an asset smoothing technique where investment gains and losses are partially recognized in the year they are incurred, with the remainder recognized in subsequent years.

This method helps to dampen large fluctuations in the employer contribution rate.

Amortization Bases
Separate payment schedules for different portions of the Unfunded Liability. The total Unfunded Liability of a Risk Pool or non-pooled plan can be segregated by "cause", creating "bases" and each such base will be separately amortized and paid for over a specific period of time. This can be likened to a home mortgage that has 24 years of remaining payments and a second on that mortgage that has 10 years left. Each base or each mortgage note has its own terms (payment period, principal, etc.) but all bases are amortized using investment and payroll assumptions from the current valuation.

Generally in an actuarial valuation, the separate bases consist of changes in unfunded liabilities due to amendments, actuarial assumption changes, actuarial methodology changes, and gains and losses. Payment periods are determined by Board policy and vary based on the cause of the change.

Amortization Period
The number of years required to pay off an Amortization Base.

Annual Required Contributions (ARC)
The employer's periodic required annual contributions to a defined benefit pension plan, calculated in accordance with the plan assumptions. The ARC is determined by multiplying the employer contribution rate by the payroll reported to CalPERS for the applicable fiscal year. However, if this contribution is fully prepaid in a lump sum, then the dollar value of the ARC is equal to the Lump Sum Prepayment.

Class 1 Benefits
Class 1 benefits have been identified to be additional benefits which have a significant, ongoing effect on the total plan cost. In some cases, a Class 1 benefit may be an alternate benefit formula. These benefits vary by employer across the risk pool. Agencies contracting for a Class 1 benefit will be responsible for the past service liability associated with such benefit and will be required to pay a surcharge established by the actuary to cover the ongoing cost (normal cost) of the Class 1 benefit.

Class 2 Benefits

Class 2 benefits have been identified to be the ancillary benefits providing one-time increases in benefits. These benefits vary by employer across the risk pool. Agencies contracting for a Class 2 benefit will be responsible for the past service liability associated with such benefit.

Class 3 Benefits

Class 3 benefits have been identified to be additional benefits which have a minimal effect on the total plan cost. Class 3 benefits may vary by rate plan within each risk pool. However, the employer contribution rate will not vary within the risk pool due to the Class 3 benefits.

Classic member (under PEPRA)

A classic member is anyone in CALPERS not defined as a new member under PEPRA (see definition of new member below.)

Discount Rate

The actuarial assumption that was called "investment return" in earlier CalPERS reports or "actuarial interest rate" in Section 20014 of the California Public Employees' Retirement Law (PERL).

Entry Age

The earliest age at which a plan member begins to accrue benefits under a defined benefit pension plan or Risk Pool. In most cases, this is the same as the date of hire.

(The assumed retirement age less the entry age is the amount of time required to fund a member's total benefit. Generally, the older a member is at hire, the greater the Normal Cost. This is mainly because there is less time to earn investment income to fund the future benefits.)

Entry Age Normal Cost Method

An actuarial cost method designed to fund a member's total plan benefit over the course of his or her career. This method is designed to produce stable employer contributions in amounts that increase at the same rate as the employer's payroll (i.e. level % of payroll).

Fresh Start

A Fresh Start is the single amortization base created when multiple amortization bases are collapsed into one base and amortized over a new funding period.

Funded Status

A measure of how well funded a plan or risk pool is. Or equivalently, how "on track" a plan or risk pool is with respect to assets vs. accrued liabilities. A ratio greater than 100% means the plan or risk pool has more assets than liabilities and a ratio less than 100% means liabilities are greater than assets. A funded ratio based on the Actuarial Value of Assets indicates the progress toward fully funding the plan using the actuarial cost methods and assumptions. A funded ratio based on the Market Value of Assets indicates the short-term solvency of the plan.

GASB 27

Statement No. 27 of the Governmental Accounting Standards Board. The accounting standard governing a state or local governmental employer's accounting for pensions.

GASB 68

Statement No. 68 of the Governmental Accounting Standards Board. The accounting standard governing a state or local governmental employer's accounting and financial reporting for pensions. GASB 68 replaces GASB 27 effective for the first fiscal year beginning after June 15, 2014.

New member (under PEPRA)

A new member includes an individual who becomes a member of a public retirement system for the first time on or after January 1, 2013, and who was not a member of another public retirement system prior to that date, and who is not subject to reciprocity with another public retirement system.

Normal Cost (also called Total Normal Cost)

The annual cost of service accrual for the upcoming fiscal year for active employees. The required employee contributions are part of the Total Normal Cost. The remaining portion, called the employer normal cost, includes surcharges for applicable class 1 benefits and should be viewed as the long term employer contribution rate.

Pension Actuary

A person who is responsible for the calculations necessary to properly fund a pension plan.

PEPRA

Public Employees' Pension Reform Act of 2013

Prepayment Contribution

A payment made by the employer to reduce or eliminate the year's required employer contribution.

Present Value of Benefits (PVB)

The total dollars needed as of the valuation date to fund all benefits earned in the past or expected to be earned in the future for *current* members.

Risk Pool

Using the benefit of the law of large numbers, a risk pool is a collection of employer plans for the purpose of sharing risk. If a pooled plan has active members at the time of valuation, it belongs to the risk pool composed of all other pooled plans with the same benefit formula. If a plan has no active members at the time of valuation, it belongs to the inactive pool.

Rolling Amortization Period

An amortization period that remains the same each year, rather than declining.

Side Fund

At the time a plan joined a risk pool, a Side Fund was created to account for the difference between the funded status of the pool and the funded status of the plan. The plan's Side Fund is amortized on an annual basis, with the discount rate net of, for active plans, the payroll growth rate assumption. The actuarial investment return assumption is currently 7.5%. A positive Side Fund cause the plan's required employer contribution rate to be reduced by the Amortization of Side Fund rate component shown in the Required Employer Contributions section. A negative Side Fund cause the plan's required employer contribution rate to be increased by the Amortization of Side Fund rate component. In the absence of subsequent contract amendments or funding changes, a plan's Side Fund will disappear at the end of the Amortization Period.

Superfunded

A condition existing when a plan's Actuarial Value of Assets exceeds its Present Value of Benefits. Prior to the passage of PEPRA, when this condition existed on a given valuation date for a given plan, employee contributions for the rate year covered by that valuation could be waived.

Unfunded Liability

When a plan or pool's Actuarial Value of Assets is less than its Accrued Liability, the difference is the plan or pool's Unfunded Liability of the Unfunded Liability is positive, the plan or pool will have to pay contributions exceeding the Normal Cost.

Finance & Administration Committee

California Public Employees' Retirement System

Agenda Item 5a

May 20, 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 month, staff brought an 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. At that time, the Board was asked to delay by one month a vote to change the risk pooling structure to allow for additional stakeholder outreach.

The stakeholder outreach has shown that there is general support for the approach recommended by staff. It has also identified one area of possible concern as described in the section on outreach.

Staff is therefore recommending the *same changes* that were recommended last month. 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 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. Since 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 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
At the April 2014 Board meeting, staff presented to the CalPERS Board 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. The two alternatives are described in more details below.

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. Attachment 1 shows a distribution of the estimated impact of changes to risk pooling on employer rates for alternatives 1 and 2.

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.

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 existing 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.

Attachment 1 shows a distribution of the estimated impact of changes to risk pooling on employer rates for alternatives 1 and 2. This comparison shows that under

alternative 2 most employers will see a smaller rate increase than under alternative 1. Attachment 2 shows a distribution of the difference in employer contributions rates between alternative 1 and alternative 2. Most employers will see a smaller increase in contribution rate under alternative 2 compared to alternative 1.

The solution for alternative 2 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 3 for a copy of the final recommended version of the Board resolution. The proposed changes highlighted in the redline version was provided in the April agenda item.
- 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 4 for a copy of the final recommended version of the Board resolution. The proposed changes highlighted in the redline version was provided in the April agenda item.
- 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 5 for a copy of the final recommended version of the Board resolution. The proposed changes highlighted in the redline version was provided in the April agenda item.
- 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 6 for a copy of the final recommended version of the Board resolution. The proposed changes highlighted in the redline version was provided in the April agenda item.
- Board resolution 05-02-AESD: minor changes to ensure consistency with the proposed changes. See Attachment 7 for a copy of the final recommended version of the Board resolution. The proposed changes highlighted in the redline version was provided in the April agenda item.
- 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 8 for a copy of the proposed new Board resolution.

Outreach

As reported to the Board last month, staff requested delaying Board action on this item in order to provide additional outreach to our public agency employers so they could fully understand the impact on their agencies. Staff made available an analysis of the estimated impact of the proposed changes to risk pools on each employer's contributions under the two alternative solutions. In addition CalPERS staff has participated in meetings with various employer organizations to provide information and answer questions. Furthermore, the Actuarial Office delivered a webinar hosted by the League of Cities on Wednesday April 30, 2014 that was made available to all pooled employers affected by the proposal. Over 250 employers signed in to listen to the webinar.

In addition to the webinar, the various employer organizations have reached out to their membership to survey them on the two alternatives being considered to address the issues identified in this agenda item. At the time of writing this agenda item, staff had not yet received a formal letter summarizing the results of the survey but based on discussions staff had with representatives of the League of Cities, the vast majority of the employers that responded to the survey were in favor of Alternative 2. Staff will provide additional detail at the Committee meeting if available. It has been brought to our attention that a small group of employer had concern 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 seems to be 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. We have been in communications with employers on this subject and staff intends to continue provide in the valuation report for information purposes what the contribution rate would have been had we set a rate for the unfunded liability component of the contribution. Charging a specific dollar amount to pay down the unfunded liability is a change that is necessary to preserve equity and ensure fairness among the employers participating in risk pools. Continuing to bill as a contribution rate to pay down the unfunded liability would result in a shifting of cost anytime an employer's payroll does not increase at a rate of exactly 3% per year. Staff is working with the stakeholders to determine how much of an issue this will be and will provide additional information at the Committee meeting. Staff is working with the stakeholders to determine how much of an issue this will be and will provide additional information at the Committee meeting.

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. Dismantling risk pools would re-introduce risks that have been eliminated by their creation and would impact contribution rates in a similar fashion to how Alternative 2 is expected to impact rates.

ATTACHMENTS

Attachment 1 – Estimated Impact of Changes to Risk Pooling on Employer Contributions: Comparison of Alternative 1 to Alternative 2
Attachment 2 – Estimated Impact of Changes to Risk Pooling on Employer Contributions: Difference in Rate Between Alternative 1 and Alternative 2
Attachment 3 – Board Resolution ACT-96-05E - Final Recommendation
Attachment 4 – Board Resolution ACT-99-03 - Final Recommendation
Attachment 5 – Board Resolution 03-03-AESD - Final Recommendation
Attachment 6 – Board Resolution 04-02-AESD - Final Recommendation
Attachment 7 – Board Resolution 05-02-AESD - Final Recommendation
Attachment 8 – Board Resolution ACT-14-01 - Final Recommendation

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