CalPERS Rate Changes Approved and More Expected

April 2013

Just as the pension community is trying to understand effects of the new AB 340/PEPRA legislation, CalPERS has three big changes on the horizon. Each of these changes would increase employer contribution rates. The three changes and probability of implementation are:

- New amortization and smoothing methods (adopted)
- Reduced discount rate (likely)
- Increased life expectancy projection (expected).

These changes are not the result of benefit increases. Rather, they are the actuary's attempt to better anticipate the true long-term cost of current benefits, and to fund for them in a balanced way that produces smooth contribution rates and does not defer costs to the future.

1. New CalPERS Amortization Periods and Smoothing Methods, Effective FY 2015/16

The proposed new actuarial methods presented by Chief Actuary Alan Milligan were adopted at the April 17, 2013 CalPERS Board meeting.

- **What did the Chief Actuary recommend?**
  - Smooth employer contribution rates directly, rather than smoothing asset values and hoping that will produce smooth contribution rates:
    - Use market value of assets to set contribution rates, eliminate asset corridor and actuarial asset value
    - Set fixed amortization periods for future gains and losses –
      5-year ramp up plus 20 years full payment plus 5-year ramp down
      (will include the difference between market and actuarial value of assets at 6/30/2013)
    - Set fixed amortization periods for future assumption changes –
      5-year ramp up plus 10 years full payment plus 5-year ramp down
    - Do not smooth the Normal Cost.
  - Convert all existing rolling amortization periods to fixed periods.
- **What will be the result?**
  - Year-to-year changes in rates will be somewhat higher in most years, but lower in years with extreme market events.
  - Funded status will improve faster – all gains/losses will be fully amortized and paid for 30 years after they occur.
  - Employer rates are going up, beginning in 2015/16. CalPERS provided 2 sample public agency plan projected rates:

Sample Plan	Current Method's Rate		Proposed Method's Rate		5-Year Net Increase*
	2015/16	2019/20	2015/16	2019/20	
Miscellaneous	16.8%	19.6%	17.8%	23.0%	6.2%
Safety	29.3%	33.9%	30.8%	39.5%	10.2%

** The change from the current method's 2015/16 rate to the proposed method's 2019/20 rate.*

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- A possible change to level dollar amortization for pooled plan side funds, which would result in increased short-term side fund payments. The new policies provide flexibility for the CalPERS actuaries to do this.

- **When will the change happen?**
  - Employer rates will first be affected for 2015/16. CalPERS is planning to provide employers with cost increase estimates in the upcoming valuation reports (October or November of 2013).

- **Why change methods?**
  - Current asset smoothing provides for very stable rates in most years. However, an extreme market event would mean a large change in the employer contribution rate – a result no one wants.
  - Recent studies have shown *very* slow progress toward full funding for many plans.
  - Having two asset measures (market and actuarial) and two funded status measures can be confusing and even misused; CalPERS thinks the process should have greater transparency.
  - New methods would better align with new accounting standard GASB 68, effective in 2014/15. For many plans, GASB 68 methodology would project a shortfall in assets attributable to current plan members under the current contribution policy, which would require disclosure and use of a reduced discount rate.

2. Reduced Discount Rate Assumption, Likely Effective FY 2015/16

Results of CalPERS asset/liability study in November-December 2013 will yield more information about possible direction of the discount rate assumption. The CalPERS actuaries' economic assumptions study will be completed in early 2014.

- **What is the probable outcome?**

Upon completion of the study, the Chief Actuary said he expects to recommend the Board drop the discount rate 0.25% or 0.5%, and that it likely will adopt a 0.25% drop, to 7.25%. The corresponding increase in employer contribution rates would be phased in over 5 years, with roughly half the impact in the first year. This will be on top of the rate increase from changing actuarial methods described above.

- **How much will rates go up by changing the discount rate?**

To gauge magnitude, employers can refer to Appendix D-3, Analysis of Discount Rate Sensitivity, in their valuation reports for the increase from a 1% drop in discount rate. Suppose this decrease resulted in an 8% contribution rate increase. If the actual discount rate drops 0.25%, the contribution rate will rise roughly 2% (or ¼ of 8%), with about 1% (from higher Normal Cost and a portion of amortization of additional unfunded liability) effective the first year and the remaining 1% (remaining amortization of additional unfunded liability) phased in over the next 4 years.

3. Increased Projected Life Expectancies Assumption, Likely Effective FY 2015/16

CalPERS will also be looking at demographic actuarial assumptions in a study to be completed in early 2014. The Chief Actuary commented he does not expect many demographic assumption changes from the experience study. However, he does expect to recommend improved future mortality rates. A person age 70 today is anticipated to live longer than someone that age would have lived 30 years ago. Current CalPERS assumptions are based on recent data, but do not take this future longevity improvement into account. The Chief Actuary will almost certainly recommend changing the

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mortality assumptions. Since retirees will be projected to live longer (and collect their pensions longer), employer contribution rates will go up.

- **How much will rates go up for a change in life expectancies?**

The Chief Actuary noted employers can expect a roughly 2% to 4% increase in their rates due to the mortality change. In general, Miscellaneous plans will be at the range's lower end, Safety at the higher end. Plans with a higher volatility index will be higher than average; those with a lower index will be lower than average. About half of the total rate increase (from higher Normal Cost and a portion of amortization of additional unfunded liability) will occur in the first year, with the increase's second half (remaining amortization of additional unfunded liability) phased in over the next 4 years. This increase will be on top of both rate increases described above.

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What can employers do?

Options to reduce employer costs are limited. PEPRA removed the stipulation that employee cost sharing (of the employer cost) be linked to a benefit improvement, so there is no longer any limit to the employee contribution that can be bargained.

Most important, employers should:

- Understand the impact of these proposed changes and build them into their budgets as soon as possible
- Be aware of these future increases when they sit down at the bargaining table.

To discuss details of how these changes could affect a specific plan, contact CalPERS-Issues@bartel-associates.com.

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