# CalPERS – Current Issues Update – March 2013

Just as the pension community is trying to understand effects of the new PEPRA legislation, CalPERS has 3 big changes on the horizon:

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

Each of these would increase employer contribution rates.

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

At the March 19, 2013 CalPERS Board Pension & Health Benefit Committee (P&HBC) meeting, CalPERS Chief Actuary Alan Milligan presented a first reading of proposed new actuarial methods.

- **Why change methods?**
  - Current asset smoothing provides for very stable rates in most years. However, an extreme market event would mean a large jump in the employer contribution rate – a result no one wants.
  - Recent studies have shown *very* slow progress toward full funding for many plans.
  - Having 2 asset measures (market and actuarial) and 2 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. GASB 68 methodology could 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.
- **What does 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
    - Smooth amortization of the Unfunded Liability portion of contribution rates over 5 years (does not affect Normal Cost)
    - Remove the corridor on assets.
  - Use a 25-year fixed period instead of a rolling 30-year amortization period for unfunded gains and losses, and convert all other existing rolling amortization periods to fixed periods.
- **What will be the result?**
  - Overall volatility of employer contribution rates will remain the same. Year-to-year changes in rates will be somewhat higher in average years, but lower in years with extreme market events.
  - A 100% funded status will be achieved more quickly – all gains/losses will be fully amortized and paid for 30 years after they occur.

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- 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.*

- **How likely is the Board to approve the method changes in April?**
  - The Chief Actuary stated he is almost certain the Board will adopt the new methods at its April Board meeting. Employer rates will first be affected in 2015/16. CalPERS is planning to provide employers with cost increase estimates in the upcoming valuation reports (October or November).

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

CalPERS will be looking at actuarial assumptions in a study next spring. Both economic (discount rate) and demographic assumptions will be considered. This fall, an asset/liability study will yield more information about possible direction of the discount rate assumption.

- **What is the probable outcome?**

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?**

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% effective the first year and the remaining 1% phased in over the next 4 years.

## 3. Potential Assumption Change to Increase Projected Life Expectancies, Likely Effective FY 2015/16

The Chief Actuary commented he does not expect many demographic assumption changes from the experience study next spring. However, he does expect to recommend improved future mortality rates. With healthcare advances, 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 mortality assumptions. Since retirees will be projected to live longer (and collect their pensions longer), employer contribution rates will go up.

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- **How much will rates go up?**

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. Again, assuming CalPERS Board adopts direct rate smoothing, about half of the total rate increase will occur in the first year, with the increase's second half 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?

Keep in mind that these changes do not come from 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.

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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