CalPERS Funding Risk Mitigation Policy

Frequently Asked Questions

In 2015, CalPERS adopted a new Funding Risk Mitigation Policy to help balance pension plan risks, funding, and costs. The policy lowers the expected investment return and the discount rate in years of good investment returns, lowers investment volatility over time, and provides greater predictability and less volatility in contribution rates for employers.

For a detailed discussion of the Funding Risk Mitigation Policy, please review our recent webinar and presentation.

What is the purpose of the policy?

The primary purpose of the policy is to reduce risk in the CalPERS investment portfolio, the Public Employees' Retirement Fund (PERF). Reducing risk in the investment portfolio also lessens the likelihood of future volatility in employer contribution rates, since an investment portfolio with less risk is less likely to experience the same downside losses as a riskier portfolio during future market drawdowns. This is accomplished by taking some of the excess returns in very good investment years and applying it toward reduce risk in the portfolio, while the other portion of the excess returns go towards reducing future employer contribution costs.

When is the policy triggered?

The policy is triggered when investment returns during the fiscal year exceed the current target rate of return by 2 or more percentage points. For example, with a current discount rate of 7%, the policy is triggered when the fiscal year returns are 9% or higher.

How does the policy work?

When the policy is triggered, the discount rate for the PERF is automatically lowered by an amount commensurate with the excess returns. The higher the excess returns, the more the discount rate drops. **For example**, if the fiscal year investment returns were 20% (exceeding the current discount rate of 7% by 13 percentage points) then the discount rate would be reduced by 0.2%, to 6.80%. The maximum amount the discount rate can be reduced in any one year in this manner is 0.25% (25 basis points). These thresholds are shown in the table below:

If actual investment returns **exceed the discount rate by**: *(percentage points)*	Then the **discount rate will be reduced by**:	And the resulting **discount rate** will be :
+2 (9%)	5 bps	6.95%
+7 (14%)	10 bps	6.90%
+10 (17%)	15 bps	6.85%
+13 (20%)	20 bps	6.80%
+17 (24%)	25 bps	6.75%

Does the policy work in reverse? Meaning, if the expected returns are lower than the discount rate in a given year, does the policy call for an increase in the discount rate?

No. The policy only triggers in years where the investment returns exceed the discount rate by at least 2 percentage points.

If the policy is triggered and the discount rate is lowered, is it for one year or for future years?

For all future years. The discount rate reduction would be in effect until either the board makes the decision to change it, or another risk-mitigation event is triggered in a later year.

What are the impacts to the investment portfolio?

The policy reduces future risk in the investment portfolio, which in turn increases the long-term sustainability of the System. When the discount rate is reduced, the CalPERS investment team adjusts the asset allocation within the portfolio. Typically, this means replacing some riskier assets into lower-risk assets. This function is not automatic or immediate, and requires consideration of market timing, asset prices, and overall investment strategy.

What are the impacts to employers?

There are two primary impacts to employers:

1) **Stabilization of future contribution rates.** Volatile investment returns are the primary cause of significant employer contribution rate volatility. Since the policy lessens the likelihood of volatile returns, it also lessens the likelihood of extreme employer contribution volatility in the future.

2) **Less relief for projected contribution rates than if the policy was not in effect**. The policy calls for some of the excess returns earned in very good investment years to be used to reduce investment risk. That means employers will not reap the immediate benefit of those excess returns in their projected contribution rates. For a given risk mitigation event, it is estimated that employer rates will decrease by about half of what they would have with no risk mitigation. Approximately half of the excess return will be used for rate relief and half of the excess return will be used to lower the discount rate.

If the policy increases employer contribution rates, how does this benefit employers?

It's important to note that employers will still benefit from the good investment performance that year, so there is direct relief in future rates. The other benefits are long-term. The policy increases the CalPERS' ability to meet its investment target and enhances the system's sustainability. By lowering the investment risk, employer contributions are stabilized over the long-term.

Why would a good year for CalPERS returns result in employers having to contribute more?

Employers only contribute "more" in the sense of "more than if the policy did not exist." When we compare future contributions to what was expected with a 7% return, employers are still going to see relief in the form of lower projected contributions.

When would the new required employer contributions take effect?

If the policy is triggered based on returns for FY 2020-21, the required employer contribution rate changes would be effective in FY 2022-23 for state and school plans and in FY 2023-24 for public agencies.

Will the rate change be phased in over multiple years?

No, the rate change emanating from the policy would not be phased in. However, if there are additional changes to the discount rate through this year's ALM process, the effect of those changes could be phased in over time. The CalPERS board would have to approve such a phased-in approach.

How does the discount rate affect employers' Unfunded Accrued Liability (UAL)?

In general, when the discount rate is lowered, liabilities increase - specifically the UAL. The UAL is determined by looking at the market value of assets of the plan or pool and comparing it with the accrued liability of that plan or pool. To the extent the assets are different from the liability, the plan or pool will also be assessed an unfunded liability payment. In other words, existing plan assets are assumed to grow at a slightly slower rate under the lower discount rate—often leading to a higher UAL.

Assuming the discount rate is lowered when the policy triggered, does the new rate become the starting point for the Asset Liability Management (ALM) process underway?

Yes.

Is there any possibility that the discount rate could be lowered further?

Yes. CalPERS is currently in its regular four-year ALM cycle review that could result in a recommendation to lower the discount rate further.

Can the Pension Outlook tool be used to model the impacts of the policy for individual agencies?

Yes. Pension Outlook is a free, publicly available tool developed by CalPERS that anyone can use to model "if/then" scenarios for pension plans. Users can generate different type of results by adjusting the discount rate and investment returns to see a variety of future scenarios. Learn more about how to use Pension Outlook and log-in here. For more detailed and specific information on plan impacts, please contact your assigned actuary.

What is the impact on Classic employees?

There is no direct impact to Classic members' required contribution rates. Rates will not change.

What is the impact to current retirees?

There is no direct impact to CalPERS retirees. Pension amounts will not change.

What is the impact on the normal cost for agencies for PEPRA members?

It is likely at least some PEPRA employees/employee groups will experience an increase in the PEPRA contribution rate.

The required member contribution rate for Public Agency PEPRA members is based on the "normal cost" for the benefit structure applicable to the member. Normal cost is an actuarially determined percentage of pay that can be thought of as the expected annual cost of funding a member's benefit from date of hire to date of retirement. A decrease in the discount rate results in an increase to the normal cost percentage.

Under PEPRA requirements, if the normal cost changes by more than 1% from the "base" normal cost (the normal cost at the time of the last change to the member rate), the member contribution rate must be reset to 50% of the new normal cost. Different PEPRA member groups are currently closer or further away from their 1% threshold. For example, one group may already have a normal cost that is only 2/10ths of 1% from hitting the 1% increase from the "base" normal cost. In that case, it does not take much of an additional increase to push that group's normal cost over the 1% threshold. Another group may be a full 1% away from the threshold, so that a bigger increase is needed to cross it.

The decrease in the discount rate due to a risk mitigation event has the potential to push normal costs over the 1% thresholds for multiple member groups. We have not performed any analysis at this time that would indicate which groups would see an increase to the PEPRA member contribution rate.

Any contribution rate changes would not take effect immediately. Instead, they would go into effect on the same timeline as employer rates, as discussed above.