California Actuarial Advisory Panel

November 28, 2017

Mr. Michael Cohen
Director
California Department of Finance
State Capitol, Room 1145
Sacramento, CA 95814-4998

Dear Mr. Cohen:

We write in response to your letter of July 13, 2017, in which you requested the California Actuarial Advisory Panel (CAAP) comment on the State's plan to make a $6 billion supplemental contribution to the California Public Employees' Retirement System (CalPERS) in 2017-18. This contribution is to be made pursuant to SB 84 (Chapter 50, Statutes of 2017), which provides the statutory authority for a cash loan from the Surplus Money Investment Fund to facilitate the supplemental payment.

The specific aspects of this plan you asked us to address, and our comment on each, are:

1. Would the making of the supplemental payment follow a model policy or best practice?

   Our response: The CAAP is not aware of any model policy or best practice that directly addresses supplemental payments. Generally, Actuarial Standards of Practice and other practice guidance cover some of the actuarial methods and amortization policies that are used in setting actuarially determined contributions.

   The CAAP published such a paper, titled "Actuarial Funding Policies and Practices for Public Pension and OPEB Plans and Level Cost Allocation Model." In 2014, the Public Plans Community (PPC) of the Conference of Consulting Actuaries issued a white paper on "Actuarial Funding Policies and Practices for Public Pension Plans." The PPC document was based on this CAAP document, and generally mirrored its findings.

Both papers define parameters that would allow someone to evaluate actuarial methods and amortization policies used to develop ongoing actuarially determined contributions. These papers do not address issues related to sources of funding or supplemental contributions.

Please be aware the Government Finance Officers Association (GFOA) issued a January 2015 Advisory saying that public agencies should not issue Pension Obligations Bonds; the CAAP takes no position on this GFOA Advisory. It is important to recognize the SB 84 supplemental payment is not a Pension Obligation Bond but it shares certain characteristics. In our answers to the subsequent questions, we discuss some of those characteristics.

2. Identify the actuarial benefits and risks of making a $6 billion supplemental payment.

Our response: Looking at benefits, by making a supplemental payment in fiscal year 2017-18, the State is accelerating payment of the existing unfunded liability, improving funding levels short-term, and likely generating long-term savings. The supplemental payment is expected to lower the State's annual contributions over the next 20 years and, according to CalPERS (and based on their current actuarial assumptions), result in approximately $5 billion in net savings to the State. The supplemental payment also improves the current funded status of the State plans by about 3 percentage points.

Looking at risks, there is a possibility CalPERS will earn less than the State's mandated interest payment (currently anticipated by the Department of Finance to range from 1.5% to 3.5%). The State bears the risk of CalPERS earning returns that are below the interest payment. While we have not calculated the likelihood or magnitude of any such shortfall, we understand CalPERS has provided this information to the Department of Finance.

While not relevant to this transaction, the Public Employees' Pension Reform Act of 2013 (PEPRA) generally requires a minimum contribution of the Normal Cost. When making supplemental payments to a pension fund, an employer should consider the likelihood such payments may push the fund into an overfunded position, resulting potentially in the inability for the employers to fully benefit from the supplemental payment. As funding levels improve, the State should consider whether any future supplemental payments could result in the State spending more in the long term to fund pension benefits than it would have without making the supplemental payment.

3. Discuss the practice of making such a payment through an internal borrowing.

   Our response: While there might be legal, financial and other issues, distinguishing internal and external borrowing, actuaries generally would not differentiate among sources of funds in their analysis. Furthermore, actuaries do not typically evaluate the opportunity cost of using internal funds to pay down pension unfunded liability as compared to using these funds for other purposes.

   Any borrowing to make pension contributions involves interest arbitrage between debt service (including the cost of issuance and interest expected to be paid) and anticipated investment earnings on proceeds in the pension trust. There may be differences in issuance and interest costs between internal and external borrowing that the State should evaluate; however, we are not qualified to do so.

We hope these responses are of help to the Department of Finance. If the Department is interested in obtaining further actuarial detail, we recommend the Department work directly with CalPERS.

Sincerely,

Paul Angelo
Chair, California Actuarial Advisory Panel

cc: Honorable Holly Mitchell, Chair, Senate Budget and Fiscal Review Committee
Honorable Phil Ting, Chair, Assembly Budget Committee
Honorable Ricardo Lara, Chair Senate Appropriations Committee
Honorable Lorena Gonzalez, Chair, Assembly Appropriations Committee
Honorable Jim Nielsen, Vice Chair, Senate Budget and Fiscal Review Committee
Honorable Jay Obernolte, Vice Chair, Assembly Budget Committee
Honorable Nancy Skinner, Chair, Senate Budget and Fiscal Review Committee Subcommittee No. 5
Honorable Jim Cooper, Chair, Assembly Budget Subcommittee No. 4
Mr. Mac Taylor, Legislative Analyst (3)
Mr. Mark lbele, Staff Director, Senate Budget and Fiscal Review Committee
Mr. Mark McKenzie, Staff Director, Senate Appropriations Committee
Mr. Kirk Feely, Budget Fiscal Director, Senate Republican Fiscal Office

Mr. Craig Cornett, Senate President pro Tempore's Office (2)
Mr. Christian Griffith, Chief Consultant, Assembly Budget Committee
Mr. Pedro R. Reyes, Chief Consultant, Assembly Appropriations Committee
Ms. Cyndi Hillery, Staff Director, Assembly Republican Fiscal Committee
Mr. Seren Taylor, Director of Strategic Policy, Assembly Republican Leader's Office
Mr. Jim Richardson, Policy and Fiscal Director, Assembly Republican Leader's Office
Mr. Christopher W. Woods, Assembly Speaker's Office (2)
Mr. John E. Bartel, Vice Chair, California Actuarial Advisory Panel