[date]

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 that the California Actuarial Advisory Panel comment on the state's plan to make a $6 billion supplemental contribution for the state's retirement plans to the California Public Employees' Retirement System 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 these plans that you asked us to address, and our comment on each, are as follows:

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

   Our response: The CAAP is not aware of any model policy or best practice around 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 determine if actuarial methods or amortization policies follow model practice, acceptable practice, acceptable practice with conditions or non-recommended practice. Amortization methods and periods used by CalPERS today generally fall under the “acceptable practice with conditions” category.

   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, strengthening the actuarial soundness of its pension plans and generating long term savings. By making a supplemental payment and paying down the unfunded liability faster, it is also possible that the time period to eliminate the unfunded liability will be reduced to a length that is equivalent to what constitutes model practice or acceptable practice as defined by the model funding practices referenced above. The CAAP has not attempted to validate whether or not the additional payment would in fact result in such an outcome.

Finally, we would like to point out a statutory provision that was added into law with the passage of the Public Employees' Pension Reform Act of 2013 (PEPRA). PEPRA added Government Section 7522.52 which states:

> "…a public employer's contribution to a defined benefit plan, in combination with employee contributions to that defined benefit plan, shall not be less than the normal cost rate, as defined in Section 7522.30, for that defined benefit plan for that fiscal year."

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. If current funding levels were closer to 90 percent, the likelihood of being overfunded long term would be much greater than it is today. Any decision by the State to send additional contributions should involve an in-depth analysis of the impact of Section 7522.52 and whether the supplemental payment could result in the State spending more in aggregate long term to fund pension benefits than it would without making the supplemental payment.

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

   Our response: Based on CalPERS' current actuarial assumptions the supplemental payment should help lower the state's annual contributions over the next 20 years and, according to CalPERS, result in approximately $11 billion in aggregate savings to the state. The supplemental payment is also likely to make a positive impact on the state's long-term pension obligations and, according to CalPERS, improves the current funded status of the State plans by about 3 percentage points. The supplemental payment also gives CalPERS Investment Office greater flexibility in investment choices since the infusion of cash would, in the short term, mitigate a cash flow situation.

   Looking at risks, there is a possibility CalPERS will earn less than the State's mandated repayment schedule plus the mandated credited interest currently (anticipated to range from 1.5% to 3.5%). If so, this creates the dual impact that the unfunded debt continues to grow and the State would also pay for investment losses. The likelihood of a catastrophic asset loss, while very small, does exist. As long as the possibility exists for a major downward shift in the economy, the State bears the risk that, if returns are negative, a portion of the money used to reduce the unfunded liability will be lost in the short-term as an investment loss and will be lost to the State for payment options that will need to be addressed if a repeat of the Great Recession should happen. Generally while we have not calculated the likelihood of CalPERS earning less than the State's debt service repayment we expect it to be relatively small.

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, as actuaries we would not, generally, prepare an analysis differently based on the source of funds. 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. Success occurs when borrowing results in lower combined (debt service plus pension) costs than would have occurred without borrowing. Typically an actuary asked to opine on such a strategy would prepare a stochastic analysis, taking into account pension plan investment return volatility, to estimate the likelihood of

success. If debt service is lower for internal, as compared to external, borrowing we would expect a higher likelihood of success using internal borrowing.

We hope these responses are of help to the Department in developing its position on this matter. There are several areas where the Department of Finance might be interested in obtaining further information; if so, 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