CALSTRS

Regular Meeting

Item Number 9c – Open Session

Subject: Actuarial Valuation of the Cash Balance Benefit Program and Consideration for the Adoption of an Additional Earnings Credit

Presenter(s): David Lamoureux and Rick Reed, CalSTRS / Nick Collier and Julie Smith, Milliman

Item Type: Action

Date & Time: May 2, 2024 – 5 minutes

Attachment(s):

Attachment 1 – June 30, 2023 Actuarial Valuation for the Cash Balance Benefit Program

Attachment 2 – Proposed Resolution for the Adoption of an Additional Earnings Credit

PowerPoint(s):

Summary of Valuation Results for the Cash Balance Benefit Program

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Item Purpose

The purpose of this item is to present the results of the June 30, 2023 actuarial valuation of the Cash Balance Benefit Program and to consider the adoption of an additional earnings credit of 4.91%.

Recommendation

Staff recommends that an additional earnings credit of 4.91% of the June 30, 2023, account balance be awarded to members of the Cash Balance Benefit Program who have not retired as of the day of the board's decision.

Executive Summary

The attached report is the annual actuarial valuation of the Cash Balance Benefit Program required as per Section 26211 of the Education Code. The actuarial valuation provides a snapshot of the fund's assets and liabilities as of June 30, 2023, and reflects the updated actuarial assumptions that were adopted by the board in January 2024 as part of the 2024 Experience Analysis.

Funded Ratio

The funded ratio of a pension plan is defined as the ratio of a plan's assets to its actuarial obligation. The following table compares key information about the funded ratio of the Cash Balance Benefit Program between June 30, 2023 and June 30, 2022 actuarial valuations.

Summary of Key Results for Cash Balance Benefit Program

	June 30, 2023 Valuation	June 30, 2022 Valuation
Actuarial Obligation	$404.5 Million	$379.4 Million
Actuarial Value of Assets	$478.0 Million	$438.1 Million
Unfunded Actuarial Obligation / (Actuarial Surplus)	($73.5 Million)	($58.7 Million)
Proposed Additional Earnings Credit (Estimated Dollar Value / Percent of Account Balance Awarded)	$19.1 Million[1] / 4.91%	$15.3 Million[2] \ 4.19%
Final Unfunded Actuarial Obligation / (Actuarial Surplus)	($54.3 Million)	($43.4 Million)
Funded Ratio		
- Before Additional Earnings Credit	118.2%	115.5%
- After Additional Earnings Credit	112.8%	111.0%

The funded status and the actuarial surplus have increased since the 2022 valuation. Note that the final funded status and actuarial surplus from the 2022 valuation are those which reflect the additional earnings credit awarded by the board. As shown above, the funded status increased by 7.2%, from 111.0% on June 30, 2022 (after the additional earnings credit) to 118.2% on June 30, 2023 (before the additional earnings credit). The actuarial surplus increased by about $30.1 million.

These increases were primarily the result of the return for fiscal year 2022-23, which was greater than both the assumed investment return for fiscal year 2022-23 of 6.5% and the minimum interest rate credited to the member's account of 2.09%. As shown on page 1 of the attached report, the investment return for the Cash Balance Benefit Program was calculated to be 9.7% for fiscal year

[1] Subject to approval by the board at the May 2024 meeting.
[2] Approved by the board in May 2023.

2022-23. There was also an increase to the actuarial surplus as a result of the updated mortality assumptions and the increase to the long-term investment return assumption that were adopted with the 2024 Experience Analysis. For more details on the changes in the surplus, please refer to Table 4, *Actuarial Gains and Losses,* on page 12 of the attached report.

Note that the calculated investment return for the Cash Balance Benefit Program was greater than the calculated return of 6.5% for the Defined Benefit Supplement Program because of differences in the asset allocations for each program in fiscal year 2022-23. Prior to fiscal year 2023-24, the assets of the Cash Balance Benefit Program had never been invested in private equity and real estate. When the Cash Balance Benefit Program was created, the board made the decision to not invest in illiquid asset classes such as private equity and real estate due to concerns over the uncertainty of the cash flow needs for the program.

In September 2023, the board adopted a revised investment policy statement that applies the same asset allocation to all programs, including the Cash Balance Benefit Program. As a result, the assets of the Cash Balance Benefit Program are now also invested in private equity and real estate. This decision was made since previous concerns over cash flows are no longer applicable.

As a result of the change in the asset allocation, the long-term assumed rate of return for the Cash Balance Benefit Program was increased from 6.5% to 7.0%, effective with the June 30, 2023 actuarial valuation, consistent with the assumed investment return used for the other programs. Going forward, the calculated returns for the Cash Balance Benefit Program and the Defined Benefit Supplement Program should be similar because of the change in the asset allocation.

The funded ratio for the Cash Balance Benefit Program is based on the market value of assets. This differs from the Defined Benefit Program which uses an actuarial value of assets which smooths the volatility in the investment markets by reflecting only one-third of the net accumulated investment gains and losses in a year. For the Cash Balance Benefit Program the volatility of the investment market is managed by establishing a gain and loss reserve, which, if positive, includes investment earnings in excess of the amount needed to fund the program liabilities and, if negative, reflects an unfunded actuarial obligation of the program. If, in any year, investment earnings are less than necessary, any positive balance in the gain and loss reserve is used to fund the minimum interest rate. If the balance in the gain and loss reserve is sufficient to properly protect the program against investment losses, any remaining actuarial surplus can be used to fund an additional earnings credit.

Additional Earnings Credit

Section 26605 of the Education Code allows the board to declare an additional earnings credit for members of the Cash Balance Benefit Program. The board has adopted a policy stating that additional earnings credits may be awarded if the funded ratio of the program surpasses certain thresholds. The thresholds are determined using a two-step allocation process.

1. The first step in the process allocates the excess of the actuarial surplus over the standard deviation of the expected long-term rate of return on the investment portfolio, limited to the difference between the minimum interest rate from the previous valuation and the long-term assumed rate of earnings.
2. The second step in the process allocates 50% of the remaining actuarial surplus over two times the standard deviation of the expected long-term rate of return on the investment portfolio.

The additional earnings credit awarded would be the sum of the allocation from the two steps.

The standard deviation for the Cash Balance Benefit Program was set at 11.3% when the board adopted the most recent experience study in January 2024. This means that the board is asked to consider an additional earnings credit only when the program has a funded status greater than 111.3%. For the second threshold, the funded ratio would have to exceed 122.6% following the first threshold allocation. As of June 30, 2023, the Cash Balance Benefit Program had a funded ratio of 118.2%, which exceeds the first threshold. After the first allocation, the funded status is 112.8% which does not exceed the second threshold.

Based on board policy, an additional earnings credit of 4.91% has been calculated. Awarding a 4.91% additional earnings credit will reduce the funded status of the program from 118.2% down to 112.8% and reduce the actuarial surplus by $19.1 million, from $73.5 million down to $54.3 million. For more details on the calculation of the recommended additional earnings credit refer to Table 6, *Additional Earnings Credit Based on Board Policy,* on page 14 of the attached report.

If awarded, the additional earnings credit of 4.91% will be applied to the June 30, 2023, account balance for members who have not yet retired as of the day of the board's decision.

Strategic Plan Linkage: Goal 1: Trusted stewards – Ensure a well-governed financially sound trust fund. (FY 2022-25 Strategic Plan).

Board Policy Linkage: Board Governance Manual: Section 7G - Benefits and Services Policy - Actuarial Valuations of the Defined Benefit Supplement Program and the Cash Balance Benefit Program.
