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Review of State Budget Solutions Report

In its report, *Promises Made, Promises Broken—The Betrayal of Pensioners and Taxpayers* (September 3, 2013), State Budget Solutions claimed that the Wisconsin Retirement System (WRS) had a funded ratio of only 57%. This is contrary to the funded ratio determined by the Department of Employee Trust Funds independent actuaries, which indicate the WRS has a funded ratio of 99%. A funded ratio is the ratio of the assets a pension plan has to the future benefits, or obligations, it owes. Generally, the higher a plan's funded ratio, the more likely it will be able to pay the owed benefits.

The report reached this conclusion by measuring future WRS pension obligations using a rate of return pegged to the yield on 15-year U.S. Treasury bonds, which at the time was about 3.225%. The report did not analyze the specifics of the WRS. It simply applied this rate to the WRS, resulting in a substantially overstated unfunded liability. Using such a low rate of return is not appropriate for the WRS, which, by appropriate measures, is better than 99% funded on a smoothed valuation basis and approximately 103% on a fair value basis as of December 31, 2012.

Defined benefit pension plans, both in the public and private sectors, typically pay a percentage of pre-retirement salary to participants in the future for employment service rendered today. Because those future benefits don't need to be paid out today, there is no need for the plan to set aside the entire future benefit payment today. Instead, plans determine the present value of those future obligations. This helps them calculate how much they need to collect (through employer and employee contributions) and invest today in order to have sufficient funding available to pay benefits in the future.

At issue is the rate of return to be used in determining the present value of those future obligations. In general, the argument for using a low rate of return, like the current yield on Treasury bonds, to measure the present value of those future benefits is based on the theory that a guaranteed, low-risk rate accurately reflects the guaranteed nature of the future benefits. Not only has the approach been rejected by the Government Accounting Standards Board (GASB), the unique benefit features of the WRS make the use of such a low rate of return inappropriate. For example, under the WRS, the future accrual of benefits for active employees is not guaranteed. Benefits to be earned in the future can and have been changed by the legislature from time to time. In addition, pension benefits for active employees and retirees are linked directly to investment performance and change based upon that performance. Effectively, the report assumes that employers bear all the risk in the WRS and that the benefits of active and retired participants and beneficiaries are immune to those risks. It is well known that the WRS does not operate that way. Indeed, benefits payable to retirees have been cut by more than $4 billion over the last 5 years in response to the financial crisis of 2008.

Furthermore, contrary to the report's assertion that the WRS uses a single 7.2% rate of return, the WRS in fact uses a far more conservative 5.0% rate for retired participants and for active and inactive participants following retirement. The 7.2% rate applies only to active participants prior to their retirement. This is approximately equivalent to using a 5.5% rate of return for all participants at all stages of life. The diversified and balanced investment portfolio of the WRS has met and is reasonably expected to continue to meet or exceed that rate over the long-term. For example, the actual rate of return for the WRS over the last 10 years is 8% through July 31, 2013. Using these more appropriate return rates for the WRS helps ensure adequate funding for future benefits at a reasonable cost today.

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