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CORRESPONDENCE MEMORANDUM

DATE: December 3, 2009

TO: Employee Trust Funds Board

FROM: David Stella, Secretary

SUBJECT: Secretary's Report

This memorandum is for informational purposes only. No action is required.

The Status of the WRS and Future Issues

This report contains a year-end review and a look forward to 2010 and beyond with some thoughts about future challenges. Despite the excellent investment market recovery year-to-date (almost 20% in the Core Fund), the Wisconsin Retirement System (WRS) will have a huge challenge ahead to recover from the losses experienced in 2008.

The WRS consulting actuary has estimated that it would take a 60% rate-of-return in the Core Fund to return to expected funding levels (prior to the 2008 loss). Currently, there are losses of $5.3 billion in the Market Recognition Account (MRA) for each year between 2008 and 2012. The investment gains necessary to overcome the losses already experienced would have to be dramatic. For example, it would take an investment return of 12.8% every year for the next ten years to return the WRS to expected funding levels.

Consequently, it is realistic to project continued negative Core Fund dividends and continued pressure on employee and employer contribution rates. For 2010, the Core Fund annuity adjustment might be in the -1% to -2% range, while the contribution rate increase for general employees and Executive/Elected employees will be 0.6% higher and 1.0% and 1.4% higher for Protective Occupation Employees with Social Security coverage and Protective Occupation Employees without Social Security coverage respectively.

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Despite the dramatic market declines and challenges the WRS faces, we are in relatively better shape than many other large public retirement systems. A review of the contribution rates for six other public retirement systems indicates that even with the 0.6% WRS contribution rate increase in 2010, our rates are between 2% and 8% lower than those systems. While we do not have a great deal of data as yet, it appears that our funded status (assets available to fund liabilities) is near 90% while similar public systems are in the 50% to 70% range.

I am attaching a paper that Keith Bozarth, Executive Director of the State of Wisconsin Investment Board, and I wrote very recently. It discusses the issues of “sustainability” of public pension funds and some distinct features of the WRS that have helped us remain viable during this very difficult economic period. This paper is now receiving broader circulation in the public pension fund industry and will be published in a major industry magazine next February.

This retirement system is a long-term enterprise designed to provide pension security for hundreds of thousands of public employees and their families. Given the challenges ahead, I will be communicating frequently with members, employers, legislators and other stakeholders about the need to be patient and allow the recovery of the WRS to occur within a very carefully constructed design that has served us well over many years.

Attachment

Pension Sustainability – The Wisconsin Example

David Stella, Secretary, Wisconsin Department of Employee Trust Funds and
Keith Bozarth, Executive Director, State of Wisconsin Investment Board

Every current gathering of two or more public pension managers generates liberal use of the word “sustainable”, a code word for the long-term survival of the pension plans. Following the financial market collapse of 2008 public pension plans around the country are examining whether promised benefits can be supported without significant changes to the benefit, investment or funding structures, or a combination of the three.

This article focuses on the Wisconsin Retirement System (WRS) and the uncommon features of that plan that will contribute to its sustainability. We do that by briefly:

- looking at how the current crisis in pensions came about;
- reviewing responses to the crisis;
- explaining design features of the WRS and how those features are working in the current environment.

Finally we offer a few high level observations about the investment implications of the WRS design.

Our assertion is not that the WRS, its participants or the funding employers are immune to the financial pain now being meted out, but rather that the WRS contains built-in features that will help maintain a viable pension plan with fewer dislocations and inequities than other plans are likely to experience. Pain is one thing; survival is another. When considering sustainability, the WRS contains elements worthy of exploration.

How Did We Get Here?

At the outset, we acknowledge that public pensions are highly varied. Benefit levels and structures range widely. Funding plans vary widely, and the commitment to stick with a funding plan also differs greatly among plan sponsors. Nonetheless, some generalizations can be stated.

Benefit levels at nearly all public plans are set by legislative bodies that have relatively short planning horizons. Pensions are not a short-term proposition. The temptation to defer expenditures until after the next election or to grant perquisites that need not be paid for currently is often too great to resist. This induces a tendency to promise now, pay later. It also

provides an opportunity for the undisciplined to play fast and loose with established funding plans. Both have occurred in various jurisdictions around the country.

In addition, the last two decades of the twentieth century saw robust bond and stock markets simultaneously, which boosted funding for promised benefits. One result was a tendency to "spend" the new found wealth by granting higher benefits or by providing employers substantial contribution reductions. What appeared to be a surplus to many, in hindsight, should likely have been treated as the top end of an asset price cycle. One can debate whether five-year smoothing mechanisms adequately account for long cycles during which equity risk premiums are absent or even negative. Since 1926, there have been three such periods of more than a decade each. Most public pension funds are heavily reliant on equities.

Add to this mix large numbers of politically powerful baby boomers approaching retirement age and one outcome has been that benefit levels were raised in many jurisdictions to what now appear to be "unsustainable" levels given prevailing financial constraints.

The broad market collapse of 2008 brought the issue to a head by reducing most pension trust asset values dramatically – the proverbial 500-year flood. The magnitude of the declines was enough that even those who resisted the temptations to elevate benefits to the highest levels or to relent on funding commitments face substantial challenges. While the period post-March 2009 has brought some recovery to asset prices, regaining all lost ground is likely to take years.

What Solutions Are Being Considered?

It is the early stages of the process, but a few basic themes have developed, and as the basic possibilities are limited, discussion likely will continue to focus on these areas.

1. Benefit reductions. The major issue regarding benefit levels is whose benefits can or should be reduced. Besides fairness concerns, there are legal protections of varying degrees for retirees and current employees that limit how much cost reduction can be achieved. Applying reductions to new hires only may not produce meaningful savings for many years, and could create a stark intergenerational disparity.
2. Changes to funding plans. Under current funding regimens, required contributions are often higher than budgets can tolerate during severe economic distress. Near-term reductions, however, do not reduce ultimate costs but only distribute them differently, whether between generations or between employers and employees. In some cases a more manageable distribution of cost may be achieved, but not a reduction of the total. The most significant risk here is in merely postponing the day of reckoning, creating an intergenerational debt transfer.
3. Changes in investment approach to increase return potential. The prospect of higher returns usually carries with it the corresponding prospect of more volatile returns or

greater risk. Many feel financial markets in general will offer fewer and lower returning investment opportunities in the years ahead. Many funds and plan sponsors are interested in less volatility after the experiences of the past decade.

4. Finally, there are advocates of closing traditional pension plans and using 401(k)-like vehicles. This approach does not create current cost relief any more than reducing benefits for new hires does. It also is a much less efficient means of generating retirement income, due to higher costs, lower investment returns and the lack of pooling for mortality and other risks.

How Does the WRS Address Some of These Issues?

The WRS has benefit and funding features that are unusual when compared to traditional public sector defined benefit plans.

The WRS is a hybrid plan that provides a modest percentage of final pay formula benefit that accrues at 1.6% of final average salary for each year of service and a "money purchase" defined contribution benefit. (The formula is ranked below average in a survey of 80 major public pension plans.) Each member of the plan accrues both a formula benefit and defined contribution benefit during the years they are actively participating. At retirement, the member's monthly annuity benefit is the higher of the formula benefit or the defined contribution benefit. Benefit vesting is immediate upon becoming eligible for coverage.

The benefit is "indexed" in the sense that upon termination a vested member's retirement account continues to grow with annual interest credits earned by the fund. The member may take a retirement benefit upon reaching minimum retirement age (55 for most members). The defined benefit remains static while the member is in inactive status, but the money purchase benefit continues to change with investment results. The defined benefit is paid only if it results in a higher monthly annuity.

Contributions to fund benefits are required from employees and employers, but the employer may agree to pay some or all of the employee contribution depending on each participating employer's compensation plan or collective bargaining agreements. By law, any increase or decrease in contribution rates must be divided evenly between the employee and employer contribution rate. This means that employees and employers are at equal risk for higher costs during periods of investment market declines, but they are left free to negotiate the distribution of any increases or decreases.

The structure of post-retirement benefit increases is also unusual. Retirees receive a guaranteed annuity benefit at retirement based upon the higher of the formula or money purchase benefit structure mentioned above. However, annual post-retirement adjustments to the monthly annuity benefit are based solely on investment returns. If a surplus in the reserve

that is held to pay retiree benefits is created by investment experience, annuity benefits may be adjusted upward. These post-retirement adjustments are called "dividends" and are not limited by the Consumer Price Index (CPI) or any other type of cap. However, dividends are not guaranteed and can be reduced when investment returns decline. This condition would occur when liabilities in the annuity reserve exceed the value of assets. (The annuity reserve must always have a ratio of assets to liabilities that equals 1.0.)

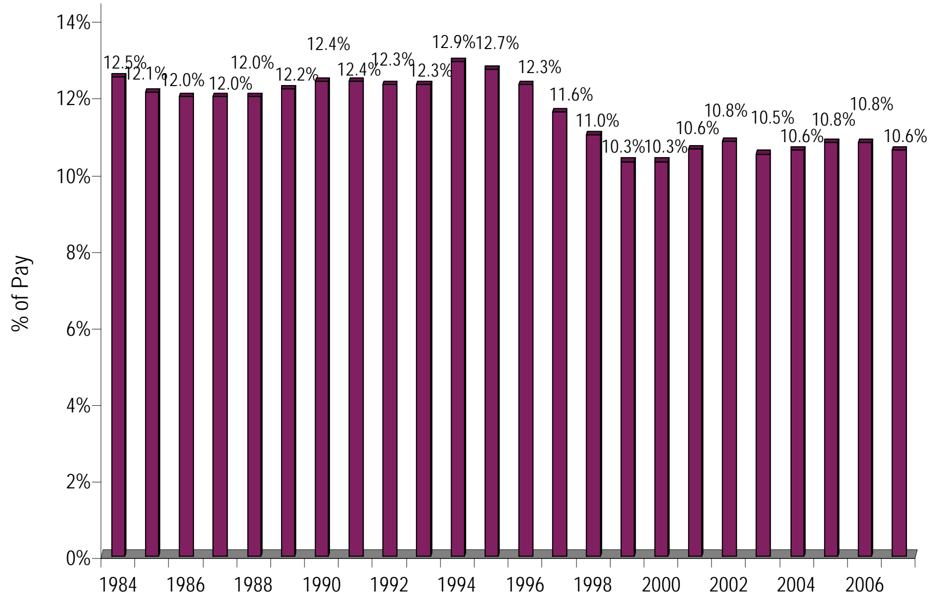
These features act as a "braking mechanism" on liability increases during periods when asset values fall. Of equal importance, they distribute risk and reward among all plan participants …..active employees, retirees, employees who have moved on to different employers and employers.

The merits of the WRS design have become apparent over time. The dividend feature has maintained and enhanced the purchasing power of the WRS annuity benefits at a reasonable cost. In fact, for a WRS participant who retired in 1984 the annuity value has increased at an average annual rate of 5.1%, while contribution rates paid by the great majority of employers and employees have fallen from 12.5% to 10.6% of pay. When combined with Social Security and a reasonable level of personal savings the income replacement ratio for a career employee with 30 years of service is designed to fall in the 75% to 80% range.

A key component of any defined benefit pension funding plan is to maintain intergenerational equity so that one generation of participants and taxpayers does not pay more than any previous or future generation to fund the value of the same pension benefit. The chart below illustrates the stable to falling contribution rate history of the WRS from 1984 to the present.

Contribution Rate History

(General)



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The 2008 financial market meltdown provided a significant "stress test" for the WRS funding and benefit design. An investment return of -26.2% for calendar year 2008 caused the assets of the annuity reserve to fall below the liabilities. This resulted in the first ever "negative dividend" of -2.1% being applied to all annuities in force that had received positive dividends in prior years. In addition, employers and employees combined will experience a small contribution rate increase of 0.6% beginning in 2010. Because investment experience is smoothed over a five-year rolling period losses from 2008 will be recognized over five years and offset by past and future investment gains. Interest crediting on participant accounts will remain very modest as the adverse 2008 experience is recognized. This will have the effect of decreasing the size and number of money purchase benefits, thereby dampening liability growth.

Despite a total decline in the fund's asset value of over $20 billion during 2008, the funded status of the WRS, based on the actuarial value of assets, remained above 85%. It is expected that by using the actuarial and funding disciplines of the current plan, contribution rates will remain within historic ranges even as the extraordinary losses experienced in 2008 are recognized in future years.

What Are the Investment Considerations?

A meaningful examination of the investment implications of the WRS structure would require a more extensive treatment than this paper will allow. We can, however, point to a few high level considerations.

Two factors not present in most pension plans merit explicit consideration when designing the investment of WRS assets. First, while the goal is to fund the long-term liabilities, just as with other pension plans, the investment results themselves increase and decrease those eventual liabilities. That is the result of the money purchase feature that can determine the pension that will be generated at retirement. It also is brought about by the dividend process for retirees that is dependent on investment results. The target moves with the results, keeping it more within range.

Second, the fact that investment risk and reward is shared widely, rather than focused solely on the employer, means that the consequences of return volatility should be evaluated differently. Contribution rates for active employees are affected. The potential money purchase benefit is affected. The retiree dividend is affected. In each case investment consequences flow through to individuals – meaning the longevity considerations are different and the wherewithal to adapt to adverse experience is different. In traditional thinking about defined benefit plans the employer has been seen as better able to bear the investment risk and reward due to a longer expected "life" and greater ability to absorb fluctuations in results. The equation has been changed with the WRS, and the interests of the employers, employees and retirees are aligned with respect to the volatility of investment returns. As volatility increases all three groups share the potential downside result.

Translating these differences to the next level of specificity, we can identify several themes. Volatility has different consequences for the WRS. Therefore, the degree of reliance on the equity risk premium, with its very long cycles, must be carefully considered. For the same reason, the value of diversification in risk terms is increased. Finally, due to the way retiree dividends are determined, there should be an emphasis on real return, especially as the number of retirees rapidly increases in the next few years.

Each of the above themes will likely have increasing importance as the system matures and the relative number of retirees increases.

Conclusion

Discussions about the relative merits of defined benefit plans and defined contribution plans usually focus on the type of risk in each plan and who should bear those risks. In the WRS, the risk is shared, and risk management takes on additional significance in the investment of plan assets and in the sustainability of the plan's benefit design. Going forward, public pension plans will be engaged in significant examination of their investment programs and benefit design.

But, even beyond the public sector discussion is the larger issue of pension security for all. As Keith Ambachtsheer recently observed in The Ambachtsheer Letter #284, "….it is time to transcend the tiresome 'DB vs. DC' debate and design formulas that combine the best of both". The Wisconsin Retirement System offers some intriguing features that bear consideration for application to other retirement plans in the public sector and beyond.

Biographical Information of Authors

- David Stella, CEBS, CRA, Secretary of the Wisconsin Department of Employee Trust Funds

  Mr. Stella has more than 23 years experience in managing retirement, deferred compensation (457), tax sheltered annuity [403(b)] and group health and life insurance plans offered to state and local government employees. He has over 37 years experience in a variety of public sector positions in Wisconsin and Colorado. Mr. Stella holds a bachelor's and master's degree from the University of Wisconsin - Madison and has earned the designation of Certified Employee Benefits Specialist (CEBS). Mr. Stella also has been awarded the designation of Certified Retirement Administrator through the International Foundation for Retirement Education.

- Keith Bozarth, Executive Director, State of Wisconsin Investment Board

  Mr. Bozarth has 17 years of experience as chief executive or legal counsel to public pension plans in Wisconsin, California, Missouri and Illinois. He has over 25 years experience in a variety of public sector positions, including legal counsel and a governing board position to a deferred compensation (457) plan and work with other employee benefit plans. Mr. Bozarth holds a bachelor's degree and a Juris Doctor degree from the University of Missouri -- Columbia.